COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF WATER SERVICE CORPORATION OF KENTUCKY FOR AN ADJUSTMENT OF RATES	)) CASE NO. 2010-00476)

ORDER

Water Service Corporation of Kentucky ("WSKY") has applied to adjust its rates for water service to produce additional revenues from water sales of $448,723, or 22 percent above normalized revenues from such sales. By this Order, the Commission establishes rates that will produce additional annual revenues of $68,898. For a customer who uses 5,000 gallons of water monthly, these rates will result in an increase of $0.70 in his monthly bill if he resides in Bell County or $1.15 if he resides in Hickman County.

BACKGROUND

WSKY, a Kentucky corporation, owns and operates facilities that treat and distribute water to approximately 7,376 customers in Hickman and Bell Counties, Kentucky.[1] WSKY is a wholly-owned subsidiary of Utilities, Inc. ("UI"), an Illinois corporation that indirectly owns over 70 water and wastewater systems in 15 states throughout the United States. Water Service Corporation, an Illinois corporation that is also a wholly-owned subsidiary of UI, provides various management, administrative,

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[1] *Annual Report of WSKY Corporation of Kentucky to the Public Service Commission of the Commonwealth of Kentucky for the Calendar Year Ended December 31, 2010* ("*2010 Annual Report*") at 5 and 30.

and technical services for WSKY as well as all other UI water and wastewater systems. Water Service Corporation, not WSKY, employs all persons who are responsible for the WSKY's provision of water service in Kentucky.[2] WSKY has no employees. WSKY's most recent rate adjustment occurred on November 9, 2009.[3]

PROCEDURE

On December 3, 2010, WSKY notified the Commission in writing of its intent to apply for an adjustment of rates using a historical test period. On January 24, 2011, it filed its application with the Commission. In its application, WSKY submitted tariff sheets containing a proposed effective date of February 24, 2011. The Commission subsequently advised WSKY that, because the submitted tariff sheets failed to comply with 807 KAR 5:011, Section 4, its notice was defective and the rates could not become effective on the proposed date. The Commission subsequently established a procedural schedule for this proceeding.

The Commission has granted the Attorney General of Kentucky ("AG") and Hickman County Fiscal Court leave to intervene in this matter. Following discovery by Commission Staff and the parties, the Commission conducted an evidentiary hearing in this matter on July 14, 2011. Testifying at this hearing were: Patrick L. Baryenbruch, President, Baryenbruch & Company, LLC; Bruce T. Haas, Regional Director of Operations for UI's Midwest Region; Steven M. Lubertozzi, UI's Executive Director of Regulatory Accounting and Affairs; and Brian Shrake, Senior Regulatory Accountant at

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[2] WSKY's Response to Attorney General's Request for Information, Item 16(c). In its annual report, WSKY reports having 11 full-time employees. *See 2010 Annual Report* at 5. The Commission assumes that the references in WSKY's annual report are to Water Service Corporation employees who are stationed or residing in Kentucky and working directly on WSKY facilities or operations.

[3] Case No. 2008-00563, *Application of Water Service Corporation of Kentucky for an Adjustment of Rates* (Ky. PSC Nov. 9, 2009).

UI. We also held public hearings to receive public comment on the proposed rate adjustment in Middlesboro, Kentucky on June 8, 2011 and in Clinton, Kentucky on June 22, 2011. On August 22, 2011, this matter stood submitted for decision following the parties' submission of written briefs.

TEST PERIOD

WSKY proposes to use the 12-month period ending September 30, 2010 as the test period to determine the reasonableness of its proposed rates. The Commission finds the use of this period reasonable. In using a historical test period, we give full consideration to appropriate, known, and measurable changes.

INCOME STATEMENT

For the test period, WSKY reports actual operating revenues and expenses of $1,907,162 and $1,667,143, respectively.[4] WSKY proposes several adjustments to revenues and expenses to reflect current and anticipated operating conditions, resulting in pro forma operating revenue of $2,009,847 and pro forma operating expenses of $1,832,663.[5] The Commission's review of these proposed adjustments is set forth below.

Operating Revenues from Water Sales

WSKY reports test-period operating revenues from water sales of $1,980,475.[6] Because its current rates became effective after the start of the test period and thus were not assessed throughout the test period, WSKY proposes to increase its revenues

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4 Application, Exhibit 4, Schedule B at 1.

5 *Id.*

6 *Id.*

from water sales by $68,214 to reflect the annualization of its current rates.[7] Finding that WSKY's proposal to annualize its rates is reasonable and meets the ratemaking criteria of known and measurable, we accept the proposed adjustment and have increased operating revenues from water sales by $68,214.

