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BEFORE THE ARIZONA CORPORATION COMMISSION

BOB STUMP
CHAIRMAN
GARY PIERCE
COMMISSIONER
BRENDA BURNS
COMMISSIONER
BOB BURNS
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SUSAN BITTER SMITH
COMMISSIONER

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AZ CORP COMMISSION
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IN THE MATTER OF THE APPLICATION OF ARIZONA WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY, AND FOR ADJUSTMENTS TO ITS RATES AND CHARGES FOR UTILITY SERVICE FURNISHED BY ITS EASTERN GROUP AND FOR CERTAIN RELATED APPROVALS.

Docket No. W-01445A-11-0310

Arizona Corporation Commission
DOCKETED
OCT 31 2013
DOCKETED BY

NOTICE OF FILING

The RESIDENTIAL UTILITY CONSUMER OFFICE ("RUCO") hereby provides notice of filing the Rebuttal Testimony of David Parcells and Ralph Smith, in the above-referenced matter.

RESPECTFULLY SUBMITTED this 31st day of October, 2013.

Daniel Pozefsky
Chief Counsel

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Phoenix, Arizona 85007

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BEFORE THE ARIZONA CORPORATION COMMISSION

BOB STUMP
Chairman
GARY PIERCE
Commissioner
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Commissioner
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SUSAN BITTER SMITH
Commissioner

IN THE MATTER OF THE APPLICATION OF ARIZONA WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR ADJUSTMENTS TO ITS RATES AND CHARGES FOR UTILITY SERVICE FURNISHED BY ITS EASTERN GROUP AND FOR CERTAIN RELATED APPROVALS.	DOCKET NO. W-01445A-11-0310

REBUTTAL

TESTIMONY

OF

DAVID C. PARCELL

ON BEHALF OF

RESIDENTIAL UTILITY CONSUMER OFFICE

OCTOBER 31, 2013

EXECUTIVE SUMMARY
ARIZONA WATER COMPANY
DOCKET NO. W-01445A-11-0310

Mr. Parcell's Rebuttal Testimony responds to the Direct Testimonies filed in the Re-hearing phase of this hearing by Joel M. Reiker (Arizona Water Co.), Paul Walker (Liberty Utilities and Global Water Utilities), and Steven M. Olea (Utilities Division Staff).

Mr. Parcell concludes that AWC's authorized return on common equity should be reduced from the 10.55 percent level authorized in Decision No. 73736, to a level of no more than 10.0 percent. This reduction in AWC's authorized return on common equity is necessary in order to reflect the impact on AWC's risks and required returns resulting from the approval of a SIB mechanism by the Commission.

I. INTRODUCTION

Q. Please state your name, occupation and business address.

A. My name is David C. Parcell. I am President of Technical Associates, Inc. My business address is 9030 Stony Point Parkway, Suite 580, Richmond, VA 23235.

Q. Are you the same David C. Parcell who filed Direct Testimony on behalf of the Residential Utility Consumer Office ("RUCO") on October 4, 2013?

A. Yes, I am.

Q. What is the purpose of your current Testimony?

A. My Rebuttal Testimony responds to the three sets of Direct Testimony filed in the Re-hearing phase of this proceeding by other parties on October 4, 2013. These are:

Joel M. Reiker	Arizona Water Co.
Paul Walker	Liberty Utilities & Global Water Utilities
Steven M. Olea	Utilities Division Staff

II. RESPONSE TO AWC WITNESS JOEL M. REIKER

Q. What is the nature of AWC witness Reiker's Direct Testimony in the re-hearing phase of this proceeding?

A. Much of Mr. Reiker's testimony is in the form of a summary reflecting AWC's interpretation of the positions taken by RUCO, AWC, Staff and the Commission in this proceeding to date. Mr. Reiker notes (page 4, lines 18-21):

> My testimony addresses only Section ll.b of RUCO's application, concerning the reasonableness of the Commission not reducing the ROE it authorized for the Company's Eastern Group in Decision No. 73938 in exchange for approving the SIB mechanism in Decision No. 73938.

I note that the respective testimonies of RUCO witnesses Ralph C. Smith and myself also address the positions taken by the parties in this proceeding, as well as RUCO's review of the history of this proceeding to date.

Q. On page 4, lines 23-26, Mr. Reiker indicates his belief that "RUCO fails to cite any evidence in the record that the Commission acted unreasonably by not reducing its authorized ROE for the Company's Eastern Group when it approved the SIB mechanism." Do you have any response to this statement?

A. Yes. Mr. Reiker is apparently referring to RUCO's Application For Re-hearing dated July 17, 2013. The "evidence" Mr. Reiker is apparently referring to is to be developed in this re-hearing phase of this proceeding. To this end, both RUCO witness Smith and myself have provided "evidence" that the 10.55 percent return on equity implicitly, if not explicitly, included a component to reflect a lack of a DSIC mechanism which should have been reflected in a lower return on equity when the SIB was approved.

I also note, in response to Mr. Reiker's statement, that the fact that the Commission agreed to reopen this proceeding reflects some recognition of RUCO's request. The Commission's Procedural Order dated August 26, 2013 contained the following finding:

> On August 15, 2013, the Commission passed the following motion made by Commissioner Bitter Smith during a Staff Open Meeting:
>
> . . .[to] grant RUCO's Application for Rehearing of Decision No. 73938, and also [re]open Decision No. 73736, under A.R.S. § 40-252, for consideration of modifying the Decision [73736] concerning the determination made related to the return on equity, and that these matters shall be consolidated. Further, as part of my motion, the Hearing Division is directed to hold proceedings on these consolidated matters and prepare a Recommended Order for the Commission's consideration.

Q. On pages 7-9 of his testimony, Mr. Reiker indicates his position that the 10.55 percent cost of equity in Decision No. 73736 was not "inflated." Do you have any response to this assertion?

A. Yes, I do. Mr. Reiker devotes a substantial amount of his testimony to his perception that RUCO claims the 10.55 percent cost of equity identified in Decision No. 73736 is "inflated". As I indicated in my Direct Testimony, the current cost of common equity for water utilities, both as developed in my analyses and in reference to commission decisions throughout the United States, is no more than 10.0 percent. This 10.0 percent cost of common equity is, indeed, the recently-determined cost of equity for AWC's Western and Northern Groups. One can quarrel with use of the word "inflated" but the fact remains the 10.55 percent cost of common equity awarded AWC in Decision No. 73736 reflects a higher return on equity than is required for AWC at this time.

Q. Please explain what you mean by your statement that the 10.55 percent cost of common equity awarded AWC in Decision No. 73736 reflects a higher return on equity than is required at this time.

A. As I indicated in my Direct Testimony, the current cost of common equity for regulated water utilities is no greater than 10.0 percent. My updated cost of equity analyses indicates the following results:

DCF	8.5 – 8.6%	8.55% mid-point
CAPM	7.1%	
CE	9.0 – 10.0%	9.50% mid-point

Based upon these results, I believe that a 9.25 percent cost of common equity is proper for AWC at this time. I note that this is consistent with the 9.4 percent recommendation of Staff witness Cassidy in his updated testimony, as filed on March 13, 2012 and testified to at the Phase I hearing in this proceeding.

I also indicated in my Direct Testimony that recently-authorized returns on equity for water utilities throughout the United States have been less than 10.0 percent over the past few years and were about 9.8 percent in 2012. Further, the vast majority of return on equity findings of this Commission for water utilities over the past few years were 10.0 percent or below, with most being in the 9.0 percent to 9.5 percent range in 2010 – 2013 (which is consistent with the national average).

As I indicated on pages 3 and 20 of my Direct Testimony, the only factor distinguishing AWC's Eastern Group from AWC's Western Group and other water utilities was the "increased need for infrastructure replacement and improvement" that was the stated reason for the establishment of a higher return on equity for this utility in the absence of its requested DSIC.

Q. **Have you seen anywhere in Decision No. 73736 where a 10.55 percent cost of equity is derived from any evidence or other quantitative analysis?**

A. No. The only reference is the 10.0 percent cost of equity approved for AWC's Western Group and an "increased need for infrastructure replacement and improvement" to the extent that this "necessitates a somewhat higher ROE" for the Eastern Group.

Q. **On page 9, lines 5-6, Mr. Reiker again states "RUCO fails to cite any evidence in the record to support its opinion that the Commission's 10.55 percent authorized ROE is 'inflated.'" Do you have any response to this assertion?**

A. Yes. Mr. Reiker is again apparently referring to RUCO's Motion to ask the Commission to re-open this case for the purpose of determining whether the return on equity should be modified as a result of the adoption of the SIB mechanism. That Motion was granted by the Commission and the current testimony is the appropriate medium with which to "cite any evidence" to support a downward adjustment to the return on equity. My Direct Testimony does, in fact, provide evidence as to why and how much the return on equity should be modified in response to the approval of the SIB.

Q. **Just to make sure the record is clear, Mr. Parcell, are you recommending that there is a quantitative link of 55 basis points associated with the approval of the SIB?**

A. No, I am not. The development of the 55 basis points is the result of the Commission's adoption of a 10.55 percent cost of equity for AWC's Eastern Group by referencing the 10.00 percent authorized return on equity for the Western Group and implicitly adding 55 basis points for the "increased need for infrastructure replacement and improvement" and the absence of the requested DSIC. It is RUCO's contention, and my belief, that the SIB offsets much of the negative impact of the infrastructure replacement and improvement, such that the 55 basis points addition is not required in connection with the implementation of the SIB.

Q. On page 11, Mr. Reiker claims that the 10.0 percent approved return on equity for AWC's Western Group and Northern Group are "inappropriate" comparisons because these cases were settled. What is your response to this assertion?

A. Both RUCO and myself address the AWC Western Group return on equity because the Commission cited the 10.0 percent return on equity for this group in Decision No. 73736. In fact, this 10.0 percent cost of equity appears to have been the "linchpin" for the 10.55 percent return on equity for the Eastern Group in Decision No. 73736.

