COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

ELECTRONIC APPLICATION OF KENTUCKY-	**)**	
AMERICAN WATER COMPANY FOR AN	**)**	**CASE NO. 2025-00122**
ADJUSTMENT OF RATES	**)**	

REBUTTAL TESTIMONY OF ANN E. BULKLEY

September 15, 2025

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I. Introduction

Q. Are you the same Ann E. Bulkley who previously submitted direct testimony in this proceeding?

A. Yes. I am submitting this rebuttal testimony before the Kentucky Public Service Commission ("Commission") on behalf of Kentucky-American Water Company ("KAWC" or the "Company"), a wholly-owned subsidiary of American Water Works Company Inc ("AWK").

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to the direct testimony of Richard A. Baudino on behalf of the Office of Attorney General of the Commonwealth of Kentucky ("OAG") and the Lexington-Fayette Urban County Government ("LFUCG") regarding the just and reasonable return on equity ("ROE") and the appropriate capital structure for the Company.[1] I have not attempted to respond to every argument made by Mr. Baudino, and the fact that I may not have responded to any particular argument or statement made by him or others does not indicate my agreement with that argument or statement.

Q. Are you sponsoring any exhibits as part of your rebuttal testimony?

A. Yes. I am sponsoring Exhibits AEB-1-R through AEB-3-R, which have been prepared by me or under my direct supervision.

[1] Kentucky Public Service Commission, Direct Testimony and Exhibits of Richard A. Baudino, August 13, 2025 ("Baudino Direct Testimony").

Q. How is the remainder of your rebuttal testimony organized?

A. The remainder of my rebuttal testimony is organized as follows:

- Section II provides a summary and overview of my rebuttal testimony and the important factors to be considered in establishing the authorized ROE for the Company.
- Section III discusses the changes in capital market conditions, and their effect on the cost of equity.
- Section IV provides my response to the issues raised by Mr. Baudino.

II. Summary of Analysis and Conclusions

Q. What analyses does Mr. Baudino conduct, and what ROE is he recommending for the Company in this proceeding?

A. Mr. Baudino conducts multiple constant growth DCF and CAPM analyses using my proxy group ("Combination Proxy Group") and a proxy group which contains only water companies including AWK ("Water Proxy Group") to arrive at his recommended ROE of 9.50 percent for the Company in this proceeding. Specifically, Mr. Baudino conducts several DCF analyses using analyst projected earnings per share ("EPS") and dividend per share ("DPS") growth rates, as well as conducts several CAPM analyses based on historical and projected market risk premiums, as well as recommended market risk premiums from several sources. Figure 1 summarizes the range of the results of Mr. Baudino's cost of equity models and his overall recommended ROE for the Company in this proceeding.

Figure 1: Summary of the Results of Mr. Baudino's Cost of Equity Analyses and Recommended ROE[2]

	Combination Proxy Group		Water Proxy Group	
	Range	Average	Range	Average
Constant Growth DCF				
Method 1	7.98% - 10.38%	9.73%	8.97% - 9.56%	9.26%
Method 2	7.75% - 10.29%	9.23%	8.49% - 9.31%	8.87%
CAPM	8.23% - 10.59%			
Recommended ROE Range	9.25% - 9.75%			
ROE Recommendation	9.50%			

Q. What factors should be considered in evaluating the results of the cost of equity analyses and establishing the authorized ROE?

A. The primary factors that should be considered are: (1) the importance of providing a return that is comparable to returns on alternative investments with commensurate risk; (2) the need for a return that supports a utility's ability to attract needed capital at reasonable terms; (3) the effect of current and expected capital market conditions; and (4) achieving a reasonable balance between the interests of investors and customers.

Q. What are your key conclusions and recommendations regarding the appropriate ROE and capital structure for the Company?

A. Nothing in Mr. Baudino's testimony has caused me to change my position. Based on my review of his testimony, my key conclusions regarding the ROE and capital structure for the Company in this proceeding are as follows.

[2] Baudino Direct Testimony, at 33; "Method 1" refers to DCF results derived using average analyst growth rates and "Method 2" refers to DCF results derived using median analyst growth rates.

- While I disagree with various aspects of the cost of equity models conducted by Mr. Baudino in this proceeding, the fundamental issue is that his ROE recommendation of 9.50 percent is directionally inconsistent with the ROE authorized by the Commission in the Company's last rate proceeding relative to the changes in market conditions since that time that are indicative of an increase – not decrease – in the cost of equity.
    - Interest rates have increased significantly since Mr. Baudino filed his testimony in the Company's last rate proceeding.
    - The results of Mr. Baudino's cost of equity analyses in this proceeding demonstrate a significant increase in the cost of equity, as the results of both his DCF and CAPM analyses have increased since he filed testimony in the Company's last rate proceeding.
    - Despite the increase in his cost of equity model results, Mr. Baudino has increased his ROE recommendation only 10 basis points relative to his recommendation in the Company's last rate proceeding. Further, Mr. Baudino's ROE recommendation of 9.50 percent is 20 basis points below KAWC's current authorized ROE of 9.70 percent.
- Mr. Baudino's methodology for determining his ROE recommendation based on the results of his cost of equity models in the current proceeding is inconsistent with the methodology he relied on in KAWC's last rate proceeding.
    - Had Mr. Baudino determined his recommended ROE consistent with the methodology he relied on in the Company's last rate proceeding, his recommended ROE would have increased from 9.50 percent to 9.80 percent.
- The Commission should disregard the results of Mr. Baudino's DCF and CAPM analyses that rely on his Water Proxy Group.
    - While Mr. Baudino contends that the DCF results of the water proxy group are lower than the DCF results of the Combination Proxy Group, he fails to note that the CAPM results for his Water Proxy Group are higher than the CAPM results for the Combination Proxy Group.
    - A comparison of financials risk metrics (*Value Line's* safety rankings, *Value Line's* timeliness rankings and *Value Line* betas) between the water and natural gas utilities included in my proxy group demonstrates that the natural gas companies and water companies in my proxy group have similar risk characteristics.
    - Mr. Baudino agrees that it is reasonable to rely on the Combination Proxy Group to estimate the cost of equity for KAWC.

- When Mr. Baudino's DCF and CAPM analyses using the Combination Proxy Group are corrected for the issues that I discuss in detail herein:
  - The average adjusted constant growth DCF result using Method 1 (average) increases from 9.73 percent to 10.31 percent while the average constant growth DCF result using Method 2 (median) increases from 9.23 percent to 9.55 percent.
  - The adjusted CAPM analysis results in a range of 9.24 percent to 10.98 percent with an average of 10.13 percent.
- Mr. Baudino does not independently evaluate the comparative business risk of the Company relative to either the Combination Poxy Group or the Water Proxy Groups. Therefore, there is no basis to conclude that the risk factors from my direct testimony should not be considered.

III. Capital Market Conditions

Q. Do the results of Mr. Baudino's cost of equity analyses demonstrate that the cost of equity has increased since the Company's last rate proceeding?

A. Yes. Figure 2 compares the results of Mr. Baudino's cost of equity analyses from the Company's prior proceeding to the current proceeding. As shown, Mr. Baudino's model results clearly demonstrate that the cost of equity has increased. For example, Mr. Baudino relied on the 30-year Treasury bond yield as the estimate of the risk-free rate, which has increased 60 basis points since September 2023 when Mr. Baudino filed his testimony in the Company's last rate proceeding. Similarly, the results of his constant growth DCF analysis using a Combination Proxy Group increased 19 to 66 basis points.[3] While the result of Mr. Baudino's CAPM using a forward-looking market return declined, as I will discuss in more detail below, this is likely due to Mr. Baudino's use of a single *Value Line*

[3] Mr. Baudino did not rely on a Water Proxy Group in the Company's last rate proceeding; therefore, only a comparison of Mr. Baudino's constant growth DCF results between the current proceeding and Case No. 2023-00191 was conducted.

report to estimate the market return which can cause significantly volatility in the estimate of the market return. If the result of Mr. Baudino's forward-looking CAPM is excluded, his CAPM results increased from 3 to 55 basis points. As a result, the results of Mr. Baudino's cost of equity analysis clearly demonstrate that the cost of equity has increased since the Company's last rate proceeding.

Figure 2: Comparison of Mr. Baudino's Cost of Equity Analyses in KAWC's Current and Prior Proceeding[4]

	Case No. 2023-00191	Case No. 2025-00122	Increase / Decrease
Interest Rates			
Risk-Free Rate			
30-Year Treasury Bond Yield	4.30%	4.90%	0.60%
Constant Growth DCF			
Combined Proxy Group			
Average	9.07%	9.73%	0.66%
Median	9.04%	9.23%	0.19%
Water Proxy Group			
Average	N/A	9.26%	N/A
Median	N/A	8.87%	N/A
CAPM			
Forward Looking Market Return	12.77%	9.55%	-3.22%
Historical Risk Premium			
Arithmetic Mean	10.04%	10.59%	0.55%
Supply side MRP	9.44%	9.77%	0.33%
Supply side less WWII Bias	8.64%	9.03%	0.39%
Kroll MRP	8.75%	9.18%	0.43%
KPMG MRP	N/A	8.98%	N/A
IESE MRP Survey	N/A	9.18%	N/A
Damodaran MRP	8.20%	8.23%	0.03%

[4] Kentucky Public Service Commission, Case No. 2023-00191, Direct Testimony and Exhibits of Richard A. Baudino, September 29, 2023, at 31- 32 and Baudino Direct Testimony, at 33.

Recommended ROE Range	8.70% - 10.00%	9.25% - 9.75%
ROE Recommendation	9.40%	9.50%

Q. Does Mr. Baudino acknowledge the relationship between the cost of equity for utilities and yields on long-term government bonds?

A. Yes. Mr. Baudino states that the level of interest rates generally affect the authorized ROE for regulated utilities:

> The common stock of regulated utilities tends to be interest rate sensitive. This means that the cost of equity for regulated utilities tends to rise and fall with changes in interest rates. For example, as interest rates rise, the cost of equity will also rise, and vice versa when interest rates fall. This relationship is due in large part to the capital-intensive nature of regulated industries, including water companies, that rely heavily on both debt and equity to finance their regulated investments.[5]

Q. Does Mr. Baudino's ROE recommendation appropriately reflect the increase in the cost of equity since the Company's last rate proceeding as indicated by the change in market conditions as well as the change in Mr. Baudino's cost of equity results?

A. No. In the Company's last rate proceeding, the Commission approved an ROE of 9.70 percent. Given that Mr. Baudino acknowledges that the cost of equity for utilities will increase as interest rates increase, and as shown in Figure 2, interest rates have increased since Mr. Baudino filed his testimony in the Company's last rate proceeding, it would be reasonable to conclude that the ROE should exceed 9.70 percent in the current proceeding. However, despite an increase in the cost of equity, Mr. Baudino recommends an ROE that is 20 basis points lower than the Company's current authorized ROE.

[5] Baudino Direct Testimony, at 5.

Further, while Mr. Baudino recommends an ROE of 9.50 percent for KAWC, which is an increase of 10 basis points from his recommended ROE of 9.40 percent in the Company's last rate proceeding, given the increase in interest rates and the results of Mr. Baudino's cost of equity analyses since he filed his testimony in the Company's last rate proceeding, it is evident that an increase in his recommended ROE of 10 basis points is insufficient and cannot be expected to reflect the investor-required return. In fact, as I will discuss in more detail below, Mr. Baudino appears to adjust his methodology for determining the ROE for KAWC and as a result his ROE recommendation does not reflect the full effect of the increase in the cost of equity indicated by his cost of equity model results.

Q. What are the expectations for inflation and interest rates over the near-term?

A. At the July 2025 Federal Open Market Committee ("FOMC") meeting, Chairman Powell noted that the economy is in a "solid position", the labor market is at or near "maximum employment" and inflation has "eased significantly" from its peak in 2022 but does still remain "somewhat" above the 2 percent long-term target.[6] As a result, the FOMC decided to maintain the current federal fund rate range of 4.25 percent to 4.50 percent.[7] Regarding the possible path of monetary policy, Chairman Powell acknowledged increased uncertainly due to the implementation of changes to government policies by the Trump administration, in particular, the effect of the changes in tariffs on inflation and economic activity.[8] According to Chairman Powell, the effect of tariffs on inflation could either be

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6 Transcript of Chair Powell's Press Conference, (July 30, 2025).
7 *Id.*
8 *Id.*

short-lived or more persistent, which is a risk the FOMC was assessing. However, Chairman Powell stated that monetary policy is well positioned to wait for greater clarity on the "likely course of the economy" before considering any changes.[9] While the FOMC did not produce economic projections at the July 2025 meeting, the FOMC's forecast of the federal funds rate at the June 2025 meeting remained unchanged from the December 2024 and March 2025 meetings, forecasting just two rate cuts before the end of 2025.[10]

Q. Given the direction of monetary policy, what are investors' expectations for the yields on long-term government bonds over the near-term?

A. Economists and analysts are expecting elevated interest rates. *Blue Chip Financial Forecasts* provides a forecast from economists on the 30-year Treasury bond. In the most recently published *Blue Chip Financial Forecasts* report, economists project the 30-year Treasury bond yield to remain relatively stable and decrease only slightly from 4.80% in Q4/2025 to 4.60% in Q4/2026.[11] Additionally, the consensus estimate over the longer-term (i.e. 2027-2031) is 4.40%.[12] Therefore, consistent with investors' expectations at the time of the filing of my direct testimony,[13] long-term interest rates are expected to continue to remain elevated during the period that the Company's rates will be in effect.

Q. What are your conclusions regarding current capital market conditions?

A. Mr. Baudino has recognized that the cost of equity for utilities increases (decreases) as interest rates increase (decrease). Long term interest rates as well as the results of Mr.

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[9] *Id.*
[10] Federal Reserve, Summary of Economic Projections, June 18, 2025, at 2.
[11] *Blue Chip Financial Forecasts*, Vol. 44, No. 8, August 1, 2025, at 2.
[12] *Blue Chip Financial Forecasts*, Vol. 44, No. 12, June 2, 2025, at 14.
[13] Bulkley Direct Testimony, at 15.

Baudino's cost of equity models have increased since Mr. Baudino recommended an ROE for the Company in the prior cost of capital proceeding. Further, long term interest rates are expected to remain elevated over the near and longer term. Therefore, it is evident that Mr. Baudino's ROE recommendation of 9.50 percent is unreasonable and not reflective of current market conditions because it is 20 basis points lower than the Company's current authorized return of 9.70 percent, which was authorized at a time when the cost of equity for utilities was lower.

IV. Response to Mr. Baudino

Q. Please summarize Mr. Baudino's testimony regarding his recommended ROE and capital structure.

A. Mr. Baudino recommends a 9.50 percent ROE based on the midpoint of his recommended ROE range 9.25 percent to 9.75 percent. He develops both a constant growth DCF analysis and a CAPM analysis using a proxy group that contains water and natural gas companies (*i.e.* the Combination Proxy Group) as well as a proxy group that contains the water companies included in his Combination Proxy Group and AWK (*i.e.* the Water Proxy Group). He relies primarily on his DCF results to develop his recommended ROE range of 9.25 percent to 9.75 percent. The low end of his range appears to be based on: (1) the average of his DCF results for the Combination Proxy Group that rely on the median analyst growth forecasts ("Method 2"); and (2) the average of his DCF results for the Water Proxy Group that rely on the average analyst growth forecasts ("Method 1"). The high end of his range is based on the average of his DCF results for the Combination Proxy Group using Method 1. Further, Mr. Baudino states that the midpoint of the results of his CAPM analyses falls within his recommended ROE range of 9.25 percent to 9.75 percent range.[14] Finally, Mr. Baudino accepts the Company's proposed capital structure consisting of 52.26 percent common equity, 46.10 percent long-term debt, 1.31 percent short-term debt and 0.33 percent preferred stock.[15]

Q. Is Mr. Baudino's methodology for recommending an ROE in the current proceeding for KAWC consistent with the methodology Mr. Baudino relied on in the Company's last rate proceeding?

A. No. In KAWC's prior proceeding, Mr. Baudino recommended an ROE of 9.40 percent, which was the midpoint of his recommended ROE range of 8.70 percent to 10.00 percent.[16] Similar to the current proceeding, Mr. Baudino relied on DCF and CAPM analyses to develop his recommendation; however, he only relied on a Combination Proxy Group and did not consider a Water Proxy Group. Mr. Baudino set the low-end of his range to 8.70 percent because he concluded that cost of equity estimates below 8.70 percent were "too conservative" given the market conditions at the time his testimony was filed.[17] Thus, Mr. Baudino contended that he excluded his constant growth DCF result of 8.41 percent based on Method 2 (median) and projected EPS growth rates from *Yahoo! Finance*.[18] This resulted in a low-end for his constant growth DCF analysis of 8.70 percent which he selected as the low-end of his recommended ROE range.[19] The high-end of his

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[14] Baudino Direct Testimony, at 34.
[15] *Id.*, at 39.
[16] Kentucky Public Service Commission, Case No. 2023-00191, Direct Testimony and Exhibits of Richard A. Baudino, September 29, 2023, at 32.
[17] *Id*.
[18] *Id.*, at 21-22.
[19] *Id.*, 22 and 32.

recommended ROE range was set equal to the high-end of his constant growth DCF results and the high-end of his CAPM analyses that rely on historical market risk premia.[20]

Q. Has Mr. Baudino provided support for why the methodology he relied on to determine his ROE recommendation in the current proceeding deviated from the methodology he relied on in the Company's last rate proceeding?

A. No. Mr. Baudino has provided neither support nor an explanation as to why his approach for determining the recommended ROE is not consistent with the approach he relied on in the Company's last rate case.

Q. How would Mr. Baudino's recommended ROE change if he determined his recommended ROE for KAWC using the methodology he relied on in the Company's last rate proceeding?

A. As discussed above, in the Company's last rate proceeding, Mr. Baudino based his recommended range on: (1) the DCF and CAPM results using the Combination Proxy Group; (2) the low-end was set-equal to the low-end of his constant growth DCF results excluding the lowest DCF result which failed Mr. Baudino's low-end screen of 8.70 percent; and (3) the high-end set equal to the high-end of his constant growth DCF results and the high-end of his CAPM analyses that rely on historical market risk premia. As shown in Figure 3, in the current proceeding, this would result in a recommended ROE range of 9.10 percent to 10.50 percent with a midpoint of 9.80 percent. While I disagree with a number of the inputs and assumptions that Mr. Baudino has relied on to estimate his

[20] *Id*., at 32.

DCF and CAPM analyses for the reasons I will discuss below, had Mr. Baudino applied the same methodology for determining the ROE as he did in the Company's last rate proceeding, his recommended ROE would have increased from 9.50 percent to 9.80 percent.

Figure 3: Mr. Baudino's Recommended ROE Using the Methodology from the Prior Proceeding

Recommended ROE Range		Recommended ROE	Lower Bound	Upper Bound
Lower Bound	**Upper Bound**			
9.10%	10.50%	9.80%	Lowest DCF result above 8.70%	Midpoint of the highest constant growth DCF result and the highest CAPM result that relies on historical market risk premia

Q. Please identify the areas of Mr. Baudino's analysis with which you disagree.

A. I disagree with the following aspects of Mr. Baudino's analyses: (1) the use of a water only proxy group; (2) the use of DPS growth rates in the constant growth DCF model; (3) the application of the constant growth DCF model to the proxy group; (4) the market risk premium relied on to estimate the CAPM analysis; (6) the relevance of the ECAPM analysis; and (7) the effect of company-specific risks on the cost of equity for KAWC. I discuss each of these issues in the following sections of my rebuttal testimony.

IV.A. Proxy Group

Q. What is the composition of Mr. Baudino's proxy group for purposes of his cost of equity analyses?

A. Mr. Baudino proposes to use two proxy groups for the purposes of his cost of equity analyses. For his first proxy group, Mr. Baudino relies on a Combination Proxy Group that consists of the same 11 natural gas and water utilities that were included in the proxy group that I relied on in my direct testimony. Mr. Baudino's second proxy group contains only 6 water utilities ("Water Proxy Group") including each of the water utilities in the Combination Proxy Group as well as KAWC's parent company, AWK.[21]

Q. Do you agree with Mr. Baudino's inclusion of AWK in his Water Proxy Group?

A. No. First, as discussed in my direct testimony, including AWK introduces circular logic and therefore AWK should be excluded from any proxy group used to determine the ROE for KAWC (*i.e.*, the ROE for KAWC is being determined in the current proceeding, which in turn contributes to the ROE of AWK; therefore, if Mr. Baudino's Water Proxy Group included AWK, AWK would be used to determine its own subsidiary's ROE).[22] Second, Mr. Baudino did not include AWK in his Combination Proxy Group. He claims that this is so his Combination Proxy Group would be consistent with the proxy group that I relied on; however, if Mr. Baudino believed it was appropriate to include AWK in the proxy group, he should have included them in both proxy groups. He appears to have only included AWK in his Water Proxy Group because without the inclusion of AWK, the water proxy

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[21] Baudino Direct Testimony, at 15-16.
[22] Bulkley Direct Testimony, at 18.

group would only consist of five companies. It is clear that Mr. Baudino is concerned with the size of the Water Proxy Group and therefore has included companies he would not have otherwise included in the proxy group used to estimate the cost of equity for KAWC in order to increase the size of the Water Proxy Group.

Q. Why do you believe it is appropriate to also include natural gas utilities in the proxy group used to estimate the cost of equity for a water utility?

A. As discussed in my direct testimony, there are several reasons why it is appropriate to include natural gas utilities in the proxy group used to estimate the cost of equity for KAWC:

- Due to consolidation in the water industry, there are only a limited number of water utilities that can be included in the proxy group. The smaller the size of the proxy group, the greater the chance the proxy group average could be affected by the results of one company. In fact, as noted above Mr. Baudino concerned about the size of his Water Proxy Group included AWK, a company that he would not otherwise have included in the proxy group (Combination Proxy Group) used to estimate the cost of equity for KAWC.
- Similar to the water utilities included in my proxy group, the natural gas utilities included in my proxy group generate a substantial portion of their operating income from regulated distribution operations. Therefore, there are significant similarities between the business and operating risks of water and natural gas distribution companies.
- Several regulatory commissions have considered the results of a proxy group that includes natural gas utilities when determining the authorized return for a water utility.
- Historical annual average authorized ROEs for water and natural gas utilities have varied relative to one another, which is indicative that these utilities are considered reasonably comparable to one another.[23]

[23] Bulkley Direct Testimony, at 18-22.

Q. Does Mr. Baudino also conclude that it is reasonable to include natural gas utilities in the proxy group used to estimate the cost of equity for KAWC?

A. Yes, he does. In fact, Mr. Baudino stated the following regarding my proxy group:

> [t]he Combination Proxy Group selected by Ms. Bulkley provides a reasonable basis upon which to estimate the ROE for KAW in this case. In my view, it is important to use a combined utility proxy group in this case since there are only six water companies in Value Line's water utilities group with 5-year dividend and earnings growth projections.[24]

Q. Have you conducted any additional analyses to examine the comparability of water and natural gas utilities?

A. Yes, I developed a comparison of financials risk metrics between the water and natural gas utilities included in my proxy group. Specifically, I reviewed *Value Line's* safety rankings,[25] *Value Line's* timeliness rankings,[26] and *Value Line* betas. As shown in Figure 4 below, these metrics demonstrate that the natural gas companies and water companies in my proxy group have similar risk characteristics.

Figure 4: Water and Natural Gas Companies Comparison[27]

	Water	Natural Gas
Safety Ranking	2.00	1.83
Timeliness Ranking	3.60	3.20
Beta	0.80	0.80

[24] Baudino Direct Testimony, at 15.

[25] *Value Line's* Safety ranking measures the risk associated with a stock, considering financial strength and volatility. The ranking is from 1 (highest) to 5 (lowest).

[26] *Value Line's* Timeliness ranking measures the forecasted relative market performance in the next 12 months. The ranking is from 1 (highest and most likely to outperform most stocks) to 5 (lowest and most likely to underperform most stock).

[27] Bloomberg Professional; *Value Line*, May 23, 2025 and July 4, 2025.

Q. Do you agree with Mr. Baudino that his analyses demonstrate that the cost of equity is lower for water utilities than natural gas utilities?

A. No, I do not. Mr. Baudino concludes that because the average DCF result for his Water Proxy Group was lower than his Combination Proxy Group that the cost of equity is lower for water utilities than natural gas utilities.[28] However, he fails to note that the average *S&P Capital IQ* and *Value Line beta* for his Water Proxy Group of 0.79 was greater than the average *S&P Capital IQ* and *Value Line* beta for his Combination Proxy Group of 0.78.[29] Therefore, the CAPM results for his Water Proxy Group were greater than the CAPM results of his Combination Proxy Group indicating the cost of equity for water utilities were greater than natural gas utilities. Given the opposing conclusions that can be reached when reviewing the results of Mr. Baudino's CAPM and DCF analyses, it is not reasonable to conclude that water utilities have a lower cost of equity than natural gas utilities.

IV.B. Constant Growth DCF

Q. Please summarize Mr. Baudino's constant growth DCF analysis.

A. Mr. Baudino conducts two constant growth DCF analyses, one using the proxy group that I relied on in my direct testimony (*i.e.* the Combination Proxy Group) and the other using a proxy group consisting of only the 5 water utilities included in Combination Proxy Group as well as AWK (*i.e.* the Water Proxy Group). Specifically, Mr. Baudino:

[28] Baudino Direct Testimony, at 34.
[29] *Id.*, at 32.

- Develops the dividend yield using 6-month average stock prices and the current annual dividend of the companies in each proxy group and adjusts the dividend yield for growth using one-half of the expected growth rate.[30]
- Relies on projected earnings per share ("EPS") growth rates from *S&P Capital IQ*, *Zacks*, and *Value Line*, as well as the projected dividend per share ("DPS") growth rates reported by *Value Line*.[31]
- Mr. Baudino then calculates his constant growth DCF analysis relying on the mean and median EPS and DPS growth rates for each proxy group, which he refers to as Method 1 and Method 2, respectively.[32]

As shown in .

Figure 5, for the Combination Proxy Group, the results of Method 1 range from 7.98 percent to 10.38 percent, while the results of Method 2 range from 7.75 percent to 10.29 percent. For the Water Proxy Group, the results of Method 1 range from 8.97 percent to 9.56 percent, while the results of Method 2 range from 8.49 percent to 9.31 percent.

