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**BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO**

In the Matter of the Application of Ohio American Water)
Company for Authority to Increase its Rates For Water and) Case No. 07-1112-WS-AIR
Sewer Service Provided to its Entire Service Area.)

**OHIO AMERICAN WATER COMPANY'S OBJECTIONS
TO THE
STAFF REPORT OF INVESTIGATION**

NOW COMES applicant, Ohio American Water Company ("Ohio American" or "Company"), by its attorneys, pursuant to Ohio Revised Code ("R.C.") Section 4909.19 and Ohio Administrative Code ("O.A.C.") Rule 4901-1-28, and makes the following objections to the Staff Report of Investigation ("Staff Report" or "S.R.") prepared by the Staff of the Public Utilities Commission of Ohio ("Staff") and filed on May 28, 2008.

The objections will follow the order of and contain the headers in the Staff Report.

OPERATING INCOME AND RATE BASE

SCOPE OF INVESTIGATION

Throughout the scope of its investigation, the Staff arbitrarily chose to use either actual expenses through March 31, 2008 (the conclusion of the Test Year), or the Test Year expenses. Staff consistently made adjustments by using either the actual expenses or pro forma Test Year revenues and expenses, depending upon which expenses were less favorable to the Company's case. The submission today of the update of the Test Year to reflect actual expenses and revenues proves that the Staff adjustments are inappropriate. Ohio American objects to Staff's arbitrary picking and choosing of the use of actual expenses versus pro forma Test Year expense in the case and instead suggests that, if actual Test Year expenses are used for the pro forma

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adjustments, then the Company's actual Test Year results should be considered throughout the case.

REVENUE REQUIREMENTS

For reasons given in the Federal Income Tax section, Ohio American objects to the Staff's calculations shown on Schedule A-1.

Plant in Service

Water A Plant

Counter and Wall Panels Exclusion (S.R. 4; Schedule B-2.2a1)

The Company objects to the Staff exclusion of the counter and wall panels. After a thorough review of the Company records, it was determined that the counter and wall panel was actually retired from plant. Thus the counter and wall panel valuation in the amount of \$3,589.50 has already been excluded from rate base. The Company believes that this amount as deducted by Staff needs to be put back into rate base to correctly reflect the records.

Corporate Office Reclassification (S.R. 5; Schedule B-2.2a5)

The Company objects to the Staff's allocation of Corporate Plant. The Staff states that the Ohio American allocated 100% of Marion corporate office to Water A Plant Investment. However, the Staff erred because this statement is not true. Prior to the Date Certain in Case No. 07-1112-WS-AIR, Ohio American segregated Corporate Plant separately from Water A plant where it formerly resided. The Company then allocated Corporate Plant based on customer count to Water A, Water C, and Wastewater in this case. The Staff began with the already allocated Corporate Plant assigned to the Marion District and made allocations to Water C and Wastewater.

The Staff also stated that Ohio American's Corporate Plant numbers were as of December 31, 2005, the Date Certain of the prior case. This statement is also not true. After the Date Certain of Case No. 06-433-WS-AIR, the Company removed Corporate Plant from the Water A Marion District, made some additions and retirements to the assets between the Date Certain of the last case and the Date Certain of this case, and allocated that Corporate Plant total to Water A, Water C, and Wastewater based on customer count.

In its application, the Company listed an allocation of \$2,817,254 in Corporate Plant in the Water A rate base. Apparently Staff did not agree with this Corporate Plant allocation. Staff then attempted to re-adjust Company total rate base by removing the adjustment the Company made for the Corporate Plant allocation. When Staff attempted to eliminate the Company allocation of \$2,817,254 to Water A, they instead eliminated a Corporate Plant amount of \$3,444,452, thus lowering the actual Water A plant by \$627,198.

The Staff made the same type of error in Water C and Wastewater. Ohio American included an allocation of \$341,772 in Corporate Plant in the Water C rate base. Staff did not agree with this allocation. When Staff attempted to eliminate the Company allocation of \$341,772 to Water C, they instead eliminated a Corporate Plant amount of \$544,271, thus lowering actual Water C plant by \$202,499.

The Company included an allocation of \$235,969 in Corporate Plant in the Wastewater rate base. Staff also did not agree with this allocation. When Staff attempted to eliminate the Company allocation of \$235,969 to Wastewater, they instead eliminated a Corporate Plant amount of \$375,780, thus lowering actual Wastewater plant by \$139,811.

In sum, the Staff erroneous adjustments to Corporate Plant totaled \$969,508, a significant understatement of plant.

Ohio American also objects to the Staff's position that Corporate Plant should be allocated on the basis of gross plant allocation factors. Customer counts of Water A, Water C, and Wastewater is a more accurate allocation factor to use because the building and assets are used primarily, if not exclusively, to serve Ohio American's customers. This method of allocation based on customer count is far more appropriate than an allocation based on gross plant allocation factors. The type, value and amount of plant in each system have no relationship to the amount of the Corporate Plant to be assigned to Water A, Water C and Wastewater. For all the reasons set forth above, Ohio American objects to the Staff's treatment of Corporate Plant.

Exclusion of Corporate Office Plant (S.R. 5; Schedule B-2.2a6)

The Company objects to the Staff's adjustments made for exclusion of Corporate Office Plant. Prior to the start of this case, the Company retired \$301,170.73 in Corporate Office assets from the books of the Company. The Company then provided Staff with a complete list of Corporate Office Plant that was included in the case. From that listing, the Staff made a further reduction in Corporate Office Plant in the amount of \$1,262,136 for items that the Staff claimed were not used and useful. Included in this adjustment was the Staff reduction adjustment for the Marion Corporate Office (see next paragraph for further detail). In preparing the application, the Company reviewed the list of assets included in Corporate Office Plant and, after retiring those assets that the Company believed were not used and useful from the Corporate Office books, included all items that the Company believed were in place and were used and useful. Therefore, the Company objects to the Staff's further exclusion of Corporate Office assets.