Uncollectibles

WSKY reports a test-period uncollectible expense of $126,200 as a credit to operating revenues and proposes to decrease this amount by $34,473 to a pro forma level of $91,727.[8] This adjustment reportedly reflects the percentage of the uncollectible accounts to the test-period revenues applied to the normalized revenues from water sales.[9]

In calculating its uncollectible expense, WSKY uses an uncollectible rate of 4.48 percent, which is significantly higher than the rate of 1.11 percent that the utility used in its previous general rate adjustment application. This increase is due in part to the use of a different methodology to calculate the rate. WSKY Witness Shrake testified that WSKY's previous methodology only included the "availability customers" in its aging schedule to calculate the uncollectible allowance.[10] The new methodology includes all customers WSKY bills and, therefore, "more accurately reflects [the] actual amount of

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[7] Application, Exhibit 4, Schedule B at 1 (filed Jan. 24, 2011). *See also* WSKY's Response to Commission Staff's First Information Request, Item 1 (filed Mar. 8, 2011).

[8] WSKY's Response to Commission Staff's First Information Request, Item 1 (filed Mar 8, 2011).

[9] *Id.,* Direct Testimony of Brian Shrake at 5 (filed Jan. 24, 2011).

[10] WSKY's Response to Commission Staff's Third Information Request, Item 10(a) (filed May 20, 2011).

collectibles."[11] WSKY also contends the uncollectible rate of 1.11 percent is less accurate because it is a three-year average.[12]

The Commission finds insufficient evidence in the record to support WSKY's use of an uncollectible rate of 4.48 percent for ratemaking purposes. For the calendar year ending December 31, 2010, WSKY's uncollectible rate was 2.55 percent.[13] During the same period, the uncollectible rate for UI's water and wastewater system was 1.12 percent.[14] Because WSKY implemented its new methodology in December 2009, the 2010 uncollectible rate of 2.55 percent is the most current rate. The most current rate is the more reasonable uncollectible rate to use for establishing rates.

Using that rate and the normalized operating revenues from water sales of $2,048,689, the Commission calculates an uncollectible expense of $52,243, which is $73,957 below the amount reported. Accordingly, we increase operating revenues by $126,200 and operating expenses by $52,243 to reflect application of the 2010 uncollectible rate.

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[11] *Id.*

[12] *Id.* Item 10(b).

[13] WSKY's Response to Hearing Data Request, Tab 3 (filed Aug. 5, 2011); WSKY's Response to Commission Staff's Third Information Request, Item 11. Although WSKY stated in its response to Commission Staff's Hearing Data Request that the uncollectible rate of 2.55 percent applies for the calendar year ending December 31, 2009, this rate appears to apply to the calendar year ending December 31, 2010. WSKY reports total uncollectibles of $51,666 for the calendar year ending December 31, 2010. It reported service revenues of $2,022,768 for the same period. As shown below, this information results in an uncollectible rate of 2.55 percent.

$51,666 (2010 Uncollectibles) ÷ $2,022,768 (2010 Service Revenues) = 2.55 percent.

[14] WSKY's Response to Hearing Information Requests, Tab 3.

Salaries and Wages – Employee

WSKY proposes to increase test-period operating expenses by $34,608[15] to annualize employee wages[16] as of the end of the test period.[17] The proposed adjustment, however, is based projected employee wage increases that became effective April 1, 2011, seven months after the end of the test-period.[18] WSKY applied the 2011 wage rates to the end-of-period employee level and the actual test-period overtime hours worked to arrive at its pro forma Salaries and Wages – Employees expense of $667,529.[19] It projects a 3.5 percent wage increase for each employee, but the actual wage increases varied from 0.0 percent to 12.5 percent[20] due to individual performance, promotions, and other factors.[21]

In support of the reasonableness of its current employee wage levels, WSKY states that it must offer competitive compensation and provide merit pay increases to

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[15] $73,324 (Salaries and Wages – Operations) - $38,716 (Salaries and Wages – Non-Operations) = $34,608.

[16] WSKY has no employees. The wages and salaries at issue are those of employees of Water Service Corporation who perform services for WSKY. *See, e.g.*, WSKY's Response to AG's Request for Information, Item 16. Water Service Corporation employs 11 persons within the state of Kentucky to operate and administer its facilities in Bell and Hickman Counties. It charges WSKY the total amount of these persons' salaries and wages. Additionally, employees at Water Service Corporation's offices outside of Kentucky provide administrative and management services to WSKY. Water Service Corporation has allocated 2.63 percent of their salaries and wages to WSKY. The allocation factor of 2.63 is based upon the proportion of WSKY's equivalent customer connections to UI's total equivalent customer connections.

[17] Direct Testimony of Brian Shrake at 5.