Figure 5: Mr. Baudino's Constant Growth DCF results[33]

	Combination Proxy Group		**Water Proxy Group**	
	Range	Average	Range	Average
Constant Growth DCF				
Method 1	7.98% - 10.38%	9.73%	8.97% - 9.56%	9.26%
Method 2	7.75% - 10.29%	9.23%	8.49% - 9.31%	8.87%

30 Baudino Direct Testimony, at 17-18.
31 *Id*., at 18-20.
32 *Id*., at 20-21.
33 *Id*., at 33.

Q. As a threshold matter, are the results of Mr. Baudino's constant growth DCF scenarios that rely on projected DPS growth rates reasonable?

A. No. The results of Mr. Baudino's constant growth DCF scenarios using projected DPS growth rates range from 7.75 percent to 7.98 percent for the Combination Proxy Group and 8.80 percent to 8.97 percent for the Water Proxy Group. Therefore, these results are either below or at the very low-end of any authorized ROE for either a water or natural gas utility in a regulatory jurisdiction comparable to Kentucky since at least 1980.[34]

Q. Has Mr. Baudino excluded DCF results that he considered to be too low in the past?

A. Yes. In KAWC's prior rate proceeding, Mr. Baudino concluded that cost of equity results below 8.70 percent are "too conservative" given current market conditions, including persistently high inflation, increasing long-term government bond yields, as well as the recent decline in utility share prices and thus did not rely on results below 8.70 percent to set his recommended ROE range and ROE.[35]

Q. If Mr. Baudino had applied a low-end screen consistent with his testimony in the Company's prior proceeding, would the low-end screen have increased given the change in market conditions?

A. Yes. As noted above, in the Company's last rate proceeding, Mr. Baudino applied a low-end screen due to changes in market conditions such as interest rates. Therefore, given the

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34 S&P Capital IQ Pro.

35 Kentucky Public Service Commission, Case No. 2023-00191, Direct Testimony and Exhibits of Richard A. Baudino, September 29, 2023, at 21-22, 32.

increase in interest rates since Mr. Baudino filed his testimony in KAWC's prior rate proceeding, it is likely that the low-end screen should be higher. For example, in Case No. 2023-00191, Mr. Baudino relied on a 30-year Treasury bond yield of 4.30 percent as his estimate of the risk-free rate in his CAPM[36] while in the current proceeding, Mr. Baudino is relying on a risk-free rate of 4.90 percent, a 60-basis point increase. As a result, changes in market conditions since KAWC's last rate proceeding not only indicate Mr. Baudino should have applied his low-end screen of 8.70 percent but that the screen should be greater than 8.70 percent.

Q. Would Mr. Baudino have excluded the results his constant growth DCF model that rely DPS growth rates had he applied a low-end screen consistent with approach he relied on in the Company's last rate proceeding?

A. Yes. The results of Mr. Baudino's constant growth DCF scenarios using projected DPS growth rates range from 7.75 percent to 7.98 percent for the Combination Proxy Group and 8.80 percent to 8.97 percent for the Water Proxy Group. Given that the change in market conditions since KAWC's last rate proceeding indicate that the low-end screen applied by Mr. Baudino of 8.70 percent should be higher, had Mr. Baudino applied a low-end screen he would have likely excluded the results his constant growth DCF model that rely on projected DPS growth rates.

[36] Kentucky Public Service Commission, Case No. 2023-00191, Direct Testimony and Exhibits of Richard A. Baudino, September 29, 2023, at 30.

Q. Do you agree with Mr. Baudino's consideration of projected DPS growth rates?

A. No. There are multiple reasons why reliance on *Value Line* projections of DPS growth is not appropriate:

- Earnings are the fundamental determinant of a company's ability to pay dividends, and over the long-term dividend growth can only be sustained by earnings growth.[37]

- Management decisions to conserve cash for capital investments, to manage the dividend payout for the purpose of minimizing future dividend reductions, or to signal future earnings prospects can influence dividend growth rates in near-term periods. These decisions affect the dividends and the payout ratio in the short term but are not necessarily indicative of a firm's long-term earnings growth. For example, forty S&P 500 companies suspended dividend payments in 2020 as a result of the increased uncertainty due to COVID-19.[38] These dividend suspensions occurred because companies believed earnings over the short term would decline and, therefore, elected to conserve cash to offset the financial effects of COVID-19.

- There is significant academic research demonstrating that EPS growth rates are most relevant in stock price valuation.[39] For example, Liu, et. al. (2002) examined "the valuation performance of a comprehensive list of value drivers" and found that "forward earnings explain stock prices remarkably well" and were generally superior to other value drivers analyzed. Gleason, et. al. (2012) found that the sell-side analysts with the most accurate stock price targets were those whom the researchers found to have more accurate earnings forecasts. The use of DPS growth

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[37] Brigham, Eugene F. and Joel F. Houston. *Fundamentals of Financial Management*. Concise Fourth Edition, Thomson South-Western, 2004, at 317 ("Growth in dividends occurs primarily as a result of growth in earnings per share (EPS). Earnings growth, in turn, results from a number of factors, including (1) inflation, (2) the amount of earnings the company retains and invests, and (3) the rate of return the company earns on its equity (ROE).").

[38] Langley, Karen. "U.S. Companies Slashed Dividends at Fastest Pace in More Than a Decade." Wall Street Journal, July 8, 2020.

[39] *See, e.g.*, Harris, Robert S. "Using Analysts' Growth Forecasts to Estimate Shareholder Required Rates of Return." *Financial Management*, Spring 1986, at 66; Vander Weide, James H. and Willard T. Carleton. "Investor growth expectations: Analysts vs. history." *The Journal of Portfolio Management*, Spring, 1988; Harris, Robert S. and Felicia C.Marston. "Estimating Shareholder Risk Premia Using Analysts' Growth Forecasts." *Financial Management*, Summer, 1992; Advanced Research Center. "Investor Growth Expectations." Summer 2004; Brigham, Eugene F. and Dilip K. Shome and Steve R. Vinson. "The Risk Premium Approach to Measuring a Utility's Cost of Equity." *Financial Management*, Vol. 14, No. 1, Spring, 1985; Morin, Dr. Roger A. New Regulatory Finance. Public Utilities Reports, Inc., 2006, pp. 299-303; Liu, Jing, et al. "Equity Valuation Using Multiples." *Journal of Accounting Research*, Vol. 40 No. 1, March 2002; Gleason, C.A., et al. "Valuation Model Use and the Price Target Performance of Sell-Side Equity Analysts." *Contemporary Accounting Research*, September 2011; Jung, Boochun, et. al. "Do financial analysts' long-term growth forecasts matter? Evidence from stock recommendations and career outcomes." *Journal of Accounting and Economics*, Vol. 53 Issues 1-2, February-April 2012.

rates ignores the academic research demonstrating that EPS growth rates are most relevant in stock price valuation.

- Investment analysts report predominant reliance on EPS growth projections. In a survey completed by 297 members of the Association for Investment Management and Research, the majority of respondents ranked earnings as the most important variable in valuing a security (more important than cash flow, dividends, or book value).[40]

- Projected DPS growth rates from *Value Line* are the views of an individual analyst. In contrast, projected EPS growth rates from *S&P Capital IQ* and Zacks are based on consensus estimates available from multiple sources. In other words, projected EPS growth rates include the contributions of more than one analyst and thus the results are less likely to be biased in one direction or another. Moreover, the fact that projected EPS growth estimates are available from multiple sources on a consensus basis attests to the importance of projected EPS growth rates to investors when developing long-term growth expectations.

For all these reasons, projected EPS growth rates, not projected DPS growth rates, should be used for purposes of estimating the cost of equity using the constant growth DCF analysis.

Q. How does relying on DPS growth rates from *Value Line* fail to satisfy one of the required assumptions to estimate the constant growth DCF model?

A. One of the primary assumptions of the constant growth DCF model is that the growth rate needs to be constant. Further, since earnings are the fundamental determinant of a company's ability to pay dividends, over the long-term, dividend growth can only be sustained by earnings growth. From this fact, it can be reasonably concluded that: (1) since DPS growth is sustained by EPS growth, DPS growth cannot exceed the growth in EPS over the long-term; and (2) while DPS growth can grow at a lower rate than EPS if a company is retaining a larger portion of earnings, eventually DPS growth will increase in

[40] Block, Stanley B. "A Study of Financial Analysts: Practice and Theory." *Financial Analysts Journal*, July/August 1999.

the future if EPS and DPS are expected to grow at a constant rate.[41] Additionally, if either condition were to exist, then the projected DPS growth rate would be expected to change and thus could not be assumed in perpetuity as required by the constant growth DCF model.

Q. Are *Value Line's* projected DPS and EPS growth rates are equivalent?

A. No. For example, as shown in Figure 6, *Value Line* only projects DPS growth to be equivalent to EPS growth for 1 of the 11 companies in the Combination Proxy Group. Projected DPS growth for the remaining companies is either less than or greater than projected EPS growth. As a result, it would not be reasonable to assume *Value Line's* projected DPS growth rate in perpetuity for these companies.

Figure 6: *Value Line*'s Projected EPS and DPS Growth Rates for Mr. Baudino's Combination Proxy Group

		Value Line Projected		Difference
		EPS	DPS	(EPS - DPS)
Atmos Energy	ATO	7.00%	7.00%	0.00%
NiSource	NI	9.50%	4.50%	5.00%
Northwest Natural Holding Company	NWN	6.50%	0.50%	6.00%
One Gas, Inc.	OGS	4.50%	2.00%	2.50%
Southwest Gas	SWX	10.00%	5.50%	4.50%
Spire	SR	4.50%	4.00%	0.50%
American States Water Company	AWR	7.00%	8.00%	-1.00%
California Water Service Group	CWT	9.50%	5.50%	4.00%
Middlesex Water Company	MSEX	7.50%	4.50%	3.00%
H2O America	HTO	6.00%	4.00%	2.00%
Essential Utilities, Inc.	WTRG	6.00%	6.50%	-0.50%

[41] Bente Villadsen, Michael J. Vilbert, Dan Harris, and A. Lawrence Kolbe, *Risk and Return for Regulated Industries*, 2017, at 99.

Q. Do you agree with Mr. Baudino that the use of projected EPS growth rates is not consistent with the infinite time horizon of the DCF model and therefore it is important to also consider projected DPS growth rates?

A. No, I disagree with Mr. Baudino's contention for several reasons.

First, Mr. Baudino's conclusion relies entirely on the accuracy of Mr. Baudino's estimate of the long-term GDP growth rate; however, Mr. Baudino's estimates of GDP growth may not be indicative of GDP growth over the long-term. For example, Mr. Baudino relies on a projected nominal GDP growth rate from the Congressional Budget Office ("CBO") for the period through 2035 (*i.e.*, the next ten years), even though Mr. Baudino's constant growth DCF model assumes growth in perpetuity. Further, while the Federal Reserve produces an estimate of GDP growth for the "longer run," it is not likely that this forecast reflects GDP growth in perpetuity given that the Federal Reserve updates the forecast quarterly. As a result, the projected GDP growth rates from the CBO and the Federal Reserve may not be indicative of the expected growth in GDP over the long term. Finally, his projected nominal GDP growth rates of 3.80 percent and 4.00 percent are significantly below the historical growth rate in nominal GDP from 1929 to 2024 of 6.1 percent that Mr. Baudino calculated.[42] It is, therefore, unreasonable to use the GDP growth rates from CBO and the Federal Reserve to conclude that projected EPS growth rates will not be sustained in perpetuity.

[42] Baudino Direct Testimony, at 44.

Second, considering the empirical studies comparing the total factor productivity (TFP) growth of the utility industry relative to the economy, it is not unreasonable to assume that long-term growth for utilities could exceed GDP growth. In a study filed as part of the Rate Regulation Initiative of the Alberta Utilities Commission, the authors calculated TFP growth[43] for 72 U.S. electric and combination electric and natural gas utilities and for the U.S. economy for the period of 1972 through 2009. For the U.S. utility group, TFP growth averaged 0.96 percent over the period of 1972 to 2009,[44] while TFP growth for the U.S. economy was 0.91 percent,[45] indicating that electric and combination electric and natural gas utilities were approximately 5 percent more productive than the U.S. economy over the study period. Therefore, the authors demonstrated that utility growth exceeded growth for the U.S. economy for approximately 40 years.

Lastly, while Mr. Baudino contends that the average projected DPS growth rate for his Combination Proxy Group of 4.73 percent is consistent with expectations for projected GDP growth; he fails to note that this resulted in a constant growth DCF result of 7.98 percent, which is lower than any comparable authorized return for either a water or natural gas utility in at least 40 years. Further, a return of 7.98 percent is well below the low-end of Mr. Baudino's recommended range of 9.25 percent, which indicates that he also concluded that a return of 7.98 percent is unreasonable.

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[43] TFP growth is a measure of productivity calculated as the difference between output growth and input growth. Higher TFP growth indicates that a company is converting inputs into higher levels of output growth (*i.e.*, increased productivity).

[44] Alberta Utilities Commission, Jeff Makholm and Agustin Ros, "Update, Reply and PBR Plan Review for AUC Proceeding 566 – Rate Regulation Initiative", February 22, 2012, at 5.

[45] Alberta Utilities Commission, Jeff Makholm and Agustin Ros, "Total Factor Productivity Study for Use in AUC Proceeding 566- Rate Regulation Initiative", December 30, 2010, at 19.

Q. How would the results of Mr. Baudino's constant growth DCF analyses change if you adjusted for the issues you have identified?

A. Making the following reasonable adjustments to Mr. Baudino's constant growth DCF model would substantially change the results of his analyses:

1. Rely only on the Combination Proxy Group;
2. Calculate individual DCF results for each company in the proxy group; and
3. Rely on projected EPS growth rates from *Value Line*, *Capital IQ*, and *Zacks.*

As shown in Figure 7 (see also Exhibit AEB-1-R), by making these reasonable changes to Mr. Baudino's constant growth DCF analysis using the Combination Proxy Group, the mean cost of equity result increases by 58 basis points for Method 1 and 32 basis points for Method 2. Likewise, the cost of equity range for both Method 1 and Method 2 also shift materially higher.

Figure 7: Summary of Adjustments to Mr. Baudino's Constant Growth DCF Results (Combination Proxy Group)

	Method 1 (Average)		Method 2 (Median)	
	Mean	COE Range	Median	COE Range
As Filed	9.73%	7.98% - 10.38%	9.23%	7.75% - 9.23%
Results for Individual Companies & EPS growth rates only	10.31%	10.20% - 10.38%	9.55%	9.51% - 9.79%

IV.C. CAPM

Q. Please summarize Mr. Baudino's CAPM analysis.

A. Mr. Baudino's CAPM analysis relies on a risk-free rate that reflects the average 3-month yield on 30-year Treasury bonds ending July 2025 of 4.90 percent, current adjusted betas for the Combination Proxy Group[46] as reported by *Value Line* and *S&P Capital IQ*[47], and three approaches to estimating the market risk premium: (1) a forward-looking market risk premium based on the expected total return for the companies in the *Value Line* universe; (2) three historical market risk premia; and (3) four published sources (*i.e.*, *Kroll*, KPMG, the IESE Survey, and Professor Damodaran) of a market risk premium.[48] Using these assumptions and inputs, Mr. Baudino derives CAPM results of 9.55 percent (based on a forward-looking market risk premium), 9.03 percent to 10.59 percent (based on historical market risk premia) and 8.23 percent to 9.18 percent (based on the published estimates of the market risk premiums).[49]

Q. Do you agree with the market risk premium used in the CAPM analyses conducted by Mr. Baudino?

A. No. Specifically, I disagree with Mr. Baudino's reliance on: (1) a single *Value Line* report to estimate the market return used to calculate his forward-looking market risk premium; (2) historical estimates of the market risk premia; and (3) the published estimates of the market risk premium from *Kroll*, the IESE survey, and KPMG, and Professor Damodaran.

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[46] Mr. Baudino only relied on the Combination Proxy Group to estimate his CAPM analysis. According to Mr. Baudino, the average beta coefficient for the Water Proxy Group was slightly higher than the average beta coefficient for the Combination Proxy Group and therefore the CAPM results for both proxy group would be similar. Baudino Direct Testimony, at 32.

[47] *S&P Capital IQ* only publishes raw betas; however, Mr. Baudino applies the Blume Adjustment to adjust the raw betas published by *S&P Capital IQ*, which is consistent with the adjustment also applied by *Value Line*.

[48] Baudino Direct Testimony, at 25-32.

[49] *Id.*, at 33.

Q. Why do you disagree with Mr. Baudino's calculation of the market return using the Summary and Index report from *Value Line*?

A. I disagree with Mr. Baudino's reliance on a *Value Line* report for a single week – August 1, 2025 – in the development of his projected market return. As shown in Exhibit AEB-**2**-R, the *Value Line* Appreciation Potential was somewhat variable since the start of 2025 resulting a market return range from 10.78 percent to 17.52 percent from January 3, 2025, through August 22, 2025. Thus, relying on a *Value Line* report for a single week could result in significant variations in the market return and thus CAPM results from week-to-week.

Furthermore, Mr. Baudino's reliance on the single *Value Line* report as of August 1, 2025 resulted in a market return estimate of 10.88 percent which is at the very low-end of the market return range for the period of January 3, 2025, through August 22, 2025. Instead of relying on a single report, Mr. Baudino should have considered an average of the market return estimates from the *Value Line* reports. For example, as shown in Exhibit AEB-**2**-R, the average market return calculated using the *Value Line* appreciation potential and dividend yield on the 1,700 companies included in the *Value Line* universe for the period of January 3, 2025, through August 22, 2025 was 12.72 percent.

Q. Why is it inappropriate to use a historical market risk premium in the CAPM to estimate the cost of equity such as Mr. Baudino has done in three of his eight CAPM analyses?

A. Fundamentally, the market return and market risk premium should be forward-looking, and Mr. Baudino's historically-derived market return and market risk premium estimates are certainly not forward-looking and nor has he provided any evidence that the historical averages on which he relies are reflective of the expected market conditions during the period in which the Company's proposed rates will be in effect. *Morningstar*, which is the prior publisher of the historical dataset relied on by Mr. Baudino for his CAPM that is now published by *Kroll*, has observed that the market risk premium is a forward-looking concept, not a historical analysis.

> It is important to note that the expected equity risk premium, as it is used in discount rates and the cost of capital analysis, is a forward-looking concept. That is, the equity risk premium that is used in the discount rate should be reflective of what investors think the risk premium will be going forward.[50]

Although the use of a historically-derived average market return and market risk premium are reflective of the returns realized by investors under different market and economic conditions, they are not necessarily reflective of the market return required by investors in the current and expected market environment. Given that the current and projected market conditions that I have discussed affect the current and projected equity risk premium, a forward-looking market return and market risk premium should be used in the CAPM analysis for estimating the cost of equity.

Q. Can the use of a historical market premium can produce counter-intuitive results?

Yes.

[50] *Morningstar Inc.*, 2010 Ibbotson SBBI Valuation Yearbook, at 55.

A. Figure 8 illustrates the problem with relying on the historical market risk premium such as Mr. Baudino has done. Specifically, the figure shows that from 2007-2009, the historical market risk premium decreased even as market volatility (the primary statistical measure of risk) significantly increased. Further, this figure demonstrates the significant swings in the annual equity risk premium that were averaged into the long-term historical average calculations. As shown, in 2008, the annual equity "premium" was negative, which implies a discount. It is incomprehensible that the perceived risk to equity was negative (implying a lower required return) in the height of the financial market collapse when the overall market return was a negative 37 percent. This individual observation, which runs counter to the theory of the equity risk premium, reduced the average market risk premium for the prior 80 years by 60 basis points.

Figure 8: Historical Market Risk Premium and Market Volatility

	Market Volatility	Market Return	Annual Equity Premium	Long-term Average Historical Market Risk Premium[51]
2007	17.54	5.49%	0.63%	7.10%
2008	32.69	-37.00%	-41.45%	6.50%
2009	31.48	26.46%	3.47%	6.70%

The assumption that investors would expect or require a lower risk premium during periods of increased volatility is counter-intuitive and leads to unreliable analytical results. The relevant objective in the application of the CAPM is to ensure that all three components of the model (*i.e.*, the risk-free rate, the beta, and the market risk premium) are consistent with market conditions and investor perceptions. The forecasted market risk premium estimates used in my original and updated CAPM analyses specifically address that concern.

Q. Is it appropriate to use the historical market risk premium and a current risk-free rate, as Mr. Baudino does in his CAPM analysis?

A. No. Mr. Baudino's use of a historical market risk premium in the CAPM with a current interest rate disregards the demonstrated relationship between interest rates and the market risk premium.

The market risk premium at any point in time is calculated as the difference between the market return and the risk-free rate at that time. Therefore, there is a relationship between the market risk premium and the risk-free rate that is particular to the

[51] Ibbotson SBBI Yearbook. *Morningstar Inc*. 2008, at 28. *Ibbotson SBBI Yearbook. Morningstar Inc*. 2009, at 23; Ibbotson SBBI Yearbook. *Morningstar Inc*. 2010, at 23. The historical market risk premium equals the total return on large company stocks less the income-only return on long-term government securities.

time period for which the market risk premium is calculated. Applying a historical average market risk premium to a current risk-free rate is incorrect because the current risk-free rate bears no relationship to the average historical interest rate that was used to estimate the average historical market risk premia. The use of assumptions from different time periods fails to account for the inverse relationship that exists between the risk-free rate and the equity risk premium. Both academic literature and market evidence indicate that the equity risk premium is inversely related to the level of interest rates (i.e., as interest rates increase, the equity risk premium decreases, and vice versa).[52]

Q. Are the market risk premia published by *Kroll*, KPMG, the IESE Survey, and Professor Damodaran and relied on by Mr. Baudino in four of his eight CAPM analyses consistent with the inverse relationship between interest rates and the market risk premium?

A. No. The market risk premia published by *Kroll*, KPMG, the IESE Survey, and Professor Damodaran that are relied on by Mr. Baudino do not reflect the inverse relationship between interest rates and the market risk premium. Given that current yields on Treasury bonds are generally consistent with the average yields historically, and there is an inverse relationship between interest rates and the market risk premium, the market risk premia published by *Kroll*, KPMG, the IESE Survey, and Professor Damodaran should be generally consistent with the historical average market risk premium; however they are instead vastly understated in the current market environment. Specifically, as shown in

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[52] *See, e.g.*, S. Keith Berry, "Interest Rate Risk and Utility Risk Premia during 1982-93," *Managerial and Decision Economics*, Vol. 19, No. 2, March 1998, available at Exh. AEB-39C; *see also*, Robert S. Harris, "Using Analysts' Growth Forecasts to Estimate Shareholder Required Rates of Return," *Financial Management*, Spring 1986, at 66.

Figure 9, the risk-free rate assumption used in Mr. Baudino's CAPM analyses is consistent with the long-term average risk-free rate, and yet contrary to the inverse relationship between interest rates and the market risk premium, the market risk premia published by *Kroll*, KPMG, the IESE Survey, and Professor Damodaran that are relied on by Mr. Baudino are well <u>*below*</u> the long-term term average market risk premium.

Figure 9: Misalignment of *Kroll*, KPMG, the IESE Survey and Professor Damodaran Market Risk Premia Relied on by Mr. Baudino

Source	Market Risk Premium	Amount Below Long-Term Avg.	Risk-Free Rate	Amount Above Long-Term Avg.
Long-Term Historical Avg.	**7.31%**		**4.86%**	
Kroll - Normalized	5.50%	-1.81%	4.90%	0.04%
KPMG	5.25%	-2.06%	4.90%	0.04%
IESE Survey	5.50%	-1.81%	4.90%	0.04%
Professor Damodaran	4.28%	-3.03%	4.90%	0.04%

Q. The IESE Survey conducted by Professor Fernandez is one of the sources that Mr. Baudino relies on as an estimate of the market risk premium in his CAPM analyses. Are there drawbacks to the use of survey data?

A. Yes. The drawbacks include biased responses and biased sampling as noted by Brigham, Shone, and Vinson (1985).[53] Further, Professor Damodaran, whose market risk premium estimate Mr. Baudino relies on in his CAPM, noted that very few practitioners were inclined to use survey results, because, among other things, they were affected by how and

[53] Eugene F. Brigham, Dilip K. Shome, and Steve R. Vinson, "The Risk Premium Approach to Measuring Utility's Cost of Equity," *Financial Management*, Vol. 14, No 1, 1985, at 33.

of whom the questions were asked and on recent stock price movements.[54] Additionally, response rates to surveys can be extremely limited, as Graham and Harvey (2018) noted in their Duke CFO survey where the response rate was only 5 percent to 8 percent.[55] Finally, and most importantly, even Professor Fernandez, the author of the survey relied on by Mr. Baudino, specifically states that the average of the distribution of the required equity premium from the survey "*<u>cannot be interpreted as the REP [required equity premium] of the market nor as the REP of a representative investor"</u>*.[56]

Q. Have you analyzed the accuracy of the market risk premia published by *Kroll*, KPMG, the IESE Survey, and Professor Damodaran?

