

**DIRECT TESTIMONY
OF
STEVE L. KLICK**

**WITH REGARD TO
PENNSYLVANIA-AMERICAN WATER COMPANY
COATESVILLE WASTEWATER OPERATIONS
RATE OF RETURN, REVENUE DEFICIENCY SUMMARY AND
INCOME TAX CALCULATION**

DOCKET NO. R-2008-2032689

DATE: April 28, 2008

1 testified before the Pennsylvania Public Utility Commission, Virginia State
2 Corporation Commission, Maryland Public Service Commission, the Public Service
3 Commission of West Virginia and the Federal Energy Regulatory Commission.

4
5 I also served for several years as an instructor for the Edison Electric Institute's Public
6 Utility Accounting course and assisted in co-authoring the update of the textbook
7 used in that course. I am a graduate of the Harvard and MIT Advanced Program on
8 Negotiation for Senior Executives. I serve on the Board of Directors of SURFA, the
9 Society of Utility and Regulatory Financial Analysts, and have served previously as a
10 Commissioner on the Washington County Maryland Water and Sewer Advisory
11 Board.

12 **4. Q. What are your current duties as Senior Manager, Rates and Regulation?**

13 A. I am responsible for the rate and regulatory activities of PAWC, including its
14 Coatesville Wastewater ("CWW") operations which are the subject of this filing. In
15 addition, I direct and coordinate the rate and regulatory activities of Maryland-
16 American Water Company and Virginia-American Water Company.

17 **5. Q. What is the purpose of your testimony?**

18 A. My testimony will cover three areas. First, I will discuss the main drivers of this rate
19 filing and will provide a ratemaking summary of the requested increase. Second, I am
20 sponsoring the Company's proposed overall Rate of Return, specifically supporting
21 the capital structure and embedded costs of capital (other than the requested rate of

1 return on common equity). Finally, I will explain the Company's development of
2 income taxes appropriate for use in this proceeding.

3 **II. NEED FOR AND SUMMARY OF THE PROPOSED RATE INCREASE**

4 **6. Q. Please summarize and then describe the major elements of the requested**
5 **increase in rates.**

6 A. CWW rates have not increased since 1994. In the intervening fourteen years,
7 substantial capital improvements have been made to the Coatesville system and
8 operating expenses have increased. As a consequence, CWW's current rates no
9 longer cover the Company's costs and provide it a reasonable return on its
10 investment. In fact, and as shown on page 1 of Exhibit No. 3-A, the CWW operations
11 are projected to produce a **negative** return on a pro forma present rate basis.

12
13 The Company is requesting an increase in annual wastewater revenues of \$2.68
14 million, which was calculated in accordance with previously accepted ratemaking
15 principles and is based on a requested rate of return of 8.63%. The ratemaking
16 components of the request are summarized on Schedule SLK-1, which is attached.
17 Capital improvements, including return on and of the investments made in CWW
18 infrastructure, supported by Mr. Kaufman and incorporated by Mr. Cox in his rate
19 base calculations, account for over \$1.4 million of the request. The other major driver
20 of this request is the compounding effect of increases in operation and maintenance
21 expenses over time, comprising approximately \$1.1 million of the proposed increase.

1 7. Q. How do current CWW rates compare to those of other wastewater service
2 providers in Pennsylvania?

3 A. CWW rates are among the lowest in the state. The current average monthly
4 residential bill, based on usage of 4,350 gallons, is \$15.00.

5 8. Q. In addition to the requested increase in base rates, is CWW requesting approval
6 of any significant changes in its tariff?

7 A. Yes. First, and as explained by Mr. Hassinger, the CWW Tariff's Rules and
8 Regulations have been completely revised to align them with the PUC's model
9 wastewater tariff and to better reflect the current practices of the CWW operations.
10 Secondly, an increase in capacity fees is requested from the current charge of \$525
11 per equivalent dwelling unit ("EDU") to \$3,250 per EDU. This increase, which is
12 supported by Mr. Herbert, is particularly important to ensure that the costs of new
13 wastewater treatment capacity currently under construction are assigned to those
14 customers who are driving the need for this project.

15 9. Q. Please briefly explain what is set forth in Exhibit No. 3-A.

16 A. Exhibit No. 3-A presents CWW's rate base, revenue, expense and tax information on
17 the basis of an historic test year ("HTY") ended December 31, 2007 and a future test
18 year ("FTY") ending December 31, 2008. As in previous PAWC rate filings, the
19 proposed rate increase is based upon adjusted FTY data. In Exhibit No. 3-A, the
20 HTY is identified as "Present Rates at December 31, 2007" and the FTY as "Present
21 Rates at December 31, 2008".