The Company also objects to the Staff's adjustment to reduce by 25% the Date Certain balance of the land, outer shell, and other components of the Marion Corporate Office Building as not used and useful. Although at the time of the Staff inspection of the Marion Office

Building the full complement of Ohio American employees may not have been occupying the building, later in the Test Year and continuing beyond, approximately 90% of offices, work spaces, and storage area of the building was occupied. At the most, the adjustment should be no more than 10%, in spite of the fact that a 90% occupancy rate justifies the inclusion of the entire building.

Depreciation

Depreciation Reserve – Water A, Water C, and Wastewater (S.R. 7-8, Schedules B-3.1a, B-3b, B-3.1c)

Ohio American objects to the depreciation reserve to the extent that the Staff has excluded items of plant (discussed above), resulting in an understatement of the depreciation reserve.

Ohio American also objects to the Staff adjustment made to exclude depreciation amounts from certain categories of plant included in Contributions in Aid of Construction used to calculate the Depreciation Reserve. In Staff work paper B-6.2, Staff claims that certain plant categories have reached a fully depreciated percentage set in Case No. 94-1287-WS-AIR. First, the case cite is incorrect, and should be Case No. 94-1237-WS-AIR. Second, a review of Case No. 94-1237-WS-AIR by the Company failed to reveal the fully depreciated plant percentages that the Staff is using. As such, the Company objects to the elimination of \$146,266 in CIAC expense as calculated in the Staff Report.

Other Rate Base Items (S.R. 10; Schedule B-6)

The Company objects to the Staff adjustment for deferred depreciation. The Staff excluded \$93,712.43 that Ohio American included in its deferred depreciation expense but provided no justification in doing so. Staff's exclusion of the deferred depreciation amount from rate base was not proper because including deferred depreciation in rate base avoids a

mismatching of components and the resulting understatement of rate base. If the unamortized deferred depreciation balance is not included in rate base, the relationship between the rate base and the capital structure will not be consistent, because Ohio American's rate base has been improperly reduced by an amount which has not yet flowed to the income statement/retained earnings.

The Company also objects to the Staff's exclusion of the waste disposal deferred balance. The Staff gives no justification in excluding the expense. The Company believes the expense is prudent. As such, the Company objects to the Staff exclusion of the waste disposal deferred balance.

ALLOCATIONS

Corporate office plant investment (S.R. 11; Schedule B-7.1)

Ohio American objects to the Staff's position that Corporate Plant should be allocated on the basis of gross plant in service and depreciation reserve. The Company, for the same reasons that support the customer allocation for Corporate Plant, believes that the customer count of Water A, Water C, and Wastewater is a more accurate allocation factor to use. Therefore Ohio American objects to the Staff position on corporate office plant investment allocation factor.

Corporate office operating expenses (S.R. 11; Schedule B-7.1)

The Company objects to the Staff's position that Corporate office operating expenses should be allocated on the basis of a seven factor formula calculated from gross plant, depreciation reserve, net plant, employees, payroll, customers, and operating revenues. Ohio American, for the same reasons that support the customer allocation for Corporate Plant, believes that the customer count of Water A, Water C, and Wastewater is a more accurate allocation factor to use.

OPERATING INCOME

Labor Expense (S.R. at 12-13)

The Company objects to the Staff's position to exclude the expense associated with employee incentive pay, which promotes appropriate financial and operational goals. This expense was not eliminated by the Staff in the last case. The expenses in this case are essentially the same type of expenses that were in the last case and these were approved. Ohio American established these incentives approximately six years ago. Financial incentives for employees are legitimate and necessary payments to valued employees for their retention. Many businesses are paying incentive payments and indeed these payments are considered within best practices standards. Since incentive payments have become common in business, were Ohio American not to have such a program, it would lose employees and the cost to replace them would far exceed the incentive payments. Thus incentive payments are prudent and reasonable.

Furthermore, the Staff has provided no basis for why it is now being eliminated. The Staff merely opines that it "is of the opinion that achievement of this goal benefits Ohio American Shareholders," without any shred of support for this statement. Achievement of financial goals benefits Ohio American customers because achieving the goals lowers costs and thus lowers the amount of the requested rate increase. For all these reasons, Ohio American objects to this disallowance.

Pension Expense and Other Post-Retirement Employee Benefits (OPEB) (S.R. at 13)

The Company objects to the Staff position relative to both pension expense and Other Post-Retirement Employee Benefits ("OPEB"). Moreover, the Staff's work papers with respect to these expenses are inconsistent with the Staff Report. The Staff work papers for OPEB expense show a total of \$385,953 for Water A, Water C, and Wastewater, including the

allocation for Corporate, while the Staff Report shows a total of only \$225,622, or a difference of \$160,331. The Company contends that the Staff work papers are correct and the Company objects to the numbers presented in the Staff Report for OPEBs.

A similar discrepancy occurs with respect to pension expense. The Staff work papers for pension expense show a total of \$676,848 for Water A, Water C, and Wastewater, including the allocation for Corporate, whereas the Staff Report shows a total of only \$571,937, or a difference of \$104,911. Nowhere does the Staff Report support the lower amount. The Company contends that the Staff work papers are correct and objects to the pension expense presented in the Staff Report.