A. Yes. Figure 10 shows the annual market risk premium forecast error for the IESE survey, Professor Damodaran, KPMG, and *Kroll* since 2009 when Kroll initiated its market risk premium publication. The forecast error is calculated as the absolute difference between the forecasts that were published by these sources and the "observed" market risk premium, calculated as the difference between the return on large company stocks and the income-only return on long-term government bonds as reported by *Kroll*. As shown in Figure 10, these sources have consistently failed to produce accurate market risk premium predictions, especially in recent years. For example, in 2024, the observed equity risk premium was 20.68 percent, whereas these sources reported market risk premia in the range of 4.33 percent to 5.50 percent. Therefore, this analysis clearly shows that the IESE survey,

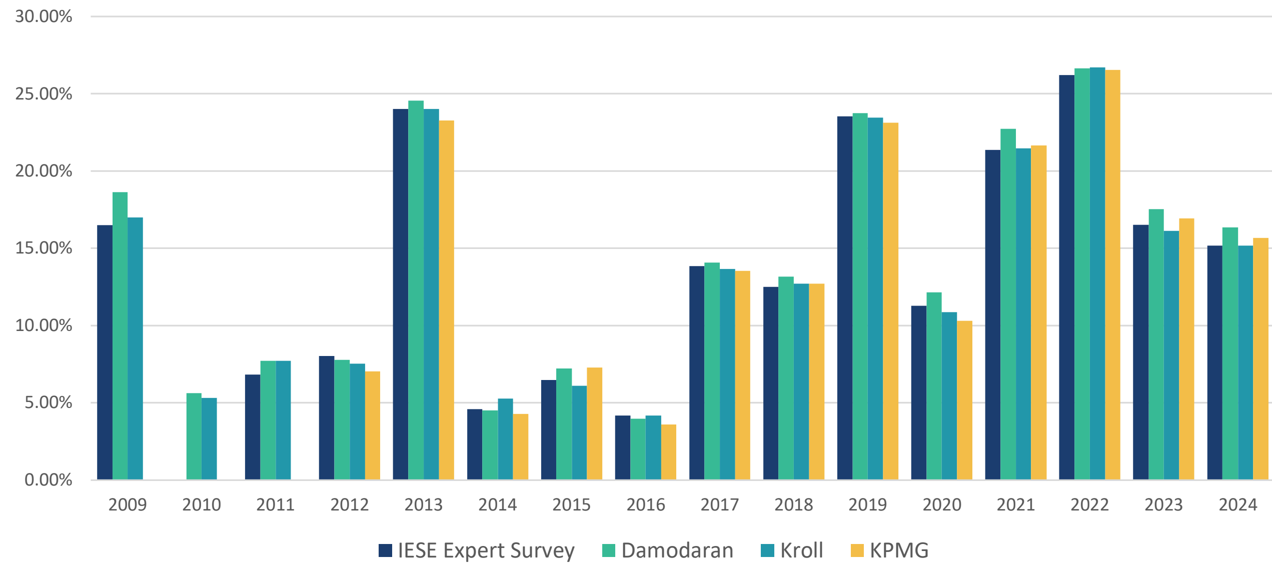
54 Aswath Damodaran, "Equity Risk Premiums (ERP): Determinants, Estimation, and Implications," 2023, at 28-29.

55 John R. Graham and Campbell R. Harvey, "The Equity Risk Premium in 2018," Social Science Research Network, March 27, 2018.

56 Pablo Fernandez, Diego Garcia, and Lucia F. Acin, "Survey: Market Risk Premium and Risk-Free Rate used for 54 countries in 2025," IESE Business School, May 20, 2025, at 9; emphasis added.

Professor Damodaran, KPMG, and *Kroll* have produced unreliable estimates of the market risk premium.

Figure 10: Kroll, KPMG, IESE Survey and Professor Damodaran Market Risk Premium Forecast Error[57]



Q. Have you recalculated Mr. Baudino's CAPM analysis to address your concerns with his estimates of the market risk premium?

A. Yes. Specifically, I adjusted Mr. Baudino's CAPM analyses to:

1. Exclude his CAPM analyses that rely on the market risk premia published by *Kroll*, the IESE survey, KPMG, and Professor Damodaran given that these market risk premia are: (1) not reflective of the inverse relationship between the market risk premium and interest rates; (2) the use of these market risk premia result in a CAPM range of 8.23 percent to 9.18 percent, which is unreasonably low; and (3) these sources have not accurately predicted the observed market risk premium.
2. Adjust his CAPM analyses that rely on the historical risk premia to not rely specifically on the historical market risk premium, but instead calculate the market

[57] The figure calculates the absolute value of the difference between the actual and forecasted market risk premia. Large company stock total returns from *Kroll* are used for market returns data, and income only returns on long-term government bonds from *Kroll* are used for the risk-free rate to calculate the actual market risk premium. A 2010 forecast was not available from IESE and estimates of the market risk premia from KPMG were not available prior to 2012.

risk premium as the difference between the historical market returns from 1926 through 2024 that he relies on (*i.e.*, arithmetic average, supply-side, and supply-side accounting for World War II Interest Rate bias) and his estimate of the risk-free rate. While I do not agree with the use of the historical market return from 1926 through 2024 as the estimate of the market return for the reasons discussed, this specification of the market risk premium is more appropriate than the specification relied on by Mr. Baudino because the CAPM formula identifies ***one*** estimate of the risk-free rate to be used as the estimate of the risk-free rate and in the calculation of the market risk premium. The formula does not specify the use of two different risk-free rates as Mr. Baudino has assumed in his CAPM analyses that rely on the historical market risk premium.

3. Adjust his CAPM analysis that relied on the expected market return calculated using a constant growth DCF model and data from *Value Line* to rely on an average of the *Value Line* projected market return.

As shown in Figure 11 (see also Exhibit AEB-3-R), by making these reasonable changes to Mr. Baudino's CAPM analysis, the average of all of his CAPM analyses increases by 81 basis points from 9.31 percent to 10.13 percent, while the range of 8.23 percent to 10.59 percent shifts higher to 9.24 percent to 10.98 percent.

Figure 11: Summary of Adjustments to Mr. Baudino's CAPM Analysis

CAPM Methodology	As Filed	As Adjusted
Forward-looking Market Risk Premium – *Value Line*	9.55%	10.98%
Historical Market Risk Premia (1926-2024)		
Arithmetic Mean	10.59%	10.55%
Supply-side Market Risk Premium	9.77%	9.73%
Supply-side Market Risk Premium less WWII Bias	9.03%	9.24%
Implied Market Risk Premia		
Kroll	9.18%	N/A
KPMG	8.98%	N/A
IESE Survey	9.18%	N/A
Professor Damodaran	8.23%	N/A
Average of CAPM Results	**9.31%**	**10.13%**

Q. What is Mr. Baudino's primary criticism of your CAPM analyses?

A. Mr. Baudino's primary criticism of my CAPM analyses is that he contends the forward-looking market return, and thus market risk premium, in my CAPM analyses are too high and are not reasonable.[58]

Q. Is it reasonable to rely on forecasted EPS growth rates in the calculation of the return on the market that exceed U.S. GDP growth?

A. Yes. It reasonable to rely on growth rates, such as forecasted EPS growth rates, in the market return calculation that exceed projected U.S. GDP growth. Companies in the S&P 500 Index operate in the modern global economy and not just in the United States. As a result, these companies' future earnings growth is not necessarily constrained by or representative of future growth in the U.S. such as reflected by projected U.S. GDP growth. The U.S. GDP does not account for companies' revenue achieved in international markets.

As stated by *Seeking Alpha*, "the most obvious difference between GDP growth and S&P 500 earnings growth is international earnings growth."[59] Additionally, it has been noted that between 1950-2014, the median S&P 500 return was 13.00 percent, while GDP grew less than 3.00 percent.[60] Similarly, as recently noted by Morgan Stanley: "U.S. companies now get more of their sales from outside the U.S. than they did in the past. GDP does not include those sales."[61] Wellington Management also provides an intuitive

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[58] Baudino Direct Testimony, at 43-46.

[59] Matt Comer, "How Do We Have 18.4% Earnings Growth In A 2.58% GDP Economy?", Seeking Alpha, April 19, 2018.

[60] Burt White and Jeff Buchbinder, "The S&P and GDP are not the Same Thing," *LPL Financial*, November 4, 2014.

[61] M. Mauboussin and D. Callahan, "Charts from the Vault. Morgan Stanley Counterpoint Global Insights," December 5, 2024.

example of how the disconnect between GDP and EPS growth can be observed between the U.S. and China:

> China EPS growth has stagnated while U.S. EPS growth has been exceptional, despite China's economy growing at twice the speed of the U.S.… When EPS is diluted by additional company share issuance, it can further exacerbate this misalignment with GDP growth.[62]

Furthermore, it is reasonable to assume that the average growth of the S&P 500 Index could be sustainable in the long run. The calculation of the market risk premium is based on the return on the broader stock market, as measured by the S&P 500 Index, less the return on a risk-free instrument (which in my case, is the yield on the 30-year Treasury bond). The S&P 500 Index is composed of the largest top performing companies. Over time, the specific companies that are included in the S&P 500 Index will vary; however, because the index is composed of the largest top performing companies, it is reasonable to assume the index will always contain individual companies with projected earnings growth rates that will be considered high. Therefore, investor expectations of growth and return for the index, as a whole, may not change over time.

Q. Have other regulatory commissions supported the use of a constant growth DCF model to estimate the market return in the CAPM such as you have done?

A. Yes. Various state utility regulatory commissions have supported the use of a constant growth DCF model to estimate the market return in the CAPM. As shown in Figure 12, the Staff of the Illinois Commerce Commission ("ICC"), the Bureau of Investigation and

[62] N. Samouihan and A. King, "Chart in focus: The need to differentiate market growth from macro growth," Wellington Management, September 2024.

Enforcement ("I&E") of the Pennsylvania Public Utility Commission ("Pennsylvania PUC"), and the Staff of the Maine Public Utilities Commission ("Maine PUC") have each supported the forward-looking market risk premium and the market return estimates using the constant growth DCF model. In each of these cases, the respective regulatory commission relied on the estimated CAPM results by the parties to the case to determine the authorized ROE and did not dispute the use of the constant growth DCF model to calculate the market return.

Figure 12: Examples of Jurisdictions Where Market Return Estimated Using the Constant Growth DCF Model

Intervening Party	Applicant	Docket No.	Approach of Intervening Party to Calculating the Market Return	Date of Order	Did the Commission Rely on the Intervening Party's CAPM?
Staff of the ICC	North Shore Gas Company	20-0810	CGDCF of the dividend-paying companies in the S&P 500 (11.95%)[63]	9/8/21	Yes[64]
I&E	Aqua Pennsylvania, Inc.	R-2021-3027385	CGDCF of the Value Line Universe and S&P 500 (12.14%)[65]	5/12/22	Yes, the regulator placed primary weight on I&E's CAPM[66]
Staff of the Maine PUC	Northern Utilities, Inc.	2019-00092	CGDCF of the dividend-paying companies in the S&P 500 (11.33%-13.49%)[67]	4/1/20	Yes[68]

63 Illinois Commerce Commission, Docket No. 20-0810, Order, September 8, 2021, at 71.
64 *Id*., at 86-87.
65 Pennsylvania Public Utility Commission, Docket No. R-2021-3027385, Opinion and Order, May 16, 2022, at 147.
66 *Id*., at 178.
67 Maine Public Utilities Commission, Docket No. 2019-00092, Bench Analysis, October 29, 2019, at 21.
68 *Id*., Order Part II, April 1, 2020, at 58.

In addition, in a recent cost of capital proceeding for the electric utilities in California, the California Public Utilities Commission noted that all parties recognized that historical market returns and economically logical projections fall within the range of 12.00 percent.[69] This recognition is consistent with the market return utilized in my initial CAPM analyses in my direct testimony and herein in my updated CAPM analyses in my rebuttal testimony.

Q. Do studies demonstrate that the market return that is used in your CAPM, and thus the market risk premium, is reasonable?

A. Yes. The Federal Reserve Bank of New York published an analysis in 2015 that reviewed 20 methodologies over the period 1960 through 2013 for estimating the market risk premium.[70] The results of this study demonstrate that the market risk premium estimates that I relied on in my direct testimony, which are in the range of 7.97 percent to 8.28 percent as presented in Exhibit AEB-4, are reasonable. Specifically, the key conclusions from this study are:

- The 20 methodologies reviewed reflected a range for the market risk premium of between -1.0 percent to 14.5 percent.
- As shown in Figure 13, the principal component analysis of the 20 models (*i.e.*, the bold black line) produced a range for the market risk premium of approximately 0 percent to over 10 percent from 1960 through 2013.
- The one-year-ahead market risk premium was consistently greater than 10% following the financial crisis of 2008/09.

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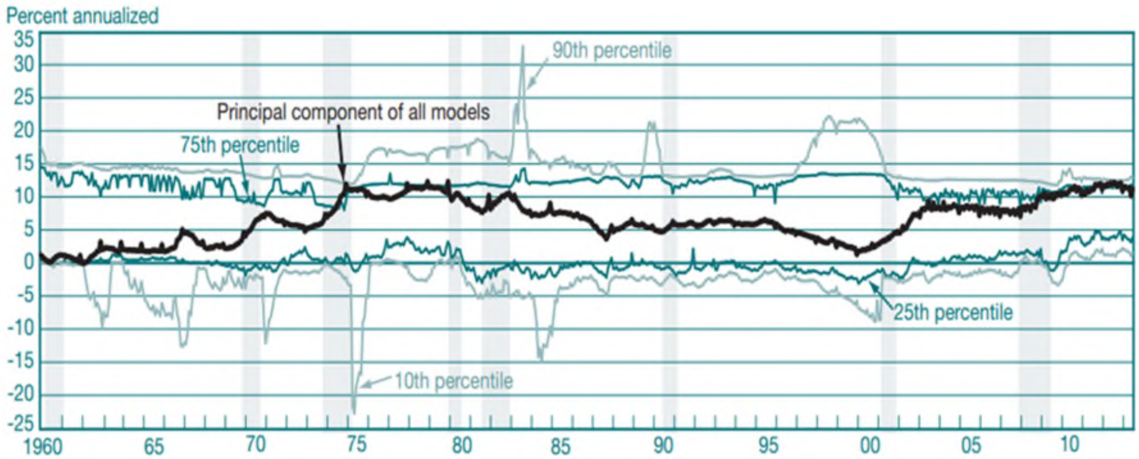
[69] California Public Utilities Commission, Application 22-04-008, *et al.*, Decision 22-12-031, December 15, 2022, at 23.

[70] Fernando Duarte and Carla Rosa, "The Equity Risk Premium: A Review of Models," Federal Reserve Bank of New York (2015).

Figure 13: The Federal Reserve Bank of New York, One-Year-Ahead Market Risk Premium[71]



Further, the Federal Reserve Bank of New York also noted the following:

> Chart 2 shows the first principal component of all twenty models in black (the black line is the same principal component shown in black in each of the panels of Chart 1). ***As expected, the principal component tends to peak during financial turmoil, recessions, and periods of low real GDP growth or high inflation***. It tends to bottom out after periods of sustained bullish stock markets and high real GDP growth. Evaluated by the first principal component, the one-year ahead ERP [*equity risk premium*] reaches a local peak in June 2012 at 12.2 percent. The surrounding months have ERP estimates of similar magnitude, with the most recent estimate in June 2013 at 11.2 percent. This behavior is not so clearly seen by simply looking at the collection of individual models in Chart 1, a finding that highlights the usefulness of principal component analysis. Similarly high levels were observed in the mid- and late 1970s, during a period of stagflation, while the recent financial crisis had slightly lower ERP estimates, closer to 10 percent.[72]

Thus, the Federal Reserve Bank of New York noted that the market risk premium is higher during periods of increased inflation. While inflation has declined significantly in the past two years, it remains above the Federal Reserve's target of 2 percent and core

[71] *Id.*, at 50.
[72] *Id.*; emphasis and clarification added.

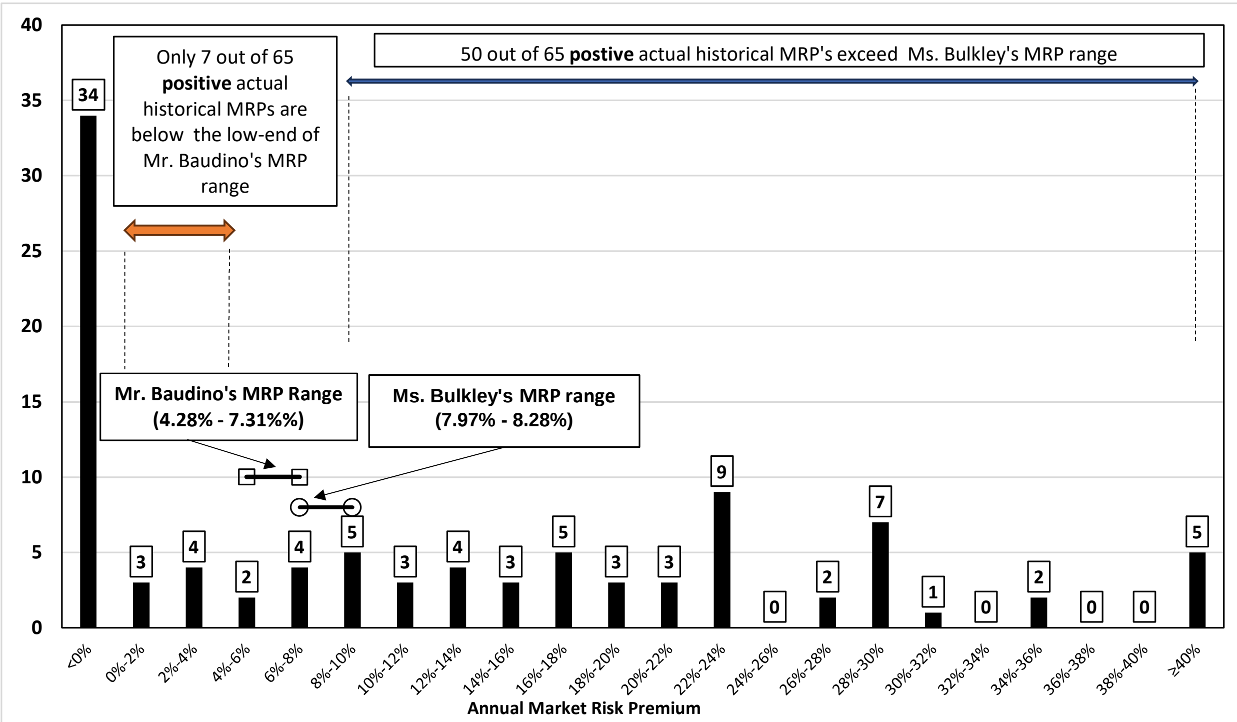
inflation has recently increased as expected by Fed officials and economists due to the Trump administration's tariffs.[73]

Q. How do the market risk premia in your CAPM compare with the observed historical market risk premia?

A. As shown in Figure 14 below, the vast majority of the positive historical market risk premia observations (50 out of 65) are at or above the market risk premia range used in my direct testimony (7.97 percent to 8.28 percent), whereas there are very few positive historical market risk premia observations (7 out of 65) that are below the low-end of Mr. Baudino's market risk premia range (4.28 percent to 7.31 percent).

[73] *See, e.g.*, Colby Smith, "US Inflation Accelerated in June as Trump's Tariffs Pushed Up Prices," *The New York Times*, July 15, 2025; "US consumer prices rise moderately; tariffs expected to fan inflation," *Reuters*, June 11, 2025; "Yellen expects Trump's tariffs will hike inflation to 3% year over year," *CNBC*, June 12, 2025; "Where's the Inflation from Tariffs? Just Wait, Economists Say," *The New York Times*, June 13, 2025.

Figure 14: Distribution of Historical Market Risk Premia (1926-2024)[74]



Q. What is your overall conclusion regarding the market return in your CAPM analysis?

A. For all of the reasons just discussed, the market return, and thus market risk premium, in my CAPM analyses are reasonable and consistent with market evidence and the findings of the Federal Reserve and other utility regulatory commissions. Therefore, there is no basis to conclude that the market return, and thus market risk premium, in my CAPM analyses is excessive.

[74] Depicts the risk premia as calculated as the difference between total annual returns on large company stocks and income only returns on long-term government bonds, as reported in the 2023 Kroll SBBI Yearbook for 1926-2022 and from S&P Capital IQ Pro (market returns) and Kroll (long-term government bond yields) for 2023-2024.

Q. Have the courts addressed Mr. Baudino's concern that your forward-looking market return is inflated?

A. Yes. In its review of FERC Opinion No. 569-B, the U.S. State Court of Appeals for the District of Columbia addressed the concern regarding the use of projected EPS growth rates in a constant growth DCF model to estimate the market return. In the Court's decision, it acknowledged that the FERC has relied on the use of projected EPS growth rates in the calculation of the market return on the S&P 500 because the S&P 500 is regularly updated to include companies with high market capitalization and it includes companies at all stages of growth, including lower and higher growth potential. The Court determined that FERC's rationale for using projected EPS growth rates was sufficient and did not accept the challenge to this assumption.[75]

Q. Is Mr. Baudino's criticism of your forward-looking market return internally consistent with his own analyses?

A. No. While Mr. Baudino criticizes my market return as being too high, his suggestion that the use of a GDP growth rate should be used as the long-term earnings growth rate of the market contradict the implied growth rates resulting from the market returns that he uses in his own CAPM analyses. In Figure 15 below, I have summarized the range of market returns that Mr. Baudino relied on in his CAPM analyses. As shown, Mr. Baudino relies

[75] United States Court of Appeals, District of Columbia Circuit, Opinion, Docket No. 16-1325, August 9, 2022, at 19.

on market returns for his CAPM analyses that range from 9.19 percent to 12.21 percent.[76] Assuming that his estimates of the total market return includes a dividend yield component equal to the dividend yield that I rely on for the S&P 500 in my DCF-derived market return (*i.e.*, 1.36 percent),[77] the average long-term EPS growth rate for the market implied in his CAPM analyses ranges from 7.78 percent to 10.78 percent, all of which are substantially higher than the historical and projected gross domestic product ("GDP") growth rates that Mr. Baudino contends demonstrates that my market return is too high. Therefore, while Mr. Baudino references historical and projected GDP growth rates to allege that my market return is too high, ironically, that same data also invalidates his own CAPM analyses.

Figure 15: Inconsistencies between the Long-Term Market Growth Rates Relied on by Mr. Baudino in his CAPM Analyses Relative to his Claimed Historical and Projected Long-Term GDP Growth Rates

Witness	Total Market Return in CAPM	Avg. Div. Yld. of Market	Implied Avg. Long-Term Market Gwth. Rate	Historical (1929-2024) Long-Term GDP Growth Rate	Projected Long-Term GDP Growth Rate
Baudino - Max	12.21%	1.36%	10.78%	6.10%	4.00%
Baudino - Min	9.19%	1.36%	7.78%	6.10%	4.00%

[76] Baudino Direct Testimony, at Exhibit RAB-6; the high-end of Mr. Baudino's range is the historical arithmetic average return for Large Company Stocks as reported by Kroll for the period of 1926-2024. The low-end of Mr. Baudino's range is the implied market return based on Professor Damodaran's market risk premium which was estimated as the sum of Professor Damodaran's market risk premium of 4.28 percent and the risk-free rate relied on by Mr. Baudino (average 3-month yield on the 30-year Treasury bond as of July 2025 of 4.90 percent).

[77] Exhibit AEB-6.

IV.D. ECAPM

Q. Please summarize Mr. Baudino's critique of the use of the ECAPM analysis.

A. It is my understanding that Mr. Baudino opposes my reliance on the ECAPM stating that I have not provided any evidence that "investors favor this version of the ECAPM over the standard CAPM."[78]

Q. Is it a necessary condition that investors favor a single model to consider the results of that model?

A. No. In fact, the expectation is that investors consider the results of multiple models. Therefore, the fact that it cannot be proven that the ECAPM would be favored over the CAPM is not a reason to exclude the results of the model from the range of possible investor required returns.

Q. Is the concept of the ECAPM and the conclusion that the risk-return relationship is flatter than predicted by the CAPM generally accepted in financial literature?

A. Yes. In *Modern Regulatory Finance*, Dr. Morin provides a list of studies each of which concludes that the CAPM understates the returns for companies with betas less than 1.0 (which is typically utilities) and overstates the return for companies with betas greater than 1.0.[79] It is these empirical studies referenced by Dr. Morin that formed the basis of the development of alternative models such as the ECAPM that would better predict the risk return-relationship observed when reviewing actual market data.

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[78] Baudino Direct Testimony, at 46-47.

[79] Morin, Dr. Roger A. *Modern Regulatory Fi*nance. Public Utilities Report, Inc., 2021, at 206-208.

Academics and researchers could then use the equation shown below to determine the value of the constant term (α) or "alpha factor" using historical market data:

$$K_e = r_f + \alpha + \beta\left(\left(r_m - r_f\right) - \alpha \right) \quad [1]$$

Where:

K_e = the required market cost of equity;

α = a constant term;

β = Beta coefficient of an individual security;

r_f = the risk-free rate; and

r_m = the required return on the market as a whole.

There have been numerous additional studies published to estimate the value of the constant term or alpha factor in the ECAPM equation. Figure 16 provides the list of studies summarized by Dr. Morin. As shown, six of the eight studies estimated positive values of the constant term, which indicates that the consensus among the studies is that the CAPM understates the observed return. Additionally, among the six studies that estimate only positive values of the constant term, the range of the constant term was 1.63 percent to 13.56 percent. Dr. Morin relied on a constant term in the range of 1 to 2 percent to develop the 0.25 and 0.75 factors included in the ECAPM and considering the range of the constant term provided in Figure 16, it would appear Dr. Morin's estimate is conservative.

Figure 16: Empirical Evidence on the Alpha Factor (Constant Term)[80]

Author	Range of Alpha
Fischer (1993)	-3.6% to 3.6%
Fischer, Jensen and Scholes (1972)	-9.61% to 12.24%
Fama and McBeth (1972)	4.08% to 9.36%
Fama and French (1992)	10.08% to 13.56%
Litzenberger and Ramaswamy (1979)	5.32% to 8.17%
Litzenberger, Ramaswamy and Sosin (1980)	1.63% to 5.04%
Pettengill, Sundaram and Mathur (1995)	4.6%
Morin (1989)	2.0%

Q. Have any of these studies examined the ability of the CAPM to estimate the return of utilities?

A. Yes. There are several academic studies that show the CAPM does understate the return for regulated utilities. For example, as referenced by Dr. Morin and as shown in Figure 16, Litzenberger, Ramaswamy, and Howard (1980) found that the CAPM tends to understate the return for stocks such as utilities that have a beta less than 1.00.[81] To develop their analysis, the authors used historical (*i.e.,* "raw") betas to estimate the "alpha" factor in the ECAPM. However, the authors also showed that an "alpha" factor can be derived for betas adjusted using the Blume procedure (*i.e.,* the adjustment relied on by *Value Line* to account for the tendency of beta to trend back over time to the market beta of 1.00). The Blume adjustment is shown in the following equation:

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[80] *Id.*, at 222.