Mr. Reiker appears to be comfortable citing the Commission's language in other parts of his testimony (e.g. page 6, lines 6-15; page 7, lines 18-23; page 8; page 9, lines 1-2; page 10, lines 5-17; page 14, lines 12-20; and page 15, lines 22-24), but he then criticizes RUCO for doing so. I respectively suggest he cannot have it both ways.

Q. On pages 15-16, Mr. Reiker claims that any reduced risk and/or impact of DSIC mechanisms is already reflected in the market value of the water proxy companies and therefore this should already be reflected in the cost of equity derived from these companies. What is your response to this assertion?

A. Contrary to Mr. Reiker's claim, this is actually a reason why AWC's cost of equity should be no higher than 10.0 percent. As I indicated in my Direct Testimony (page 20) the implementation of the SIB mechanism for AWC's Eastern Group would have the effect of placing this entity more in line with the proxy group members from a risk standpoint. As a result, there is no need for a higher return on equity to account for this entity's "increased need for infrastructure replacement and improvement." It is clear that Mr. Reiker, and AWC, are asking for both a higher return on equity and a SIB mechanism to account for the same perceived risk factor.

Q. Mr. Reiker devotes several pages of his Direct Testimony to his perception that the implementation of the SIB mechanism does not shift any risk from the Company's shareholders to its ratepayers. Do you agree with this assertion?

A. No, I do not. As I indicated on pages 17-20 of my Direct Testimony, regulatory mechanisms in general and of the type adopted in this proceeding, are viewed as risk-reducing to utilities. In my Direct Testimony, I cited reports by the rating agencies citing such regulatory mechanisms as "positive for credit quality." In addition, even AWC witness Pauline Ahern indicated that DSIC mechanisms "are widely accepted and adopted throughout the U.S. and are considered credit supportive by two of the major bond/credit rating agencies…" (Page 5 and elsewhere of her Rebuttal Testimony)

As both myself and RUCO witness Smith indicated in our respective Direct Testimonies, AWC's SIB is risk reducing to AWC because it improves cash flow and reduces regulatory lag related to cost recovery of qualifying infrastructure investment.

III. RESPONSE TO LIBERTY UTILITIES AND GLOBAL WATER UTILITIES WITNESS PAUL WALKER

Q. What is the nature of the Re-Hearing Direct Testimony of Paul Walker?

A. Mr. Walker's testimony is primarily related to expressing his perception that AWC's SIB mechanism is similar to Arizona Public Service Company's ("APS") adjustor mechanisms that the Commission has approved and RUCO has "supported."

Q. What is your response to Mr. Walker's assertions?

A. I note that APS has an approved return on equity of 10.0 percent, which was implemented in conjunction with these mechanisms. This return on equity reflects a level similar to that of other Arizona utilities, such as I described in my Direct Testimony.

Q. You cite a 10.0 percent authorized return on equity for APS. How do authorized returns on equity for water utilities compare to those of other utilities?

A. The table below compares the average authorized returns on equity for several types of utilities, as tabulated by AUS Utility Reports (published by the firm of AWC witness Pauline Ahern):

Year	Elec	Comb E&G	Gas	Water
2008	10.75%	10.74%	10.94%	10.08%
2009	10.59%	10.61%	10.69%	10.06%
2010	10.72%	10.58%	10.62%	10.02%
2011	10.66%	10.53%	10.64%	9.98%
2012	10.52%	10.40%	10.60%	9.98%

Source: AUS Utility Reports.

These figures, which reflect period currently-authorized returns on equity and not necessarily authorized returns on equity established during the periods shown, show a declining trend in the authorized returns on equity for various types of utilities. In addition, the average authorized returns on equity for water utilities are significantly lower than those of the other types of utilities. This is indicative of a regulatory acceptance of the lower risks and correspondingly lower costs of capital for water utilities in comparison to that for electric, combination gas-electric and natural gas utilities.

Q. In your previous response, you indicated that the cited authorized returns on equity were not necessarily authorized returns decided in the indicated periods. Can you provide the most recently-authorized returns on equity for electric and natural gas utilities?

A. Yes, I can. The table below provides the authorized returns on equity (by year) for electric and natural gas utilities throughout the United States:

Year	Electric	Natural Gas
2008	10.46%	10.37%
2009	10.48%	10.19%
2010	10.34%	10.08%
2011	10.29%	9.97%
2012	10.01% 1/	9.94%
2013	9.90% 1/	9.50%

1/ Excludes Virginia surcharge/rider generation cases.
Source: Regulatory Research Associates, Regulatory Focus.

This indicates a declining trend in regulatory awards to electric and natural gas utilities. It also indicates that the most recent return on equity award averages (i.e., 2012 and 2013) are at 10.0 percent and below.

Q. How do these return levels compare to recently authorized returns on equity in Arizona for electric and natural gas utilities?

A. This is shown on my Schedule DCP-10. This also is reflective of authorized returns on equity of below 10.0 percent.

IV. RESPONSE TO STAFF WITNESS STEVEN M. OLEA

Q. What is the nature of Utilities Division Staff Witness Steven M. Olea?

A. Mr. Olea's Direct Testimony in the Re-hearing phase of this proceeding reflects Staff's position that "adjustments to the ROE were not necessarily precluded" in connection with the implementation of the SIB mechanism (page 2, line 3). Mr. Olea also notes, however, that Staff considers the 10.55 percent cost of equity to be appropriate even in connection with the SIB mechanism. It appears that the Staff position in the Re-hearing phase of this proceeding is summed up by Mr. Olea (page 2, lines 15-21):

> Since the Commission granted AWC a 10.55 percent ROE in Phase I of this case, Staff assumed that was the ROE that the Commission believed was fair and reasonable for the Company based on the test year facts. Therefore, Staff is of the opinion that the question before the Commission is not whether the 10.55 percent ROE should be reduced because AWC was subsequently granted a SIB, but the question is whether or not the Commission

> believes that the 10.55 percent ROE is the proper ROE regardless of the presence of a SIB mechanism.

Q. Do you believe that the 10.55 percent return on equity is proper at this time?

A. No, I do not. As I noted in my Direct Testimony, and recited in previous pages of this Rebuttal Testimony, the current cost of equity for water utilities is less than 10.0 percent (actually 9.25 percent). I also noted that recent Commission decisions for water utilities both in Arizona and throughout the United States are less than 10.0 percent. In fact, it is apparent (see Schedule DCP-9 and DCP-10) that the 10.55 percent authorized for AWC in Decision No. 73736 is one of only two instances since 2010 where this Commission has authorized a return on equity greater than 10.0 percent.

As stated previously, the only stated reason for giving AWC Eastern Group a higher return on equity is to recognize its "increased need for infrastructure replacement and improvements." Since the SIB mechanism is designated to address this need, there is no compelling reason to also grant a higher return on common equity.

Q. On page 5, lines 9-12, Mr. Olea states "The 10.55 percent ROE should be adjusted, either up or down, by the Commission only if the Commission receives evidence in this case that convinces it that the 10.55 percent ROE is not the proper ROE regardless of the SIB, not because of the SIB." How does this statement relate to your Direct Testimony and Rebuttal Testimony in this proceeding?

A. As I have indicated above, my testimony indicates that the current cost of equity for a water utility is below 10.0 percent, and well below the 10.55 percent return on equity cited in Decision No. 73736.

Q. On pages 2 and 3, Mr. Olea distinguishes between the concepts of cost of capital and the SIB. Do you have any comments about this?

A. Yes, I do. Mr. Olea indicates the following on the bottom of page 2 and the top of page 3:

> Staff believes the ROE granted to a water utility is not expressly related to whether or not the utility is granted a SIB. Staff believes that the Commission grants a ROE to a utility based on what the Commission believes is reasonable for that utility according to the facts and evidence attributable to each utility's pro-forma test year. A SIB is a post-test year matter in that the SIB mechanism addresses plant investments that will be installed over a five year period following the Commission's decisions

My response to this statement relates to the use of the terms cost of capital and test year in the same sentence. I want to emphasize that the cost of capital is a forward-looking concept which focuses on capital market data that, in an efficient market, takes into consideration all known and relevant facts and circumstances. One such circumstance would be the existence of a SIB mechanism and its impact on future cost recovery by the utility.

I emphasize that I do not mean to imply that Mr. Olea is not aware that the cost of capital is forward looking. I just want the record to be clear that cost of capital is not an historic concept, like many test year items, and is distinguished from the test year concept that focuses on current considerations of relevant future information.

Q. Does this conclude your Rebuttal Testimony?

A. Yes it does.

Exhibit DCP-9

RECENT AUTHORIZED RETURNS ON COMMON EQUITY FOR ARIZONA WATER UTILITIES

Utility	Decision	Date	Return on Equity
Far West Water & Sewer, Inc.	ROO only	8/29/2013	9.50%
Arizona Water Company --Northern Group (2 systems)	Settlement Agreement	8/27/2013	10.00%
Rio Rico Utilities, Inc.	73996	7/30/2013	
Water			9.20%
Waste Water			9.20%
Arizona Water Company -- Eastern Group			
(6 systems)	73736	2/20/2013	10.55%
Pima Utility Company	73573	11/21/2012	9.49%
AZ-American Water Co. (3 systems)	73145	5/2/2012	10.60%
Arizona Water Company -- Western Group (3 systems)	73144 approved settlement	5/1/2012	10.00%
GoodmanWater Company	72897	2/21/2012	NA
Rio Rico Utilities, Inc.	72059	1/6/2011	
Water			9.50%
Waste Water			9.50%
Litchfiled Park Service Co.	72026	12/10/2010	
Water			8.01%
Waste Water			8.01%
Global Utilities	71878	9/14/2010	
Palo Verde			9.00%
Valencial/Gr. Buckeye			9.00%
WUGT			N/A
Willow			9.00%
Santa Cruz			9.00%
Valencial/Town			9.00%
Arizona Water Company (17 systems)	71845	8/25/2010	9.50%
Litchfiled Park Service Co.	Application Filed		
Water			9.20%
Waste Water			9.20%

Source: Information compiled by RUCO from Arizona Corporation Commission decisions.