Waste Disposal Expense (S.R. 14; Schedule C-3.7)

The Company objects to the Staff's calculations of waste disposal expense. First, the Staff excluded amortization of costs falling in the Test Year that are scheduled to expire the last quarter of 2008, subsequent to the Test Year. Apparently the Staff wrongly concluded that because the amortization period was to end months after the Test Year, it would arbitrarily exclude the amortization costs that occurred throughout the Test Year. The Staff was not justified in eliminating these actual expenses. Second, the Staff recommended that the amortization period for an accrual associated with cleaning costs associated with the Ashtabula lagoon be three years instead of two years as the Company had recommended. The Company objects to the three years, because the two-year amortization more closely matches the period of time between Ashtabula lagoon cleanings (an overage of 18 months). Third, the Staff reduced the expense for waste disposal for Tiffin by \$27,335 without providing an explanation for their adjustment. The Company objects to this adjustment and believes the Tiffin expense is recurring, fixed, known and measurable and as such should be included in the case.

Rate Case Expense (S.R. at 14; Schedule C-3.8)

The Company objects for several reasons to the Staff position relative to rate case expense. First, the Staff is arbitrarily reducing the amount of rate case expense to \$400,000, based on "the Applicant's current estimate of rate case expense to prior rate case expense levels". In the last rate case, the Staff once again arbitrarily reduced the Company's rate case expense to \$400,000, even though the actual expense for Case No. 06-433-WS-AIR was more than \$578,000 at the time that the tariffs approved in the last case were filed. In addition, Ohio American incurred approximately \$10,000 of subsequent expenses in legal costs for meetings, filings, and other activities associated with the 2006 rate case commitments from the period April 2007 through the end of the year (though 2006 rate case expenses continued on during 2008).

The Staff essentially pulled the \$400,000 expense level out of the air. Notably, the Ohio Supreme Court refuses to allow arbitrary reductions of rate case expenses. For example, in *Ohio Fuel Gas Co. v. PUCO* (1942), 139 Ohio St. 581, the Court concluded that there was no justification for the Commission to have reduced the utility's rate case expenses by forty percent (40%). Likewise, it has long been Commission precedent to reject a rate cap not founded on evidence. As the Commission explained in Case No. 85-675-EL-AIR, *In the Matter of the Application of The Cleveland Electric Light Company for Authority to Amend and Increase Certain of its Filed Schedules Fixing Rates and Charges for Electric Service*, "[i]t is our conclusion that no basis exists in the record for imposition of a 'cap' on rate case expense as proposed by the city." Thus, the Company objects to the Staff "estimate" and recommends the amount originally included in the rate case.

Second, the Staff recommends an amortization of that rate case expense over a three-year period, while the Company proposed a two-year amortization. The Company filed Case No. 06-

433-WS-AIR in March 2006, received new rates in March 2007, and filed Case No. 07-1112-WS-AIR in October 2007, or 18 months apart. A three-year amortization as suggested by the Staff is unreasonable and unrealistic. Moreover, the Staff has consistently recommended unrealistically long and unsupported amortization periods in the last five rate cases:

The table below shows the Staff's consistent error in selecting an unrealistically high number of years for the amortization of rate case expense as well as the Staff's gross understatement of the actual rate case expense:

Case No.	Application Filed	Date Approved	Actual Number of Months Between Rate Cases	Actual Expense	Staff Cap on Rate Case Expense	Months in the Staff's Amortization Period
99-1038-WW-AIR	09/01/1999 ¹	6/29/2000		\$507,235	\$312,400	36 months
01-626-WW-AIR	05/03/2001	2/6/2002	11 months	\$386,000 ²	\$246,000	36 months
03-2390-WS-AIR	03/12/2004	2/3/2005	25 months	\$349,000 ³	\$292,000	36 months
06-433-WS-AIR	04/17/2006	3/7/2007	14 months	\$557,472	\$400,000	36 months
07-1112-WS-AIR	11/13/2007		8 months	\$551,320	\$400,000	36 months

First, this treatment by the Staff of Ohio American's actual rate case expense violates the Ohio Supreme Court's longstanding principle that reasonable rate case expenses should be

¹ The application was originally filed on 7/2/1999 under Case No. 99-535-WW-AIR and then refiled under Case No. 99-1038-WW-AIR.

² Includes \$140,000 of the unamortized portion from the 1999 rate case.

³ Includes \$42,000 of the unamortized portion from the 2001 rate case.

included as part of a utility's operating expenses. *See, e.g., City of Canton v. PUCO* (1980), 63 Ohio St.2d 76. The Commission itself has recognized that a rate case expense is a proper Test Year expense, explaining that a utility has a "right to recover reasonable rate case expense as an ordinary and necessary business expense." *In the Matter of the Cincinnati Gas & Electric Company for an Increase In Electric Rates in its Service Area*, Case No. 91-410-EL-AIR, Opinion and Order of May 12, 1992 ("CG&E Case"). Indeed, the Ohio Supreme Court concluded that "when a utility challenged the rates fixed by the commission as being unfair or unjust, and the utility is successful in that appeal, 'proper expenses incurred by the utility in the preparation and presentation of its side of the controversy may be included by the commission among the operating expenses in computing a fair return to the company.'" *City of Canton v. PUCO* (1980), 63 Ohio St.2d 76, 82.

Secondly, the Commission itself has stated that the proper amortization period for rate case expense is one that reflects the length of time the new rates are in effect. In the CG&E Case, the Commission stated, "...such allowance [for rate case expense] should be amortized over the period for which the new rates will be in effect." (Emphasis Added.) In this case, the PUCO allowed the electric company to amortize the following rate case expenses over a three-year time period; the best evidence in the record supported this length as the period over which the new rates were to be in effect. The best evidence in this and in the prior Ohio American rate cases is (and has been) that the new rates will be in effect for no longer than 2 years. For these reasons, the Company seeks a two-year amortization period.

Finally, the Staff eliminated recovery of the remaining rate case expense that is being amortized from Case No. 06-433-WS-AIR. This position is unfair and unreasonable and, as such, the Company objects to this treatment.