[81] Robert Litzenberger, *et al.*, "On the CAPM Approach to the Estimation of A Public Utility's Cost of Equity Capital," *The Journal of Finance*, Vol. 35, No. 2, 1980, at 369-383.

$$\beta_i = \omega\beta_{i(historical)} + (1-\omega) \quad [2]$$

Where:

β_i = adjusted beta

β_i [historical] = raw beta

ω = Blume Adjustment factor (*i.e.*, 0.67)

The estimate of "alpha" using Blume-adjusted betas can be derived using the results presented in the "Raw Beta" section of Table 1 on page 380 and the equations on page 376:

$$a = a' - b'\left(\frac{1-\omega}{\omega}\right) = 0.326 - 0.330\left(\frac{0.33}{0.67}\right) = 0.163 \qquad [3]$$

Where:

a = estimated alpha factor for Blume adjusted betas

a' = estimated alpha factor using raw betas

b' = estimated excess return over the risk-free rate using raw betas

Because the authors relied on monthly returns for stocks in the New York Stock Exchange, the estimated "alpha" factor using adjusted betas of 0.163 percent must be annualized.[82] When annualized, the estimated "alpha" factor is 1.97 percent using Blume-adjusted betas, which is consistent with the "alpha" factor relied on by Dr. Morin of 1.0 to 2.0 percent to develop the 0.25 and 0.75 factors included in the ECAPM that I rely on in the ECAPM analyses presented in my direct and rebuttal testimonies.

Additionally, I have also reviewed the more recent Chrétien and Coggins (2011) study that evaluated the CAPM and its ability to estimate the risk premium for the utility industry in particular subgroups of utilities for a data set that included market data through

[82] (1.00163)^12-1 = 1.97 percent

the end of 2006.[83] Chrétien and Coggins (2011) considered the CAPM, the Fama-French three-factor model and a model similar to the ECAPM used in my Direct Testimony. The study shows that the ECAPM significantly outperformed the traditional CAPM at predicting the observed risk premium for the various utility subgroups.

Q. Are you aware of state regulatory commissions that have accepted the use of the ECAPM in the manner as you have conducted?

A. Yes. There are various regulatory commissions that have supported the use of the ECAPM in establishing an authorized ROE and have done so when adjusted betas are used in the ECAPM analysis. For example, the New York Public Service Commission ("NYPSC") and North Carolina Utilities Commission ("NCUC") have accepted the ECAPM analysis with the use of adjusted beta coefficients in establishing the authorized ROE for regulated utilities. Specifically, the NYPSC gives equal weight to the CAPM and ECAPM (which it refers to as the "Zero Beta" CAPM) results,[84] and the NCUC has recently found that both the adjustment to beta in the CAPM and the adjustment in the ECAPM were needed because they correct for different things.[85]

[83] Chrétien, Stéphane, and Frank Coggins. "Cost Of Equity For Energy Utilities: Beyond The CAPM." *Energy Studies Review*, Vol. 18, No. 2, 2011.
[84] *See, e.g.*, New York Public Service Commission, Case No. 20-G-0101, Order, May 19, 2021, at 44-46.
[85] North Carolina Utilities Commission, Docket No. E-2, SUB 1300, Order Accepting Stipulations, Granting Partial Rate Increase, and Requiring Public Notice, August 18, 2023, at 162-163.

IV.E. Business and Regulatory Risks

Q. As a general matter, what is Mr. Baudino's position regarding the business and regulatory risks that you identified and discussed in your direct testimony?

A. For each of the business and regulatory risks that I identified and discussed, Mr. Baudino states that the Commission should not increase the authorized ROE of the Company.

Q. Do you agree with Mr. Baudino's position?

A. No. As noted in my direct testimony, I did not make a specific adjustment to my recommended ROE based on the business and regulatory risks of the Company relative to the proxy group, but rather I did consider them in the aggregate when determining where the Company's requested ROE falls within the range of the analytical results of the cost of equity analyses. Mr. Baudino does not dispute the results of the comparative risk analysis that I presented in my direct testimony, including the comparative regulatory risks of the Company versus the proxy group in Exhibit AEB-8, thus there is no basis to suggest that such factors should not be considered by the Commission in its authorization of the ROE in this proceeding.

Q. What is Mr. Baudino's position regarding flotation costs?

A. Mr. Baudino states that, consistent with past practice, the Commission should not allow flotation costs in the authorized ROE, and that I have not provided any new evidence that indicates the Commission should change its practice. Mr. Baudino contends that it is likely that flotation costs are already accounted for in current stock prices, and thus a flotation cost adjustment in the authorized ROE would be double counting.[86]

Q. Do you continue to believe that flotation costs should be considered by the Commission when establishing the ROE in this proceeding?

A. Yes. While I am not recommending a specific flotation cost adjustment, flotation costs are legitimate costs for equity holders that are not recovered through the rate of return on equity derived from the DCF or CAPM analysis. Just as rate base investments, flotation costs are also part of the invested costs of the utility, and the need to reimburse shareholders for the lost returns associated with equity issuance costs has been recognized by the academic and financial communities. Since the actual book equity of a stock issuance is calculated as the market value less flotation costs, the book equity of that issuance is always less than the market value of the stock. Therefore, all else equal, investors can earn their cost of equity in any year only if the company is allowed to earn a return on the common equity that is higher than the required return. This is because the total common equity base has been permanently reduced by the amount of the flotation cost. As noted in *Modern Regulatory Finance*: "Since flotation costs of common stock issues cannot be amortized because they have no finite maturity, they must be recovered by way of an upward adjustment to the allowed return on equity."[87] The text goes on to state that a permanent adjustment is needed because:

> "…(a) even if no further stock issues are contemplated, the flotation cost adjustment is still permanently required to keep shareholders whole, and (b) flotation costs are only recovered if the rate of return is applied to total

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[86] Baudino Direct Testimony, at 48.
[87] Morin, Roger A. *Modern Regulatory Finance.* Public Utilities Reports, Inc., 2021, at 337.

> equity, including retained earnings, in all furture years, even if no future financing is contemplated."[88]

Q. Is there academic support for the method you used to estimate flotation costs?

A. Yes. *Modern Regulatory Finance* identifies the "conventional approach" to calculating flotation costs in regulatory proceedings as dividing the expected dividend by 1 minus the flotation cost (e.g., for flotation costs of 5 percent, dividing the expected dividend by 0.95 will produce the adjusted cost of equity capita), and states regarding this approach that:

> Its use in regulatory proceedings by cost of capital witnesses is widespread. The formula is discussed in several college-level corporate finance textbooks, such as Brigham and Ehrhardt (2011).[89]

Q. Have regulatory commissions approved the inclusion of flotation costs in the authorization of a utility's ROE?

A. Yes. Various regulatory commissions across the United States have previously allowed the recovery of flotation costs in the authorization of a utility's ROE based on the circumstances in the case.[90]

Q. What is Mr. Baudino's position regarding the Company's risk associated with its future capital expenditures?

A. Mr. Baudino agrees that the Company has a significant projected capital expenditure program; however, he states that the Company's use of a future test year and the Qualified

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[88] *Id*., at 338.
[89] *Id*., at 336.
[90] *See, e.g.*, Indiana Utility Regulatory Commission, Cause No. 42359, Order, May 18, 2004, at 43; Connecticut Public Utilities Regulatory Authority, Docket No. 10-12-02, June 29, 2011, at 133–13. South Dakota Public Utilities Commission, Docket No. EL11-019, Final Decision and Order, July 2, 2012, at 6; South Dakota Public Utilities Commission, Docket No. EL18-021, Final Decision and Order, May 30, 2019, at 8; Maine Public Utilities Commission, Docket No. 2017-00198, Order, June 28, 2018; Maine Public Utilities Commission, Docket No. 2017-00065, Order, February 28, 2018.

Infrastructure Program ("QIP") help mitigate the risk of that capital expenditure program, and thus the Commission should not increase the Company's authorized ROE due to its capital expenditure risk.[91]

Q. Has Mr. Baudino appropriately assessed the Company's risk related to its extensive capital expenditure program?

A. No. First, while I agree with Mr. Baudino that the use of a future test year and the QIP help mitigate the Company's regulatory cost recovery risk; as I show in my direct testimony, the Company still faces significant regulatory lag as KAWC underearned its authorized return over the past seven years.[92] Second, the appropriate comparison for purposes of assessing the risk of business and regulatory risk of the Company is relative to the operating utilities of the proxy group – not focusing solely on the Company. As shown on Exhibit AEB-8, the majority of the operating subsidiaries of the proxy group companies also utilize partially or fully forecasted test years for ratemaking purposes, and the vast majority also have mechanisms to recover the cost of capital expenditures outside of rate proceedings. In addition, as noted, the cost recovery related to the QIP is limited to the replacement of only certain specified aging infrastructure and not related to expansion investments. Accordingly, while the Company's future test year and QIP aid in the timely recovery of costs, they do not reduce the Company's risk relative to the proxy group. Therefore, it is reasonable that the Commission consider the risk associated with the extent

[91] Baudino Direct Testimony, at 47.
[92] Bulkley Direct Testimony, at 43.

of the Company's capital expenditure program relative to the proxy group when setting the authorized ROE in this proceeding.

Q. Do you agree with Mr. Baudino that there is "no basis whatsoever" for you to conclude that the Company as greater regulatory risk than the proxy group?[93]

A. No, I do not. Mr. Baudino contends that because Regulator Research Associates ("RRA") assigns Kentucky a regulatory ranking of "Average/2", which he notes is the "average ranking", it is unreasonable for me to conclude that KAWC has greater regulatory risk than the proxy group.[94] However, I have two concerns with Mr. Baudino's conclusion. First, Mr. Baudino has not compared Kentucky's RRA regulatory ranking to the average regulatory ranking for the proxy group. While RRA's average ranking may be "Average/2", depending on the jurisdictions in which the proxy group operate, the average ranking for the proxy group may not equal "Average/2".

Second, the RRA ranking is generalized for all utilities operating in Kentucky, including KAWC. Therefore, relying on the RRA regulatory ranking alone might not fully reflect the regulatory risk of the Company. The analysis that I conducted in my direct testimony focuses on the specific regulatory risk of KAWC relative to the proxy group through a review of the Company's cost recovery mechanisms as compared to those available to the companies in the proxy group. Further, I also assessed the effect of

93 Baudino Direct Testimony, at 48-49.

94 RRA assigns a ranking for each regulatory jurisdiction as "Above Average", "Average" or "Below Average", and then within each of those categories, a numeric ranking from 1 to 3. Thus, there are a total of nine RRA rankings, with the rankings for each jurisdiction ranging from "Above Average/1", which is considered the most supportive, to "Below Average/3," which is the least supportive. Therefore, as noted by Mr. Baudino, the middle of the ranking would be "Average/2".

regulatory lag on the Company by determining if the Company has been able to earn its authorized return over the last several years. As noted in my direct testimony, I concluded that KAWC has greater regulatory risk relative to the proxy group because: (1) the proxy group companies had more timely cost recovery than KAWC had in Kentucky, and (2) the Company has underearned its authorized return over the past seven years.[95] Mr. Baudino has not evaluated the specific regulatory risk of the Company relative to the proxy group and therefore, absent this comparison, is unable to comment on the relative risk of KAWC to the proxy group.

Q. Mr. Baudino suggests that there is Commission precedent to reduce the ROE for tracking mechanisms. Has the Commission reduced the Company's ROE for the implementation of the QIP in prior rate proceedings?

A. No. The Commission approved the Company's QIP in its 2018 rate proceeding and did not specify a lower ROE to be applied to investments that are recovered through this mechanism. Further, in the Company's last rate proceeding, the Commission did not reduce the ROE for the investments that are included in the QIP. The market-based cost of equity estimates developed using the models, which the Commission has routinely referenced as critical to the development of the return on equity, include the effects of mechanisms that have been implemented by the proxy group companies. Therefore, in setting the ROE in this proceeding, it is necessary to consider the risk of KAWC as compared with that proxy group to determine the appropriate return on equity. Mr. Baudino has provided no evidence that demonstrates that KAWC has lower risk relative to the proxy group as a result of the

[95] Bulkley Direct Testimony, at 44.

QIP mechanism to justify his recommended reduction to the ROE for investments recovered through the QIP. As discussed previously and shown on Exhibit AEB-8 to my direct testimony, approximately 75 percent of the proxy group companies have mechanisms that provide more timely recovery of capital investments. Therefore, the recovery of KAWC's investments through the QIP is consistent with the proxy group companies and should not result in a lower ROE.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.

VERIFICATION

COMMONWEALTH OF MASSACHUSETTS)
) SS:
COUNTY OF SUFFOLK)

The undersigned, Ann E. Bulkley, being duly sworn, deposes and says that she is a Principal at The Brattle Group, that she has personal knowledge of the matters set forth in the accompanying testimony for which she is identified as the responsible witness, and that the answers contained therein are true and correct to the best of her information, knowledge and belief.

____
Ann E. Bulkley

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 9 day of September, 2025.

____
Notary Public

My Commission Expires:
9/30/2028

MR. BAUDINO'S - COMBINATION PROXY GROUP - 6-MONTH CONSTANT GROWTH DCF AT THE PROXY COMPANY LEVEL

		[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]	[9]	[10]	[11]
Company	Ticker	Dividend Yield	Value Line Earnings Growth	Value Line Dividend Growth	S&P Capital IQ	Zacks Earnings Growth	Average Growth Rate	Value Line Earnings ROE	Value Line Dividend ROE	S&P Capital IQ	Zacks Earnings ROE	Average Growth ROE
Atmos Energy	ATO	2.27%	7.00%	7.00%	7.27%	7.30%	7.14%	9.35%	9.35%	9.63%	9.66%	9.50%
NiSource	NI	2.84%	9.50%	4.50%	8.08%	7.90%	7.50%	12.47%	7.40%	11.03%	10.85%	10.44%
Northwest Natural Holding Company	NWN	4.74%	6.50%	0.50%	5.75%	5.75%	4.63%	11.39%	5.25%	10.62%	10.62%	9.47%
One Gas, Inc.	OGS	3.61%	4.50%	2.00%	5.84%	5.60%	4.49%	8.20%	5.65%	9.56%	9.32%	8.18%
Southwest Gas	SWX	3.35%	10.00%	5.50%	10.74%	10.50%	9.19%	13.52%	8.95%	14.27%	14.03%	12.69%
Spire	SR	4.18%	4.50%	4.00%	9.23%	7.10%	6.21%	8.78%	8.27%	13.61%	11.43%	10.52%
American States Water Company	AWR	2.41%	7.00%	8.00%	5.65%	5.70%	6.59%	9.50%	10.51%	8.13%	8.18%	9.08%
California Water Service Group	CWT	2.56%	9.50%	5.50%	8.78%	8.80%	8.15%	12.18%	8.13%	11.45%	11.47%	10.81%
Middlesex Water Company	MSEX	2.37%	7.50%	4.50%	5.74%	5.70%	5.86%	9.96%	6.93%	8.18%	8.14%	8.30%
H2O America	HTO	3.19%	6.00%	4.00%	5.19%	6.50%	5.42%	9.29%	7.25%	8.46%	9.79%	8.70%
Essential Utilities, Inc.	WTRG	3.41%	6.00%	6.50%	5.48%	5.20%	5.80%	9.51%	10.02%	8.98%	8.70%	9.30%
Mean		3.18%	7.09%	4.73%	7.07%	6.91%	6.45%	10.38%	7.97%	10.36%	10.20%	9.73%
Median		3.19%	7.00%	4.50%	5.84%	6.50%	6.21%	9.51%	8.13%	9.63%	9.79%	9.47%

Notes:
[1] Source: Exhibit RAB-2
[2] Source: Exhibit RAB-3
[3] Source: Exhibit RAB-3
[4] Source: Exhibit RAB-3
[5] Source: Exhibit RAB-3
[6] Equals Average ([2], [3], [4], [5])
[7] Equals [1] x (1 + 0.50 x [2]) + [2]
[8] Equals [1] x (1 + 0.50 x [3]) + [3]
[9] Equals [1] x (1 + 0.50 x [4]) + [4]
[10] Equals [1] x (1 + 0.50 x [5]) + [5]
[11] Equals [1] x (1 + 0.50 x [6]) + [6]

MR. BAUDINO'S - COMBINATION PROXY GROUP - CONSTANT GROWTH DCF AT THE PROXY COMPANY LEVEL - ADJ. TO EXCLUDE DPS GROWTH RATES

		[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]	[9]
Company	Ticker	Dividend Yield	Value Line Earnings Growth	S&P Capital IQ	Zacks Earnings Growth	Average Growth Rate	Value Line Earnings ROE	S&P Capital IQ ROE	Zacks Earnings ROE	Average Growth ROE
Atmos Energy	ATO	2.27%	7.00%	7.27%	7.30%	7.19%	9.35%	9.63%	9.66%	9.55%
NiSource	NI	2.84%	9.50%	8.08%	7.90%	8.49%	12.47%	11.03%	10.85%	11.45%
Northwest Natural Holding Company	NWN	4.74%	6.50%	5.75%	5.75%	6.00%	11.39%	10.62%	10.62%	10.88%
One Gas, Inc.	OGS	3.61%	4.50%	5.84%	5.60%	5.31%	8.20%	9.56%	9.32%	9.02%
Southwest Gas	SWX	3.35%	10.00%	10.74%	10.50%	10.41%	13.52%	14.27%	14.03%	13.94%
Spire	SR	4.18%	4.50%	9.23%	7.10%	6.94%	8.78%	13.61%	11.43%	11.27%
American States Water Company	AWR	2.41%	7.00%	5.65%	5.70%	6.12%	9.50%	8.13%	8.18%	8.60%
California Water Service Group	CWT	2.56%	9.50%	8.78%	8.80%	9.03%	12.18%	11.45%	11.47%	11.70%
Middlesex Water Company	MSEX	2.37%	7.50%	5.74%	5.70%	6.31%	9.96%	8.18%	8.14%	8.76%
H2O America	HTO	3.19%	6.00%	5.19%	6.50%	5.90%	9.29%	8.46%	9.79%	9.18%
Essential Utilities, Inc.	WTRG	3.41%	6.00%	5.48%	5.20%	5.56%	9.51%	8.98%	8.70%	9.07%
Mean							10.38%	10.36%	10.20%	10.31%
Median							9.51%	9.63%	9.79%	9.55%

Notes:
[1] Source: Exhibit RAB-2
[2] Source: Exhibit RAB-3
[3] Source: Exhibit RAB-3
[4] Source: Exhibit RAB-3
[5] Equals Average ([2], [3], [4])
[6] Equals [1] x (1 + 0.50 x [2]) + [2]
[7] Equals [1] x (1 + 0.50 x [3]) + [3]
[8] Equals [1] x (1 + 0.50 x [4]) + [4]
[9] Equals [1] x (1 + 0.50 x [5]) + [5]

Summary of Projected Market Return based on
Value Line Projected Dividend Yield and Market Appreciation Potential

VL Report Date	Dividend Yield	Appreciation Potential	Growth Rate	DCF Result
1/3/2025	2.10%	45%	9.73%	11.83%
1/10/2025	2.10%	45%	9.73%	11.83%
1/17/2025	2.10%	45%	9.73%	11.83%
1/24/2025	2.10%	45%	9.73%	11.83%
1/31/2025	2.00%	40%	8.78%	10.78%
2/7/2025	2.00%	45%	9.73%	11.73%
2/14/2025	2.10%	45%	9.73%	11.83%
2/21/2025	2.10%	45%	9.73%	11.83%
2/28/2025	2.10%	45%	9.73%	11.83%
3/7/2025	2.10%	50%	10.67%	12.77%
3/14/2025	2.20%	55%	11.58%	13.78%
3/21/2025	2.20%	55%	11.58%	13.78%
3/28/2025	2.20%	55%	11.58%	13.78%
4/4/2025	2.20%	55%	11.58%	13.78%
4/11/2025	2.20%	60%	12.47%	14.67%
4/18/2025	2.50%	75%	15.02%	17.52%
4/25/2025	2.50%	65%	13.34%	15.84%
5/2/2025	2.40%	70%	14.19%	16.59%
5/9/2025	2.40%	60%	12.47%	14.87%
5/16/2025	2.30%	55%	11.58%	13.88%
5/23/2025	2.30%	50%	10.67%	12.97%
5/30/2025	2.20%	45%	9.73%	11.93%
6/6/2025	2.30%	50%	10.67%	12.97%
6/13/2025	2.30%	50%	10.67%	12.97%
6/20/2025	2.20%	45%	9.73%	11.93%
6/27/2025	2.20%	45%	9.73%	11.93%
7/4/2025	2.20%	45%	9.73%	11.93%
7/11/2025	2.20%	45%	9.73%	11.93%
7/18/2025	2.10%	40%	8.78%	10.88%
7/25/2025	2.10%	40%	8.78%	10.88%
8/1/2025	2.10%	40%	8.78%	10.88%
8/8/2025	2.10%	40%	8.78%	10.88%
8/15/2025	2.20%	45%	9.73%	11.93%
8/22/2025	2.20%	45%	9.73%	11.93%
Average Jan. 1, 2025-Aug. 22, 2025			10.53%	12.72%

MR. BAUDINO ADJUSTED CAPM

Line No.		Forward-Looking MRP: Value Line	Historical MRP: Arithmetic Mean	Historical MRP: Supply Side ERP	Historical MRP: Supply Side ERP Less WWII Bias
1	Market Return	12.72%	12.17%	12.17%	11.53%
2	Risk-free	4.90%	4.90%	4.90%	4.90%
3	Supply Side Adj.	0.00%	0.00%	1.05%	1.05%
4	Risk Premium	7.82%	7.27%	6.22%	5.58%
5	Proxy Group Beta	0.78	0.78	0.78	0.78
6	Proxy Group Beta * Risk Premium	6.08%	5.65%	4.83%	4.34%
7	CAPM Return on Equity	10.98%	10.55%	9.73%	9.24%

Notes:
[1] *Forward-looking market return* : Exhibit AEB-1-R; *Historical arithmetic average market return (1926-2024)* : Kroll; *Historical arithmetic average market return (1926-2024) Less WWII Bias* : Kroll and Exhibit AEB-3-R, pg.3.
[2] Source: Exhibit RAB-6
[3] Equals 7.31% (i.e., Historical Arithmetic Avg. MRP) - 6.26% (*i.e.* , Supply Side MRP)
[4] Equals [1] - [2] - [3]
[5] Source: Exhibit RAB-6
[6] Equals [4] x [5]
[7] Equals [2] + [6]

Historical Equity Market Returns

	Large Co Stock Total Return
1926	11.62%
1927	37.49%
1928	43.61%
1929	-8.42%
1930	-24.90%
1931	-43.34%
1932	-8.19%
1933	53.99%
1934	-1.44%
1935	47.67%
1936	33.92%
1937	-35.03%
1938	31.12%
1939	0.41%
1940	-9.78%
1941	-11.59%
1942	20.34%
1943	25.90%
1944	19.75%
1945	36.44%
1946	-8.07%
1947	5.71%
1948	5.50%
1949	18.79%
1950	31.71%
1951	24.02%
1952	18.37%
1953	-0.99%
1954	52.62%
1955	31.56%
1956	6.56%
1957	-10.78%
1958	43.36%
1959	11.96%
1960	0.47%
1961	26.89%
1962	-8.73%
1963	22.80%
1964	16.48%
1965	12.45%
1966	-10.06%
1967	23.98%
1968	11.06%
1969	-8.50%
1970	4.01%
1971	14.31%
1972	18.98%
1973	-14.66%
1974	-26.47%
1975	37.20%
1976	23.84%
1977	-7.18%
1978	6.56%
1979	18.44%
1980	32.50%
1981	-4.92%
1982	21.55%
1983	22.56%
1984	6.27%
1985	31.73%
1986	18.67%
1987	5.25%
1988	16.61%
1989	31.69%
1990	-3.11%
1991	30.47%
1992	7.62%
1993	10.08%
1994	1.32%
1995	37.58%
1996	22.96%
1997	33.36%
1998	28.58%
1999	21.04%
2000	-9.10%
2001	-11.89%
2002	-22.10%
2003	28.68%
2004	10.88%
2005	4.91%
2006	15.79%
2007	5.49%
2008	-37.00%
2009	26.46%
2010	15.06%
2011	2.11%
2012	16.00%
2013	32.39%
2014	13.69%
2015	1.38%
2016	11.96%
2017	21.83%
2018	-4.38%
2019	31.49%
2020	18.40%
2021	28.70%
2022	-18.11%
2023	26.29%
2024	25.02%
Arithmetic average	12.30%
Arithmetic average Excl. 1942-1951)	11.66%
Difference	0.64%

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

ELECTRONIC APPLICATION OF KENTUCKY-	**)**	
AMERICAN WATER COMPANY FOR AN	**)**	**CASE NO. 2025-00122**
ADJUSTMENT OF RATES	**)**	

REBUTTAL TESTIMONY OF MICHI CHAO

September 15, 2025

I. Introduction

Q. Please state your name and business address.

A. My name is Michi Chao. My business address is 727 Craig Road, St. Louis, Missouri 63141.

Q. Did you previously submit Direct Testimony in this proceeding on behalf of Kentucky-American Water Company ("Kentucky-American," "KAWC" or the "Company") in this proceeding?

A. Yes. I filed Direct Testimony in this proceeding on May 16, 2025.

Q. What is the purpose of your Rebuttal Testimony in this proceeding?

A. The purpose of my Rebuttal Testimony is to respond to the Office of the Attorney General of the Commonwealth of Kentucky and Lexington-Fayette Urban County Government ("AG/LFUCG") witness John Defever's proposed revenue requirement adjustments for:

- KAWC O&M Growth Factor
- Membership Dues Expense

Q. Are you sponsoring any schedules or exhibits with your Rebuttal Testimony?

A. No.

II. KAWC O&M Growth Factor

Q. Mr. Defever recommends disallowing the use of KAWC's Growth Factor that is applied to certain O&M expense categories.[1] Do you agree with his recommendation?

A. No, I do not. Mr. Defever's position is that an assumed "growth factor" increase is unknown and unwarranted because he states that KAWC's total bucketed costs decreased from 2020 to 2021 and 2021 to 2022; he also cites the Commission's Order from Case No.

[1] Direct Testimony of John Defever, p. 27.

2023-00191 to establish Commission precedent on this issue; however, as described in Mr. Prendergast's Rebuttal Testimony,[2] Defever mischaracterizes the Commission's Order in that case.

Q. Please briefly describe the Growth Factor KAWC developed for use in this case.

A. As described in Company witness Robert Prendergast's Direct Testimony on page 21-22, in response to the Commission's request that KAWC utilize a more robust forecasting methodology, Kentucky-American developed its Growth Factor based upon a review of its historical O&M expense trends.

Q. Mr. Defever points to fluctuations and occasional declines in historical costs to argue that no increase is warranted.[3] Please respond.