Schedule DCP-10

RECENT AUTHORIZED RETURNS ON COMMON EQUITY FOR ARIZONA ELECTRIC AND NATURAL GAS UTILITIES

Utility	Decision	Date	Return on Equity
Southwest Gas	Decision No. 72723	Jan. 6, 2012	9.50%
UNS Gas	Decision No. 73142	May 1, 2012	9.75%
Arizona Public Service	Decision No. 73183	May 24, 2012	10.00%
Tucson Electric Power	Decision No. 73912	June 27, 2013	10.00%
UNS Electric	Settlement Agreement		9.50%

Source: Information compiled by RUCO from Arizona Corporation Commission decisions.

BEFORE THE ARIZONA CORPORATION COMMISSION

BOB STUMP
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SUSAN BITTER SMITH
Commissioner

IN THE MATTER OF THE APPLICATION OF ARIZONA WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR ADJUSTMENTS TO ITS RATES AND CHARGES FOR UTILITY SERVICE FURNISHED BY ITS EASTERN GROUP AND FOR CERTAIN RELATED APPROVALS.	DOCKET NO. W-01445A-11-0310

REBUTTAL

TESTIMONY

OF

RALPH C. SMITH

ON BEHALF OF

RESIDENTIAL UTILITY CONSUMER OFFICE

OCTOBER 31, 2013

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EXHIBITS

EXECUTIVE SUMMARY
ARIZONA WATER COMPANY
DOCKET NO. W-01445A-11-0310
REBUTTAL TESTIMONY OF RALPH C. SMITH

Mr. Smith's rebuttal testimony responds to the direct testimony on rehearing filed by American Water Company, Liberty Utilities Corp (Rio Rico Water and Sewer) and Global Water Utilities, ("Liberty/Global") and Staff.

Mr. Smith concludes that the implementation of the SIB with a 10.0 percent ROE strikes the right balance and produces a reasonable result in the current Arizona Water Company's Eastern Group rate case.

I. INTRODUCTION

Q. Please state your name, occupation and business address.

A. My name is Ralph C. Smith. I am a Senior Regulatory Consultant at Larkin & Associates, PLLC, 15728 Farmington Road, Livonia, Michigan 48154. However, as noted below, for purposes of this case, my work is being conducted not on behalf of Larkin & Associates but rather as an independent subcontractor/consultant to Technical Associates, Inc. which has contracted with RUCO to provide regulatory consulting services in this case.

Q. Are you the same Ralph C. Smith, who filed direct testimony on rehearing on behalf of the Residential Utility Consumer Office ("RUCO") in this case?

A. Yes.

Q. What is the purpose of your rebuttal testimony in this proceeding?

A. My rebuttal testimony responds to the direct testimony on rehearing filed by Arizona Water Company, Liberty Utilities Corp. (Rio Rico Water & Sewer) and Global Water Utilities ("Liberty/Global") and the Staff on issues relating to the impact of the System Improvement Benefits ("SIB") mechanism and the cost of common equity for Arizona Water Company (AWC). Another witness for RUCO, Mr. David Parcell, is also addressing the cost of common equity for AWC and provides additional explanations of how the SIB reduces risk and why an ROE of no higher than 10.0 percent is appropriate for the AWC Eastern Group in this case.

Q. How is your testimony organized?

A. My testimony is organized into the following sections.

First, I respond to certain issues raised in the direct testimony on rehearing by Arizona Water Company.

Second, I respond to the direct testimony on rehearing by Liberty.

Third, I respond to the direct testimony of Staff.

Fourth and finally, I summarize my recommendations.

II. RESPONSE TO ARIZONA WATER COMPANY

Q. What is the position of Arizona Water Company concerning the return on equity and the SIB?

A. AWC's position is that in this case it should be entitled to both a 10.55 percent return on equity and the SIB.

Q. Do you agree with AWC's position on this?

A. No. A 10.55 percent ROE is too high.[1] Additionally, because the 10.55 ROE was specifically stated to be for addressing the Company's need to replace aging

[1] See, e.g., , the direct rehearing testimony of RUCO witness David Parcell, which presents an updated ROE study for this utility. Additionally, as pointed out by Mr. Parcell in his rebuttal testimony, there appears to be no evidence in Decision No. 73736 where a 10.55 percent cost of equity was derived from any evidence or other quantitative analysis. As he points out, the only reference for the 10.55 percent ROE there is the referral to the 10.0 percent cost of equity approved for AWC's Western Group and statements citing the "increased need for infrastructure replacement and improvement" and the extent that this "necessitates a somewhat higher ROE" for the AWC Eastern Group. From such statements, it appears that the 10.0 percent ROE that would otherwise apply had been increased to 10.55 percent to address the need for infrastructure replacement and improvement.

infrastructure, it is conceptually duplicative of the impact of implementing a new rate surcharge (the SIB). Both the higher ROE and the SIB provide additional revenue and cash flow to the utility between rate cases.

Q. How did the 10.55 percent ROE address the Company's need to replace aging infrastructure?

A. The 10.55 percent ROE addressed the Company's need to replace aging infrastructure by providing a higher than otherwise necessary ROE which provides additional return and cash flow to the Company between rate cases and results in an increased revenue requirement of approximately $294,000 annually.[2]

Q. How does a DSIC mechanism, such as the SIB, address the Company's need to replace aging infrastructure?

A. Distribution System Investment Charge (DSIC) mechanisms, such as the SIB, allow for rate increases for non revenue producing investments to replace aging infrastructure outside of general rate proceedings. The DSIC (or SIB) reduces regulatory lag and provides the utility with cash flow and earnings support between rate cases, meaning that the revenue increases associated with the spending on qualified infrastructure occur on a more timely basis and the utility does not need to wait until the next rate case to start receiving recovery.

Q. Are a higher than necessary ROE and the SIB both ways of providing for higher revenue and cash flow between rate cases to address replacement of aging infrastructure?

[2] See, e.g., Exhibit RCS-1, filed with my Direct Testimony.

A. Yes. The series of Decisions in this case were first to approve the higher ROE (without a DISC) to address infrastructure replacement needs and then subsequently to approve the SIB (which is a form of DSIC). Both the higher ROE and the SIB are ways of providing for higher revenue and cash flow between rate cases to address replacement of aging infrastructure.

Q. How does the inclusion of an efficiency credit in the SIB function affect whether the SIB provides for higher revenue and cash flow between rate cases to address the utility's replacement of aging infrastructure?

A. The inclusion of an efficiency credit is apparently intended to recognize that replacing aging infrastructure such as old, leaking pipe should result in a reduction to the utility's expenses. Expense savings could be difficult to estimate precisely in advance, but could include reductions to costs such as maintenance expense and lost and unaccounted for water. Without something such as an efficiency credit being included in the SIB, the benefits of such expense reductions would flow entirely to the utility's investors during the period between rate cases. Having an efficiency credit incorporated into the SIB helps assure that at least some of the cost savings are used to offset the additional surcharge revenue requirements related to the infrastructure replacement. Having the efficiency credit in the SIB is thus a design improvement over most of the other water utility DSICs that are being used in other jurisdictions. While representing a design improvement (versus having no efficiency credit or provision for expense reductions), it has not been demonstrated that the 5 percent efficiency credit that has been included in the SIB sufficiently accounts for expense savings related to infrastructure replacement. In summary, the SIB, even with an efficiency credit, constitutes a new utility surcharge that provides additional revenue and cash flow to the utility between rate case to address infrastructure replacement.

Q. Please explain how the SIB is risk reducing to AWC.

A. The SIB is risk reducing to AWC because it improves cash flow and reduces regulatory lag related to cost recovery of qualifying infrastructure investment. The SIB provides for a quicker recovery of capital costs on such infrastructure investment than would typically occur by the utility filing periodic rate cases at multi-year intervals. RUCO witness Parcell explains further that credit rating agencies tend to view such utility surcharges positively because they reduce the utility's risk.

Q. Does AWC's testimony on the SIB and ROE cause you to change your recommendation that a 10.0 percent ROE with the addition of the new SIB surcharge strikes the appropriate regulatory balance?

A. No. As explained below, I continue to recommend 10.0 percent ROE with the SIB as striking the appropriate regulatory balance. As discussed below, I believe that Judge Nodes' well-reasoned ROO which found that an ROE of 10.0 percent was reasonable for this utility represents the most reasonable outcome for this case.

III. REPONSE TO LIBERTY/GLOBAL

Q. What is the position of Liberty/Global on the System Improvement Benefits (SIB) mechanism?

A. Liberty/Global's position is that if the Commission has allowed "electric companies such as APS or TEP to have these types of plant rate adjustors it seems that it should be okay for water/wastewater companies as well."[3] Liberty/Global's witness, Mr. Walker, sites extensively to an APS rate case decision that was based upon a 2012 settlement. He also criticizes RUCO for its supposed "inconsistent" support of the APS settlement (which had included some surcharge mechanisms) and RUCO's opposition in the current case to the SIB.[4]

Q. Do electric utilities and water utility's have the same level of risk?

A. I don't believe so. Water utilities are typically understood to have a lower risk than electric utilities. RUCO witness Parcell presents additional testimony concerning this.

Q. Is RUCO's support of a settlement reached in the APS rate case inconsistent with RUCO's position in the current re-hearing regarding the AWC return on equity and SIB issues?