Unaccounted-for Water (S.R. 14; Schedule C-3.9)

The Company objects to the Staff position of adjusting the Unaccounted-for Water percentage by the latest quarterly unaccounted-for water schedule provided to the PUCO by Ohio American operations personnel. Once again, as stated at the beginning of the Company objections, the Staff is arbitrarily picking and choosing which actual numbers best suit their case. If the Staff wants to use actual numbers, the Company is of the position that the Staff should use actual numbers for all revenues and expenses for the Test Year period. The Company's Test Year pro forma unaccounted-for water expense adjustment reflects the use of a 15% unaccounted-for cap. The Staff's adjustment adds to this expense adjustment inappropriately.

Insurance Other Than Group Expense (S.R. 15; Schedule C-3.10)

The Company objects to the Staff exclusion of Executive Risk and Officer's Liability Insurance. The expense is proper, known and measurable. The Staff has never excluded this time in prior Ohio American rate cases. Executive Risk and Officer's Liability Insurance is required for all types of businesses, including the water industry. Therefore, the Company objects to the Staff position of eliminating this expense. The Company also objects to the Staff allocation of Insurance Other Than Group and instead believes that the Company's recommendation of allocation by customer is more appropriate.

Uncollectible Expense (S.R. 15; Schedule C-3.13)

The Company objects to the Staff's position relative to uncollectible expense. The Company proposed a three-year average of uncollectible expense as representative of the true uncollectible expense for the Test Year (see Work Paper C-13). However, the Staff chose to use Test Year uncollectible expense for its calculation. As the Work papers demonstrate, uncollectibles vary from year to year, so an average is the most representative of the expense.

However, if the Staff insists on using the actual uncollectible expense, it should use the actual expense number. As will be shown in the update filed today, when one compares the actual uncollectible expense for the period ended March 31, 2008, the actual write off ratio is 2.3898%. This percentage is above the three-year average of 2.1595%. (At the time of the filing of the case, Ohio American had projected a write off ratio of only 0.996% for the Test Year).

As noted, the Company believes that a three-year average is a better representation of uncollectible expense and thus objects to the Staff position relative to uncollectible expense.

Tank Painting Expense (S.R. 15-16; Schedule C-3.14)

The Company objects to the Staff's calculations of tank painting expense. Initially the Company inadvertently included a tank painting work paper from the last rate case with the application, which did not reflect the correct information. However, correct information was sent to Staff and the OCC in data request OCC RPD 164, but the Staff has not incorporated the correct information and, thus, the Staff adjustment needs to be revised. Therefore, Ohio American objects to the Staff adjustment for tank painting expense.

Advertising and Community Expense Adjustment (S.R. 16; Schedule C-3.15)

The Company objects to the adjustments the Staff made to advertising and community expense. Advertising and community expenses in the amount of \$1,801.41 were necessary to inform customers of such items as hydrant flushing. Placing the Company name and contact information in local yellow page publications at a cost of \$2,463.20 is also a necessary expense.

Ohio American also does its part as a good community citizen and supports such causes as local fire department fund raisers; breast cancer awareness; Veteran's Day activities; fire prevention awareness; girl scouts; boy scouts; 4-H; back to school safety; and Easter Seals. Participation in the advertisements, such as these, benefits not only the communities Ohio

American serves, but its customers as well. As such, the Company objects to the elimination of these expenses from the Test Year by Staff.

Social and Service Club Dues (S.R. 16; Schedule C-3.16)

The Company objects to the Staff's calculation of social and service club dues. Memberships in these associations and in civic organizations do benefit the consumers of Ohio American. These memberships, in which Ohio American employees play an active role, give the Company an avenue to build partnerships with businesses, communities, and consumers alike. These activities provide a forum to discuss plans, coordinate building activities, and promote such programs as water conservation to consumers, fellow utility members, business and government leaders. Doing so benefits our customers. As such, the Company objects to the elimination of these expenses from the Test Year by Staff.

Depreciation and Amortization Expense (S.R. 16; Schedule C-3.19 and Schedules B-3.2a, B-3.2b and B-3.2c)

The Company objects to the Staff's depreciation and amortization expense. First, the Staff appears to have inadvertently used the Test Year Depreciation Expense from the previous rate case (Case No. 06-433-WS-AIR) as their starting point instead of the Test Year depreciation shown in this case (it appears that the Staff merely did not update the schedule from the last rate case).

Second, it appears that the Staff made adjustments to re-allocate plant from one plant account to another, effectively lowering depreciation expense. These re-allocations are unsubstantiated in either the Staff work papers or the Staff Report. The Company believes that its plant is being categorized appropriately in the Company records. Thus the Company objects to the Staff re-allocation of plant for depreciation purposes.

Third, the Staff made in error by re-allocating the Corporate Plant after the Company had already allocated Corporate Plant to Water A, Water C, and Wastewater. Thus Staff used the already-allocated Corporate Plant and did a second allocation to the other plants that of course resulted in a lower number than the total corporate plant. The net results of these additional adjustments are that the Staff schedules excluded approximately one million dollars in rate base that are part of plant and therefore are excluded from the corresponding depreciation. Depreciation for this excluded plant should be included.

Finally, Ohio American objects to the depreciation and amortization expense of other items to the extent that they are understated due to the exclusions Staff made in the plant schedules, and Ohio American objects as well to any other excluded item that would flow through to understate this expense.

Taxes Other Than Income Taxes (S.R. 17; Schedules C-3.20 and C-3.20a through C-3.20e)

The Company objects to the Staff calculation of tax expenses to the extent that they are understated by the exclusions Staff made in B and C schedules, and Ohio American objects as well as to any other excluded item in the B and C Schedules that would flow through to understate this expense.