A. As detailed by Mr. Prendergast, Mr. Defever relies on two isolated periods, 2021 vs. 2020 and 2022 vs. 2021, ignoring KAWC's broader historical trends to justify his disallowance, and further, not portraying a complete picture of the current economic environment and its impact on Company expenses.[4] In general, expense fluctuations are expected as the business continues to grow, improves operational efficiency, adapts to customer demands, meets contractual obligations and regulatory requirements, and addresses aging infrastructure. Additionally, as detailed and supported by Mr. Prendergast, I believe using the 3 Year Average of 5.16% is reasonable and appropriate for KAWC's Base Year and Forecasted Test Year as it is applied to the applicable O&M expense categories because it

[2] Rebuttal Testimony of Robert J. Prendergast, p. 14-15.
[3] Direct Testimony of John Defever, p. 27.
[4] Rebuttal Testimony of Robert J. Prendergast, p. 15.

is specific to KAWC's experiences and aligns with the Commission's directive in Case No. 2023-00191.[5]

Q. Which categories of expense provided in your direct testimony utilize the Growth Factor for the Test Year?

A. The Growth Factor is applied to the following categories of my sponsored expenses: Building Maintenance and services, Maintenance supplies and services, Miscellaneous Expense, Office supplies and services, Telecommunication, and Rent.

Q. Please provide some examples that support the Growth Factor application to KAWC's forecasted increases.

A. As provided in KAWC's O&M Growth Factor Workpaper,[6] several categories of expense have increased at rates beyond KAWC's 5.16% 3-year average. For example:

- Building Maintenance and Services grew by an average 11.2% annually between 2021 and 2024, and grew significantly between 2022 and 2023, which yielded a 28.4% year over year increase.
- Maintenance Supplies and Services rose from approximately $2.1 million in 2021 to $2.9 million in 2023, exhibiting a 37.0% increase over the 2-year span.
- Telecommunications expense rose from $256,000 in 2022 to $354,000 in 2024, an increase of over 37.1% over 2 years.
- Rents represented a 96.7% increase over the three-year period, from $30,000 in 2021 to $59,000 in 2024.

[5] *Id*.
[6] Please see KAWC's response to PSC DR 1-1 (2025 KAWC Rate Case – KAWC O&M Growth Factor Workpaper).

These examples illustrate that certain categories of KAWC's historical expense have trended much higher than KAWC's calculated O&M Growth Factor. Accordingly, applying the Growth Factor provides a conservative and consistent approach because it helps to smooth significant year over year increases, and provides the Company with a normalized percentage and greater predictability over historically unstable expenses.

Q. Why is it reasonable and appropriate to apply the Growth Factor to these expense categories?

A. As discussed by KAWC witness Robert Prendergast, the Growth Factor is not an arbitrary inflation factor, but instead a company-specific percentage grounded in KAWC's actual experience, and which was developed by KAWC to address the Commission's concerns regarding KAWC's use of general inflationary percentages in previous rate cases. As detailed above, certain volatility can impact KAWC's O&M expenses and KAWC's Growth Factor is a conservative, company-specific metric grounded in KAWC's actual data and known costs, that further helps to smooth irregularities across expenses. Disallowing the Growth Factor, as Mr. Defever recommends, would not be representative of KAWC's forecasted level of expense. Based on this analysis, I believe that the 5.16% growth factor best represents our 2026 forecast test year O&M expense projection.

III. Membership Dues Expense

Q. How do you respond to Mr. Defever's recommendation to disallow all membership dues?

A. Mr. Defever's adjustment removes all membership dues on the basis that KAWC was unable to provide a detailed breakdown of the lobbying activity of the respective organizations. However, in KAWC's response to PSC 4-3, KAWC provided that breakdown. While preparing that response and this rebuttal testimony, KAWC revisited the 2024 Total Dues of $55,209. KAWC determined that it had incorrectly included licensing fees associated with the Kentucky Environmental Protection Agency (KY Environment Protect) in the amount of $13,946. As detailed in its response to PSC 4-3, KAWC updated its Dues expense which should exclude the $13,946 associated with that licensing, resulting in a revised Total Dues amount of $41,263.

Organization	2024
American Water Works Association/AWWA Amortization	16,898
Kentucky Chamber of Commerce	9,240
Commerce Lexington	5,862
Georgetown-Scott City Chamber of Commerce	1,781
Other Organizations	7,482
KY Environment Protect	13,946
Total	**55,209**
Removed KY environment protect	(13,946)
Total Dues	**41,263**

Q. Do you agree with Mr. Defever's recommendation to remove all membership dues that he characterizes as lobbying or image-building?

A. No, I do not. Mr. Defever's recommendation relies on the assumption that these civic and regional organizations advocate for KAWC and its interests, which is inaccurate. While these organizations may engage in lobbying activities, they do so on behalf of their regions, their member communities, and the broader interests of Kentuckians, not on behalf of KAWC.

While KAWC is a dues-paying member of these organizations, our participation is not for the support of lobbying provided by these organizations. Instead, KAWC participates to provide support to the communities we serve and to contribute to regional initiatives that help strengthen local economic activity and our relationships with the communities we serve. KAWC's participation with these organizations helps ensure that KAWC remains engaged with our customers and the communities we serve and at the forefront of local initiatives that may impact KAWC facilities or operations.

Q. Can you provide examples of community-focused organizations and explain the nature of their advocacy efforts?

A. With exception of American Water Works Association, these organizations are mostly comprised of regional, Kentucky-focused non-profit organizations. KAWC provided detailed descriptions of each organization in its response to AG 1-25(c). Generally, these organizations advocate on behalf of Kentucky businesses, citizens, and their respective communities, ultimately to enhance quality of life in the Commonwealth. For example:

- Kentucky League of Cities and Kentucky Association for Economic Development: These organizations work to support municipalities and advance local government priorities, with advocacy focused on the success and prosperity of Kentucky communities.
- Kentucky Rural Water Association: This organization's primary goal is to foster professionalism in the water and wastewater industry through training and technical assistance programs as well as advocacy, representing member utilities across the state that have a direct impact on the quality of life for nearly 95% of the public drinking water and wastewater customers across Kentucky.
- Commerce Lexington, Downtown Lexington Partnership, Kentucky Chamber of Commerce and local Chambers of Commerce: These organizations advocate

economic development, job growth, and investment in their respective communities, ultimately to enhance quality of life for citizens.

In these cases, these organizations are not lobbying on behalf of utilities or specifically for KAWC, they are advocating for Kentucky-focused initiatives and strengthening the Kentucky communities where KAWC customers live and work. KAWC participates in these groups to support its customers, build relationships with local leaders, and engage with the community on a personal level.

Q. Please discuss American Water Works Association ("AWWA"), and its advocacy on behalf of water utilities.

A. AWWA advocates on behalf of water utilities, which includes KAWC. AWWA's advocacy is fundamentally about ensuring safe, affordable, and reliable water service for customers; these interests are not necessarily specific to KAWC or KAWC shareholders, but to the water industry and its consumers as a whole.[7] For example, AWWA's legislative efforts include the Low-Income Household Water Assistance Program (LIHWAP), CERCLA liability protections for passive receivers of PFAS, and the Water Risk and Resilience Organization (WRRO) Establishment Act, all of which ultimately benefit customers. Further, American Water is currently advocating for H.R. 4733, Low Income Household Water Assistance Program Establishment Act which would re-establish the program to the benefit of eligible American Water customers in need.

Therefore, while AWWA advocates on behalf of US water utilities, it also advances customer interests like improving water quality, lowering long-term costs, and advocates to help ensure customer access to safe and reliable water infrastructure.

[7] KAWC's response to AG 1-25(c).

Q. Can KAWC quantify the portion of membership dues that is attributable to lobbying across these organizations?

A. Yes. In preparing my rebuttal testimony and in response to PSC 4-3, KAWC was able to determine the percentage amounts of lobbying expense through the organizations' IRS Form 990s and annual reports. KAWC provided the breakdown of lobbying costs attributable to KAWC's membership dues in that response which is replicated below. The table below shows that while some portion of dues can be attributed to lobbying activities, only a small fraction of the Total Dues expense is impacted by lobbying activities of these organizations.

Form 990				
Lobbying $ and %		Dues	**Organization**	**2024**
3,867,206	55.6%	6,956,592	American Water Works Association/AWWA Amortization	16,898
447,575	11.9%	3,745,793	Kentucky Chamber of Commerce	9,240
22,809	1.8%	1,259,670	Commerce Lexington	5,862
-	0.0%	207,874	Georgetown-Scott City Chamber of Commerce	1,781
			Other Organizations	7,482
			KY Environment Protect	13,946
average	**17.3%**		**Total**	**55,209**
			Removed KY environment protect	(13,946)
			Total Dues	**41,263**
			Lobbying %	17.3%
			Lobbying	**7,154**
			Dues	**34,109**

Q. Why should customers share in these costs?

A. As I mentioned previously in my testimony, these organizations are often ahead and aware of developing and proposed trends and projects that may impact KAWC's operations. Additionally, KAWC's participation helps ensure we are aligned with regional interests and with civic and community development efforts, resulting in more effective collaboration with regional partners that leads to enhanced quality of life for Kentucky communities.

Q. How should the Commission treat the portion of membership dues identified as lobbying?

A. The small portion of dues attributable to lobbying support policies and initiatives that benefit the Commonwealth's communities and customers. For that reason, KAWC believes that Mr. Defever's recommendation to disallow all membership dues is inappropriate, and KAWC instead recommends that the Commission find that all portions of dues are reasonable costs for recovery.

IV. CONCLUSION

Q. Does this conclude your rebuttal testimony?

A. Yes.

VERIFICATION

STATE OF MISSOURI)
) **SS:**
COUNTY OF ST. LOUIS)

The undersigned, Michi Chao, being duly sworn, deposes and says that she is Principal Regulatory Analyst for American Water Works Service Company, Inc., that she has personal knowledge of the matters set forth in the accompanying testimony for which she is identified as the responsible witness, and that the answers contained therein are true and correct to the best of her information, knowledge and belief.

____
Michi Chao

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 10 day of September, 2025.

Ashley Randell
Notary Public

My Commission Expires:
9/10/2027

ASHLEY RANDELL
Notary Public - Notary Seal
Jefferson County - State of Missouri
Commission Number 19775353
My Commission Expires Sep 10, 2027

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

ELECTRONIC APPLICATION OF KENTUCKY-	**)**	
AMERICAN WATER COMPANY FOR AN	**)**	**CASE NO. 2025-00122**
ADJUSTMENT OF RATES	**)**	

REBUTTAL TESTIMONY OF DOMINIC DEGRAZIA

September 15, 2025

I. Introduction

Q. Please state your name and business address.

A. My name is Dominic J. DeGrazia. My business address is 2300 Richmond Road, Lexington, Kentucky 40502.

Q. Did you previously submit Direct Testimony in this proceeding on behalf of Kentucky-American Water Company ("Kentucky-American," "KAWC" or the "Company") in this proceeding?

A. Yes. I filed Direct Testimony in this proceeding on May 16, 2025.

Q. What is the purpose of your Rebuttal Testimony in this proceeding?

A. The purpose of my Rebuttal Testimony is to:

1. Support the Company's updated total revenue requirement and revenue deficiency;
2. Respond to the Office of the Attorney General of the Commonwealth of Kentucky and Lexington-Fayette Urban County Government ("AG/LFUCG") witness John Defever's proposed revenue requirement adjustments for Rate Case Expense;
3. Respond to the AG/LFUCG witness John Defever's recommended revenue requirement;
4. Respond to the AG/LFUCG witness John Defever's testimony on treatment of QIP;
5. Respond to the AG/LFUCG witness John Defever's testimony on AMI and the Nexus transaction; and
6. Respond to the AG/LFUCG witness Richard Baudino's recommended ROE for QIP.

Q. Are you sponsoring any schedules or exhibits with your Rebuttal Testimony?

A. Yes, I am sponsoring the Exhibit DD-1-Rebuttal attached to my Direct Testimony and the Company's Base Period Update being filed contemporaneously with the Company's rebuttal testimony which includes Exhibit 37 Schedule A through Exhibit 37 Schedule N.

II. KAWC Updated Revenue Requirement

Q. What is the Company's as filed total revenue requirement and revenue deficiency?

A. The Company's proposed revenue requirement, equal to the cost of providing service, is approximately $163.5 million for the forecasted test year, which is the 12 months ending January 31, 2026, as originally filed. The Company's as-filed revenue deficiency is approximately $26.9 million, which is an approximate 19.9 percent deficiency, in water service revenues, net of QIP revenues.

Q. Are there updates to the Company's originally filed total revenue requirement?

A. Yes. The Company's total revenue requirement for the forecasted test year, equal to the cost of providing service, is approximately $163.1 million, as updated in this testimony and the Base Period Update that is being filed contemporaneously with my testimony. The Company's updated revenue deficiency is approximately $27.2 million, which is an approximate 20.0 percent deficiency, in water service revenues, net of QIP revenues. However, KAWC recognizes the originally proposed increase of $26.9 million applies in this case and KAWC is not seeking an increase above that amount. The updated total revenue requirement reflects updates to the following:

1) Present Rate Revenues
2) Fuel & Power
3) Other Customer Accounting
4) Office Supplies & Services
5) Postage, Printing, & Stationary
6) Insurance Other Than Group
7) Rate Base

A summary of the impacts from these updates has been included as the cover page to the Company's Base Period Update being filed contemporaneously with the Company's rebuttal testimony.

Q. Please summarize the update to Present Rate Revenues.

A. The updated total revenue requirement and revenue deficiency reflects a downward adjustment of approximately $686,891 to the Present Rate Revenue in the forecasted test year. This adjustment accounts for the correction of the number of private fire hydrants in the base year and the forecast year, of which corrected amounts are 17,115 and 17,306 respectively (see KAW's response to AG 1-26(j) on this issue).

Q. Please summarize the update to Fuel & Power expense.

A. The updated total revenue requirement and revenue deficiency reflects a downward adjustment of approximately $318,000 to the Fuel and Power Expense in the forecasted test year. Through the discovery process, KAWC identified that the 6.5% escalation was applied to both the base period and the forecasted test year. This compounding effect is a misapplication to KAWC's Fuel and Power Expense (see KAW's response to AG 2-55 on this issue).

Q. Please summarize the update to Other Customer Accounting expense.

A. The updated total revenue requirement and revenue deficiency reflects a downward adjustment of approximately $33,000 to the Other Customer Accounting Expense in the forecasted test year. Through the discovery process, additional analysis was performed, and the Company believes that the 2024 level of expense is a better representation of the forecasted test year (see KAW's response to AG 1-80 on this issue).

Q. Please summarize the update to Office Supplies & Services expense.

A. The updated total revenue requirement and revenue deficiency reflects a downward adjustment of approximately $18,000 to the Office Supplies & Services Expense in the forecasted test year. Through the discovery process, Kentucky-American realized that the normalized adjustment was made in error and removed this amount from the calculation (see KAW's response to PSC 3-20 on this issue).

Q. Please summarize the update to Postage, Printing, & Stationary expense.

A. The updated total revenue requirement and revenue deficiency reflects a downward adjustment of approximately $23,000 to the Postage, Printing, & Stationary Expense in the forecasted test year. Through the discovery process, additional analysis was performed, and the Company believes that the 2024 level of expense, adjusted for a 3-year average of account, 52566016 – Postage – Admin & General, is a better representation of the forecasted test year (see KAW's response to AG 1-151 on this issue).

Q. Please summarize the update to Insurance Other Than Group expense.

A. The updated total revenue requirement and revenue deficiency reflects a downward adjustment of approximately $1,000 to the Insurance Other Than Group Expense in the forecasted test year. KAWC incorrectly allocated Non-Owned Aircraft expense in the actual base period. KAWC has not incurred Non-Owned Aircraft insurance expense in the forecasted portion of the Base Period, nor the Forecasted Test Period (see the attachment to KAW's response to AG 1-120(g) on this issue).

Q. Please summarize the update to Rate Base.

A. The updated proposed revenue requirement and revenue deficiency reflects an upward adjustment of approximately $138,000 to the Deferred taxes as part of rate base in the forecasted test year. Additionally, KAWC has updated cash working capital based on the adjustments that were addressed above in the forecasted test year.

III. AG/LFUCG Proposed Revenue Requirement Adjustments

Q. Did AG/LFUCG propose adjustments for Rate Case expense?

A. Yes. AG/LFUCG recommended two adjustments that reduced the rate case expense by $425,566. The first adjustment recommended the remaining balance of $332,246 from KAWC's 2023 rate case to be amortized over three years. The second adjustment recommends an amortization period of three years versus the two years proposed in the application for rate case expense in the current case.

Q. Do you agree with the adjustments to Rate Case expense?

A. No, I do not agree with either adjustment. Regarding the prior rate case expense balance adjustment, the extension of the amortization of an additional three years would not align with the approved amortization in the prior case. In addition, the unamortized balance from KAWC's 2023 rate case at the start of the 2026 forecasted test year would be $ $359,933. Regarding the recommended three-year amortization for the current case, the timing does not align with the two-year time frame between this application and the prior case.

Q. Did AG/LFUCG recommend the Commission approve only the actual rate case expenses?

A. Yes. AG/LFUCG recommended "that Commission approve only Kentucky-American's actual rate case expenses that are determined to be reasonable and necessary and supported by sufficient evidence, as opposed to the Company's estimated amounts."

Q. Do you agree with the recommendation on rate case expense.

A. No. Although KAWC does not intend to recover more or less than the actual rate case expenses in this proceeding, the relative unknown timing of the expenses and the possibility of rehearing and appeals necessitates the use of the estimated rate case expense as proposed. In addition, KAWC has provided updated actual rate case expense and will continue to show the supported evidence of each expense.

Q. Did AG/LFUCG recommend a revenue requirement based on the rate case expense and other adjustments, including the flow through adjustments?

A. Yes. The total revenue requirement recommended is $141,704,380. This includes $126,609,983 of present rate revenue excluding the roll-in of QIP and the $15,094,397 of a revenue increase excluding the QIP from rate base.

Q. If the AG/LFUCG's adjustments and recommended revenue requirement are adopted in this case, what would be the resulting Rate of Return ("ROR") for KAWC, and why?

A. If the AG/LFUCG's adjustments and recommended revenue requirement are adopted, KAWC's ROR would be 6.74%, which is below the recommended overall rate of return of 7.20% by AG/LFUCG witness Baudino. This is because the AG/LFUCG's proposed adjustments do not take into account that the Company will still incur certain expenses, such as labor expense related to the pay-out of APP and LTPP to employees, regardless of whether the Company is permitted to recover those expenses in this case. Stated another way, adopting the AG/LFUCG's adjustments in their entirety deprives KAWC of the opportunity to earn the AG/LFUCG's recommended 9.5% return on equity (ROE). Exhibit DD-1-Rebuttal, attached to this testimony, illustrates this calculated ROR & ROE. This calculation incorporates the AG/LFUCG's recommended revenue requirement without QIP roll-in plus the present rate revenue of the current QIP, and the expenses as proposed by KAWC, adjusted accordingly for impacts of taxes and fee and interest synchronization. The rate base incorporates the AG/LFUCG's recommended rate base plus the current QIP rate base.

IV. Qualified Infrastructure Program ("QIP")

Q. Did AG/LFUCG recommend what QIP amounts should be excluded from the revenue requirement?

A. Yes. AG/LFUCG witness Defever stated "I recommend using Kentucky-American's alternative revenue requirement calculation that allegedly excludes QIP as the starting point for the Company's overall rate increase request, but also remove the 2026 QIP plant additions from rate base as well as the corresponding revenues and expenses from the forecasted test period." Mr. Defever further stated "Removing some QIP, but not all, may result in less transparency and a greater administrative burden to keep track of and reconcile the different "buckets" of QIP".

Q. Do you agree with the AG/LFUCG's recommendation of the treatment of QIP and the explanations?

A. No. There will be a greater administrative burden if QIP is not reset as stated in the Company's response to AG 2-69, which states:

> KAWC has filed 6 QIP applications along with balancing adjustments since the Commission approved KAWC's QIP in Case No. 2018-00358. As designed, this requires a roll forward and the continued tracking of the QIP projects and the costs of capital, depreciation, expenses and taxes associated with qualified infrastructure investment, in each of the filings to account for and be able to calculate the averaging of the rate base, respective to each filing and time period covered The roll-in of QIP into base rates

> would therefore be a reset of the historical QIP filings and tracking of the filings, which would result in less administrative burden.

In addition, if the QIP charge is not reset, it would continue to represent a significant percentage of a customer's bill. Resetting QIP would result in full cost of service being reflected in base rates. Regarding the exclusion of the forecasted projects that would be QIP eligible, Kentucky American Water assumed the replacement of approximately 15 miles of main in the forecasted period, which is based on the 11-13 miles of main replacement typically approved as part of the QIP plus additional replacement of mains that have not been approved as part of the QIP program to date. This in part addresses the statement LFUCG made in its post-hearing brief in Case No. 2023-00191: "KAWC did not, however, accelerate main replacement under "traditional" ratemaking mechanism but, rather, only did so upon implementation of the QIP." (LFUCG's January 5, 2024 Post-Hearing Brief in Case No. 2023-00191 at 9).

Q. What do you recommend for the treatment of QIP?

A. I recommend the Commission approve the revenue requirement as proposed by the Company in this case which includes the roll-in of QIP.

Q. If the Commission decides against rolling QIP into base rates as KAWC proposes, would the QIP charge as proposed in KAWC's tariff at Sheet 49 in this matter be 0.0%?

A. No. The proposed zero amount for the QIP charge assumes rolling QIP into base rates. If the Commission decides against that, for KAWC to be made whole on its pipeline replacements, the Commission would need to approve a new QIP charge accordingly. The current charge is 11.09%, but that number includes two balancing adjustments that expire at the end of 2025.

Q. Did AG/LFUCG recommend a reduction in ROE for KAWC's QIP?

A. Yes. Mr. Baudino recommended a 10-basis point reduction in its allowed ROE for investments in KAWC's QIP.

Q. Do you agree with AG/LFUCG's recommended reduction in ROE for QIP?

A. No. The KAWC approved tariff at Sheet 48 under the calculation of QIP Program Revenue Requirement states: "c. Return on the net QIP-eligible plant in-service at the overall rate of return on capital authorized in the Company's latest base water rate case, grossed up for federal and state income taxes." Thus, the Commission has already authorized the ROE on QIP rate base to be the same ROE that is set in KAWC's base rate cases. Furthermore, I disagree with the notion that the return is guaranteed, and the timeline of recovery is known and not meaningfully delayed. Despite the balancing adjustment component of the QIP program, the recovery of the actual costs could be delayed by a year or more from the time the costs are incurred, considering the QIP rate is based on authorized but not guaranteed base revenues from the last rate order. Under-collection of costs from prior periods would be subsequently recovered over a future period of time. Please note that Company witness Ann Bulkley also responds to this recommendation on pages 56-57 of her Rebuttal Testimony.

IV. ADVANCED METERING INFRASTRUCTURE ("AMI")

Q. Did AG/LFUCG take a position on KAWC's proposed transition to AMI technology which KAWC has proposed in another Commission proceeding?

A. No, at least not on whether AMI should be approved. However, Mr. Defever stated in testimony, "Unless and until the Commission grants Kentucky-American the CPCN allowing the Company to implement AMI, no AMI amounts should be included in the forecasted test period."

Q. Do you agree with this statement?

A. Yes, and KAWC would only implement AMI if the Company is granted approval for the use of such technology. Furthermore, the forecasted test period in this case includes meter capital expenditures that are agnostic to the type of metering technology utilized, meaning that the capital expenditures presented in this case are not affected by the metering technology implemented by KAWC. (See KAWC's response to PSC 4-7 on this issue).

V. NEXUS MERGER APPLICATION

Q. Did AG/LFUCG recommend that the Company be required to track all merger-related savings to be reviewed in the next rate case.

A. Yes. Mr. Defever's stated in testimony "If the transaction is approved, I recommend that the Company be required to track all merger-related savings to be reviewed in the next rate case."

Q. Do you agree with this recommendation as it pertains to the rate case application?

A. No. The Commission has evaluated the merger and concluded that it is in the public interest and will benefit customers. *See* Case No. 2025-00171 Final Order, p. 10-11 (Sep. 9, 2025). In that Order, it addressed any reporting it wanted to receive as a result of the merger, and it did not conclude that tracking or reporting related to savings was necessary. Since that was the proceeding where the merger was evaluated, and it is not included for consideration in this rate proceeding, no such finding is necessary or appropriate in this proceeding.

VI. CONCLUSION

Q. Does this conclude your rebuttal testimony?

A. Yes.

VERIFICATION

COMMONWEALTH OF KENTUCKY)
) SS:
COUNTY OF FAYETTE)

The undersigned, Dominic DeGrazia, being duly sworn, deposes and says that he is a Senior Manager Rates and Regulatory for Kentucky-American Water Company, that he has personal knowledge of the matters set forth in the accompanying testimony for which he is identified as the responsible witness, and that the answers contained therein are true and correct to the best of his information, knowledge and belief.

Dominic DeGrazia
Dominic DeGrazia

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 11th day of September, 2025.

Molly McCleese Van Over
Notary Public

My Commission Expires:

July 31, 2029
Notary ID:KYNP26988

Kentucky American Water Company
Case No. 2025-00122
ROR Proof

Line No.	Description	KAWC Update Forecast Year at Proposed Rates	Ilustration Forecast Year at AG/LFUCG Recommended Revenue + QIP Revenues @ Present Rates	
1	**Total Operating Revenues**	**$163,084,191**	**$141,704,380**	**AG/LFUCG Recommended Excluding QIP**
2			**$9,949,870**	**QIP Revenues @ Present Rates**
3			**$151,654,250**	**Total Operating Revenues**
4				
5	**Total O&M Expenses**	**$50,756,230**	**$50,278,332**	
6				
7	**Other Expenses**			
8	Depreciation & Amortization	$35,067,695	$35,067,695	
9	State Income Tax	2,474,295	1,939,913	
10	Federal Tax	8,887,467	6,755,284	
11	General Taxes	12,903,143	12,885,381	
12	**Total Other Expense (Sum of Lines 8-11)**	**$59,332,600**	**$56,648,273**	
13				
14	**Total Expenses (Line 5 + 12)**	**$110,088,830**	**$106,926,605**	
15				
16	**Utility Operating Income (Line 1 minus 14)**	**$52,995,361**	**$44,727,645**	
17				
18	**Interest Expense / Other Income/Expense**			
19	Interest Expense	$14,900,732	$14,657,387	
20	Other Income/Expense	202,272	198,969	
21	**Total Other Income/Expense (Line 19 + 20)**	**$15,103,004**	**$14,856,356**	
22				
23	**Net Income (Line 16 minus 21)**	**$37,892,357**	**$29,871,289**	
24				
25	**Rate Base**		**$581,134,007**	**AG/LFUCG Recommended Excluding QIP**
26			**$82,249,891**	**QIP Rate Base**
27		**$674,241,247**	**$663,383,898**	**Total Rate Base**
28				
29	**Equity Weighting**	**52.26%**	**52.26%**	
30				
31	**ROE (Line 23 / (Line 27 * Line 29))**	**10.75%**	**8.62%**	
32				
33	**ROR (Line 16 / 27)**	**7.86%**	**6.74%**	
34				

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. 2025-00122**

REBUTTAL TESTIMONY OF WILLIAM A. LEWIS

September 15, 2025

Table of Contents

I. Introduction

Q. Please state your name and business address.

A. My name is William A. Lewis. My business address is 2300 Richmond Road, Lexington, Kentucky 40502.

Q. Did you previously submit Direct Testimony in this proceeding on behalf of Kentucky-American Water Company, Inc. ("Kentucky-American," "KAWC" or the "Company") in this proceeding?