A. I don't believe so. RUCO has stated that it reviews surcharge mechanisms on a case-by-case basis. Moreover, for purposes of this rehearing, RUCO is advocating that if the SIB remain in place, the excess ROE that addresses AWC's infrastructure replacement should be removed and AWC's Eastern Group ROE should be reduced to 10.0 percent. As noted in my direct testimony, a 10.0 percent ROE and a SIB in the current AWC Eastern Group rate case would be similar to the settlement results recently reached by other parties (not including RUCO) for AWC's Northern Group case (Docket No. W-01445A-12-0348) which reflects a 10.0 percent ROE and which includes a nearly identical SIB mechanism to the one approved herein.[5] A 10.0 ROE result for the AWC Eastern Group in the

[3] Walker Rehearing Direct Testimony, page 3.
[4] Id at page 2.
[5] RUCO was not a party to that agreement as it opposed the SIB and currently there is a Motion for Rehearing in that matter before the Commission.

current case would also compare with the AWC Western Group where there was a 10.0 percent ROE and no SIB.[6]

Q. What is RUCO's position concerning the ROE that should apply?

A. In this re-hearing, as explained in my testimony and in the testimony of Mr. Parcell, RUCO is advocating for a return on equity for the AWC Eastern Group that is no higher than 10.0 percent. In the current AWC Eastern Group rate case, RUCO has concluded that the combination of an enhanced ROE of 10.55 percent that was originally boosted by approximately 55 basis points to address infrastructure replacement, coupled with the later authorization of a new SIB surcharge that also addresses infrastructure replacement, is unbalanced and unreasonable.[7] A lower than 10.0 percent ROE for a water utility such as AWC could be supported (and has been by RUCO witness Parcell). The 10.0 percent ROEs used by AWC's Northern Group and Western Group from recent settlements, also provide a reasonableness check on what the ROE should be for AWC's Eastern Group. A 10.0 percent ROE also incidentally corresponds with the 10.0 ROE for APS that is stated in the materials cited by Mr. Walker from the APS rate case order and settlement. In particular, Mr. Walker's testimony attached Decision No. 73183 from the APS case, which states at page 11 that Section V of the APS settlement "adopts a return on common equity of 10.0 percent." Based on such factors, an ROE of no higher than 10.0 percent for the AWC Eastern Group would be reasonable in this case.

IV. RESPONSE TO STAFF

Q. What is Staff's position about the SIB and the 10.55 percent ROE?

[6] See, e.g., Decision No. 73144.

[7] The Commission's Order No. 73736, dated February 20, 2013, had used a 10.55 percent ROE and no DSIC.

A. Staff direct testimony on rehearing supports the settlement that had been reached among the parties (not including RUCO). As described by Mr. Olea at page 2 of his direct rehearing testimony:

- Staff believed that adjustments to the ROE were not necessarily precluded when the SIB was approved;
- Staff considered the 10.55 percent ROE to be appropriate at the time Staff made its recommendation in this case to grant the Company a SIB and not reduce that ROE; and
- Staff still considers that ROE to be appropriate.

Staff's position is also apparently that the inclusion of a 5 percent Efficiency Credit in the SIB presents a reason for justifying a 10.55 percent ROE for this utility.

Q. Do you agree with the Staff position in support of the settlement among other parties (not including RUCO) that a 10.55 percent ROE is appropriate for this water utility at this time?

A. No. The ROE was originally boosted to 10.55 percent (apparently from the 10.0 percent from AWC's other group) to address infrastructure replacement needs and in conjunction with the denial of a DSIC. The subsequent approval of a DSIC-type mechanism (i.e., the SIB) to address infrastructure replacement needs should thus result in a similar adjustment of the ROE back down to 10.0 percent. Judge Nodes' ROO dated May 28, 2013 at page 55 concluded that the ROE for AWC's Eastern Group should be 10.0 percent. At pages 50-54, the ROO concluded that the SIB should be adopted. Page 55 of the ROO contained a related explanation of why the ROE should be 10.0 percent. I agree with Judge Nodes' conclusion that the ROE for AWC's Eastern Group should be 10.0 percent.

Q. Please discuss the reasons cited by Judge Nodes for finding a 10.0 percent ROE to be reasonable for AWC's Eastern Group.

A. The following explanation from Judge Nodes at page 55 of the ROO explains why the adoption of the SIB should be accompanied with an ROE of 10.0 percent:

> **In adopting a higher ROE for AWC in Phase 1 than would otherwise have been authorized, we believe the Company's infrastructure replacement needs were recognized, at least in part. Our approval of the proposed SIB mechanism in this Phase 2 proceeding is also intended to enable AWC to pursue its replacement and improvement needs in a more timely manner and, therefore, at least partially achieves the same goal that was contemplated in awarding the Company a higher ROE in Phase 1. ... We therefore find that the 10.55 percent ROE authorized in Phase 1 should be adjusted downward to 10.0 percent to reflect that commonality of purpose. We believe that a 10.0 percent ROE is reasonable under the circumstances of this case, especially given the authorized Western Group ROE of 10.0 percent (with no SIB mechanism) in Decision No. 73144, and AWC's recent settlement in the pending Northern Group case (Docket No. W-01445A-12-0348) reflecting a 10.0 percent ROE (which includes a nearly identical SIB mechanism to the one approved herein).** ... Applying the Company's 6.82 percent cost of debt and 10.0 percent cost of equity to the capital structure of 49.03 percent debt and 50.97 percent equity produces an overall WACC for AWC of 8.44 percent, which we find to be reasonable under the overall facts and circumstances of this case.
> (Emphasis supplied; footnotes and citations omitted.)

Q. Has Staff acknowledged that the Commission could reduce the 10.55 percent ROE that had been granted to AWC?

A. Yes. For example, Staff's testimony states at page 4 that: "Staff has also stated numerous times, and in many cases, that the Commission has vast authority and discretion when it comes to rate setting. **<u>If this Commission believes that it is just and reasonable to reduce a utility's ROE because it grants that utility a SIB, it has every right to do so.</u>**" (Emphasis supplied.)

Q. At the June 12, 2013 Open Meeting, what did Staff state about Judge Nodes' ROO and a 10.0 percent ROE with the SIB?

A. At pages 27-28 of the Commission's June 12, 2013 Open Meeting transcript, Mr. Olea indicated, as a settlement signatory party, that Staff supported the settlement agreement that had been reached (with the 10.55 percent ROE and the SIB), but acknowledged that Judge Nodes' ROO, as written, indicated that the ROE should have been 10.0 percent all along, and Mr. Olea concluded that "Staff can also live with the ROO the way it was written" with the 10.0 percent ROE.

Q. Since the filing of your direct rehearing testimony, which had presented material on DSIC research compiled by the Alaska AG-RAPA, has other material on water utility DSIC and ROE determinations come to your attention?

A. Yes. I have recently become aware of an Order dated October 25, 2013 from the Kentucky Public Service Commission in the most current Kentucky American Water Company rate case which rejected a utility-proposed DSIC (and a utility proposed Purchased Power & Chemical Charge Adjustor ("PPCCA") mechanism) and authorized an ROE of 9.7 percent. This is the most recent regulatory decision of which I am aware in a litigated water utility rate case which addressed both DSIC and ROE issues. Exhibit RCS-4, attached to my rebuttal, includes the relevant sections from that Order which discuss the DSIC, PPCCA and ROE issues.

V. RECOMMENDATION

Q. Please summarize your recommendation.

A. Providing an ROE of 10.0 percent for AWC's Eastern Group in combination with the granting of the SIB strikes the right balance and is reasonable in this case. Judge Nodes' well-reasoned ROO found that an ROE of 10.0 percent was appropriate for this utility given the SIB, which provided a means of addressing AWC's infrastructure needs, and given that a 10.0 percent ROE is also being used in AWC's Western Group and Northern Group cases. A 10.0 percent ROE for AWC's Eastern Division compares with the 10.0 percent ROEs that has been found to be reasonable for other AWC water utility divisions (such as the Western Group that does not have a DSIC or SIB) and the Northern Group (which does have a SIB that is nearly identical to the one approved by the Commission in Decision No. 73736). Additionally, as noted above, the most current decision in a litigated water utility rate case of which I am aware that has addressed both DSIC and ROE issues rejected the utility-proposed DISC and authorized an ROE of 9.7 percent.[8] Finally, RUCO witness Parcell has shown in the updated cost of equity study filed with his direct testimony that the ROE could be set lower than 10.0 percent; however, an ROE of 10.0 percent could be reasonable for this water utility under the circumstances of this case, where the utility has been granted the risk-reducing rate mechanism of new rate surcharge to address infrastructure replacement, i.e., the SIB. I recommend that the ROE for AWC's Eastern Group be set at no higher than 10.0 percent.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.

[8] See excerpts from the October 25, 2013 Kentucky PSC Order in Kentucky American Water Company's rate case, Case No. 2012-00520, on ROE and DSIC issues, included in Exhibit RCS-4.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY-AMERICAN WATER COMPANY FOR AN ADJUSTMENT OF RATES SUPPORTED BY A FULLY FORECASTED TEST YEAR	))))	CASE NO. 2012-00520

ORDER

Kentucky-American Water Company ("Kentucky-American") has applied to adjust its rates for water service to produce additional revenues of $12,317,702, or 15.05 percent, over forecasted operating revenues from existing water rates of $81,832,138.[1] By this Order, we establish rates that will produce an annual increase in revenues from water sales of $6,904,134, or 8.25 percent, over adjusted forecasted revenues from water sales of $83,642,642; deny Kentucky-American's request to establish a Distribution System Improvement Charge and a Purchased Power and Chemical Charge; and approve adjustments to Kentucky-American's nonrecurring charges.

BACKGROUND

Kentucky-American, a Kentucky corporation, owns and operates water production and distribution facilities that provide water service to 124,344 customers in Bourbon, Clark, Fayette, Gallatin, Grant, Harrison, Jessamine, Owen, Scott, and Woodford counties, Kentucky.[2] It provides wholesale water service to Harrison County

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[1] As required by KRS 278.192(2)(b), Kentucky-American submitted its base period update on May 15, 2013, to report the actual results for the base period months that were originally forecasted. This update contains corrections of certain errors and the "slippage" that result in a revised revenue increase of $12,068,431, or $249,271 below the originally proposed increase.

[2] *Annual Report of Kentucky-American Water Company to the Public Service Commission for the Calendar Year Ended December 31, 2012* at 5, 30.