Federal Income Tax (S.R. 17; Schedules C-3.21 and C-4)

The Company has three objections to the Staff's calculation of Federal Income Tax. First, the Staff inadvertently excluded the negative sign on the Test Year Federal Income Taxes for Water A on Schedule C-3.21. The correct Test Year Federal Income Taxes is shown in the Applicant's Schedule C-2 and in Staff Schedule C-2 is (\$268,903). Staff Schedule C-3.21 shows Test Year Federal Income Taxes as \$268,903. By not reflecting Test Year Federal Income Tax

as a negative amount on Staff Schedule C-3.21, the Federal Income Tax Adjustment is incorrect. The adjustment should be \$965,150 rather than \$427,344 as shown on Staff Schedule C-3.21. This error carries through to Staff Schedule C-2, Staff Schedule C-3, and to Staff Schedule A-1. The error results in the improper Adjusted Operating Income on Line (2) of Staff Schedule A-1 and the improper calculation of the revenue increase required on Line (8) of Staff Schedule A-1. Correcting the resulting Adjusted Operating Income on Line (2) of Staff Schedule A-1 results in an additional \$863,298 in Revenue Increase Required for Water A.

Second, current federal income taxes should be calculated at a flat 35% and not run through the graduated rate blocks. Ohio American is part of a consolidated federal income tax return for American Water Works Company ("AWW"). The consolidated taxable income of AWW (and its subsidiaries) is not run through the rate block in the determination of current income tax on the federal return. Ohio American gets many benefits from being part of the AWW system; but, one of the additional costs it must bear is that its federal income taxes are not calculated as if it were a stand-alone company (as the Staff has calculated). The income taxes recorded on the books are at 35% of Ohio American's federal taxable income, and the calculation for rate purposes should match what actually occurs. Essentially, the Staff has picked and chosen which expenses it would hypothetically bear as a stand-alone company. However, Staff accepted the lesser expenses of a consolidated company in such items as chemicals, group insurance, pensions, other than group insurance, supplies from bulk contracts and vehicle leases. The Staff's tax treatment is thus inconsistent and arbitrary. The effect of the Staff's tax treatment is to understate current federal income taxes in the Adjusted Operating Income column and to understate them in the Pro Forma Operating Income column and, thus, the Company objects.

Third, the Company objects to the Staff Federal Income Tax calculation to the extent that they are understated due the exclusions made in the schedules as well as to any other excluded items that would flow through to understate this expense.

RATE OF RETURN

Cost of Common Equity (S.R. at 18-19)

Ohio American has several objections to the Staff's Rate of Return section.

First, Staff selected publicly traded water companies listed with MSN Investor with capitalization above \$250 million. Thus, Staff's group is significantly less business risky than Ohio American, which at June 30, 2007 had total capitalization of \$86.447 million as shown on Schedule D-1 of the Staff Report. Because Staff's recommended common equity cost rate is based upon the market data of a group of companies which is less business risky based upon size than Ohio American, Staff's recommended common equity cost rate understates the true common equity cost rate to Ohio American.

Based upon Ohio American's relatively small size, an adjustment of 3.62% (362 basis points) is indicated based upon data contained in Chapter 7 entitled, "Firm Size and Return" from Ibbotson SBBI – 2008 Yearbook – Market Results for Stocks, Bonds, Bills and Inflation for 1926-2007. The determinations are based upon the size premia for decile portfolios of New York Stock Exchange (NYSE), American Stock Exchange (AMEX) and NASDAQ listed companies for the 1926-2005 period. Testimony and schedules of Ohio American's rate of return expert, Pauline Ahern, will address these points. A conservative adjustment of approximately 0.25% (25 basis points) should be made to reflect the business risk differential between Ohio American and the comparable group, based upon Ohio American's increased business risk and due to its small relative size, relative to that of the comparable group. Therefore, Staff's recommended common

equity cost rate understates Ohio American's true common equity cost rate by at least 0.25%, but in actuality it is understated by 3.62%. Adding this conservative 25-basis point adjustment to the Staff's recommended common equity cost rate range yields a common equity cost rate range of 10.73% - 11.77%, which more appropriately reflects Ohio American's greater relative business risk.

Capital Asset Pricing Model (CAPM)

Staff's application of the CAPM is flawed in five respects: 1) Staff utilized an historical yield on U.S. Treasury bonds as the risk-free rate instead of the more appropriate forecasted rate; 2) Staff inappropriately averaged the historical yield on 10-year U.S. Treasury bonds with the historical yield on 30-year U.S. Treasury bonds; 3) Staff incorrectly calculated the market equity risk premium using the total return on long-term U.S. Treasury bonds and not the income return; 4) Staff incorrectly utilized only the historical market equity risk premium without also evaluating a prospective market equity risk premium, notwithstanding the fact that in the current volatile capital markets, causing the current forecasted market equity risk premium to not be representative of the expected long-term risk; and 5) Staff did not include an empirical CAPM analysis to reflect the fact that the empirical Security Market Line ("SML") described by the CAPM is not as steeply sloped as the predicted SML.

Discounted Cash Flow (DCF) Model

Ohio American also objects to Staff's DCF analysis that is also flawed, specifically in the following respects: 1) Staff's exclusive reliance upon a non-constant growth version of the DCF, implicitly rejecting constant growth version of the DCF, i.e., the standard regulatory form; and 2) Staff's use of a long-term historical growth rate in Gross National Product ("GNP").