A. Yes. I filed Direct Testimony in this proceeding on May 16, 2025.

Q. What is the purpose of your Rebuttal Testimony in this proceeding?

A. The purpose of my Rebuttal Testimony is to respond to the Office of the Attorney General of the Commonwealth of Kentucky and Lexington-Fayette Urban County Government ("AG/LFUCG") witness Defever's proposed adjustments to the following operational and maintenance (O&M) expenses:

- Employee Levels
- Employee compensation
- Production costs related to unaccounted for water ("UFW") loss

Q. Are you sponsoring any schedules or exhibits with your Rebuttal Testimony?

A. No.

II. Employee Levels

Q. AG/LFUCG witness Mr. Defever proposes a reduction in labor expense to reduce the revenue requirement based on unfilled employment positions or "vacancies." Do you agree with this proposal?

A. No, I do not. The Company's work must be completed with available resources which consists of full-time employees, overtime, temporary employees or contract employees. KAWC has two methods by which it can present the cost structure to accomplish its work: (1) assume no vacancies and adjust overtime, temporary employee and contractor expenses accordingly; or (2) assume a vacancy rate and include increased expenses for overtime, temporary employee and contractor expenses to complete the work. The Company has chosen the first methodology and has presented its cost structure accordingly. Indeed, Company witness Robert Prendergast, in his Rebuttal Testimony, confirms that the Company did *not* include increased expenses for overtime, temporary employees or contractor expenses when calculating its forecasted labor expense.

Q. Why do you disagree with Mr. Defever's adjustment?

A. Mr. Defever chose only a portion of the second methodology, a reduction for employee vacancies. He did not provide for the corresponding increased overtime, temporary or contract labor costs that would be incurred to accomplish the same level of work, as contemplated by the Company's proposed employee level. Therefore, this proposed reduction is incomplete and insufficient to address the costs required to perform the work.

Q. Has this topic been discussed in prior rate cases?

A. Yes, AG witnesses have proposed similar reductions in prior KAWC rate cases (Case No. 1995-00554, Case No. 2004-00103, Case No. 2010-00036, Case No. 2018-00358, Case

No. 2023-00191) and the Commission has upheld the Company's methodology in each case, recognizing that:

> If vacant employee positions exist, work will either be shifted to other employees and thus result in an increase in overtime costs or Kentucky-American will hire additional temporary/contract labor. Kentucky-American has shown that its forecasts for overtime and temporary/contract labor have been reduced to reflect a full workforce. The vacant employee positions to which the AG refers will result in decreased direct labor costs, but that decrease will be offset by increases in overtime or temporary labor costs.[1]

In Case No. 2018-00358, the Commission stated the following on the employee vacancy issue:

> We are not persuaded by the Attorney General/LFUCG's arguments. They are similar to arguments from the Attorney General that we have rejected in prior Kentucky-American rate proceedings in which we noted that the Attorney General considered only the impact of employee vacancies on Kentucky-American's labor forecast and did not consider the impact of the vacancies on Kentucky-American's overtime and temporary/contract forecast. We continue to adhere to this position. If vacant employee positions exist, work will either be shifted to other employees and thus result in an increase in overtime costs, or Kentucky-American will hire additional temporary/contract labor.[2]

And in Case No. 2023-00191, the Commission again rejected the AG's proposed vacancy adjustment, stating that the AG/LFUCG's adjustment "does not account for an increase in overtime or contractor labor to offset unfilled positions."[3]

Q. Do you believe the Commission should continue to follow its precedent on this issue?

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[1] Case No. 2010-00036, *Application of Kentucky-American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year*, Order, p. 25 (Dec. 14, 2010).

[2] Case No. 2018-00358, *Application of Kentucky-American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year*, Order, p. 39 (June 27, 2019).

[3] Case No. 2023-00191, *Application of Kentucky-American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year*, Order, pp. 15-16 (May 3, 2024).

A. Yes, not only because it is grounded in precedent, but because it is based on the sound principle that, if we are accomplishing our workload with a combination of regular time, overtime, temporary labor and contractors, and we propose a full complement of employees while making a commensurate reduction of overtime, temporary labor or contractors, then Mr. Defever's reduction would have to be accompanied by an increase in overtime, temporary workers and/or contractors.

Q. Does the Company intend to fill its current vacant positions?

A. Yes, the Company intends to fill its current vacancies, and all current vacancies are in active recruitment. Since the Company filed its rate case, the Company has filled five of the 17 vacancies that existed at that time; however, two other positions that were filled at the time the case was filed have since become vacant. The Company has also filled 18 of the 20 new positions the Company has added since its prior rate case. My response to PSC 4-2 provides which of the 20 new positions are now filled and how these new positions will aid the Company in continuing to provide safe and reliable water service to our customers.

III. Employee Compensation

Q. Mr. Defever recommends that the Commission remove 50% of the Company's APP and 70% of the Company's LTPP. What is his basis for proposing to remove these expenses?

A. Mr. Defever concludes that the financial metrics tied to 50% of the Company's APP and to 70% of the Company's LTPP primarily benefit shareholders and not customers, and since shareholders are the primary beneficiaries, they should be responsible for the costs of the performance compensation tied to financial goals.

Q. Did Mr. Defever's testimony correctly account for how the Company's LTPP is structured?

A. Yes. Mr. Defever correctly recognized that 30% of the LTTP was based on restricted stock units ("RSUs"), which as I discussed in my Direct Testimony at page 43, lines 4-9, utilize time-based vesting, meaning they vest in three equal installments over the three-year vesting period. Unlike, performance stock units ("PSUs"), RSUs are awarded based on time in service and not financial metrics.

Q. Do you agree with Mr. Defever's conclusion regarding the use of financial metrics in the Company's APP and LTPP?

A. No, I do not. Mr. Mustich and I presented significant testimony on the benefits that accrue to customers. Mr. Defever simply asserts that shareholders are the primary beneficiaries of financial goals, without addressing the benefits that the Company has supported.

Q. Does Mr. Defever contend the total market-based compensation paid to the Company's employees, including APP and LTPP, is unreasonable?

A. No. Mr. Defever does not claim or present any basis to conclude that the market based total compensation paid to Company employees is unreasonable or otherwise imprudent, nor does he present any testimony that contradicts the testimony Mr. Mustich and I have presented that KAWC's total market-based compensation is a reasonable and necessary cost incurred to serve customers. Mr. Mustich has demonstrated that KAWC employees' total target compensation, which *includes* performance pay, is slightly *below* the market for similarly skilled employees. That finding has not been refuted. As I noted in my Direct Testimony, the Company must be able to attract and retain experienced personnel to help ensure the Company can continue to provide safe and reliable service to customers and total compensation that is near market is a critical component of attracting this talent. The Company's total market-based compensation, including performance pay, is a necessary cost to provide service to customers and therefore, all of it should be recoverable through rates. Performance pay is a variable component of total market-based compensation, not pay made in addition to KAWC employees' reasonable compensation; it must be included to make KAWC employees' total market-based compensation reasonable.

Q. Does Mr. Defever express any other concerns about the Company's performance compensation plan?

A. Yes. Mr. Defever, pages 11 to 12 of his Direct Testimony, points to the fact that every eligible employee received performance compensation between 2020 and 2024 and concludes that because of this, the plan does not incentivize additional effort from employees and therefore customers receive no benefits.

Q. Does the fact that all KAWC employees consistently receive performance compensation negate how employees approach their jobs and performance compensation as Mr. Defever contends?

A. No. First, the fact that employees consistently receive performance compensation goes directly to the important role performance compensation plays in employees' Total Compensation as Mr. Mustich explains on pages 7 and 8 of his Direct Testimony. Simply, receiving performance compensation says nothing about what specific plan goals are met or exceeded or the specific payouts for each goal.

Second, as I stated in my Direct Testimony, performance compensation has varied from year to year based on achievement of targets or exceeding targets, but the organization's performance has resulted in the payment of performance compensation typically equal to or greater than the target level. The specific variances in payouts year by year, and by goal, were provided to Mr. Defever in AG 1-111 (see Confidential Attachment). It is the ability for the payouts for each goal to flex above target and up to 200% that motivates employees to put forth additional effort. Mr. Defever ignores this point.

Q. Please explain how different levels of performance compensation are funded and any important implications.

A. As I stated in my Direct Testimony at 47, lines 13-14, Kentucky-American is only seeking recovery of performance compensation at the target levels. This is the same level that Mr. Mustich incorporated into his assessment that KAWC's Target Total Remuneration is at the low end of the competitive market range. The target levels represent expected performance of KAWC and its employees to continue to provide safe and reliable service at just and reasonable rates. If the Company exceeds the target levels, the incentive costs above target remain with shareholders. It is only in exceeding target levels that performance compensation creates benefits beyond what customers should be expected to pay, as the compensation would exceed the Target Total Remuneration levels assessed by Mr. Mustich.

Q. How would the Company fare in attracting a qualified workforce if APP and LTPP were removed from employee compensation?

A. Mr. Mustich has prepared an analysis demonstrating KAWC's total market-based employee compensation would be far below market without the APP and LTPP levels Mr. Defever contends should not be included in rates. The Company would have a difficult time retaining employees much less attracting new employees at pay levels that are 14% to 16% below market-based compensation for the Midwest and National markets. This is not a theoretical problem. A recent survey of Kentucky's water and wastewater workforce published in the July/August 2023 edition of the American Water Works Journal identified significant gaps in qualified employees in the Bluegrass State and noted that pay gaps was a driver.[4]

Q. Would Mr. Defever's recommendation to remove APP and LTPP from recoverable costs be impacted if the Company changed its compensation structure?

A. I think so, yes. As I discussed in my Direct Testimony at 44, lines 12-22 to 45, lines 1-3, if the Company included the disputed portion of compensation in employees' fixed base pay rather than awarding it through the variable APP and LTPP components, it appears Mr. Defever would not be proposing to adjust the amount the Company has forecasted as the appropriate level of market-based compensation to be recovered from customers. Mr. Defever does not dispute the Company's demonstration that its total market-based employee compensation, including the portion embedded in performance pay, is reasonable and prudent. Mr. Defever only disputes the manner in which the Company pays part of the compensation. Changing the manner of compensating employees to remove the disputed method (APP and LTPP) and placing all of the compensation in fixed base pay should result in recovering one hundred percent (100%) of the higher base pay in the revenue requirement. However, making this adjustment would not be in the long-term interest of our customers because it would remove the strong incentive APP and LTPP provide employees to proactively work towards efficiency. The Company's performance compensation goals would only focus on operational goals without the counter-balancing

[4] The July/August 2023 edition of the American Water Works Journal is available athttps://awwa.onlinelibrary.wiley.com/toc/15518833/2023/115/6.

goals of managing KAWC's financial performance. In my experience, the APP and LTPP metrics focus employees on managing the business more efficiently.

Q. Mr. Defever contends that the portion of the APP and LTPP he proposes to remove does not provide measurable benefits to customers. Are there measurable customer benefits that accrue from LTPP and the financial components of the APP?

A. Yes. Measurable customer benefits accrue to customers from appropriately aligning employees' interests with pursuing financial results for the Company in line with market expectations. For operational examples of initiatives that improve the Company's financial performance by improving or mitigating against increasing operational costs, please see the Direct Testimony of Company witness John Magner, specifically pages 15-17, for his discussion of the Millersburg Transmission Main project, placed into service in February 2025, which improves water supply to Millersburg while reducing operational costs; pages 17-18 for his discussion of the KRS1 Project, which is a project KAWC undertook not only to improve residual handling at this water treatment plant but also to address the increased operational costs associated with treatment at this plant; and also pages 22-23, where he discusses the KRS1 Pump Replacements project which is a project to replace pumps and associated motors to reduce operational costs. I note that these are just a few of KAWC's operational initiatives identified in Mr. Magner's Direct Testimony that improve the Company's financial performance and thus benefit customers.

Another example is in financing executed by the Company. KAWC and its affiliates must raise capital on a regular basis to fund the capital improvements critical to maintaining adequate and safe service. Rising interest rates have required the Company to think creatively about ways to manage the interest rates, both for the financial health of the

Company and to help achieve lower costs for customers. This incentive to maximize the financial health of the Company resulted in our treasury group exploring alternatives to long-term financing that resulted in American Water Capital Corp. issuing exchangeable notes with a lower rate. Indicative new issue pricing for a 10-year or 30-year bond would have required a higher annual fee. Customers will directly benefit from these lower financing costs.

Company witness Jennifer Gonzales, testified to the "direct link between a utility delivering predictable financial results and maintaining solid credit ratings" and that "[r]atings agencies consider an entity's financial results both as a qualitative and a quantitative measure in establishing a company's credit rating." Gonzales Direct, p. 10. As I explain in my Direct Testimony, this is why it is important to focus utility employees on the financial health of the organization: a financially healthy utility benefits customers because it enables the utility to meet its service obligations at reasonable financing costs.[5] Mr. Mustich makes clear the importance of financial goals in managing any organization, when he highlights "many privately held companies, and even mission based not-for-profit organizations, incorporate financial goals in their performance pay programs to send the message to employees that financial efficiency and viability are essential to operational success, and to delivering on customer objectives and expectations." Mustich Rebuttal, page 4, lines 6-12.

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[5] The Commission has recognized that it must balance the interests of customers and investors. *Columbia Gas of Kentucky, Inc.*, Case No. 10498, 1989 WL 418512 (Ky. PSC 10/6/98). The financial component of APP and LTPP presents a straight-forward path to achieving a win-win in this balance. A result that benefits both is good for the state of Kentucky, both because customers served within the state by KAWC realize the benefits of efficiencies and because residents who invest in the Company, such as the Kentucky Public Pension Authority, benefit from returns consist with market expectations. See Kentucky Public Pension Authority Investments, https://www.kyret.ky.gov/Investments/Investments%20Holdings/KTYALL%20Holdings%20as%20of%2030%20June%202025.pdf.

As I explained in my Direct Testimony, the financial measures of APP and LTPP serve to align the interests of our customers, employees and investors. In order to achieve financial performance pay goals, such as targeted earnings per share ("EPS") performance, employees must continuously work to maintain and improve operating efficiency. This has and will continue to result in tangible and material cost savings that would otherwise be incurred by customers. The financial components of APP and LTPP incentivize KAWC employees to identify these savings opportunities because controlling operating costs is essential to achieving a targeted EPS, and helping to maintain the affordability of our service for our customers. The benefits to customers are measurable and significant.

Q. Is it appropriate to justify the costs of the financial components of APP and LTPP by comparing them to the savings and efficiencies customers derive?

A. No. First, looking at the APP and LTPP financial components simply as a cost to be balanced against savings that inure to customers is inappropriate because the APP/LTPP cost is not incremental to the reasonable expense KAWC must incur to fairly compensate employees. As I explained above and noted in my Direct Testimony, the appropriate and reasonable expense KAWC incurs to compensate employees is the total amount of market-based compensation, including the component of APP and LTPP related to financial metrics. Conditioning a portion of the expense we must incur to operate the business in a financially responsible manner is a prudent way of aligning employee interests with our customers.

Second, efforts to quantify many of the benefits derived from incentivizing employees to operate the business in a financially responsible manner would be challenging, although such benefits clearly exist. Every time KAWC secures goods or services, employees are expected and incentivized to make the most efficient decision. The incentive derives from the financial component of the APP and LTPP and each decision adds up to a material amount of benefits for customers. Employees regularly make these decisions but capturing and quantifying all of them would be impractical.

Q. Are there other benefits of LTPP that provide tangible benefits to customers?

A. Yes. The LTPP reduces attrition among employees that receive it by incentivizing them to remain with the organization. Because stock-based compensation vests on a phased basis in three installments over a prospective three-year period, employees must remain with the organization to realize the vesting of their awards. The Company provides LTPP primarily to leadership level employees. Maintaining leadership level employees' benefits customers by retaining experienced, high quality employees that understand the Company and the initiatives that support the Company's ability to continue to provide safe, reliable, and affordable service.

Q. Why is KAWC proposing to recover its full APP and LTPP notwithstanding the Commission's findings in the Company's last rate case?

A. The testimony provided in this proceeding demonstrates the direct, tangible and meaningful benefits that customers receive from encouraging employees to operate the business efficiently to help achieve APP and LTPP goals (including financial metrics) negates the Commission's concerns that customers receive "little benefits" from these measures. Refusing to allow recovery of a portion of total market-based employee compensation, merely because it is used to incentivize activity that promotes efficiency by employees, inappropriately renders costs that are necessary to serve the best interest of our customers unrecoverable.

Q. Why is it inappropriate to disallow recovery of total market-based employee compensation that has been shown to be reasonable?

A. Employee compensation is a necessary cost of providing utility service. Therefore, it should be assessed under the same lens as other necessary operating costs: if a utility prudently incurs reasonable compensation costs, relative to what the industry pays for the same services, it should be permitted to recover all of those costs through rates. So, the Commission should rightly be concerned when total market-based employee compensation is too high, which may unreasonably increase rates, and when employee compensation is too low, which may impact service to customers. The Commission's focus should be on the reasonableness of the Company's overall level of total compensation, giving management the discretion to design the compensation package that is best structured to compensate employees properly and to motivate efficiency, safety, courtesy and other valuable employee traits. If the Company's overall compensation level is reasonable, because it is in line with or below the market, regardless of the combination of fixed and variable payments that the employees earn, then, by definition, the Company's overall compensation expense is reasonable and prudently incurred and should be recoverable. As noted above, Mr. Defever does not dispute the reasonableness of the Company's overall compensation package. Accordingly, it is inappropriate to disallow a component of that cost simply because it does not align with his view of how employee compensation should be structured.

IV. Unaccounted For Water Loss

Q. AG/LFUCG witness Mr. Defever proposes a reduction to purchased water, waste disposal, chemical, and fuel and power expenses for unaccounted for water ("UFW") loss above 15 percent. Please respond.

A. While I do not oppose an adjustment being made to these cost categories for UFW loss above 15%, as the Company did not request an alternative level of UFW loss be adopted by the Commission in this case, I do disagree with the UFW loss percentage Mr. Defever used to calculate the adjustment.

Q. Please explain why you disagree with the UFW loss percentage Mr. Defever used to calculate the adjustment to be applied to purchased water, waste disposal, chemical, and fuel and power expenses.

A. In calculating his adjustment to these expenses, Mr. Defever has incorrectly used the Company's non-revenue water ("NRW") percentage for the "Forecasted Test Period" instead of unaccounted for water (UFW). This can be seen in the table he reproduced on page 16 of his testimony. While the table accurately reflects KAWC's annual UFW percentages from 2016-2024, the last line of the table "Forecasted Test Period" reflects an UFW percentage of 18.40%, which is incorrect. The 18.40% is actually the NRW percentage KAWC assigned to the forecasted test year. In accordance with 807 KAR 5:006, Section 6(3), *unaccounted for water loss* shall not exceed 15% of total water produced and purchased, excluding water used by a utility in its own operations. UFW loss and NRW are not the same and NRW cannot be substituted for UFW.

Q. Please explain why NRW cannot be substituted for UFW.

A. Below is a recent example of the monthly Water Loss Report KAWC submits to the Commission. This report illustrates how UFW (water loss) is calculated and reported to the Commission each month. As seen below, NRW is equal to water produced and purchased, minus water sold. UFW is equal to NRW minus other water used.

PUBLIC SERVICE COMMISSION

Monthly Water Loss Report

Water Utility: Kentucky American Water - Total Company

For the Month of: July Year: 2025

LINE #	ITEM	GALLONS (Omit 000's)
1	**WATER PRODUCED AND PURCHASED**	
2	Water Produced	1,494,633
3	Water Purchased	10,997
4	**TOTAL PRODUCED AND PURCHASED**	1,505,630
5		
6	**WATER SALES**	
7	Residential	572,807
8	Commercial	394,933
9	Industrial	88,844
10	Bulk Loading Stations	515
11	Wholesale	43,308
12	Public Authorities	114,012
13	Other Sales (explain) Fire Service Usage (Not Fire Dept)	778
14	**TOTAL WATER SALES**	1,215,197
15		
16	**OTHER WATER USED**	
17	Utility and/or Water Treatment Plant	444
18	Wastewater Plant	423
19	System Flushing	5,522
20	Fire Department	35
21	Other Usage (explain) Street Cleaning and other donated water	-
22	**TOTAL OTHER WATER USED**	6,424
23		
24	**WATER LOSS**	
25	Tank Overflows	-
26	Line Breaks	7,938
27	Line Leaks	-
28	Excavation Damages	-
29	Theft	77
30	Other Loss	275,994
31	**TOTAL WATER LOSS**	284,009
32		
33	**Note**: Line 14 + Line 22 + Line 31 **MUST** Equal Line 4	
34		
35	**WATER LOSS PERCENTAGE**	
36	(Line 31 divided by Line 4)	18.86%

Q. Did Mr. Defever use NRW instead of UFW anywhere else in his adjustment for unaccounted for water?

A. Yes, on page 17, lines 5-10 of Mr. Defever's testimony, Mr. Defever again incorrectly interchanges the convention of NRW and UFW. Specifically, he states that he "calculated the unaccounted-for water percentage appliable to the forecast test period by dividing the *non-revenue water gallons* by the system delivery gallons." Defever Direct. P. 17, lines 5-6 (emphasis added). Dividing the non-revenue water gallons by the system delivery gallons will result in a NRW percentage, NOT an UFW percentage. As a result of Mr. Defever's error, his calculated adjustment to forecasted test year water production expenses that exceed the 15% threshold is also incorrect. UFW will always be less than NRW and as such, the calculated adjustment for UFW in excess of the 15% threshold will be less than the 3.40% calculated by Mr. Defever.

Q. What is the appropriate UFW percentage to apply to the forecasted test year?

A. Using the table of historical NRW and UFW percentages found on page 32 of my testimony, and using a nine-year average variance between NRW and UFW, the forecasted test year UFW should be 17.24%. Table 1, below, illustrates how the nine-year average was produced and Table 2, also below, demonstrates how the nine-year average was used to calculate the UFW percentage for the forecasted test year.

Table 1

NRW/UFW 20216-2024			
Year	**NRW**	**UFW**	**Var**
2016	16.80%	15.69%	1.11%
2017	19.80%	18.86%	0.94%
2018	21.15%	19.95%	1.20%
2019	22.79%	21.10%	1.69%
2020	21.62%	20.47%	1.15%
2021	22.08%	21.08%	1.00%
2022	22.67%	21.59%	1.08%
2023	19.68%	18.83%	0.85%
2024	19.38%	17.96%	1.42%
		Average	1.16%

Table 2

Projected Test Year UFW	
Test Year NRW =	18.40%
Ave. 9 Yr. Variance (NRW/UFW	1.16%
Test Year UFW =	***17.24%***
PSC UFW Threshold =	15.00%
Test Year UFW % Reduction =	***2.24%***

This results in a forecasted exceedance of the 15% threshold of 2.24%. Please reference Mr. Prendergast's rebuttal testimony for the correct production cost adjustment related to UFW.

V. Conclusion

Q. Does this conclude your rebuttal testimony?

A. Yes.

VERIFICATION

COMMONWEALTH OF KENTUCKY)
) SS:
COUNTY OF FAYETTE)

The undersigned, William Andy Lewis, being duly sworn, deposes and says that he is the Vice President of Operations for Kentucky-American Water Company, that he has personal knowledge of the matters set forth in the accompanying testimony for which he is identified as the responsible witness, and that the answers contained therein are true and correct to the best of his information, knowledge and belief.

____
William A. Lewis

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 11th day of September, 2025.

Molly McCleese Van Over
____
Notary Public

My Commission Expires:
July 31, 2029
____
Notary ID: KYNP26988

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

ELECTRONIC APPLICATION OF KENTUCKY-	**)**	
AMERICAN WATER COMPANY FOR AN	**)**	**CASE NO. 2025-00122**
ADJUSTMENT OF RATES	**)**	

REBUTTAL TESTIMONY OF ROBERT V. MUSTICH

September 15, 2025

Q. Please state your name and business address.

A. My name is Robert V. Mustich. I am Managing Director and East Region Work and Rewards Business Leader for WTW ("WTW"). WTW is a leading global professional services company which has 45,000 associates throughout the world and offers solutions in the areas of corporate risk and broking; human capital and benefits; health care exchange solutions; and investment, risk, and reinsurance. My business address is 800 North Glebe Road, Arlington, VA 22203.

Q. Did you previously submit Direct Testimony in this proceeding on behalf of Kentucky-American Water Company ("Kentucky-American," "KAWC" or the "Company") in this proceeding?

A. Yes. I filed Direct Testimony in this proceeding on May 16, 2025.

Q. On whose behalf are you submitting this testimony?

A. Kentucky-American, a wholly-owned subsidiary of American Water Works Company Inc. ("American Water").

Q. What is the purpose of your Rebuttal Testimony in this proceeding?

A. The purpose of my testimony is to rebut John Defever's testimony on behalf of Office of the Attorney General of the Commonwealth of Kentucky ("OAG") and the Lexington-Fayette Urban County Government ("LFUCG") and demonstrate that his arguments against recovery of 50% of the Annual Performance Plan ("APP") and 70% of the Long-term Performance Plan ("LTPP") because they are aligned to financial goals are inconsistent with providing reasonable and effective employee compensation programs that serve as management tools to drive positive customer outcomes. Mr. Defever's testimony suggests that the APP does not incentivize improved performance, which reflects a fundamental misunderstanding of how the plans are structured and intended to operate. In addition, he recommends disallowing recovery of the discounts the Employee Stock Purchase Program ("ESPP") provides to employees who participate in the plan and disallowing some recovery of healthcare expense.