Water Association, East Clark Water District, Peaks Mill Water District, Jessamine-South Elkhorn Water District, and the cities of Georgetown, Midway, North Middletown, Nicholasville, and Versailles.[3] It directly or indirectly provides potable water service to approximately 490,000 persons.[4] Kentucky-American last applied for a rate adjustment in 2010.[5]

Kentucky-American is currently organized into two divisions: Northern Division and Central Division. The Northern Division consists of all facilities located in Gallatin, Grant, and Owen counties, Kentucky. As of May 31, 2012, the Northern Division had approximately 3,862 customers.[6] Kentucky-American's remaining facilities compose the Central Division. The Central Division has approximately 120,500 customers.

PROCEDURE

On November 29, 2012, Kentucky-American notified the Commission in writing of its intent to apply for an adjustment of rates using a forecasted test period. On December 28, 2012, it submitted its application. The Commission established this docket and permitted the following parties to intervene in this matter: the Attorney General of Kentucky ("AG"), Lexington-Fayette Urban County Government ("LFUCG"), and Community Action Council for Lexington-Fayette, Bourbon, Harrison, and Nicholas Counties, Inc. ("CAC").

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[3] *Id.* at 33.

[4] *See* http://www.amwater.com/kyaw/about-us/ (last visited Oct. 20, 2013).

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

[6] Case No. 2012-00096, *Application of Kentucky-American Water Company for a Certificate of Public Convenience and Necessity Authorizing Construction of the Northern Division Connection*, Kentucky-American's Response to Commission Staff's First Request for Information, Item 33 (filed July 23, 2012).

On January 22, 2013, the Commission suspended the operation of the proposed rates for six months and established a procedural schedule for this proceeding. Following discovery, the Commission held an evidentiary hearing in this matter on June 4-5, 2013, in Frankfort, Kentucky.[7] We also conducted a public meeting in Lexington, Kentucky, on May 28, 2013 to receive public comment on the proposed rate adjustment. All parties submitted written briefs following the conclusion of the evidentiary hearing.

On July 26, 2013, Kentucky-American notified the Commission of its intent to place the proposed rates into effect for service rendered on and after July 27, 2013. In response, we directed Kentucky-American to maintain appropriate records of its billing to permit any necessary refunds.

[7] The following persons testified at the evidentiary hearing: Cheryl Norton, President, Kentucky-American; Keith Cartier, Vice President of Operations, Kentucky-American; Scott Rungren, Financial Analyst, American Water Works Service Company, Central Division; Melissa Schwarzell, Financial Analyst, American Water Works Service Company, Central Division; Linda C. Bridwell, Manager Rates and Regulation for Kentucky and Tennessee, American Water Works Service Company; Gary VerDouw, Director of Rates, American Water Works Service Company, Central Division; Carl Meyers, Director of Income Tax, American Water Works Company; David Baker, Vice President, American Water Works, North East Division, and President, New Jersey-American Water Company; Paul R. Herbert, President, Valuation and Rate Division, Gannett Fleming, Inc.; Stephen M. Rackers, Consultant, Brubaker and Associates, Inc.; Brian Kalcic, Principal, Excel Consulting; William O'Mara, Commissioner of Finance, LFUCG; and Jack E. Burch, Executive Director, CAC. The following persons submitted written testimony but did not appear at the evidentiary hearing: Lance Williams, Director of Engineering for Kentucky and Tennessee, American Water Works Service Company; Lewis Keathley, Financial Analyst, American Water Works Service Company, Central Division; Jermaine Bates, Rates Analyst, American Water Works Service Company, Central Division; James H. Vander Weide, Professor of Finance and Economics, Duke University; and J. Randall Woolridge, Professor of Finance, Pennsylvania State University. After the hearing, Witnesses Meyers, Vander Weide, and Woolridge responded to written questions from Commission Staff.

Table IV

Account Titles		Application Forecasted Revenues and Expenses		Commission Adjustments		Commission Forecasted Revenues and Expenses
Operating Revenue:						
Water Sales	$	81,832,138	$	1,810,504	$	83,642,642
Other Operating Revenues		1,834,066		0		1,834,066
AFUDC		491,629		4,244		495,873
Total Operating Revenues		84,157,833		1,814,748		85,972,581
Operating Expenses:						
Operation and Maintenance Expenses		33,892,178		(123,840)		33,768,338
Depreciation		13,121,602		19,815		13,141,417
Amortization - UPAA		210,261		0		210,261
Current State Income Tax		491,702		83,919		575,621
Deferred State Income Tax		674,791		38,745		713,536
Current Federal Income Tax		3,658,210		485,601		4,143,811
Deferred Federal Income Tax		2,899,194		465,976		3,365,170
Investment Tax Credit		(84,792)		0		(84,792)
General Taxes		5,114,771		11,406		5,126,177
Total Operating Expenses		59,977,917		981,622		60,959,539
Net Income Available for Common	$	24,179,916	$	833,126	$	25,013,042

Rate of Return

Capital Structure. Kentucky-American's proposed capital structure, which is based on the projected 13-month average balances for the forecasted test period, and the costs assigned to each capital component are shown in Table V.

Table V

Kentucky-American's Application				
Components		Capitalization	Ratio	Assigned Returns
Short-Term Debt	$	7,845,933	2.041%	0.8100%
Long-Term Debt		200,086,655	52.037%	6.1400%
Preferred Stock		4,489,951	1.168%	8.5200%
Common Equity		172,085,833	44.754%	10.9000%
Total Capitalization	$	384,508,372	100.000%	

In its base year update, Kentucky-American revised its forecasted capital structure to reflect: (1) the delay of Kentucky-American's issuance of $8 million of long-term debt from November 2012 to May 15, 2013; (2) the delay of Kentucky-American's issuance of $3 million of long-term debt from May 2013 to November 2013; (3) revisions in interest rates and issuance costs for the projected long-term debt issuance in May 2013, November 2013, and May 2014; (4) revisions in Kentucky-American's projection for the cost of short-term debt; and (5) the weighted average cost of capital to reflect the effect of the other revisions.[178] Kentucky-American's revised forecasted capital structure and assigned cost rates are shown in Table VI.

Table VI

Kentucky-American's Update			
Components	Capitalization	Ratio	Assigned Returns
Short-Term Debt	$ 9,204,650	2.391%	0.5000%
Long-Term Debt	199,241,777	51.748%	6.0600%
Preferred Stock	4,489,938	1.166%	8.5200%
Common Equity	172,085,452	44.695%	10.9000%
Total Capitalization	$ 385,021,817	100.000%	

Although he did not object to Kentucky-American's capital structure, the AG used the capital structure that appears in Table VII to develop his recommended weighted cost-of-capital.[179]

[178] Rebuttal Testimony of Scott W. Rungren at 5.

[179] Direct Testimony of J. Randall Woolridge, Ex. JRW-1.

Table VII

AG's Capital Structure			
Components	Capitalization	Ratio	Assigned Returns
Short-Term Debt	$ 7,845,926	2.040%	0.8100%
Long-Term Debt	200,086,674	52.040%	6.0500%
Preferred Stock	4,489,964	1.170%	8.5200%
Common Equity	172,085,807	44.750%	8.5000%
Total Capitalization	$ 384,508,371	100.000%	

Upon review of the record, the Commission finds that Kentucky-American's revised capital structure accurately projects the test-year capitalization requirements, and should be used to develop the weighted cost-of-capital.

Short-Term and Long-Term Debt. Kentucky-American originally projected short-term and long-term interest rates of 0.81 percent and 6.14 percent, respectively.[180] In its base period update, Kentucky-American revised its original projections of short-term and long-term interest rates to 0.5 percent and 6.06 percent, respectively.[181] The AG proposed short-term and long-term interest rates of 0.5 percent and 6.05 percent, respectively.[182] Upon review of the supporting calculations, the Commission finds that Kentucky-American's revised projections result in a more current projection of the forecasted debt rates and that Kentucky-American's proposed cost of debt is reasonable and should be accepted.

[180] Application Ex. 37, Sch. J-1.1/J-2.1.

[181] Base Period Update Filing-Schedule J-1.1/J-2.1.

[182] Direct Testimony of J. Randall Woolridge at 16 - 17.

Preferred Stock. Kentucky-American proposed an embedded cost of preferred stock of 8.52 percent.[183] No party objected to this forecasted cost rate. We find that the proposed embedded cost of preferred stock is reasonable and should be accepted.

Return on Equity. Kentucky-American recommends a return on equity ("ROE") ranging from 10.4 percent to 11.4 percent and specifically requests an ROE of 10.9 percent based on its discounted cash flow model ("DCF"), the ex ante risk premium method, the ex post risk premium method, and Capital Asset Pricing Model ("CAPM").[184]

To perform its analysis, Kentucky-American Witness Vander Weide employed two comparable risk proxy groups in its analysis. The first proxy group consists of six water companies included in the *Value Line Investment Survey* ("*Value Line*") that: pay dividends; did not decrease dividends during any quarter for the past two years; have an analyst's long-term growth forecast; and are not part of an ongoing merger. All of these water companies have a *Value Line* Safety Rank of at 2 or 3, with 3 being the average of all *Value Line* companies.[185]

Dr. Vander Weide's second proxy group consisted of seven natural gas local distribution companies. Each company is in the natural gas distribution business; paid quarterly dividends over the last two years; had not decreased dividends over the last two years; was not involved in an ongoing merger; and had an available I/B/E/S long-

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[183] Application Ex. 37, Sch. J-1.1/J-2.1.

[184] Direct Testimony of Gary M. VerDouw at 10; Direct Testimony of James H. Vander Weide at 3-4.

[185] Direct Testimony of James H. Vander Weide at 27.

term growth estimate.[186] Each also had a *Value Line* Safety Rank of 1, 2 or 3 and an investment grade bond rating.[187]

Dr. Vander Weide applied a quarterly DCF model to the water and gas proxy groups. He relied upon a comparable group of gas distribution utilities for the ex ante risk premium ROE estimation. He relied upon Standard & Poor's ("S&P") 500 stock portfolio and Moody's A-rated Utility Bonds to derive the ex post risk premium ROE estimation. He conducted a second study using stock data from the S&P Utilities rather than the S&P 500. Although Dr. Vander Weide performed CAPM analyses using both proxy groups, he did not rely upon the CAPM estimations in reaching his recommended ROE. He rejected the CAPM analyses because the average beta coefficient for the proxy companies was significantly below a value of 1 and because of the proxy group of water companies' small market capitalization.[188] As part of his ROE recommendations, Dr. Vander Weide also made adjustments for flotation costs.