1) Staff relied exclusively upon a non-constant growth version of the DCF, although constant DCF results, which average 12.46%, are shown on page 9 of Schedule D-1.4 of the Staff Report. Absent evidence to the contrary and consistent with the Efficient Market Hypothesis (“EMH”) which states that all information available to investors is evaluated by investors in making their investment decisions, it is reasonable and more probable that investors would utilize the constant growth version of the DCF as it is more widely used in regulatory ratemaking than is the non-constant version used by Staff. In addition, Staff provided no theoretical or empirical support for the use of a non-constant growth DCF for water utilities. Staff never provided any theoretical or empirical support for the use of a non-constant growth DCF for water utilities. Staff provided no evidence which supports the assumption implicit in this version of the model, that growth in EPS, DPS or stock price will approach that of the economy as a whole at any given future point in time. In fact, Staff was silent relative to its constant Growth DCF analyses.

2) Staff utilized an historical long-term growth rate in GNP as the growth rate in the third stage of the model, from year 25 onward. However, ratemaking as well as the cost of capital is prospective. Therefore, to properly apply the non-constant growth version of the DCF, a prospective growth rate is required. Assuming for the sake of argument and because Staff utilized growth in GNP for the final stage of the non-constant, the prospective growth in GDP (“Gross Domestic Product”) (growth in GNP is no longer available) should have been utilized. Averaging the growth of 4.66% in GDP forecasted by the Energy Information Administration (“EIA”) for the years 2024 - 2030 (the last year for which EIA forecasts GDP) with the growth in GDP forecasted by the Social Security Administration (“SSA”) for the years 2024-2085 in the amount of 4.58% from each of their 2008 annual reports, results in a forecasted growth in GDP

of 4.62%. This contrasts with the 6.77% historical GNP growth rate utilized by Staff. Although Staff's GNP growth rate is higher than the current average forecasts of GNP, once again the forecasts are conceptually correct, as rate making and the cost of capital are prospective.

As with the CAPM results discussed above, Ohio American objects because these results reflect the riskiness of the larger, more geographically diverse comparable group water companies and not the greater relative riskiness experienced by Ohio American due to its small size. A conservative size adjustment of 0.25% should have been added to the DCF results of Staff's water company group. This results in a non-constant DCF results of 10.54% ($10.54\% = 10.29\% + 0.25\%$) and of constant DCF results of 12.71% ($12.71\% = 12.46\% + 0.25\%$). An evaluation of the median results of Staff's non-constant (10.25%) and constant (11.95%) DCF analyses shows that using the median results and adding the 25 basis point adjustment to reflect Ohio American's small size relative to that of Staff's comparable group of water companies, yields a median risk-adjusted non-constant DCF result of 10.50% and constant DCF result of 12.20%.

For all the reasons given above, Ohio American objects to the understatement of Staff's rate of return conclusions.

RATES AND TARIFFS

MISCELLANEOUS CHARGES

Account Activation Charge (S.R. 25-26)

The Company objects to the Staff recommendation that the Account Activation Charge be reduced from \$23.10 to \$22.40. The Company recommended that the Account Activation Charge remain at \$23.10. Subsequent data request information provided to Staff showed that the itemized cost for account activations should be \$24.25. (Staff Data Request S-024) Yet, Staff

recommends that the charge be lowered even more. The Company believes that this charge at a minimum should remain at \$23.10.

REVENUE ANALYSIS

Revenue Distribution (S.R. 29)

Staff criticizes the Company for not including Miscellaneous Metered Sales as a separate customer classification in the cost allocation study. Miscellaneous Metered Sales are a very small portion of the total consumption and of total revenue – about one-one hundredth of a percent. Miscellaneous sales are not mentioned in the American Water Works Association (“AWWA”) manual as a separate service classification – these are typically temporary and infrequent sales and do not represent sales on a continuous basis like the other classifications. The practical solution is to include such sales and revenues with the commercial class, which is the way Ohio American accounted for these sales.

Staff’s only reason why it should be a separate class is because it is separately identified in the E Schedules. However, inasmuch as the AWWA manual of accounts does not list a separate account, this rationale does not support separate customer class treatment in the cost allocation study.

Customer Charge (S.R. 32-35)

The Company objects to Staff’s calculation of the customer charge. Staff omitted costs associated with public fire protection and the customer-related portion of management fees. Public fire costs are fixed costs that are not recovered through public fire hydrant rates and thus should be included in the customer cost analysis. They are allocated to customer classifications based on meter equivalents so that customers with larger meters pay more toward fire protection. (This reflects that customers with larger meters generally have higher property values.) Public

fire costs are fixed costs which primarily include the depreciation, return and taxes on the rate base facilities required to provide fire service as well as hydrant maintenance. These costs do not vary with the amount of water consumed and therefore should not be included in volumetric charges. The customer-related portion of the management fee is directly related to customer costs appropriately recovered through the customer charge. These costs relate to the Call Center and any other customer-related costs such as billing and collecting. Such costs would have to be covered directly by the Company in its Customer Accounting Expenses if these services were not provided by the American system. As such, the Company objects to the Staff recommended monthly customer charge of \$7.21. Rather, Company's recommended monthly customer charge of \$10.59 has been supported.

Large Quantity User Rates (S.R. 38-39)

The Company objects to Staff's calculation of the Large Quantity User Rate. The calculation is inconsistent with the calculation performed by the Staff in Case No. 06-433-WS-AIR. In that case, Staff totaled Operating Income, Depreciation, Property Tax, Gross Receipts Tax, Payroll Tax, and Federal Income Tax to arrive at a "Total Capital Costs" total. This method has been consistently approved in prior rate cases. Unfortunately, when the Company provided information to the Staff in S-031, there was an error in the calculation which deducted Operating Income rather than adding it. The Staff carried this error through and the result was a much lower production cost calculation.

If the proper production cost calculation method were used, as it was in the last case, the "Total Capital Costs" would be \$20,740,964 instead of the \$2,388,317 as calculated by Staff. If that total was multiplied by the ratio of total plant of 28.44% and added to the total Net Production Cost of \$5,183,359, and that total divided by total sales of 6,657,534 ccf, it yields a

revised Unit Production Cost of \$1.66. The Company thus objects to the error in the calculation and urges that the correct unit production cost of \$1.66 be used to compute the Large Quantity User Rate.