[18] WSKY's Response to Commission Staff's Third Information Request, Item 5(a) (filed May 20, 2011).

[19] $516,265 (Salaries and Wages – Operations) + $151,264 (Salaries and Wages – Non-Operations) = $667,529.

[20] WSKY's Response to Commission Staff's Second Information Request, Item 7 (filed Apr. 20, 2011).

[21] WSKY's Response to Commission Staff's Third Information Request, Item 5(a) (filed May 20, 2011).

compete with municipalities and other utilities. Its studies of its own compensation packages and those offered by other utilities suggest that the current level of compensation for its employees is comparable to or below industry benchmarks.[22]

The Commission finds insufficient evidence to support the reasonableness of the proposed adjustment to the test-year expense. Although WSKY asserts that local wage information was incorporated into the benchmarks used to develop its 2010 and 2011 wage increases,[23] it failed to produce any studies or documentary evidence to support its assertion.[24] It has offered no evidence to compare the 2011 wage increases with local, regional or state wage trends or to suggest that the 2011 increase was necessary or reasonable. Accordingly, we deny WSKY's proposed adjustment to Salaries and Wages – Employees expense and allow an increase of only $11,209[25] for a pro forma level of $644,130.[26]

Operating Expenses Charged to Plant

WSKY proposes to increase its operating expenses charged to plant of ($50,427) by ($44,689). Having reviewed WSKY's supporting calculations, the Commission finds that they are reasonable and has increased expenses charged to plant by ($44,689).

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22 *Id.*

23 WSKY's Response to Hearing Data Request, Tab 2.

24 *See, e.g.*, WSKY's Response to Commission Staff's Third Information Request, Item 6(a) (filed May 20, 2011); WSKY's Response to Hearing Information Requests, Tab 2 (filed Aug. 5, 2011).

25 $55,865 (Salaries and Wages – Operations) - $44,656 (Salaries and Wages – Non Operations = $11,209.

26 $498,806 (Salaries and Wages – Operations) + $145,324 (Salaries and Wages – Non Operations) = $644,130.

Rate Case Expense

WSKY proposes to increase test-period rate case amortization of $55,885 by $26,960 to reflect the amortization over three years of the estimated cost of this current case of $147,422 and the unamortized rate case expense from its prior rate proceeding of $101,114. Based upon our review of submitted invoices, we find that WSKY incurred rate case expense of $141,408 in this proceeding. We further find that $56,624 of WSKY's rate case expenses from its last rate case proceeding have yet to be amortized. Amortizing the sum of these expenses[27] over three years results in a pro forma rate case amortization expense of $66,011, which is $10,126 above the actual test-period expense. Accordingly, the Commission finds that WSKY's proposed adjustment should be denied and that Rate Case Amortization expense should be increased by $10,126.

Employee Pensions and Other Benefits

WSKY proposes to increase Employee Pension and Benefit expense by $39,523 to a pro forma level of $162,867 to reflect the effect of the April 2011 wage increases on WSKY's contributions for employee retirement and current employee insurance premiums. Eliminating the effects of the April 2011 wage increases and including the current premiums results in a pro forma Employee Pension and Benefit expense of $161,338, which is $37,994 above actual test-period expense. Accordingly, the Commission denies WSKY's proposed adjustment and increases Employee Pension and Benefit expense by $37,994 for ratemaking purposes.

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[27] $141,408 (Actual Rate Case Cost Current Case) + $56,624 (Unamortized Cost of Case No. 2008-00563) = $198,032.

Indirect Expense Allocations

Water Service Corporation, a UI subsidiary, manages WSKY's water operations. Those costs that Water Service Corporation incurs and that cannot be directly assignable to a specific UI subsidiary are booked to Water Service Corporation and then allocated to UI subsidiaries at year-end, based on the proportion of active Equivalent Residential Customers ("ERCs") served by an operating company to the total number of active ERCs the UI affiliates serve. Water Service Corporation charged approximately $169,886 of these allocated indirect charges to WSKY during the test period. These charges are part of its pro forma operating expenses.

The AG requests the disallowance and removal of these charges from pro forma operating expenses. He argues that WSKY bears the burden of demonstrating not only the reasonableness of its proposed rates, but also the reasonableness of each component upon which those rates are based. He asserts that WSKY has failed to demonstrate their reasonableness.