KAWC'S EMPLOYEE PERFORMANCE COMPENSATION

Q. Does Mr. Defever provide reasons for his recommendation to reduce recovery of APP and LTPP?

A. Yes, he believes that the portion of the Company's APP and LTPP aligned to financial goals primarily benefits the Company's shareholders, not customers. He argues that shareholders are the primary beneficiaries of financial goals, and therefore, they should be responsible for the costs of the performance compensation tied to the financial goals.

Q. Mr. Mustich, are you familiar with the practices of industry, generally, and public utility companies in particular, with respect to performance-based compensation?

A. Yes, I am.

Q. With respect to the utilities industry and industry in general, is it common for businesses across America to have in place performance-based compensation plans similar to KAWC's APP and LTPP?

A. Yes, it is. Based on WTW's study referenced in my direct testimony and my personal experience working with hundreds of companies and WTW advising thousands of companies annually, the vast majority of companies have APPs that use financial and non-financial metrics and have LTPPs that use, to some extent, financial and/or relative total shareholder return metrics. Consequently, it is safe to say that the performance-based compensation plans that KAWC maintains are consistent with the practice followed by a vast amount of corporations in American business.

Q. Generally, what is the purpose of such performance-based compensation plans?

A. With respect to plans such as the APP, the purpose is to attract and retain a performance-oriented workforce that provides tangible financial incentives in the form of variable performance based compensation to drive productivity, efficiency and other desirable goals (such as safety, environmental compliance, customer satisfaction, etc.) that management deems important to conducting a successful business. These plans send powerful messages to employees because their compensation is contingent on these important customer-oriented goals. In the case of the LTPP-type metrics, the goal is to reduce the costs and disruptions associated with employee turnover by providing incentives to remain with the company and improve company performance. As noted, both of these types of plans are quite common in American business and are time-tested and successful ways to increase productivity, efficiency, and employee performance while reducing the costs and inefficiencies of employee turnover. In addition, employees expect to participate in such plans since they are widely prevalent and the absence of them would make KAWC less competitive from a talent attraction perspective.

Q. Does Mr. Defever's testimony suggest that customers and shareholders have competing interests when financial metrics are in performance plans?

A. Yes, he does.

Q. How does he suggest this?

A. He recommends that the expenses related to financial goals primarily benefit shareholders and that related performance plan expenses be allocated to shareholders

Q. What is wrong with Mr. Defever's recommendations?

A. He does not recognize that including financial goals in performance compensation programs, like the approach that KAWC takes, reflects the interdependence of a company's financial performance with its operational success. Strong financial performance enables the Company to invest in resources—both people and infrastructure—that helps ensure the efficient operation of the Company, which ultimately benefits customers. Incorporating financial goals in performance plans is common across all types of organizations, even those that are not publicly traded, or owned by publicly traded parent companies, as KAWC is. In fact, many privately held companies, and even mission based not-for-profit organizations, incorporate financial goals in their performance pay programs to send the message to employees that financial efficiency and viability are essential to operational success, and to delivering on customer objectives and expectations.

Q. Mr. Defever references the Commission precedent of disallowing performance compensation aligned to financial goals as further justification for disallowing them. Are you aware of Utility Commissions and/or regulatory bodies changing their views regarding disallowing recovery of the financial goals portion of performance plans?

A. Yes. I have two recent examples. In 2015, the Public Service Commission of West Virginia acknowledged in a rate case filed by West Virginia-American Water Company that "[Annual Performance Plans] that tie some portion of an employee's compensation to an employee's actual performance are prevalent in the compensation packages for larger businesses and [have] become the 'norm' for major utility companies."[1] The Public Service Commission of West Virginia further agreed that "the [Annual Performance Plan]

[1] *Final Order*, p. 48-49, Public Service Comm'n of West Virginia, Case No. 15-0675-S-42T (Feb. 24, 2016).

is an integral part of the overall compensation plan of [West Virginia-American Water Company] and that the total compensation (the combination of base pay and incentive pay) to eligible employees is intended to place that total compensation at or near the market rate for each particular job or salary band."[2]] In that 2015 case, the Commission also approved a portion of the company's long-term performance plan costs.[3]

In 2021, the Public Service Commission of West Virginia went further in allowing 100% of the demonstrated long-term performance compensation in its revenue requirements after concluding that "[i]t is not reasonable to pick one expense and arbitrarily eliminate it or reduce it by 50% because it indirectly benefits shareholders."[4] This was reaffirmed by the Public Service Commission of West Virginia in 2023.[5]

As a second example, Gas Utility Regulatory Act ("GURA") § 104.060[6] was enacted in Texas in 2019, which established a specific framework that regulatory authorities must use to evaluate the reasonableness and necessity of employee compensation and benefits expenses in a gas utility rate case. The plain text of GURA § 104.060 provides that the regulatory authority "shall presume that employee compensation and benefits expenses are reasonable and necessary if the expenses are consistent with market compensation studies issued not earlier than three years before the initiation of the proceeding to establish the rates." GURA § 104.060 defines "employee compensation and benefits" to include base salaries, wages, incentive compensation, and benefits. There are certain items, not included in the term of compensation and benefits, but overall total

[2] *Id.* at 49.
[3] *Id.* at 51.
[4] *Final Order*, p. 40, Public Service Comm'n of West Virginia, Case No. 21-0369-W-42T (Feb. 24, 2022).
[5] *See Final Order*, p. 31, Public Service Comm'n of West Virginia, Case No. 23-0383-W-42T (Feb. 23, 2024).
[6] Texas Utilities Code § 104.060

compensation (base salary, APP, LTPP and benefits) at a utility for the vast majority of its employees is fully recoverable provided it is competitively reasonable and consistent with peers, as determined through recent market studies. The WTW study of KAWC attached to my direct testimony is a recent market study.

Q. Mr. Defever states that the APP is ineffective because for the years 2020 through 2024, all eligible employees received performance compensation and by definition, the performance plan should create motivation for employees to provide extra effort. He asserts the plan is more like a bonus and there is not incentive to improve performance which would benefit ratepayers. Do you agree with Mr. Defever's assessment?

A. I do not. KAWC's APP is consistent with the design of similar utilities' performance plans. The payout range is 0% to 200% of target incentive. KAWC's APP payouts for the years 2020 to 2024 ranged from 106% of target to 157% of target. As explained by Company witness William A. Lewis, the Company only is seeking recovery at 100% of target levels, and if the Company exceeds the target levels, the Company will not seek recovery of the incentive costs above target. With the APP having the ability to payout up to 200% of target incentive, I would strongly argue that the plan provides incentive and motivation for employees to exceed performance expectations.

Q. If KAWC employees did not receive their performance pay, how would it affect their compensation?

A. If KAWC employees didn't receive their performance pay, or even a portion of it, they would receive compensation that is well below reasonable and competitive levels of market median total remuneration as shown in the table below:

Table 1

Kentucky American Water Less Performance Pay (APP & LTPP) versus Market Median				
Perspective	Base Salary	Target Total Cash Compensation	Target Total Direct Compensation	Target Total Remuneration
National	-9%	-16%	-18%	-15%
Midwest	-7%	-14%	-17%	-13%

KAWC'S EMPLOYEE STOCK PURCHASE PLAN

Q. In addition to Mr. Defever recommendations on performance pay, he recommends that discounts for the Employee Stock Purchase Plan be removed because they do not benefit the Company's ratepayers and excluding them is consistent with Commission precedent. Do you agree with Mr. Defever's recommendation?

A. I do not. From a total remuneration standpoint, as shown in table 2 below, with the ESPP included, total remuneration is still at the low end of the competitive median range.

Table 2

Kentucky American Water versus Market Median				
Perspective	Base Salary	Target Total Cash Compensation	Target Total Direct Compensation	Target Total Remuneration
National	-9%	-8%	-10%	-9%
Midwest	-7%	-5%	-8%	-7%

As with Mr. Defever's recommendations regarding performance pay, he wants to arbitrarily exclude the ESPP because he feels it does not benefit customers. Offering compensation and benefits programs that provide reasonable and competitive total remuneration is essential to attracting and retaining qualified employees. A skilled and motivated workforce is critical to delivering high-quality services, which directly benefits customers by helping ensure reliability, efficiency, and innovation in operations. Furthermore, for companies that offer an ESPP, a discount provision is a prevalent plan feature. According to data from WTW Benefits Data Source, 86% of companies that provide an ESPP offer an employee discount. For a relatively low cost, and as part of the total remuneration program that is at the low end of the competitive median range, the ESPP can be a very efficient benefit to support the attraction and retention of a qualified workforce.

KAWC'S EMPLOYEE HEALTHCARE EXPENSE

Q. Does Mr. Defever provide reasons for his recommendation to reduce recovery of health care costs?

A. Yes, he believes to the extent that KAWC health care costs exceed the Bureau of Labor Statics health care cost averages, that excess should be removed from the forecasted test period.

Q. Do you agree with Mr. Defever's recommendations?

A. No. The study performed by WTW using our BenVal model is more relevant than the BLS survey as it measures KAWC benefits against other utility companies. Our analysis supported by our BenVal study shows that the American Water employer subsidized portion of the healthcare plan is on par with competitors. The employer supported value as a percentage of pay is 14.25% for American Water and 14.57% for the energy industry.

When medical and dental are combined, the employer supported value as a percent of pay is 15.11% for American Water compared to 15.21% for the energy industry. Therefore, I do not agree with Mr. Defever.

CONCLUSION

Q. Does this conclude your rebuttal testimony?

A. Yes.

VERIFICATION

COMMONWEALTH OF VIRGINIA)) SS: COUNTY OF ARLINGTON)

The undersigned, Robert V. Mustich, being duly sworn, deposes and says that he is Managing Director and East Region Work and Rewards Business Leader for WTW, that he has personal knowledge of the matters set forth in the accompanying testimony for which he is identified as the responsible witness, and that the answers contained therein are true and correct to the best of his information, knowledge and belief.

Robert V. Mustich

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 10th day of September, 2025.

Notary Public

My Commission Expires:

11/30/2025

DAVID J. REINER
NOTARY PUBLIC
REG # 7717674
MY COMMISSION EXPIRES 11/30/2025
COMMONWEALTH OF VIRGINIA

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

ELECTRONIC APPLICATION OF KENTUCKY-	**)**	
AMERICAN WATER COMPANY FOR AN	**)**	**CASE NO. 2025-00122**
ADJUSTMENT OF RATES	**)**	

REBUTTAL TESTIMONY OF ROBERT PRENDERGAST

September 15, 2025

TABLE OF CONTENTS

I. Introduction

Q. Please state your name and business address.

A. My name is Robert Prendergast. My business address is 1 Water Street, Camden, NJ 08102.

Q. Did you previously submit Direct Testimony in this proceeding on behalf of Kentucky-American Water Company ("Kentucky-American," "KAWC" or the "Company") in this proceeding?

A. Yes. I filed Direct Testimony in this proceeding on May 16, 2025.

Q. What is the purpose of your Rebuttal Testimony in this proceeding?

A. The purpose of my Rebuttal Testimony is to respond to the Office of the Attorney General of the Commonwealth of Kentucky and Lexington-Fayette Urban County Government ("AG/LFUCG") witness Defever's proposed revenue requirement adjustments for:

- Labor Vacancies
- Other Benefits Expense: Employee Stock Purchase Program ("ESPP") and 401(k) Expense
- Unaccounted for water
- Support Services Business Development
- KAWC O&M Growth Factor
- Group Insurance

Q. Are you sponsoring any schedules or exhibits with your Rebuttal Testimony?

A. No.

II. Labor Vacancies

Q. What recommendation has Mr. Defever made to KAWC's payroll expense?

A. Mr. Defever recommends making a 3.6% adjustment to the Company's direct and allocated payroll expense based on information provided in response to PSC First Set, question 28. This reduction of $610,390 to payroll expense also makes corresponding adjustments to benefits expense and payroll taxes in the amounts of $127,819 and $179,556, respectively.

Q. Do you agree with these adjustments?

A. No, I do not. As Company witness Lewis explains, the vacancy adjustment is inappropriate, particularly without any corresponding upwards adjustment to overtime and/or contract services. For example, the Company is projecting 29,637 overtime hours in this case per Exhibit 37, Schedule G-2, even though there were 34,518 overtime hours during the base period, 29,794 overtime hours in 2024, and 33,172 overtime hours in 2023. Moreover, Mr. Defever improperly includes Service Company payroll expense in his vacancy adjustment calculation, while utilizing KAWC-specific headcount data. In addition, Mr. Defever's calculation of the 3.6% adjustment to the Company's payroll expense is inaccurate. Because his adjustment utilizes the 3.6% vacancy rate, which is specific to KAWC and is not applicable to Service Company, Mr. Defever has artificially inflated his proposed adjustment.

Q. Should Mr. Defever include Service Company payroll expense in the calculation of a vacancy adjustment?

A. No. As I mention above, the inclusion of Service Company in Mr. Defever's vacancy adjustment is not accurate. Mr. Defever adjusts Service Company payroll expense by a 3.6% vacancy rate which is specific to KAWC's historic to actual employee count. Mr.

Defever applies the same 3.6% vacancy factor to $7.4 million that was billed from Support Services to KAWC without any reasoning for the adjustment or data that would justify an adjustment to Support Services payroll expense. Furthermore, Mr. Defever ignores Company Witness Michael Adams's Direct Testimony (Page 7-8) which states that Support Services has saved KAWC more than $5.4 million in managerial and professional services from the work completed by shared services personnel. The Commission should reject Mr. Defever's adjustment to Support Services payroll expense as it is unreasonable, inaccurate, and blindly applies an unrelated adjustment to the payroll expense billed to KAWC by Support Services.

Q. What errors arise from Mr. Defever's calculation of payroll adjustments?

A. Mr. Defever calculates the payroll expense adjustments for vacancies and APP/ LTPP as if these two adjustments are independent and do not impact each other, when they in fact affect the same underlying expense. Mr. Defever applies the 3.6% vacancy percentage to the Company's overall payroll expense of $16,955,288, while also proposing to remove 50% of APP and 70% of LTPP. If accepted, this adjustment would reduce the total payroll expense by $1,846,693.[1] The lower payroll amount would, in turn, reduce the vacancy adjustment by $66,481. By failing to account for the interactions between the APP/LTPP and vacancy adjustments, Mr. Defever overstates the vacancy adjustment itself and the overall impact on the KAWC's payroll expense.

Q. How should the Commission address Mr. Defever's vacancy adjustment?

A. The Commission should reject Mr. Defever's vacancy adjustment. Mr. Defever's vacancy adjustment fails to provide a corresponding upwards adjustment to overtime or contracted

[1] KAWC's response to AG DR 1-40.

services for the implied vacancies calculated by his adjustment. Further, Mr. Defever's calculation of his vacancy adjustment is incorrect because he misapplies his vacancy factor to Support Services payroll expense and also overstates the impact of his APP & LTPP adjustments which in turn, inflates the impact on KAWC's overall payroll expense. Accordingly, both Mr. Defever's payroll vacancy adjustment and corresponding adjustments to benefits expense and payroll taxes should be denied.

Q. If the Commission rejects Defever's 3.6% vacancy adjustment, should it adopt his alternative position asserting that a 6.5% reduction to payroll is warranted?[2]

A. No. Mr. Defever's alternative recommendation should also be rejected. First, while Mr. Defever claims that a 6.5% reduction to payroll is warranted, his own calculation of the budget to actual variance uses only a 6.05% variance.[3] More importantly, the KAWC labor expense was not calculated using budget data, but was calculated on an position-by-position basis using the expected 2026 headcount supported by Company Witness Lewis.[4] Because the payroll calculation is based on projected headcount rather than budget assumptions, Mr. Defever's proposed adjustment does not reflect how the Company's labor expense was actually developed, therefore is inappropriate because he seeks to apply a reduction to payroll expense based on arbitrary data that does not pertain to the calculation of KAWC labor expense.

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[2] Direct Testimony of John Defever, CPA, p. 9, lines 13-15.
[3] *Id*. at p. 7.
[4] Direct Testimony of Robert J. Prendergast p. 4, lines 5-6 ; Direct Testimony of Witness William A. Lewis, p. 35.

III. Other Benefits Expense: Employee Stock Purchase Program ("ESPP") and 401(k) Expense

Q. What recommendations have Mr. Defever made regarding Other Benefits Expense?

A. Mr. Defever has proposed to remove: (1) $61,961 related to ESPP program expenses, and (2) $40,950 related to 401(k) expenses for employees that are also covered under a defined benefit plan.

A. ESPP Expense

Q. What does Mr. Defever say in support of his recommendation to remove the ESPP expense?

A. Mr. Defever states that the ESPP employee benefit "does not benefit the Company's ratepayers" citing a prior Commission decision in support of his position.[5]

Q. Do you agree with Mr. Defever's recommended adjustment to remove the ESPP program expense from the Company's test year?

A. No, I do not. The ESPP is a valuable benefit to KAWC's employees, and Mr. Defever highlights that 26% of KAWC's 150 eligible employees choose to participate.[6] Through ESPP, employees gain a stake in American Water, and by extension KAWC, and have a vested interest in KAWC's success.

As identified by Company witness Robert Mustich, the ESPP is part of his Target Total Remuneration analysis.[7] Mr. Mustich shows that KAWC's Total Remuneration to its employees is 9% below the national market median and 7% below the Mid-West regional

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[5] Defever Direct at 14, line 1 to 6 , lines 16 to 18.
[6] *Id*. at 13, line 4 to 8, citing Kentucky-American's response to the Attorney General's First Request, No. 49; Kentucky-American's response to the Attorney General's Second Request, No. 44.
[7] Direct Testimony of Robert Mustich, p. 3, lines 7-9

market median.[8] KAWC's ESPP is utilized by 26% of KAWC employees and contributes to keeping their Total Remuneration closer, but still well below the median levels of companies KAWC competes with to recruit and retain employees.

ESPP as a non-base pay form of employee compensation is an efficient and cost effective way for customers to compensate KAWC employees. The ESPP discount is only available to employees while they are employed with KAWC, making it an effective retention tool for the Company. In addition, because individuals retain their stock after leaving the Company, the ESPP helps retain former employees' interest in KAWC's continued success.

B. 401k Expense associated with Pension Wind-Down

Q. Does Mr. Defever address KAWC's 401(k) expense associated with its Pension-Wind Down?

A. Yes. Mr. Defever's recommends an adjustment for the disallowance of 401(k) expense for Kentucky-American and Service Company allocated employees who also participate in the Company's defined benefit retirement plan (i.e., "Pension" or "DBP") in the amount of $40,950.

Q. Do you agree with Mr. Defever's recommended adjustment to 401(k) expense for the Company's test year?

A. No, I do not. The Company disagrees with Mr. Defever's characterization of the expense as duplicative. In Case No. 2018-00358, the Commission recognized that Pension plans and 401(k) plans should be evaluated in context for adjustments to duplicative benefits. In this case, this expense should be viewed as a cost associated with the pension's wind-down

[8] Mustich Direct at 7, Lines 3-15; Rebuttal Testimony of Robert Mustich, p. 7, Table 2.

because it is representative of transitioning American Water's employees from the Company's locked Pension to the 401(k) that now serves as the Company's standard retirement benefit.

There are only 12 employees that have a pension benefit and the actual amount of expense included in the forecasted test year for employees enrolled in a non-frozen benefit plan is $30,815, which is minimal in terms of customer impact. These employees were relatively new hires during American Water's transition from a pension to 401(k) benefit structure. However, continuing to honor this benefit helps ensure a smooth transition to the Company's 401(k) benefit plan and helps retain a small number of legacy employees that have been with the Company for close to 20 years or more. Of the 12 employees that have a pension plan benefit 5 are union employees, which would require a renegotiation of the CBA to strip these employees of their pension benefit plan.

Q. How has the Company managed its benefit costs for all employees in light of the Pension wind down?

A. The Company has actively managed compensation and benefit costs for all employees. The Company's retirement plans are one component of an employee's overall compensation. Throughout the past two decades, the Company has modified retirement benefits to control costs, including closing the defined benefit plan to new hires in 2006, and eliminating the availability of retiree medical benefits for non-collective bargaining unit new hires in 2002 and collective bargaining unit new hires in 2006.

The Company's retirement benefits underwent a significant change in 2006 when a defined contribution plan ("DCP") replaced the defined benefit plan for all employees hired after January 1, 2006, union employees hired between January 1, 2001 and December 31, 2005 had their pension benefit frozen and were also moved to the DCP. As of January 1, 2023, American Water split the Pension Plan into two separate plans (Active and Inactive). The Inactive Plan contains all retirees prior to July 1, 2017. Savings are achieved from the longer amortization period available under the Inactive Plan, which reduces the Amortization of Unrecognized Losses for the year and therefore lowers the expense level.

Q. What is the practical result as employees who participate in the Pension retire?

A. As these employees retire, and the Pension phases out, the costs associated with maintenance of the plan decline. However, until that point, KAWC must continue to honor its commitment to these remaining, long-serving employees, that is tied to its former benefit structure. The chart below demonstrates that KAWC's Pension Service expense has significantly declined over the past 7 years. This trend reflects the natural phase-out of the plan as employees retire and the declining service expenses associated with the plan.

KAWC PSC Cases	2018-00358	2023-00191	2025-00122
Pension Service Expense Filed	$399,519	$117,960	$82,145
Pension Eligible Employees	53	22	15

Q. Why is it reasonable for KAWC to recover the Pension costs as the plan winds down?

A. Again, these remaining costs represent commitments made under a prior benefit structure that serve our longest tenured employees, and which was offered as a standard practice benefit in the industry at the time. Therefore, these costs are reasonable and reflect the Company's transition from an outdated benefit structure to more modern cost efficient plans, helping to ensure that customers benefit from lower long-term costs while still honoring commitments to KAWC's longest serving employees.

IV. Unaccounted for Water ("UFW")

Q. What recommendations has Mr. Defever made with regard to UFW?

A. Mr. Defever recommends a reduction of $394,049 to KAWC's production costs: purchased water, fuel & power, chemicals, and waste disposal. He bases this reduction on an 18.4% forecasted Non-Revenue Water ("NRW") percentage from the workpaper titled KAWC 2025 Rate Case – Exhibits (25, 26, 37) in Kentucky-American's Response to Staff's First Request Item No. 1.

Q. Do you agree with Mr. Defever's use of the NRW percentage in the calculation of his UFW adjustment?

A. No, I do not. As explained more fully in Company witness William A. Lewis's Rebuttal Testimony, Mr. Defever incorrectly uses the NRW percentage instead of the UFW percentage to calculate his adjustment.[9] As discussed by Mr. Lewis in Direct Testimony, NRW is the difference between all water produced and all water sold.[10] UFW on the other hand, refers to the water produced by a utility that doesn't reach its intended customer less accounted for water such as distribution system flushing, fire department water use, and water used in the water treatment process. UFW is equal to NRW less accounted for water.[11] Therefore, by using the NRW percentage, Mr. Defever overstates the adjustment by erroneously including water that the Company can account for.

Q. What percentage should be used to calculate an UFW adjustment to the Company's production costs?

[9] Rebuttal Testimony of William A. Lewis, p.14, lines 12-14.
[10] Direct Testimony of William A. Lewis, p. 32, lines 11-12.
[11] *Id*., lines 12-15.

A. The Commission should use the forecasted test year UFW percentage that Company Witness Lewis describes in his rebuttal testimony, which is 17.24%.

Q. Using 17.24% as the UFW percentage for the forecasted test year, what is the appropriate adjustment to production costs?

A. The appropriate UFW adjustment is $252,471, based upon the calculations provided in the chart below.

	Forecasted Test Period Expense		% exceeding 15%	Reduction	
Purchased Water	$	201,875	2.24%	$	(4,522)
Fuel & Power	$	5,721,873	2.24%	$	(128,170)
Chemicals	$	4,632,446	2.24%	$	(103,767)
Waste Disposal	$	714,836	2.24%	$	(16,012)
Total	$	11,271,030		$	(252,471)

V. Support Services Business Development

Q. Does Mr. Defever address KAWC's business development expense?

A. Yes. Mr. Defever recommends an adjustment to remove Service Company business development costs allocated to the Company in the amount of $213,516.

Q. Do you agree with Mr. Defever's recommended adjustment to remove business development costs from the Company's test year?

A. No, I do not. Mr. Defever's stated rationale is that the Company did not provide detail how the Service Company's business development costs specifically benefitted Kentucky customers, and that prior Commission cases have disallowed similar costs.[12] Contrary to Mr. Defever's assertion, the Company did identify how Service Company's business development costs benefit customers of Kentucky-American in response to AG 2-49.

[12] Defever Direct Testimony, p. 21-22.

These costs, directly and indirectly, support activities that strengthen KAWC and helps to mitigate the costs to be recovered on a per customer basis. Additionally, business development helps enhance American Water's purchasing power through facilitating growth within its footprint, and spurs activities that contribute to local economies. Additionally, business development supports activities that help the Company build relationships with local community leaders and businesses that can lead to better communications in emergencies, sharing of best practices, and provide support for local community needs.

Q. Please provide additional detail describing how Service Company business development activities benefit customers and the broader communities that KAWC serve.

A. Business development activities directly and indirectly benefit KAWC customers because they help grow our customer base, which enables the Company to spread system investment costs and operating expenses across a larger customer group, thereby mitigating the costs to be recovered per customer. For example, the recently approved Nexus transaction,[13] provides a clear example of the benefits of Service Company business development. The acquisition, sourced and executed at the Service Company level, expands KAWC's footprint and creates additional economies of scale directly benefiting KAWC and its customers.

As we grow in size in Kentucky and nationwide, American Water strategically invests in our operating platforms to help serve customers more efficiently. American Water's relatively large scale is a great benefit to KAWC customers who receive

[13] *Verified Joint Application of American Water Works, Kentucky-American Water Company, et. al.*, Case No. 2025-00171 (Ky. PSC, Sept. 9, 2025).

operational benefits of being part of the 3.5 million metered customers we serve nationally. During the period 2015 through the end of 2024, American Water has added nearly 420,000 customer equivalent connections to our operating platform, which represents ~12% of our customer total. Due in part to the customer base expanding by approximately 14,000 customers during that time period the Company has managed to keep the level of O&M expense, net of production costs, since 2014, below the corresponding rate of inflation over the same period. New customers added in Kentucky or, in fact, anywhere in American Water's national footprint, will help spread a portion of operating expenses from Service Company that would otherwise be allocated to KAWC's customer base.