AG Witness Woolridge takes issue with several aspects of Kentucky-American's methodology. First, he argues that Dr. Vander Weide's water proxy group is too small to estimate an equity cost rate and that Dr. Vander Weide erred in excluding the three smallest water companies from his proxy group. He also disagrees with the inclusion of NiSource in Dr. Vander Weide's gas proxy group due to its riskier operating and financial profile and its electric operations. Second, he states that Dr. Vander Weide's DCF approach included an excessive adjustment to the dividend yield to reflect

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[186] *Id.* at 30. I/B/E/S, a division of Thomson Reuters, reports analysts' earnings per share ("EPS") growth forecasts for a broad group of companies. The I/B/E/S growth rates are widely circulated in the financial community, include the projections of reputable financial analysts who develop estimates of future EPS growth, are reported on a timely basis to investors, and are widely used by institutional and other investors. *Id.* at 22.

[187] *Id.* at 30.

[188] *Id* at 3 - 4, 45 - 48.

quarterly payment of dividends. Third, Dr. Woolridge asserts that the Kentucky-American study relies exclusively on the forecasted earnings per share ("EPS") growth rates of Wall Street analysts and *Value Line* to compute the equity cost rate, that the long-term earnings growth rates of Wall Street analysts are overly optimistic and upwardly-biased, and that the estimated long-term EPS growth rates of *Value Line* are overstated.

Fourth, Dr. Woolridge notes several problems associated with weighting the DCF results for the water and gas proxy groups by the market capitalization of the companies in computing the average DCF for each group. Fifth, he contends that both the risk premium and CAPM analyses performed by Kentucky-American contain excessive base interest rates and market risk premiums. Sixth, he observes that Dr. Vander Weide ignored his own CAPM equity cost rate results. Seventh, Dr. Woolridge states that flotation cost adjustments to the equity cost rate results are unwarranted.[189] Contending that the utility has failed to identify any actual floatation costs and questioning whether the necessary conditions that support the use of a floatation cost adjustment are present in the current case, Dr. Woolridge challenges the appropriateness of Dr. Vander Weide's use of floatation cost adjustment in his DCF analysis.[190]

Dr. Woolridge conducted his own analysis, applying the DCF model and the CAPM methods to a water proxy group and a gas proxy group and affording primary weight to the results of the DCF analysis. Based upon that analysis, he proposes an

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[189] Direct Testimony of J. Randall Woodridge at 58.

[190] *Id.* at 68 - 70.

ROE range from 7.3 percent to 8.6 percent and recommends an awarded ROE of 8.5.[191]

To perform his analysis, Dr. Woolridge uses a proxy group of nine publicly-held water utility companies covered by *Value Line* and *AUS Utility Reports* and a second proxy group of nine natural gas distribution companies covered by the Standard Edition of *Value Line*. The water proxy group received 96 percent of its revenues from regulated water operations; has an 'A' bond rating and a common equity ratio of 46.5 percent; and an earned return on common equity of 9.8 percent. The gas proxy group consists of eight natural gas distribution companies listed as Natural Gas Distribution, Transmission, and/or Integrated Gas Companies in *AUS Utility Reports* and as Natural Gas Utility companies in the *Value Line* Standard Edition and having an investment grade bond rating by Moody's and S&P. The gas proxy group utilities received 69 percent of revenues from regulated gas operations, a common equity ratio of 47.7 percent, and an earned return on common equity of 10.5 percent.[192]

Dr. Woolridge argues that the use of natural gas distribution companies as a proxy for Kentucky-American is appropriate, since the financial data necessary to perform a DCF analysis on the members of the water proxy group, as well as analysts' coverage of water utilities, is limited. He also argues that the return requirements of gas companies and water companies should be similar, as both industries are capital intensive, heavily regulated, and provide essential commodity with rates and rates of return set by state regulatory commissions. Dr. Woolridge acknowledges, however, that

[191] *Id.* at 2.

[192] *Id.* at 14 - 15.

water companies do not face the same risk of substitution that exists for gas distribution companies.[193]

Dr. Woolridge places significant emphasis on current economic conditions and concluded that capital costs for utilities are historically low and are likely to be so for some time.[194] He further states that the investment risk of utilities is very low and that the cost of equity for utilities is among the lowest of all industries in the U.S. as measured by their betas.[195]

In his rebuttal testimony, Dr. Vander Weide addresses the criticism of his analysis and critiques Dr. Woolridge's analysis. Countering criticism of his proxy group selections, he notes that his proxy group of water utilities has a higher S&P bond rating and a slighter higher average *Value Line* safety than AWWC, and that his proxy group of natural gas utilities has a higher average *Value Line* safety rating and slightly higher average S&P bond rating than AWWC.[196]

Dr. Vander Weide rejects criticism of his use of a quarterly DCF model. He testifies that all companies within his proxy groups paid quarterly dividends and noted the same applied for those companies in Dr. Woolridge's proxy group. He further testifies that, as the DCF model is based on the assumption that a company's stock price is equal to the expected future dividends associated with investing in the

[193] *Id.* at 13 - 14.

[194] *Id.* at 12.

[195] *Id.* at 23 - 24.

[196] Rebuttal Testimony of James Vander Weide at 6 - 7.

company's stock, an annual DCF model cannot be based upon this assumption when dividends are paid quarterly.[197]

Dr. Vander Weide takes exception to Dr. Woolridge's internal growth method. He argues that this method is not only circular, but underestimates the expected growth of his proxy companies by neglecting the possibility that such companies can grow by issuing new equity at prices above book value. He notes that many of the proxy companies are currently engaging in this practice or are expected to do so in the future. This possibility is noteworthy, he asserts, because the water industry is expected to undertake substantial infrastructure investments in the near future and to finance those investments in part through this practice.[198]

As to his use of EPS growth rates in his DCF analysis, Dr. Vander Weide argues that his studies show that stock prices are more highly correlated with analysts' growth rates than with historical or internal growth rates that Dr. Woolridge considered. He states that, if Dr. Woolridge had used the average EPS share growth rates of Yahoo, Reuters, and Zacks in his DCF analysis, his DCF for the water utility proxy group would have been equal to 9.7 percent.[199] He further maintains that correctly using a full year of growth in the analysis would produce a 9.8 percent DCF result.[200] Dr. Vander Weide asserts that the proper application of the DCF model requires that matching of stock prices and investors' growth expectations. Moreover, he argues, historical growth rates are inherently inferior to analysts' forecasts because analysts' forecasts already incorporate all relevant information regarding historical growth rates and also

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197 *Id.* at 8 - 9.

198 *Id.* at 11 - 12.

199 According to Dr. Vander Weide, this result occurs even if a 1/2 g multiplier is used. *Id.* at 13.

200 *Id.*

incorporate the analysts' knowledge about current conditions and expectations regarding the future. He refers to financial research that strongly supports the conclusion that analysts' growth forecasts are the best proxies for investor growth expectations.[201] Dr. Vander Weide concludes his discussion of the use of analysts' growth forecasts with his findings that analysts' EPS growth forecasts are not optimistic and that they are reasonable proxies for investor growth expectations, while Dr. Woolridge's historical and retention growth rates are not.[202]

Based upon our review of the record, we find that Kentucky-American's proposed ROE should be denied and that an ROE of 9.7 percent will continue to provide Kentucky-American with a fair and reasonable rate of return. In reaching our finding, we have focused upon the water utilities within the proposed proxy group. In Case No. 2010-00036, we found that Kentucky-American's use of natural gas distribution companies as proxies for water utilities to be inappropriate.[203] The water utility group consists of large and small publicly traded water utilities. While Kentucky-American is a relatively small water utility, it is part of a large, multi-state operation that has access to investment capital under conditions that few small water utilities could obtain. Accordingly, we are of the opinion that a proxy group consisting of water utilities is a more accurate indicator of risk and market expectations.

Our finding as to an ROE of 9.7 percent also continues to reflect Kentucky-American's regulatory history, with Kentucky-American's frequency of rate case

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[201] *Id.* at 21.

[202] *Id.* at 25.

[203] Case No. 2010-00036, Order of Dec. 14, 2010 at 70 ("[S]everal of the companies within the natural gas proxy group that Kentucky-American has used engage in exploration, production, transmission, and other non-regulated and non-distribution activities. These activities extend well beyond a distribution function and have greater risk.").

applications since 1992 clearly demonstrating management's focused efforts to minimize regulatory risk and the risk associated with the recovery of capital investments. Kentucky-American has applied for rate adjustments on a more frequent basis than other water utilities within the proxy group, using a forecasted test period with each rate application. Not only does the ability to use a forecasted test period tend to reduce the risk associated with the recovery of capital investments, it is also a mechanism that is unavailable to several of the utilities in Kentucky-American's proxy group and their subsidiaries.[204]

In reaching our finding, we have also excluded any flotation cost adjustment from our analysis and have placed much greater emphasis on the DCF and the CAPM model results of the water utility proxy groups compiled by Kentucky-American and the AG. While recognizing that historic data has some value for use in obtaining estimates, we have given considerable weight to analysts' projections regarding future growth. Finally, in assessing market expectations, we have given considerable weight to present economic conditions.

Weighted Cost of Capital. As shown in Table VIII, applying the rates of 6.06 percent for long-term debt, 8.52 percent for preferred stock, 0.5 percent for short-term debt, and 9.70 percent for common equity to the adjusted capital structure produces an overall cost of capital of 7.59 percent. We find this cost to be reasonable.

[204] *See* Kentucky-American's Response to Commission Staff's Second Request for Information, Item 23 at 2.