1 10. Q. Please describe your specific areas of responsibility regarding Exhibit No. 3-A.

2 A. I am sponsoring page one of Exhibit No. 3-A – the Pro Forma Statement of Income,
3 including the calculation of the requested increase in rates. I am also supporting the
4 calculations of state and federal income taxes which are included in Exhibit No 3-A.
5 Ms. Lontz and Mr. Cox support the specific revenue, expense and rate base elements
6 of our claim.

7 III. CAPITAL STRUCTURE

8 11. Q. What capital structure was used in calculating the revenue deficiency in this
9 case?

10 A. The capital structure used for developing the requested rate of return was PAWC's
11 projected capital structure at December 31, 2008 – the end of the FTY in this case.
12 The actual capital structure at December 31, 2007 was the starting point, adjusted to
13 reflect anticipated equity infusions of \$33 million and debt issuances of \$156.7
14 million, as well as the extinguishment of short-term debt. The resulting FTY capital
15 structure and costs are not significantly different from the historic test year levels and,
16 in my opinion, are representative of the costs that the Company will incur when the
17 proposed rates are in effect.

18 12. Q. What interest rate and issuance costs did you assign to the long-term debt issues
19 anticipated in 2008?

20 A. We used an interest rate of 6.3% and total issuance costs of \$470,100, which were
21 based on an American Water Capital Corp. ("AWCC") permanent debt financing in

1 October 2007. The cost rates for all other issues of debt and preferred stock were
2 calculated in a manner identical to previously accepted methodologies, as set forth in
3 the workpapers contained in Exhibit 3-B.

4 **13. Q. What common equity cost rate did you incorporate in developing your requested**
5 **rate of return?**

6 A. The testimony and exhibits of Mr. Moul support a range for rate of return on common
7 equity ("ROE") of 11.50% to 12.50%. After consideration of a number of factors
8 including the magnitude of the requested increase, an ROE of 11.50% was used in
9 determining the revenue deficiency.

10 **14. Q. What overall rate of return are you requesting in this case?**

11 A. Using the capital structure and debt/preferred stock costs rates previously discussed
12 and an ROE of 11.5%, the overall rate of return is 8.63%, as shown on Exhibit SLK-1

13 IV. INCOME TAXES

14 **15. Q. How were the Company's proposed income tax expense allowances developed?**

15 A. No income taxes are shown on the first five columns of page one of Exhibit No. 3-A
16 because CWW has no taxable income at the revenue level produced by its present
17 rates. The derivation of state and federal income taxes at proposed rate levels is
18 shown on pages 36 and 37 of Exhibit No. 3-A. As shown in those calculations, the
19 tax effects of accelerated depreciation were normalized for federal income tax
20 purposes and flowed-through in calculating state income taxes. Deferred taxes were

1 calculated for the FTY and deducted from rate base as shown on page 20 of Exhibit
2 No. 3-A. No rate base reduction was made for deferred income taxes prior to the
3 FTY because existing rates were established by the City of Coatesville Authority,
4 which was not a taxable entity and, therefore, its rates did not reflect any allowance
5 for current or deferred income taxes.

6 **16. Q. Does this conclude your testimony?**

7 A. Yes, it does.

**Pennsylvania – American Water Co.
Coatesville Wastewater Operations
Summary Of Rate Increase Request**

<u>Filing Date:</u>	April 28, 2008
<u>Test Year:</u>	12 Months Ended December 31, 2007
<u>Future Test Year:</u>	12 Months Ended December 31, 2008
<u>Increase Requested:</u>	\$2.7 Million
<u>Percentage Increase:</u>	111% in overall revenues
<u>Effective Date:</u>	January 27, 2009 (based on full suspension)
<u>Rate of Return:</u>	8.63% on rate base; 11.5% ROE

<u>Type of Capital</u>	<u>Proportion of Total</u>	<u>Cost Rate</u>	<u>Weighted Cost</u>
Debt	52.90%	6.12%	3.24%
Preferred Stock	.75%	8.11%	.06%
Common Stock	<u>46.35%</u>	11.50%	<u>5.33%</u>
Total	<u>100%</u>		<u>8.63%</u>

Elements of Increase:

	<u>Required Revenue (\$ in thousands)</u>
Capital projects (Rate Base)	\$1.4 Million
Operation and Maintenance Expenses	1.1
Return on Equity	<u>.2</u>
Total	\$2.7 Million

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