The AG's position centers upon the lack of any independent review of allocated indirect expenses. The agreement between Water Service Corporation and WSKY contains no provisions for WSKY to monitor and challenge assignments of indirect expenses. Moreover, the members of WSKY's Board of Directors also serve as directors of other UI subsidiaries, including Water Service Corporation. On its face, this arrangement presents an apparent conflict of interest and raises questions about WSKY's willingness to question transactions with Water Service Corporation. "In that Water Service Corporation has virtually no compunction when it comes to allocating amounts to Kentucky which have no discernable connection with the provision of reasonable utility service," the AG argues, "the lack of independence works to the material detriment of . . . [WSKY's] ratepayers."[28]

Responding to these arguments, WSKY notes that Water Service Corporation actually provided services for the expenses in question. "Rather than depriving . . . [Water Service Corporation of Kentucky] of an actual expense reasonably incurred, actually used for the benefit of the customers, and actually used to comply with Commission regulations as to certain service standards such as billing, record keeping, regulatory reporting and other aspects of utility operations," WSKY asserts, "the Commission is obligated to allow . . . [Water Service Corporation of Kentucky] to recover its costs of operations."[29]

WSKY also presented testimony on the reasonableness of the proposed charges. WSKY Witness Baryenbruch conducted a study of the services that Water Service Corporation provided to WSKY. He concluded that, based upon comparisons with costs of electric utility service companies, the cost of Water Service Corporation's services were reasonable. He further concluded that Water Service Corporation's charges for these services were at the lower of cost or market and that the services provided were necessary.[30]

The AG asserts that no weight should be afforded to Mr. Baryenbruch's study. He contends that Mr. Baryenbruch's comparison group does not involve comparable utilities. The study group did not contain any water utility and the utilities studied were

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[28] AG Brief at 5 (filed Aug. 22, 2011).

[29] WSKY Brief at 17 (filed Aug. 22, 2011).

[30] Supplemental Testimony of Patrick L. Baryenbruch at 3-4 (filed Jan. 31, 2011).

much larger than IU and its subsidiaries. He describes the study as merely a "device by which . . . [Mr. Baryenbruch] seeks to discuss whether . . . [Water Service Corporation's] costs allocations are in 'the ballpark' with amounts on the FERC Form 60."[31] The AG asserts that the standard of reasonableness requires a "far more exacting and demanding than an 'in the ballpark' standard."[32]

An applicant for a rate adjustment generally has the burden to demonstrate the reasonableness of its proposed rates.[33] Management decisions are generally presumed to be reasonable.[34] When costs, however, are not the product of an arms-length transaction, the presumption of reasonableness does not follow.[35] The applicant must demonstrate the reasonableness of the charges for the services provided by the affiliate. "[I]f there is an absence of data and information from which the reasonableness and propriety of the services rendered and the reasonable cost of rendering such services can be ascertained by the Commission, allowance is properly refused."[36]

Based upon our review of the record, we find that WSKY has failed to demonstrate the reasonableness of the charges for indirect services. We agree with the AG's criticism of Mr. Baryenbruch's study as failing to involve similar type and sized

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[31] AG Brief at 6.

[32] *Id.*

[33] KRS 278.190(3).

[34] *Pa Pub. Util. Comm'n v. Phila. Elec. Co.*, 561 A.2d 1224 (Pa. 1989); *West Ohio Gas Co. v. Ohio Pub. Util. Comm'n*, 294 U.S. 63 (1935).

[35] *See, e.g., Hilton Head Plantation Utilities, Inc. v. Pub. Serv. Com'n*, 441 S.E.2d 321 (S.C. 1994); *Boise Water Corp. v. Idaho Pub. Util. Com'n*, 555 P.2d 163 (Idaho 1976); *State ex rel. Util. Com'n v. General Tel. Co.*, 189 S.E.2d 705 (N.C. 1972).

[36] *Hilton Head Plantation Utilities, Inc.*, 441 S.E.2d at 323.

utilities and, therefore, decline to afford it any weight. Moreover, the record indicates an absence of any independent review of the cost allocations by WSKY's management. In the absence of adequate support for the charges, the Commission disallows allocated indirect costs of $169,886 from pro forma operating expenses.[37]

Depreciation

WSKY proposes to decrease depreciation expense by $14,075[38] to reflect the gross depreciable plant at the end of the test period multiplied by the appropriate depreciation rates.[39] WSKY's proposed pro forma depreciation expense includes depreciation on accounting and financial systems that UI placed into service as a result of its Project Phoenix study.[40]

Asserting that WSKY has failed to demonstrate the purchase and implementation of the Project Phoenix systems was reasonable or that the project costs were reasonable, the AG urges the Commission to exclude any depreciation expense associated with the Project from rate recovery.[41] He argues that WSKY has failed to demonstrate that a "reasonable utility of comparable size would spend in excess of a half-million dollars on software similar to that contained in Project Phoenix." He refers

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[37] For a listing of these expenses, see Appendix B to this Order.

[38] Application, Exhibit 4, Schedule B at 1.

[39] Direct Testimony of Brian Shrake at 5.