Table VIII

Component	Capital Structure	Capital Ratios	Commision Returns	Commission Average Weighted Cost
Short-Term Debt	$ 9,204,650	2.391%	0.5000%	0.01%
Long-Term Debt	199,241,777	51.748%	6.0600%	3.140%
Preferred Stock	4,489,938	1.166%	8.5200%	0.10%
Common Equity	172,085,452	44.695%	9.7000%	4.34%
Total Capitalization	$ 385,021,817	100.000%		7.5900%

Authorized Increase

The Commission finds that Kentucky-American's net operating income for rate-making purposes is $29,200,937. We further find that this level of net operating income requires an increase in forecasted present rate revenues of $6,904,134.[205]

Cost of Service Study/Rate Design

For general water service, Kentucky-American currently charges a monthly service charge and a flat volumetric fee. The service charge is based in part on the customer's meter size. It is intended to recover the cost of customer facilities such as meters and services, and the cost of customer accounting, including billing and collecting and meter reading. The volumetric fee is intended to recover the cost of producing, transporting, and distributing the water.

Kentucky-American included with its application a cost-of-service allocation study that uses the base-extra capacity method.[206] This methodology is widely recognized

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[205]

Net Investment Rate Base	$ 384,729,083
Multiplied by: Rate of Return	x 7.5900%
Operating Income Requirement	$ 29,200,937
Less: Forecasted Net Operating Income	- 25,013,042
Operating Income Deficiency	$ 4,187,895
Multiplied by: Revenue Conversion Factor	x 1.64859300
Increase in Revenue Requirement	$ 6,904,134

[206] Application Ex. 36.

Under Kentucky-American's proposed rates, the same customer would have seen his or her monthly bill increase 16.47 percent to $41.23.

Other Issues

Distribution System Improvement Charge. Kentucky-American proposes to implement a Distribution System Improvement Charge ("DSIC") to permit it to "accelerate the replacement of its aging infrastructure."[219] The DSIC is intended to encourage increased stockholder investment by eliminating the regulatory lag between the time when Kentucky-American makes an investment in plant and when it recovers the carrying cost in rates. Kentucky-American argues that the regulatory lag between investment and recovery in rates limits the amount of capital the stockholders are willing to make available to fund plant replacement.

The proposed DSIC would allow recovery through a separate billed charge of the cost of capital, depreciation, and property tax associated with qualified investment between rate case proceedings. The investment must be on plant that is non-revenue producing and was not included in rate base in a prior base rate case. The DSIC charge would be established on an annual basis using a 13-month average end-of-month UPIS balances and would reflect qualified plant additions constructed after the conclusion of the forecasted test year in the previous rate case. Qualified UPIS additions would be reduced by the projected UPIS retirements associated with the DSIC additions when calculating depreciation and property tax expense.[220]

An application for a DSIC would be filed 90 days prior to the effective date of each DSIC implementation. Each DSIC would include an annual reconciliation filing

[219] Testimony of Gary M. Verdouw at 17.

[220] *Id.* at 22.

made not later than 60 days after the conclusion of each DSIC year. Each filing would contain a detailed listing of each qualifying DSIC project completed and placed in service during the immediate preceding year. The filing is subject to Commission review and adjustment. The DSIC would be cumulative and would re-established at zero at the conclusion of the next base rate proceeding at which time the DSIC costs would be included in base rates. The DSIC would be capped at 10 percent of the authorized revenue level established in Kentucky-American's most recent rate proceeding.[221]

Kentucky-American argues that a pressing need exists to replace the distribution infrastructure that has exceeded its life expectancy. It argues that the reliability of its service is dependent upon its ability to replace aging distribution infrastructure.[222] It further states that implementation of the DSIC will permit it to focus upon replacement of mains that are six inches or less in diameter. These mains, it argues, are responsible for the majority of the distribution system leaks and failures.[223]

Kentucky-American contends that the DSIC "has a host of attendant customer protection measures that dispel any suggestion that KAWC is seeking to push through costs without sufficient regulatory oversight."[224] It further contends that the DSIC is a well-accepted regulatory mechanism that has been used in several states to address

[221] *Id. at 23.* In this case the proposed DSIC would be limited to $9,393,361 [$12,068,431(Kentucky-American's Revised Increase) + $81,865,176 (Revised Revenue from Water Sales) x 10%].

[222] *Id.* at 16.

[223] *Id.* at 19.

[224] Kentucky-American Brief at 24.

defined and significant infrastructure deficiency.[225] It compares the DSIC to the accelerated main replacement programs and gas line trackers the Commission has approved for other utilities.[226]

Kentucky-American explains that currently 82 miles of its six-inch or smaller water mains are 75 years old or older.[227] At the current annual investment rate of $3 million to $5 million, it will take approximately 41 years to replace the identified mains.[228] At the conclusion of this period, there will be an additional 947.77 miles of six-inch or smaller main with lives of greater than 75 years.[229] If a DSIC is approved, Kentucky-American intends to increase the capital available for the main replacement to a range of $5 million to $7 million, which Kentucky-American expects will shorten the replacement period to 16 to 27 years.[230]

The AG opposes the proposed DSIC tariff rider. He contends that the DSIC is ill-advised and unnecessary. The AG argues that Kentucky-American wants a solution for something that is not actually a problem.[231] Noting that since 1992 Kentucky-American has submitted a rate case with a forecasted test period every two years, the AG contends that the frequency of Kentucky-American's rate case applications "demonstrates management's focused efforts to minimize regulatory risk and the risk

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[225] Testimony of Gary M. Verdouw at 20 – 21.

[226] Kentucky-American Brief at 117.

[227] Direct Testimony of Lance Williams at 15.

[228] *Id.*

[229] *Id.*

[230] Kentucky-American Response to the Commission Staff's Second Information Request, Item 50.

[231] AG Brief at 8.

associated with the recovery of capital investments."[232] According to the AG, the DSIC offers no material, incremental benefit, and that its approval would throw aside twenty years of effective regulatory oversight.[233]

He points to Kentucky-American's admission that there is no certainty that the DSIC tariff rider will reduce the frequency of base rate filings or that it will result in any short-term savings in operation and maintenance expenses.[234] The AG further argues that Kentucky-American has not identified the specific projects that will be recovered through the DSIC, nor does it have written procedures or policies to rank or prioritize the replacement of aging mains.[235] The AG argues that the DSIC "stands to reverse all of the gains made during the last twenty years in KAWC's capital budgeting and construction practices."[236]

Kentucky-American counters that it has provided details of its infrastructure planning process, identified the amount of its system that has exceeded its useful life, provided its current replacement rates, and identified the number of years it will take to replace 6 inch and less mains that have been in service longer than 75 years.[237] Kentucky-American asserts that it has shown that the replacement rate for its system mains is inadequate and must be accelerated if the problem is to be addressed in a timely fashion.[238]

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[232] *Id.* at 7 - 8.

[233] *Id.* at 8.

[234] Direct Testimony of Stephen M. Rackers at 10.

[235] *Id.* at 8

[236] *Id.*

[237] Kentucky-American Brief at 26.

[238] *Id.*

Kentucky-American argues that the primary purpose of the DSIC tariff rider "is not to produce cost savings or delay rate cases, but to accelerate the needed remediation of aging water utility infrastructure on a proactive and sustained basis."[239] Incident to achieving this goal, are long-term cost reductions that may occur through reduced energy usage, pumping costs, reductions in unaccounted for water loss, reduced main breaks, and fewer customer calls about service interruptions.[240] Kentucky-American contends that its ratepayers will benefit from any of these cost reductions in the long term, and that the DSIC "will permit the Company to reduce the frequency of base rate cases."[241] These benefits are secondary to the principal benefit of Kentucky-American's DSIC.[242]

Kentucky-American is currently investing between $3 million to $5 million annually to replace its six-inch or smaller mains that have been in service 75 years or longer. Kentucky-American estimates that at this rate of investment, it will take 41 years to replace the identified mains. If it is granted a DSIC tariff rider, Kentucky-American will increase its annual investment to a range of $5 million to $7 million and estimates that it will take between 16 and 27 years to replace the mains. The annual replacement rate will increase from the current rate of two miles per year to a range of three miles to five miles.

Based upon our review of the evidence, the Commission finds that the proposed DSIC tariff should be denied. Given the minimal impact of Kentucky-American's increased investment on main replacement, the Commission is of the opinion that the

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[239] *Id.* at 27.

[240] *Id.*

[241] *Id.*

[242] *Id.*

effect of the DSIC tariff rider will be marginal. If Kentucky-American continues its current course of submitting rate cases approximately every two years, then its estimated impact of the accelerated replacement of the mains has been overstated. Further, Kentucky-American contradicts itself when it states that mains with a diameter of six inches or less are responsible for the majority of the distribution system leaks and failures,[243] but then claims that DSIC tariff rider will not result in any identifiable cost savings in the near term. Unlike the DSIC tariff rider, the accelerated gas main tariff riders were allowed for safety concerns and the main replacements were for a defined accelerated replacement period.

Purchased Power and Chemical Charge. Kentucky-American proposes to establish a Purchased Power and Chemical Charge ("PPACC") to reflect the incremental changes in purchased power and purchased chemical costs from the level authorized for recovery in a base rate case proceeding.[244] The PPACC would have the following features:

- In a base rate case proceeding, the Commission would establish the appropriate level of purchased power and chemical expenses to be included in base rates.

- Each month this base cost, which is established on a per unit basis (1,000 gallons of water), would be compared to current month actual purchased power and chemical costs.

- Annually, Kentucky-American would file with the Commission a report of its actual purchased power and chemical costs, as well as the reconciliation of any prior period PPACC Rider over or under-recoveries.

- The PPACC would be determined by dividing the cumulative annual incremental increase or decrease in purchased

243 Rebuttal Testimony of Scott W. Rungren at 10.

244 Direct Testimony of Gary M. Verdouw at 28; Application Ex. 2 at 23.

power and chemical costs, grossed-up for the associated impact of revenue taxes, by projected annual base rate revenue subject to the PPACC Rider.

- The PPACC Rider would be expressed as a percentage and would be applied to the amount billed to each customer. The PPACC Rider amount would be reflected as a separate line item on the bill of each customer.