Purchased Water Rate (S.R. 40-41)

The Company disagrees with the Staff contention that the Company is not complying with the stipulation signed in Case No. 06-433-WS-AIR in regard to the purchased water surcharge for Portage County. In a meeting between the Company and the Staff on October 4, 2007, just prior to the Company's filing of Case No. 07-1112-WS-AIR, the Company and Staff agreed to work together to design a purchased water rate that is agreeable to both parties as part of this rate case proceeding. Following that meeting, the Company documented the agreement by filing a compliance letter in both Cases Nos. 06-433-WS-AIR and 07-252-WS-UNC on December 3, 2007. Thus Ohio American objects to the Staff's characterization of non compliance with the Portage County commitment. The Company, however, remains committed to working with the Staff to achieve a mutually satisfactory rate design for purchased water.

Mansfield District Flat Rate Customers (S.R. 43)

The Company filed Case No. 07-1112-WS-AIR to reflect an across-the-board increase to Water A, Water C, and Wastewater tariff groups. This across-the-board percentage was also used for the flat rate customers in the Mansfield District. The Company believes that this uniform approach to all tariff groups is the most fair and equitable to its customers in this rate case and, as such, objects to the Staff recommendation to adjust the flat rate charge based on the historical method of increase of the average metered customer bill. Its recommendation is a departure from the last five rate cases where the across-the-board percentage increase for nonmetered services was recommended by Staff and approved by the Commission.

Sewer Rates (S.R. 45)

The Staff and Company agree that the water and sewer customer charges should be identical. However, the Company objects to the customer charge calculation recommended by Staff as set forth in the Customer Charge objection above. For the same reason, Ohio American argues that the Company's recommended monthly customer charge of \$10.59 is more appropriate.

SERVICE MONITORING & ENFORCEMENT

The Company has only a few objections to this portion of the Staff Report and most of them are clarifications or suggestions to modify the recommendations.

STIPULATION REVIEW

[11 B] Unaccounted-for-Water Identification, Reporting and Reduction (S.R. 50-51)

Ohio American objects to the Staff's recommendation that the Company be held to a 15% standard because the Staff no longer excludes identified leaks in the UFW percentage as was allowed in prior years. When Ohio American initially agreed to the 15% UFW commitment it was based upon the Company's belief that identified leaks were to be excluded. It was only later that the Company learned that this exclusion was no longer to be applied. For all the reasons given in its Reply Comments in Case No. 07-292-WS-ORD, filed May 24, 2007 (pp. 9-13), the Company objects to this standard. Furthermore Ohio American objects to the Staff recommendation about a timetable for the development of a complex remedial plan and the implementation time table for same. No cost/benefit determination has been performed or demonstrated to support the customer benefiting from the Staff's recommendation.

Tank Inspections, Storage Studies and Replacements

[11 E ii] Ashtabula Bunker Hill Storage Tank (S.R. 54)

The Staff noted that the Company had complied with the Stipulation in providing options with respect to how it could inspect and maintain the tank, but not take the tank out of service, and that the Company had not yet selected the option to accomplish this task. However, the Staff then recommended that Ohio American select the option within six months and, if the option were that the Company would build another tank, the new tank construction should be accomplished within two years. Ohio American objects to the Staff's recommendation, because on a preliminary basis it appears that the most economical course of action for the customer is to upgrade the pump and pressure controls at the Ashtabula Treatment Plant at a cost of \$180,000 and to manage the distribution system pressures and demands while the Ashtabula Bunker Hill storage tank is out of service for inspection/maintenance. However, the Company is also evaluating whether the proposed pumping upgrade fits the scope of the Ashtabula Treatment Plant upgrade. The timing of the upgrade is not known precisely at this time, but in any event, economy and efficiency demands that the two projects should be accomplished by coordination, and not subject to an arbitrary time table.

[11 E iii] New Lake White Storage Tank (S.R. 54-55)

At the time this portion of the Staff Report was drafted, the Company had not submitted its documentation (submitted on May 29, 2008 in Cases Nos. 06-433-WS-AIR and 07-252-WS-UNC) that the Lake White Storage Tank had been completed and was in service. The Company met the June 30, 2008 commitment in the Stipulation in the last case. Thus this question has now been answered.

[12 D] Distribution Model and Unidirectional Flushing Program (S.R. 56)

The Staff noted that Ohio American had completed its unidirectional flushing program as agreed to in the Stipulation and recommended that the Company continue the flushing program. Ohio American plans to continue the program, but the Staff did not specify the number of flushings for the Huber Ridge service area. Ohio Administrative Code Rule 4901:1-15-10 (B) specifies flushing once a year unless there is a dead end [the new rules retain the same requirement and retain the same rule number]. The Stipulation agreed to flush two times for the Huber Ridge area but Ohio American flushed three times in 2007 and already it has flushed unidirectionally one time in 2008.

To the extent that the Staff is suggesting more than Rule 4901:1-15-10 (B), Ohio American objects because it believes that Company managers should retain the operational and management judgment about how many more times than once a year, unidirectional flushing needs to occur in the Huber Ridge service area. At this point, Ohio American does not anticipate a need to annually flush the system three times a year and believes it is appropriate for the Company to make decisions about the number of unidirectional flushings required as circumstances warrant. Thus if the Staff recommendation is that the Company flush more than required by Rule 4901:1-15-10 (B), Ohio American objects.