[40] In 2006, UI began Project Phoenix, an internal and external evaluation of its accounting and billing software and computer system. After evaluating the potential solutions, UI selected J.D. Edwards Enterprise One as the financial system and Oracle's Customer Care and Billing System as the customer information system. On December 3, 2007, UI placed the J.D. Edwards system into service at a total cost of $13,955,789. It placed the Oracle system into operation on June 2, 2008, at a total cost of $7,126,679. Using an allocation factor based upon the equivalent residential connections, UI allocated $368,069 of the total cost of the JD Edwards system and $178,432 of the Oracle cost to WSKY. *See* Direct Testimony of Steven M. Lubertozzi at 5-11.

[41] AG Brief at 3.

to the Commission's decision in WSKY's last rate case proceeding[42] to deny rate recovery to such an expense as a basis for similar action in the present proceeding. Responding to these arguments, WSKY contends that the testimony of WSKY Witnesses Lubertozzi and Baryenbruch provided ample support to demonstrate the reasonableness of Project Phoenix.

Our review of the record in this proceeding and in WSKY's last rate proceeding indicates no new evidence that requires us to alter our earlier findings. In the last proceeding, we expressly noted the failure of UI to perform an analysis to show that Project Phoenix benefited WSKY's ratepayers.[43] While Mr. Baryenbruch did not testify in the earlier proceeding, we note that his written testimony did not address Project Phoenix and his testimony at hearing did not expressly address the prudency of Project Phoenix.

We find WSKY's depreciation calculations are reasonable and accept them. We further accept WSKY's proposed adjustment to decrease Depreciation expense by $14,075. In light of WSKY's failure to provide convincing evidence as to the reasonableness or need of Project Phoenix, however, we have decreased Depreciation expense by an additional $69,565[44] to eliminate the Depreciation expense associated with Project Phoenix.

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[42] Case No. 2008-00563, *Application of Water Service Corporation of Kentucky for an Adjustment of Rates* (Ky. PSC Nov. 9, 2009) at 3-6.

[43] *Id.* at 6.

[44] $368,089 (Allocated – JD Edward Costs) + $188,432 (Allocated – Oracle Costs) = $556,521 x 12.5% (Depreciation Rate – Computers) = $69,565.

Amortization of Contributions In Aid of Construction ("CIAC")

WSKY proposes to increase Amortization of CIAC expense of ($1,536) by ($2,814)[45] to reflect CIAC at the end of the test period multiplied by the appropriate depreciation rates.[46] Based upon our review of WSKY's calculations and workpapers, we find that the proposed adjustment is reasonable and we accept it.

Plant Acquisition Adjustment ("PAA")

WSKY proposes to increase pro forma operating expenses by $3,660 to reflect removal of the Amortization PAA.[47] Based upon our review of WSKY's calculations and workpapers, we find that the proposed adjustment is reasonable and we accept it.

General Taxes

WSKY proposes to increase test-period General Tax expense of $145,450 by $3,255 to annualize payroll taxes and utility commission taxes.[48] Eliminating the effect on payroll taxes of the April 2011 wage increases results in a pro forma General Tax expense of $146,279. This amount is $829 greater than actual test-period General Tax expense. Accordingly, we deny WSKY's proposed adjustment and increase General Tax expense by $829.

Expense Reduction – Clinton Sewer

WSKY proposes to decrease its sewer expense allocation by $34,206 from ($137,459) to ($103,253). This adjustment reflects the requested pro forma operating expenses' effect on the allocation of costs to the city of Clinton's sewer operations. The

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[45] Application, Exhibit 4, Schedule B at 1.

[46] Direct Testimony of Brian Shrake at 5.

[47] Application, Exhibit 4, Schedule B at 1.

[48] Direct Testimony of Brian Shrake at 5.

Commission calculates a revised decrease of $35,243 based upon the pro forma operating expenses determined reasonable herein, which results in expense allocation of ($102,216).

Interest Expense

WSKY proposes to increase Interest expense of $179,640 to $191,934, an increase of $12,294. WSKY is adjusting interest expense using a debt-to-equity ratio of 50.11 percent to 48.89 percent and a cost of debt of 6.58 percent. The elimination of interest expense associated with the debt incurred to finance Project Phoenix results in a decrease of $1,471 to Interest Expense. The Commission denies WSKY's proposed adjustment and decreases interest expense by $1,471 to eliminate interest on debt related to Project Phoenix.

Income Tax

Based upon its pro forma operating revenues and expenses, WSKY calculates an income tax expense credit of ($8,350). Using the pro forma operating revenues and expenses determined reasonable herein, the Commission calculates a pro forma income tax expense of $120,027 as shown in Table I. The Commission finds that Income Tax expense should be increased by $217,463 to reflect its pro forma level.