The growing customer base also enhances American Waters purchasing power capabilities, which allows American Water greater negotiating leverage to purchase goods and services in bulk quantities at competitive prices, for the benefit of all customers including Kentucky-American customers. On its own, KAWC is a relatively small utility, with approximately 139,500 water service connections[14]; therefore, this customer base would limit KAWC's ability to absorb costs. Again, as a part of American Water's growing presence across its footprint, KAWC customers gain access to cost efficiencies it would otherwise incur standing alone.

In addition, through the improvements in the operations of the wastewater and water utilities that the Company acquires, business development activities achieve public policy objectives of improving the quality of the water consumed by customers and the quality of the public bodies of water into which wastewater effluent is discharged.

[14] Lewis Direct Testimony, p. 3, line 11.

For these reasons, the Company's business development costs are not speculative and provide a demonstratable benefit to KAWC customers. I believe that the Commission should approve the Company's full business development costs.

VI. KAWC O&M Growth Factor

Q. Does Mr. Defever address KAWC's O&M Growth Factor?

A. Yes. Mr. Defever recommends an adjustment for the disallowance of the KAWC O&M Growth Factor for a $698,109 reduction to the forecasted test period expense. Mr. Defever argues that an assumed "growth factor" increase is unknown and unwarranted since the total bucketed costs decreased from 2020 to 2021 and 2021 to 2022. Mr. Defever also cites the Commission's order from Case No. 2023-00191 but misinterprets the Commission's decision.

Q. Mr. Defever cites the Commission's ruling in Case No. 2023-00191 as precedent for disallowing KAWC's O&M Growth Factor. Do you agree with his interpretation?

A. No, I do not. Mr. Defever mischaracterizes the Commission's directive. As described in my Direct Testimony on page 21, the Commission directed that KAWC should develop and implement forecasting methodologies that are more reflective of KAWC's historical costs, and rejected the Company's use of general CPI inflation factors.[15] The Company has complied with this request by conducting a review of its historical expenses for certain O&M expense categories[16] and used that data to develop the 5.16% O&M Growth Factor.[17] Mr. Defever ignores the Commission's instruction and recommends a broad disallowance

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[15] *In re Kentucky American Water Company, Inc.*, Case No. 2023-00191 (Order, May 5, 2024), p. 18.
[16] Direct Testimony of Robert J. Prendergast, p. 21. (Service Company (non-labor costs), Contracted Services, Building Maintenance and Services, Telecommunication, Office Supplies and Services, Employee Related, Miscellaneous, Rents, Customer Accounting, and Maintenance Supplies and Services.)
[17] Prendergast Direct Testimony, pp. 21-22; *See also* KAWC response to PSC 2-1.

that would effectively leave KAWC unable to recover its reasonable O&M costs. This position is inconsistent with the Commission's order and disregards the methodology KAWC developed in direct response to the order.

Q. Do you agree with Mr. Defever's assertion that an assumed "growth factor" increase for the forecasted test year is unknown and unwarranted?

A. No, I do not. Mr. Defever selectively relies on two years (2020-2021 and 2021-2022) when total O&M expenses decreased, and which happens to coincide with the onset of the COVID-19 pandemic and related economic disruptions. Regardless, those two time periods are not representative of longer-term trends in KAWC's O&M expense; and the past three years of data reflect a more normal and representative environment of expense growth which is also consistent with the Company's budgeting methodology.[18]

Additionally, Mr. Defever fails to recognize that the Company included the decrease in expense from 2021 to 2022 in its O&M Growth Factor calculation, which still resulted in a compound annual growth rate of 5.16%. As explained in the Company's response to PSC DR 2-1, the Company utilized a 3-year average growth rate to capture the current economic environment and Company specific impacts. If the Company were to expand its Growth Factor to a 4-year average, which would account for the additional decrease cited by Mr. Defever (i.e., 2020 to 2021), the KAWC O&M Growth Factor would still result in an average compound annual growth rate of 2.99%. This demonstrates that KAWC's O&M forecasting methodology is reasonable utilizing varying inputs.

[18] Please see KAWC's response to PSC 2-1.

Q. How does KAWC's forecasting methodology balance short-term fluctuations and longer-term expense trends that inevitably occur?

A. KAWC's approach utilizes Company-specific data and expense trends to help ensure consistency with the Commission's directive in Case No. 2023-00191. By using multi-year averages the Company's methodology KAWC balances short term fluctuations and long-term trends by utilizing averages to help ensure that temporary irregularities do not distort the forecast. This helps provide a stable and representative measure of KAWC's O&M expense needs. In contrast, Mr. Defever's analysis uses stagnant and isolated selective data points, which do not capture the broader expense trends and instead exaggerates anomaly impacts. This approach ignores both annual expense trends and the Commission's instruction to KAWC to rely on specific historical experience.

VII. Healthcare Expense

Q. What does Mr. Defever say in support of his recommendation to remove a portion of the Company's Healthcare expense?

A. Mr. Defever states that the Commission should reduce the Company's forecasted test period healthcare expense by $315,000 to remove costs of health care above "the most current United States Bureau of Labor Statistics' ("BLS") averages for single and family coverage" as the Commission has done in Case No. 2021-00407.[19]

[19] Defever Direct Testimony at 27-28 citing Case No. 2021-00407, *Electronic Application of South Kentucky Rural Electric Cooperative Corporation for a General Adjustment of Rates, Approval of Depreciation Study, and Other General Relief* (Ky. PSC June 30, 2022), Final Order at 9.

Q. Does Mr. Defever identify specific employer healthcare coverage percentages in his testimony to support his adjustment?

A. No. Mr. Defever does not state the specific percentages of employer provided medical expense coverage in his testimony. However, he does reference the data requests where he identifies the specific percentages. In the text of AG 2-50, Mr. Defever points to "the Bureau of Labor Statistics' average of 80% for single coverage and 68% for family coverage employee insurance premiums."

Q. Is Mr. Defever's use of the "average" appropriate for a utility like Kentucky-American with a strong unionized workforce?

A. No. Reliance on a national "average" for single and family health insurance premiums is not appropriate for Kentucky-American. Unlike the generalized BLS averages Mr. Defever cites, KAWC's cost share is determined through collective bargaining with its unionized workforce and is not set each year based on the Bureau of Labor Statistics. While benchmarking data is considered, along with claim data, KAWC's cost share (employee / employer contributions), is a result of the collective bargaining agreement reached between KAWC and its union workforce. These agreements are legally binding, are negotiated every 5 years, and cannot be unilaterally changed by KAWC. KAWC applies the same contribution cost share levels to its nonunion employees. Finally, the BLS data referenced by Mr. Defever shows significant variation in the union versus nonunion cost sharing percentages and demonstrates why national BLS averages are a poor fit for KAWC's workforce.

Q. Please explain these differences in healthcare premiums.

A. The Company's share of healthcare premiums differs between both the single and family and Union and Nonunion employees. Union employees receive a larger Company contribution than nonunion employees for both single and family coverage. For single coverage the difference is one percentage, with union coverage being equal to the "average" share of premium used by Mr. Defever. However, the difference increases dramatically for family coverage. Union employee coverage is eleven percentage points higher than nonunion employees and ten percentage points higher than the "average" share of premium used by Mr. Defever.[20] As I stated above, Mr. Defever's reliance on BLS data fails to consider KAWC unique factors, specifically, its unionized workforce and the binding obligations that follow the collective bargaining process.

Q. Does Commission precedent support Mr. Defever's proposed adjustment?

A. No. In fact, the Commission's prior orders regarding health insurance expense make clear that a reduction to the BLS averages is not warranted in this case. As described in response to AG 1-41(B), KAWC's aggregate contribution to health insurance coverage is 84% for its union and non-union employees. Earlier this year, in a rate proceeding involving another utility, the AG proposed the same adjustment as it has in this proceeding, and it was flatly rejected.

As to union employees, in a February 28, 2025 decision, the Commission held: "Regarding the union employees, the Commission finds that Jackson Purchase Energy's payment of 82.5 percent of the insurance premiums for union employees is reasonable. The Commission has generally found that benefits that are provided under union contracts,

[20] *See* https://www.bls.gov/news.release/ebs2.t03.htm, Table 3, for Single Coverage; *See also* https://www.bls.gov/news.release/ebs2.t04.htm, Table 4, for Family Coverage.

given the arms-length negotiating that lead to them, generally indicates that costs agreed to were necessary to attract and retain the employees, and therefore, that the costs are reasonable. There was no evidence presented in this matter to indicate that Jackson Purchase Energy's union contract was not an arms-length negotiation or that the employer's share of insurance premiums based on the contract is unreasonable."[21] Likewise, there is no evidence that KAWC's union contract was not an arms-length negotiation or is otherwise unreasonable, as the 84% contribution rate is very similar to the 82.5% found reasonable this year.

Jackson Purchase contributed 92% for its non-union employees' health insurance premiums, as compared to 82.5% for its union employees. The AG recommended that the 92% be reduced to the BLS average. In rejecting this adjustment, the Commission held: "Unlike most cases in which the Commission has adjusted to the BLS average, Jackson Purchase Energy does not pay 100 percent of employee insurance premiums, which indicates that there was some consideration by Jackson Purchase Energy of the appropriate contribution levels."[22] The Commission did adjust the non-union contribution rate to match the union contribution rate.[23] KAWC already has the same contribution rate for union and non-union employees, which is 84%. This synchronization is precisely the arrangement the Commission deemed reasonable earlier this year. In addition, the Commission also held in several other cases that as long as the employee contribution rate for health insurance is at least 12 percent, the Commission will not make a further adjustment to the BLS national

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[21] *In the Matter of: Electronic Application of Jackson Purchase Energy Corporation for a General Adjustment of Rates and Other General Relief* (Case No. 2024-00085) (Ky. PSC Feb. 28, 2025).
[22] *Id*., at 14.
[23] *Id*.

average as Mr. Defever recommends.[24] KAWC presently requires employees to contribute 14 percent, which is in excess of the 12 percent standard applied in prior cases.

Q. Do you agree with Mr. Defever's recommended adjustment to remove a portion of the Company's Healthcare expense based on national BLS data?

A. No, I do not. As a preliminary matter, Mr. Defever does not contest or otherwise take issue with the Company's proposed healthcare expense amounts. His adjustment is based only on the incorrect application of Commission policy that caps utility healthcare expenses at the BLS national average coverage percentages. As explained above, the Commission has not adjusted a utility's healthcare expense to BLS averages when the union contribution rates have been negotiated, and the utility requires at least 12 percent contribution from employees. Moreover, the use of such national BLS level health spending caps conflicts with the Commission's determination regarding the use of national Consumer Price Index ("CPI") data from the BLS. The Commission expressly rejected KAWC's use and reliance on generic national inflation data as "not specific to Kentucky-American's experience", finding national CPI unsuitable for forecasts and not reflective of KAWC's costs.[25]

Q. Is there information specific to Kentucky-American that supports the reasonableness of the Company's Healthcare expense?

A. Yes. Company witness Robert Mustich, in his direct testimony looked at the impact of the Company's benefits on the Total Remuneration offered to Kentucky-American's employees relative to the competitive market. Specifically, Mr. Mustich found that from

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[24] *Electronic Application of Jackson Purchase Energy Corporation For A General Adjustment In Existing Rates*, Case No. 2019-00053 (Ky. PSC June 20, 2019) Order at 9; *Electronic Application of Northern Kentucky Water District For An Adjustment of Rates; Issuance of Bonds; Financing; and Tariff Revisions*, Case No. 2022-00161 (Ky. PSC Mar. 16, 2023) at 5-6; *Electronic Application of Oldham County Water District For An Alternative Rate Adjustment*, Case No. 2023-00252 (Ky. PSC June 18, 2024) Order at 16.

[25] Case No. 2023-00191, Order at 18, (Ky. PSC May 3, 2024).

a national perspective "Kentucky American Water's Target Total Remuneration . . . is at the low end of the market median range by being 9% (represents a weighted average of all positions reviewed) below the market median," and from a regional perspective "Kentucky American Water's Target Total Remuneration as reported in Table 2 (below) is 7% below median, but within the competitive market median range (represents a weighted average of all positions reviewed)."[26]

Further, in the WTW Total Remuneration Study, attached to Mr. Mustich's Direct Testimony as Exhibit RVM-1 (Confidential) and explained as part of Mr. Mustich's Rebuttal Testimony, Mr. Mustich demonstrates, with information specific to Kentucky-American, that the Company's share of medical expenses are below the median of both the General Industry set of companies and specifically Energy Services Industry set of companies.[27] Here, Mr. Defever attempts to substitute non-correlative national BLS averages in place of actual national and regional market data, factors unique to KAWC's workforce, and actual KAWC-specific expense data.

Q. How should the Commission address Mr. Defever's proposed adjustment to Kentucky-American's Healthcare Expense?

A. The Commission should reject Mr. Defever's adjustment because it directly conflicts with the Commission's precedent and relies solely on general average with no explanation of its relevance to the Company's expense. In contrast, Company witness Mustich, through his study in Exhibit RVM-1 (Confidential), clearly demonstrates that Kentucky-American's Healthcare expenses are based on employer coverage percentages that are below those of uncontested national and regional peer groups. Therefore, since the Company's filed

[26] Mustich Direct at 7, lines 3-15.
[27] Exhibit RVM-1 (Confidential) at 10; Mustich Rebuttal Testimony at 8-9.

expenses are reasonable, represent actual costs, and are consistent with Commission precedent, they should be incorporated into the Company's revenue requirement.

VIII. CONCLUSION

Q. Does this conclude your rebuttal testimony?

A. Yes.

VERIFICATION

STATE OF KENTUCKY)
) SS:
COUNTY OF FAYETTE)

The undersigned, Robert Prendergast, being duly sworn, deposes and says that he is Senior Manager Regulatory Services for American Water Works Service Company, Inc., that he has personal knowledge of the matters set forth in the accompanying testimony for which he is identified as the responsible witness, and that the answers contained therein are true and correct to the best of his information, knowledge and belief.

____
Robert Prendergast

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 10th day of September, 2025.

Molly McCleese Van Over
____
Notary Public

My Commission Expires:
July 31, 2029
____
Notary ID: KYNP26988

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. 2025-00122**

REBUTTAL TESTIMONY OF HAROLD WALKER, III

September 15, 2025

TABLE OF CONTENTS

I. INTRODUCTION, PURPOSE, AND SUMMARY

Q. Please state your name and address same.

A. My name is Harold Walker, III. My business address is 1010 Adams Avenue, Audubon, Pennsylvania, 19403.

Q. Are you the same Harold Walker, III who previously submitted direct testimony in this proceeding on behalf of Kentucky-American Water Company ("Kentucky-American," "KAWC" or the "Company") in this proceeding?

A. Yes. I filed Direct Testimony in this proceeding on May 16, 2025.

Q. What is the purpose of your Rebuttal Testimony?

A. The purpose of my testimony is to reply to the direct testimony submitted by Office of the Attorney General of the Commonwealth of Kentucky ("OAG") and the Lexington-Fayette Urban County Government ("LFUCG") witness John Defever as it relates to his adjustments to the cash working capital ("CWC") allowances included in the Company's rate base.

Q. Are there any areas of agreement in the cash working capital testimonies presented in this proceeding?

A. Yes, Mr. Defever adopts the majority of the lead/lag days used in my Direct Testimony.

Q. Are there any updates in the cash working capital as part of your Rebuttal Testimony?

A. Yes. As referenced in Company's witness Dominic DeGrazia's testimony, the Company is filing an update to the total revenue requirement for the following expenses: reduction to Fuel & Power, reduction of Other Customer Accounting, reduction to Office Supplies & Services, reduction to Postage, Printing, & Stationery and reduction to Insurance Other

Than Group. As a result, the cash working capital for the forecasted period has changed to $2,772,000.

Q. Please summarize the areas of disagreement between your Direct Testimony and the testimony from Mr. Defever that you will address in this Rebuttal Testimony.

A. Mr. Defever's testimony differs from my testimony in two primary areas: (1) he adjusts the expense lead days for service company charges; and (2) he removes noncash cost of service items from the Company's Total Operating Funds. I will address the areas of disagreement I have regarding Mr. Defever's testimony in the remainder of my Rebuttal Testimony.

II. SERVICE COMPANY CHARGES LEAD DAYS ADJUSTMENT

Q. What is Mr. Defever's recommendation for Service Company charges in his cash work capital lead-lag study?

A. Mr. Defever recommends changing the expense lead days for Service Company charges utilized by the Company from -4.2 day (negative) expense lead to 50.7 days expense lead to match the Contracted Services expense lead days.

Q. On page 40 of Mr. Defever's testimony he states, "[r]atepayers should not be responsible for costs related to the Company paying earlier than necessary for service company expenses." Does the Company pay for Service Company expenses earlier than necessary?

A. No. The Company processes and pays for Service Company expenses in the same manner as it processes and pays for all invoices it receives. That is, payments of all invoices, including Service Company invoices, are made within a reasonable time after receipt of the invoice. According to USLegal,

> Reasonable time refers to the amount of time that is fairly required to do whatever is required to be done, conveniently under the permitted circumstances.
>
> In contracts, reasonable time refers to the time needed to do what a contract requires to be done, based on subjective circumstances. If the parties entering the contract do not fix a time for performance, the law will infer a reasonable time within which it should be done.
>
> Generally the reasonableness or unreasonableness of time used or taken by a party are made subject of judicial review. Reasonable time is interpreted by the court in the in light of the nature [*sic*], purpose, and circumstances of each case. Other factors considered by the court while determining the unreasonable delay in performance include prior dealings between the parties, business routine or custom within the trade, and whether there were any objective manifestations of expectation expressed between the parties.[1]

The Company does not pay Service Company invoices before the service is rendered. Rather, the Company pays Service Company expense before the midpoint of the service period, not before it receives service. For example, the services provided in January are paid for in the middle of January, and February services are paid for in the middle of February, so on and so forth.

In addition to Service Company invoices, the Company also pays other vendors' invoices prior to the midpoint of their service periods. For example, according to the lead-lag study, some purchased water invoices are paid before the midpoint of their service periods, as are some contract services invoices, pension invoices, most insurance other than group invoices, most rents invoices, some building maintenance invoices, some telecommunication invoices, some miscellaneous expense invoices, utility tax invoices,

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[1] *USLegal*. (n.d.). https://definitions.uslegal.com/r/reasonable-time

some state income taxes (current) invoices, and some federal income taxes (current) invoices.

Q. On page 42 of Mr. Defever's testimony he states, "I recommend that the service company charges reflect the same lag as contracted services as ordered by the Commission in the last rate case." Did Mr. Defever provide any analysis or justification for using contracted services lead days as a substitute for the actual lead days of service company charges in the current case?

A. No. Mr. Defever's only justification for his recommendation of using contracted services lead days in the current case is the fact that it was done in the last rate case.

Q. Are the lead days for Contract Services currently the same as they were in the last rate case?

A. No. The lead days for Contract Services were 25.6 days in the last rate case but are 50.7 days in the current rate case.

Q. On page 41 of Mr. Defever's testimony he states, "[r]atepayers should not be forced to bear a higher cost if Kentucky-American has an agreement with an affiliate to pay for a service earlier than its other vendors." Do KAWC customers bear a higher cost due to Kentucky-American's agreement for Service Company services?

A. No. The Service Company provides services to KAWC at cost. That is, **there is no mark-up or financial gain for any services** that the Service Company or its employees charge to KAWC. Because the Service Company makes no profit on the services it provides to KAWC, it has no retained earnings and it does not internally generate funds with which to provide working capital to fund the services it provides to KAWC prior to receipt of payment for those services. Whereas the services and the related expense of Contract

Services include entrepreneurial profit (i.e., marked-up for financial gain). The level of entrepreneurial profit, or marked-up for financial gain, the Contract Services providers make for providing their services is not known because they are private companies and typically varies across industries. However, the operating margin[2] experienced by the S&P 500[3] companies in 2024 was 28%, which provides an indication of the "typical" profit marked-up experienced by companies who earn a profit on the services they provide.

Q. Are the services, costs, and/or billing terms for Service Company charges similar to the Contract Services providers?

A. No. The services provided by Service Company charges and Contract Services expenses are quite different in nature and scope. Further, the lead-lag study used to determine the Company's CWC shows a range of expense lead days for the Contract Services providers of -102.5 (negative) to 279.5, while the Service Company charges lead days only ranged from -11.0 (negative) to 9.5. Similarly, the length of the service period of the Contract Services providers ranged from 1.0 day to 214.0 days, while the length of the service period of the Service Company charges only ranged from 29.0 days to 31.0 days.

Expense lead days are comprised of three components: service period lead days; billing lead days; and payment lead days. KAWC only has control of the payment lead days component of the expense lead days. Each vendor is responsible for and has control over the service period lead days and billing lead days components of the expense lead days, which vary from vendor to vendor as is the case for the Contract Services provider

[2] Operating margin is a profitability ratio that calculates the percentage of operating profit the company produces from its revenue. In other words, it shows how much of each dollar of revenues is left over after both costs of goods sold and operating expenses are deducted and is calculated as: earnings before interest and taxes ÷ revenues.
[3] The S&P 500, or Standard and Poor's 500, is a stock market index tracking the stock performance of 500 of the largest companies, by market capitalization, listed on stock exchanges in the United States.

vendors. Mr. Defever's recommendation did not consider differences between services provided with a markup for profit and those that do not. Accordingly, Mr. Defever's recommendation ignores that the circumstances are not parallel between the Contract Services expense service providers and the Service Company.

III. ELIMINATED COST OF SERVICE LINE ITEMS

Q. Mr. Defever states that six cost of service line items[4] should be excluded from cash working capital ("CWC") because they are "non-cash" expenses.[5] Please respond.

A. Mr. Defever's position focuses only on whether an expense involves a cash outflow, but that misses the point of CWC. CWC is not about whether an expense is cash or non-cash, it is about the timing difference between when the Company incurs costs and when it actually collects the revenues necessary to cover those costs.

Q. Please explain why "non-cash" could be misleading in this context.

A. While non-cash items do not result in a direct cash disbursement, KAWC still recovers those items through customer bills. Customers pay for these expenses as part of their total bill, and revenues attributable to these expenses are subject to the same service period and collection lag as all other revenues. Excluding the non-cash items ignores that KAWC must ultimately bridge the lag.

Q. Is there an inherent logical flaw in excluding these items from CWC?

A. Yes. Removal of non-cash items ignores parts of the revenue requirement and understates the amount of capital necessary to bridge the timing gap between when service is provided

[4] The six line items include: regulatory expense; amortization; uncollectibles; depreciation; deferred income taxes; and net income.
[5] Direct Testimony of John Defever, p. 39.

and ultimately paid for.

Q. Please explain Mr. Defever's recommended treatment of cash-generating cost of service items such as depreciation and amortization, deferred taxes and net income.

A. Mr. Defever recommends excluding the non-cash items from KAWC's CWC calculation. His adjustment reduces the cost of service or total operating funds by $79,088,899 as shown on Mr. Defever's Schedule B-1.

However, as shown in Table 1 below, this recommendation creates an imbalance between his recommended revenue requirement and the costs of service or total operating funds used in his CWC determination. The result is a $62,615,481 revenue requirement deficit that remains uncollected from customers for 39.1 days. Therefore, the Company's investors must provide $6,707,576 in working capital to finance the deficit as summarized in Table 1. This inequity is inappropriately borne entirely by the Company and investors because it shifts the financing burden of the lag from the customers who ultimately are responsible for the lag through their payment behavior and requires the Company and its shareholders to incur an uncompensated financing burden.

Mr. Defever's Current Operating Revenues (Schedule C)	$126,609,983
Plus Mr. Defever's Revenue Increase (Schedule A)	15,094,397
Mr. Defever's Revenue Requirement	141,704,380
Less Mr. Defever's Total Operating Funds (Schedule B-1)	(79,088,899)
Mr. Defever's Revenue Requirement Deficit	62,615,481
Divided By Days in a Year	365
Daily Deficit	171,549
Multiplied by Revenue Requirement Lag Days	39.10
Investor Supplied Working Capital	$6,707,576

Table 1

Additionally, if the "non-cash expense" line items are disregarded, it implies KAWC would suffer no impact if customers did not pay the portion attributable to non-cash items of their bills. The collection of the entire cost of service is essential to the operations of a company, otherwise "non-cash expense" items would not be included in the determination of a company's cost of service.[6] Excluding these items creates a potential shortfall and understates KAWC's needed capital to bridge the timing gap created by excluding non-cash items.

Q. Is this result inconsistent with the regulatory compact?

A. Yes. Utilities should be given a fair opportunity to recover their costs and earn a reasonable return. By failing to recognize non-cash items in CWC, KAWC, through its reserves and ultimately its investors, is required to finance recovery of and return on capital during the lag between cash outflow and inflow. This shifts costs that appropriately belong to customers who ultimately are responsible for the lag through their payment behavior and requires the Company and its shareholders to incur an uncompensated financing burden.

Q. What is your recommendation?

A. I recommend that all components, cash and non-cash items alike, be recognized in the cash working capital calculation.

Q. Does this conclude your Rebuttal Testimony?

A. Yes, it does.

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[6] The Company's current lead/lag study includes noncash items because the noncash items represent 52% of their Net Operating Funds. The operations of the Company are dependent on the receipt of all their Net Operating Funds since Net Operating Funds represent the Company's cost of service or revenue requirement. Accordingly, the Company is impacted when noncash expenses are not paid for by customers.

VERIFICATION

STATE OF NEW JERSEY)
) **SS:**
COUNTY OF GLOUCESTER)

The undersigned, Harold Walker, III being duly sworn, deposes and says that he is the Manager Financial Studies for Gannett Fleming, that he has personal knowledge of the matters set forth in the accompanying testimony for which he is identified as the responsible witness, and that the answers contained therein are true and correct to the best of his information, knowledge, and belief.

____
Harold Walker

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 10 day of September, 2025.

____
Notary Public

My Commission Expires:

____

HEATHER L MARQUETTE
Notary Public, State of New Jersey
My Commission Expires 7/23/2029