[12 E] Evaluation of Internal Status of Distribution Pipes from Sample Sections (S.R. 57)

The Staff made a recommendation that when the Company removed any pipe samples from the Huber Ridge distribution system, it make these samples available to the Staff for a 12-month period. Ohio American does not object to the Staff's inspection nor to the preservation of the samples for a 12-month period; however, the Staff's recommendation is open ended. Though

the Company does not agree that this action is necessary based on the samples taken in 2007, the Company objects to complying with this recommendation into the indeterminate future. Rather, Ohio American believes that a recommendation should be that where the Company takes excavation samples during the 12-month period from the date of the order in this case, those samples would be preserved for a 12-month period dating from the excavation.

[12 G] Discontinuance of Reverse Osmosis Charge (S.R. 59)

Ohio American objects to the Staff recommendation to continue the reverse osmosis charge penalty of the Stipulation in the last case. Firstly, the reverse osmosis surcharge has nothing to do with the maintenance of a minimum level of contaminants measured at the plant site. The proposed penalty is not related at all to the performance of the osmosis treatment process, but rather to the finished water at the plant. Thus, it is inequitable to provide such a penalty on the performance (and associated cost of operation and maintenance of one treatment process). It is feasible that the reverse osmosis treatment process is operated properly and performs well within its design performance parameters, but the Secondary Maximum Contaminant Levels for iron and/or manganese to be exceeded by other conditions. Thus the automatic connection of penalty to the Reverse Osmosis surcharge assumes the cause of the problem is the Reverse Osmosis treatment process without factual evidence.

Though the Company, in the interest of settling the case, acquiesced to a similar proposed penalty in the last case, the principle of applying a penalty that has nothing to do with the breach is still abhorrent to Ohio American and thus it objects. Secondly the recommendation is not factually based. The penalty was never triggered in the last case and thus to suggest that it be continued for an additional period of time in this case is not merited. Finally, the recommendation itself is vague. It does not specify how the 95% "of the time" is to be measured.

In the event that this unfortunate recommendation remains after the parties have discussed this issue during the prehearing process, Ohio American urges that the 95% be based upon the total number of tests that the Company conducts in a given period. For all these reasons, the Company objects to this Staff recommendation.

[13] Lake Darby Softening (S.R. 61-64)

Ohio American would like to clarify the Staff note that Ohio American made a one-time aggregate credit of \$1,000 to the Lake Darby customers. While that statement is technically correct, the context of the Staff's discussion gives the impression that the Company was required to make the credit. As stated in the filing of March 4, 2008 in Cases Nos. 06-433-WS-AIR and 07-252-WS-UNC, Ohio American's daily testing showed compliance with the Stipulation. Nevertheless recognizing an operator error that occurred to have an effect after the testing, the Company voluntarily made the one time aggregate credit of \$1,000 to the customers of Lake Darby.

More important than the record clarification, however, is the Staff recommendation that the Company take from four to six water samples at the plant evenly spaced per day. Since the plant is only staffed on average, one and one half hours per day, to increase the staffing over an entire day will cause significant increased employee and operating costs. In addition, the Staff recommends that one of the samples be taken when a water softener is regenerating. Since water softeners regenerate at irregular time intervals, based on water volume treated, the only practical way to guarantee sampling during a water softening regeneration is to staff the plant full time. Ohio EPA does not require the man power coverage levels at this size of a plant that would be necessary to achieve the Staff recommendation. The Ohio EPA requires no water distribution

sample for hardness, while the Staff is recommending a minimum of two samples per week from the distribution system.

In addition, the Staff is recommending that the Company notify the Staff before the testing of any hardness sample (a minimum of four calls a day!). This type of requirement hinders the performance of the operation of the water system.

Ohio American is also compelled to object to the Staff's recommendation that the softness range for Lake Darby remain at 120 mg/L to 150 mg/L. Lake Darby customers, including a Prairie Township Trustee, have consistently expressed a desire for even softer water than the current level of 120 mb/L hardness concentration. Ohio American is willing to accommodate a lower level that meets Ohio EPA recommendations. In the past, penalties and credits have always been associated with exceeding 150 mg/L, not going below the softness lower limit. Moreover, the Ohio EPA is the agency that regulates and recommends public drinking water quality criteria. It is inappropriate for the Staff to impose separate and different criteria for its regulated water companies. Ohio American therefore agrees to a maximum hardness value of 150 mb/L, but objects to the continuation or establishment of a minimum hardness in a numeric value other than the lowest hardness value recommended by the Ohio EPA.

[17] Leak Repair (S.R. 66-67)


The Staff noted that the Company had substantially complied with its leak repair commitment from the last rate case. Nevertheless, it recommended continuation of the seven-day commitment for repairs for non service affecting leaks. Ohio American objects to this recommendation. In principle, Ohio American believes that repairing leaks promptly is good management practice and would do so even without a commitment. However, a hard/fast

requirement to repair *every* leak, no matter how small, within seven days of detection does not comport with cost effective water management. It is Ohio American's own interest to repair leaks promptly because such leaks will affect its unaccounted for water percentages. But, an artificial seven-day commitment for all sized leaks is not reasonable and Ohio American objects.

[18] Restoration of Property (S.R. 67-68)

Though the Company disagrees with the characterization that it "had developed a history of taking a long time in repairing its excavation sites," the more important point to be clarified is the recommendation about internal monitoring (at 68). The Company is more than willing, and indeed, has recently implemented a monitoring program whereby each excavation project is visually inspected for completeness after restoration. Because Ohio American believes that clarification is necessary, it must object to the Staff recommendation.

Respectfully submitted on behalf of
OHIO AMERICAN WATER COMPANY


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CERTIFICATE OF SERVICE

The undersigned hereby certifies that the OBJECTIONS OF OHIO AMERICAN WATER COMPANY TO THE STAFF REPORT were served by either electronic mail or regular U.S. Mail this 27th day of June 2008.


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