Table I: Income Tax				
Account Titles		Revenues & Expenses		Taxes
OPERATING REVENUES				
Operating Revenues	$	2,101,576		
OPERATING EXPENSES				
Maintenance Expenses	$	1,368,284		
Depreciation		206,857		
General Taxes		146,279		
Exp. Reduction - Clinton Sewer		(102,216)		
Amortization CIAC & AIAC	+	(4,350)		
Total Operating Expenses	$	1,614,854		
State Taxable Income before Interest Exp.	$	486,722		
Less: Interest Expense	-	178,169		
State Taxable Income	$	308,553		
Multiplied by: State Income Rate	x	6%		
Total State Income Tax Exp.			$	18,513
State Taxable Income	$	308,553		
Less: State Income Tax Exp.	-	18,513		
Federal Taxable Income	$	290,040		
Federal Tax Rate	x	35.00%		
Total Federal Tax Exp.			+	101,514
Total Income Tax			$	120,027

Based on the accepted adjustments to operating revenues and expenses, the Commission finds WSKY's net operating income at present rates to be $366,695 as shown in Table II.

Table II: Income Statement Comparison			
Account Titles	Test Period Operations	Pro Forma Adjustments	Pro Forma Operations
OPERATING REVENUES			
Service Revenues - Water	$ 1,980,475	$ 68,214	$ 2,048,689
Miscellaneous Revenues	52,887	0	52,887
Uncollectible Accounts	(126,200)	126,200	0
Operating Revenues	$ 1,907,162	$ 194,414	$ 2,101,576
OPERATING EXPENSES			
Maintenance Expenses:			
Salaries & Wages	$ 442,941	$ 55,865	$ 498,806
Purchased Power	78,100	0	78,100
Purchased Water	79,635	0	79,635
Maintenance & Repair	87,087	0	87,087
Maintenance Testing	24,880	0	24,880
Meter Reading	345	0	345
Chemicals	101,313	0	101,313
Transportation	47,173	0	47,173
Operating Exp. Charged to Plant	(50,427)	(44,689)	(95,116)
Outside Services - Other	30,721	0	30,721
Total Maintenance Exp.	$ 841,768	$ 11,176	$ 852,944
General Expenses:			
Salaries & Wages	$ 189,980	$ (44,656)	$ 145,324
Office Supplies & Other Exp.	102,242	0	102,242
Regulatory Commission Exp.	55,885	10,126	66,011
Pension & Other Benefits	123,344	37,994	161,338
Rent	18,906	0	18,906
Insurance	59,054	0	59,054
Office Utilities	53,825	0	53,825
Bad Debt Expense	0	52,243	52,243
Service Company - Allocated Exp.	0	(169,886)	(169,886)
Miscellaneous	26,283	0	26,283
Total General Exp.	$ 629,519	$ (114,179)	$ 515,340
Total Operation & Maint. Exp	$ 1,471,287	$ (103,003)	$ 1,368,284
Depreciation	290,497	(83,640)	206,857
Amortization PAA	(3,660)	3,660	0
General Taxes	145,450	829	146,279
Exp Reduction - Clinton Sewer	(137,459)	35,243	(102,216)
Amortization CIAC & AIAC	(1,536)	(2,814)	(4,350)
Income Tax Exp - Federal	(97,436)	217,463	120,027
Total Operating Expenses	$ 1,667,143	$ 67,738	$ 1,734,881
Net Operating Income	$ 240,019	$ 126,676	$ 366,695

OPERATING RATIO

WSKY proposes the use of an operating ratio methodology to determine its revenue requirement. Its proposal follows our comments in WSKY's last rate adjustment proceeding that suggested that the use of return-on-equity approaches is problematic and that an operating ratio methodology is more appropriate.[49] We noted several problems associated with the use of return-on-equity approaches. The Commission has historically used an operating ratio approach[50] to determine the revenue requirement for small, privately-owned utilities. This approach is used primarily when no basis exists for a rate-of-return determination or the cost of the utility has fully or largely been funded through contributions. For these reasons, the Commission finds that the operating ratio method should be used to determine WSKY's revenue requirement and that an operating ratio of 88 percent will allow WSKY sufficient revenues to cover its reasonable operating expenses and to provide for reasonable equity growth.

AUTHORIZED INCREASE

The Commission finds that WSKY's net operating income for ratemaking purposes is $366,695. We further find that this level of net operating income and an 88

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[49] Case No. 2008-00563, *Application of Water Service Corporation of Kentucky for an Adjustment of Rates* (Ky. PSC Nov. 9, 2009) at 23-24 ("the operating ratio is the most commonly used methodology in determining the return of a company the size of Water Service, and is highly preferable to a full ROE analysis such as the company has presented").