- The PPACC Rider would be subject to an annual reconciliation to determine the amount of any prior period PPACC Rider over or under-recovery which amount would be deferred and included in the Company's next PPACC for return to or recovery from customers.[245]

Kentucky-American contends that the PPACC is necessary to address the unpredictability and lack of control over purchased power and chemical expenses.[246] It maintains that the combined cost of purchased power and chemicals is the largest non-labor related component of its operations and maintenance expenses[247] and that the cost of purchasing these commodities is generally beyond Kentucky-American's control and their pricing can be volatile.[248]

Kentucky-American's forecasted chemical expense accounts for 5.3 percent of its total forecasted operation and maintenance expenses and 1.85 percent of its total revised revenue requirement.[249] Purchased power expense accounts for 11.22 percent

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[245] Direct Testimony of Gary M. Verdouw at 31 – 31.

[246] *Id.* at 29 – 30.

[247] *Id.* at 30.

[248] *Id.* at 31.

[249] Base Period Update-Ex. 37 Sch. A and Sch. C-1. $1,779,872 (Chemical Expense Forecast) ÷ $33,587,569 (Total Operation and Maintenance Expense Forecast) = 5.3%. $1,779,872 (Chemical Expense Forecast) ÷ $96,208,414 (Revenue Requirement Revised Forecast) = 1.85%. *See also* Kentucky-American's Response to Hearing Data Requests, Item 31 ("chemical expense comprises 5.24% of Kentucky American's total operations and maintenance expenses from the Cost of Service Study ("COSS") and 2.16% of the Total Cost of Service").

of Kentucky-American's total operation and maintenance expenses and 3.92 percent of its total revised revenue requirement.[250]

The AG argues that these expenses do not, separately or combined, warrant deviation from traditional rate-making methodologies.[251] AG Witness Rackers testified that the use of PPACC effectively allows Kentucky-American to engage in single issue ratemaking. He contends that it allows Kentucky-American to receive additional revenue in rates due to an increase in a tracked expense or decrease in tracked revenue without any consideration of whether it would simultaneously be receiving offsetting decreases in expenses or offsetting increases in revenues for those expenses and revenues that are not being tracked.[252]

The AG also asserts that, given Kentucky-American's frequent rate applications, no certain incremental benefit associated with the use of a tariff tracker mechanism exists. He further asserts that the PPACC tracker may actually add regulatory burden and unnecessary complexity.[253] He warns that a tracker may serve as a disincentive for

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[250] Base Period Update-Ex. 37 Sch. A and Sch. C-1. $3,768,292 (Fuel and Power Expense Forecast) ÷ $33,587,569 (Total Operation and Maintenance Expense Forecast) = 11.22%. $3,768,292 (Fuel and Power Expense Forecast) ÷ $96,208,414 (Revenue Requirement Revised Forecast) = 3.92%. *See also* Kentucky-American's Response to Hearing Data Requests, Item 31 ("The purchased power expense comprises 9.16% of total operations and maintenance expenses, and 4.58% of Total Cost of Service.").

[251] AG Brief at 19 - 20.

[252] Direct Testimony of Stephen M. Rackers at 20.

[253] AG Brief at 20.

Kentucky-American to control or to minimize its expenses.[254] The AG concludes that, if Kentucky-American needs a deviation, then the deferred debit methodology is better-suited for this application.[255]

Based upon our review of the record, we find that the proposed PPACC tariff rider should be denied. We do not agree with the premise that chemical and purchased power are totally outside of utility control. A utility may enter into long-term contracts for the purchase of chemicals. It may invest in energy-efficient equipment and take advantage of time-of-day rates to lessen its power costs. Moreover, if it is greatly concerned about its power costs, it can intervene in regulatory proceedings to zealously protect its interest when electric power rate adjustments are sought. As Kentucky-American concedes that its customers' water usage is decreasing, corresponding decreases in chemical and power purchases are also likely.

Finally, given that purchased power and chemical expenses account for a relatively small percentage of total utility expenses, the Commission finds no compelling need for the proposed tariff rider. For Kentucky-American, neither expense is at a level that is comparable to the level of purchased gas expense for a natural gas distribution

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[254] AG Witness Rackers testified:

> [T]he use of a tracker eliminates the inherent incentive a utility has to minimize expenses and maximize revenues between base rate proceedings, which over time works to keep electric rates lower than they otherwise would be. When a utility is allowed to track an expense, it can become indifferent with regard to minimizing that expense since it knows it will not need to file a new base rate case in order to recover any increases in that expense. Similarly, when a utility is allowed to track a revenue, it can become indifferent with regard to maximizing that revenue since it knows that it will not need to file a base rate case in order to recover any shortfall in that revenue.

Direct Testimony of Stephen M. Rackers at 20.

[255] *Id.*

utility or purchased fuel expense for an electric utility. Other state commissions have reached the same conclusion.[256]

Tap Fees. Kentucky-American proposes to increase its tap fees based upon a five-year average of its actual cost of meter installation. Historically, Kentucky-American has used a three-year average to establish this fee, but since its last general rate adjustment application has used a five-year average. It has used the longer period to establish the fee due to the fewer number of connections caused by slower economic growth.[257] We find that the proposed tap fees will yield only enough revenue to pay the expenses incurred in rendering the service, are reasonable and should be approved.

Activation Fee. Kentucky-American proposes to increase its activation fee from $26 to $28. It has analyzed the costs incurred for service runs related to service activation, disconnection and reconnection. These analyses reflect that the current charge does not recover the full cost of the service activity. Ms. Bridwell testified that due to the utility's efforts in integrating technology and driving efficiencies, the costs of service trips have been very flat, but that the proposed adjustment is appropriate to bring the fee closer to the actual costs of providing the service.[258] We find that the proposed activation fee will yield only enough revenue to pay the expenses incurred in rendering the service, is reasonable, and should be approved.

Reconnection Fee. Kentucky-American proposes to increase its reconnection fee from $26 to $56. The proposed revision recognizes that the activity involved with a

[256] *See, e.g., Re West Virginia-American Water Co.*, 290 PUR4th 125 (W.Va. PSC Apr. 18, 2011) (rejecting a request to establish an investigation into the establishment of a purchased power adjustment clause because purchased power was not a dominant part of the water utility's cost of service).

[257] Direct Testimony of Lance Williams at 2-3.

[258] Direct Testimony of Linda C. Bridwell at 13-14.

member has fully complied with the spirit of Order. Notwithstanding their public posturing, collaborative members made little investment of time or effort in the process. No attempt was made to solicit potential stakeholders from outside this proceeding to expand the view, to explore administrative or ratemaking alternatives, or to seek the assistance of outside governmental or non-governmental organizations to examine the problem. When problems with the process arose, no collaborative member attempted to inform the Commission of the alleged problems or request our intervention. As a result, the collaborative has not met our expectations or produced any meaningful ideas.

While CAC's suggestion to involve the Center on Poverty Research has merit, this Commission lacks the authority to require Kentucky-American to expend its monies to fund an independent study on the issue and cannot grant CAC's requested relief. We find the parties' failure to seek out the Center on Poverty Research's assistance when the collaborative process began to be both unfortunate and indicative of the lack of imagination and initiative that they have displayed throughout the process.

The Commission finds that the collaborative should not continue in its present form. We will continue to evaluate possible forums for exploring this issue, either through a formal proceeding or through some informal process that may include the greater involvement of Commission's Staff. For the time being, however, we will not take any action to continue the collaborative process.

SUMMARY

After consideration of the evidence of record and being otherwise sufficiently advised, the Commission finds that:

1. Kentucky-American's proposed rates would produce revenues in excess of those found reasonable herein and should be denied.

2. Kentucky-American's proposed DSIC tariff rider and PPACC charge are unreasonable and should be denied.

3. Kentucky-American's proposed non-recurring charges are reasonable and should be approved.

4. The rates in the Appendix to this Order are fair, just, and reasonable and should be charged by Kentucky-American for service rendered on and after July 26, 2013.

5. Kentucky-American should, within 60 days of the date of this Order, refund to its customers with interest all amounts collected from July 26, 2013 through the date of this Order that are in excess of the rates that are set forth in the Appendix to this Order. Interest should be based upon the average of the Three-Month Commercial Paper Rate as reported in the Federal Reserve Bulletin and the Federal Reserve Statistical Release on the date of this Order.

IT IS THEREFORE ORDERED that:

1. Kentucky-American's proposed rates, except for those directly related to non-recurring services, are denied.

2. The rates set forth in the Appendix to this Order are approved for service rendered on and after July 26, 2013.

3. Within 60 days of the date of this Order, Kentucky-American shall refund to its customers with interest all amounts collected for service rendered from July 26, 2013, through the date of this Order that are in excess of the rates that are set forth in the Appendix to this Order.

4. Kentucky-American shall pay interest on the refunded amounts at the average of the Three-Month Commercial Paper Rate as reported in the Federal Reserve Bulletin and the Federal Reserve Statistical Release on the date of this Order. Refunds shall be based on each customer's usage while the proposed rates were in effect and shall be made as a one-time credit to the bills of current customers and by check to customers that have discontinued service since July 26, 2013.

5. Within 75 days of the date of this Order, Kentucky-American shall submit a written report to the Commission in which it describes its efforts to refund all monies collected in excess of the rates that are set forth in the Appendix to this Order.

6. Within 20 days of the date of this Order, Kentucky-American shall file using the Commission's Electronic Tariff Filing System its revised tariff sheets containing the rates approved herein and signed by an officer of the utility authorized to issue tariffs.

7. Any documents filed with the Commission pursuant to Ordering Paragraph 5 shall reference this case number and shall be retained in the utility's general correspondence file.

8. At least 90 days prior to the execution of any agreement to acquire a water system that is not subject to Commission jurisdiction, Kentucky-American shall advise the Commission in writing of the pending transaction, to include the name and location of the water system and a brief description of the transaction.

By the Commission

ENTERED

OCT 25 2013

KENTUCKY PUBLIC SERVICE COMMISSION

ATTEST:

Executive Director

Case No. 2012-00520