[50] Operating Ratio is the ratio of expenses, including depreciation and taxes, to gross revenues. It is expressed mathematically by the following formula:

$$\textit{Operating Ratio} = \frac{\textit{Operating Expenses + Depreciation + Taxes Other Than Income Taxes}}{\textit{Gross Revenues}}$$

percent operating ratio requires an increase in present rate revenues of $61,898, as shown in Table III.

Table III: Revenue Requirement		
Operating Expenses	$	1,734,881
Less: State & Federal Income Taxes	-	120,027
Operating Expenses Net of Income Taxes	$	1,614,854
Divide by: Operating Ratio	÷	88.00%
Revenue to Cover Operating Ratio	$	1,835,062
Less: Operating Expenses Net of Income Taxes	-	1,614,854
Net Operating Income After Income Taxes	$	220,208
Multiplied by: Gross-up Factor	x	1.6822813
Net Operating Income Before Income Taxes	$	370,451
Add: Operating Expenses Net of Income Taxes		1,614,854
Interest on Long-Term Debt	+	178,169
Total Revenue Requirement	$	2,163,474
Less: Other Operating Revenues	-	52,887
Revenue Requirement from Water Sales	$	2,110,587
Less: Normalized Revenue - Water Sales	-	2,048,689
Revenue Requirement Increase	$	61,898
Percentage Increase		3.021%

RATE DETERMINATION

WSKY has requested that its monthly water service rates be increased across-the-board by approximately 21.9 percent. The Commission has generally accepted this method for allocating required revenue increases. Nothing in the record of this proceeding indicates that such methodology would be inappropriate in the current case. The revenue requirement determined reasonable herein is an approximate 3.021 percent increase over WSKY's normalized operating revenues. The Commission uses this percentage increase to calculate WSKY's monthly water service rates.

SUMMARY

Having considered the evidence of record and being sufficiently advised, the Commission finds that:

1. The 12-month period ending September 30, 2010 should be used as the test period to determine the reasonableness of WSKY's current and proposed rates.

2. Based upon pro forma test-period operations, WSKY's pro forma total operating expenses, after adjusting for known and measurable changes, are $1,734,881.

3. The use of an operating ratio is the most appropriate means to determine WSKY's total revenue requirement.

4. An operating ratio of 0.88 will permit WSKY to meet its reasonable operating expenses and provide a fair and reasonable return for equity growth and should be used to determine WSKY's total revenue requirements.

5. Applying an operating ratio of 0.88 to WSKY's pro forma total operating expenses of $1,734,881 and adjusting for the effects of state and federal taxes produces a total revenue requirement from water sales of $2,110,587, or $61,898 greater than the annual revenue from water sales that WSKY's current rates produce.

6. WSKY's proposed rates would produce revenue from water sales in excess of $2,110,587 and should be denied.

7. The rates set forth in Appendix A to this Order will produce revenue from water sales of $2,110,587.

IT IS THEREFORE ORDERED that:

1. WSKY's proposed rates are denied.

2. The rates set forth in Appendix A to this Order are approved for service rendered by WSKY on and after the date of this Order.

3. Within 20 days of the date of this Order, WSKY shall file revised tariff sheets setting forth the rates approved herein and reflecting their effective date as authorized by this Order.

By the Commission

ENTERED

NOV 23 2011

KENTUCKY PUBLIC SERVICE COMMISSION

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2010-00476 DATED NOV 23 2011

The following rates and charges are prescribed for the customers in the area served by Water Service Corporation of Kentucky. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of the Commission prior to the effective date of this Order.

Monthly Water Rates

CLINTON

5/8-inch x 3/4-inch Meter:

First	1,000	gallons	$ 11.99	Minimum bill
Next	9,000	gallons	6.79	per 1,000 gallons
Next	15,000	gallons	6.23	per 1,000 gallons
Next	25,000	gallons	5.68	per 1,000 gallons
Next	50,000	gallons	5.04	per 1,000 gallons
All Over	100,000	gallons	4.40	per 1,000 gallons

1-inch Meter:

First	5,300	gallons	$ 41.19	Minimum bill
Next	3,700	gallons	6.79	per 1,000 gallons
Next	15,000	gallons	6.23	per 1,000 gallons
Next	25,000	gallons	5.68	per 1,000 gallons
Next	50,000	gallons	5.04	per 1,000 gallons
All Over	100,000	gallons	4.40	per 1,000 gallons

1 1/2-inch Meter:

First	11,200	gallons	$ 80.59	Minimum bill
Next	13,800	gallons	6.23	per 1,000 gallons
Next	25,000	gallons	5.68	per 1,000 gallons
Next	50,000	gallons	5.04	per 1,000 gallons
All Over	100,000	gallons	4.40	per 1,000 gallons

2-inch Meter:

First	17,600	gallons	$ 120.48	Minimum bill
Next	7,400	gallons	6.23	per 1,000 gallons
Next	25,000	gallons	5.68	per 1,000 gallons
Next	50,000	gallons	5.04	per 1,000 gallons
All Over	100,000	gallons	4.40	per 1,000 gallons

6-inch Meter:

First	250,500	gallons	$ 1222.45	Minimum bill
All Over	250,500	gallons	4.40	per 1,000 gallons

MIDDLESBORO

5/8-inch x 3/4-inch Meter:

First	1,000	gallons	$ 8.96	Minimum bill
Next	9,000	gallons	3.61	per 1,000 gallons
Next	15,000	gallons	3.29	per 1,000 gallons
Next	25,000	gallons	3.12	per 1,000 gallons
Next	50,000	gallons	2.79	per 1,000 gallons
All Over	100,000	gallons	2.55	per 1,000 gallons

1-inch Meter:

First	6,000	gallons	$ 26.97	Minimum bill
Next	4,000	gallons	3.61	per 1,000 gallons
Next	15,000	gallons	3.29	per 1,000 gallons
Next	25,000	gallons	3.12	per 1,000 gallons
Next	50,000	gallons	2.79	per 1,000 gallons
All Over	100,000	gallons	2.55	per 1,000 gallons

1 1/2-inch Meter:

First	13,000	gallons	$ 51.22	Minimum bill
Next	12,000	gallons	3.29	per 1,000 gallons
Next	25,000	gallons	3.12	per 1,000 gallons
Next	50,000	gallons	2.79	per 1,000 gallons
All Over	100,000	gallons	2.55	per 1,000 gallons

2-inch Meter:

First	21,400	gallons	$ 78.80	Minimum bill
Next	3,600	gallons	3.29	per 1,000 gallons
Next	25,000	gallons	3.12	per 1,000 gallons
Next	50,000	gallons	2.79	per 1,000 gallons
All Over	100,000	gallons	2.55	per 1,000 gallons

3-inch Meter:

First	68,400	gallons	$ 220.05	Minimum bill
Next	31,600	gallons	2.79	per 1,000 gallons
All Over	100,000	gallons	2.55	per 1,000 gallons

4-inch Meter:

First	127,500	gallons	$ 378.43	Minimum bill
All Over	127,500	gallons	2.55	per 1,000 gallons

6-inch Meter:

First	281,500	gallons	$ 771.41	Minimum bill
All Over	281,500	gallons	2.55	per 1,000 gallons

Monthly Fire Protection Rates

Private Sprinkler	$ 19.93	per sprinkler
Private Hydrant	$ 19.93	per hydrant
Municipal Hydrant	$ 4.43	per hydrant

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2010-00476 DATED NOV 23 2011

DISALLOWED ALLOCATED INDIRECT EXPENSES

Account	Schedule B Category		Adjustment
Direct Expenses:			
5810 MEMBERSHIPS	Miscellaneous	$	(5,630.68)
5890 PUBL SUBSCRIPTI	Office Supplies & Other Office Exp.		(395.66)
6185 TRAVEL LODGING	Miscellaneous		(1,480.85)
6190 TRAVEL AIRFARE	Miscellaneous		(408.40)
6195 TRAVEL TRANSPOR	Miscellaneous		(140.00)
6200 TRAVEL MEALS	Miscellaneous		(949.11)
Allocated Expenses:			
5810 MEMBERSHIPS	Miscellaneous		(225.00)
5815 PENALTIES/FINES	Miscellaneous		(27.00)
5825 OTHER MISC EXPE	Miscellaneous		(6,816.00)
5870 HOLIDAY EVENTS/	Office Supplies & Other Office Exp.		(78.00)
5890 PUBL SUBSCRIPTI	Office Supplies & Other Office Exp.		(787.00)
6015 EMPLOY FINDER F	Outside Services - Other		(2,323.00)
6045 TEMP EMPLOY - C	Outside Services - Other		(4,272.00)
6185 TRAVEL LODGING	Miscellaneous		(1,871.00)
6190 TRAVEL AIRFARE	Miscellaneous		(961.00)
6195 TRAVEL TRANSPOR	Miscellaneous		(229.00)
6200 TRAVEL MEALS	Miscellaneous		(609.00)
6205 TRAVEL ENTERTAI	Miscellaneous		(237.00)
6207 TRAVEL OTHER	Miscellaneous		-
Subtotal		$	(27,439.70)
Add: Corporate Salaries			(142,446.00)
Total Adjustment		$	(169,885.70)

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