COMMONWEALTH OF KENTUCKY

BEFORE THE UTILITY REGULATORY COMMISSION

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In the Matter of:

APPLICATION OF KENTUCKY WATER SERVICE COMPANY, INC., TO CONTINUE SHORT-TERM FINANCING OF $2,300,000; AND NOTICE OF ADJUSTMENT OF RATES IN SOMERSET, MIDDLESBORO, AND CLINTON, KENTUCKY	)	CASE NO. 7867

O R D E R

On May 23, 1980, Kentucky Water Service Company, Inc. (hereinafter Applicant or the Company) filed an application with this Commission requesting an extension of Commission approval of short-term financing in the amount of $2,300,000 previously approved in Case No. 6904; and to give notice of an adjustment of rates in the communities of Somerset, Middlesboro, and Clinton, Kentucky. Applicant stated that the proposed rate adjustment was just and reasonable and was necessary in order for Applicant to adequately render service and to maintain its financial integrity.

The Commission scheduled the matter for hearing June 25, 1980, and ordered Applicant to give notice of the hearing and the proposed rate adjustment. The hearing, for the purpose of presenting witnesses' prepared testimony, was conducted as scheduled at the Commission's offices in Frankfort, Kentucky.

On June 9, 1980, the Consumer Intervention Division in the Office of the Attorney General filed a motion to intervene in this proceeding. On June 19, 1980, the water districts and associations of Pulaski County (hereinafter the Intervenors), which purchase water from the Applicant, filed a motion to intervene in this proceeding which was sustained. The Intervenors moved that Applicant establish a wholesale rate for the furnishing of water to said districts and associations or show cause to this Commission as to why a wholesale rate could not be established.

A second hearing was scheduled for August 19, 1980, for the purpose of cross-examination of Applicant's witnesses. The hearing was conducted as scheduled and the absence of the Intervenors was duly noted.

COMMENTARY

Kentucky Water Service Company, Inc., is an investor-owned water distribution system serving approximately 11,350 customers in the Kentucky counties of Pulaski, Bell, and Hickman. Applicant produces the water it furnishes in Pulaski and Hickman Counties and purchases water in Bell County from Fern Lake Company. Among Applicant's customers are Pulaski County Water District No. 1, Pulaski County Water District No. 2, Barnesburg Water District, Elihu-Rush Branch Water Association, Nelson Valley Water Association, Oak Hill Water Association, Pleasant Hill Water Association, and the City of Eubank Water Association. These customers are the aforementioned Intervenors in this proceeding.

TEST YEAR

Applicant proposed and the Commission has adopted the twelve-month period ending March 31, 1980, as the test period for determining the reasonableness of the proposed rates and charges. In utilizing the historic test period, the Commission has given full consideration to known and measurable changes where appropriate.

VALUATION

The Company presented the Net Original Cost and Capital Structure as valuation methods herein. The Commission has given due consideration to these and other elements of value in determining the reasonableness of the proposed rates and charges.

Net Original Cost

Applicant proposed, in Exhibit 13, page 2 of 2, a total Net Original Cost rate base of $7,211,754. The Commission has generally accepted the items of value included therein with the following exceptions.

The Commission has adjusted Materials and Supplies and Prepayments to utilize the thirteen-month average. The Commission has further adjusted Applicant's rate base to reflect the pro forma adjustments to Operation and Maintenance Expense in the calculation of Working Capital. The Commission has further reduced Applicant's rate base to reflect the treatment of the Job Development Investment Tax Credit (JDITC) as explained on page 3 herein. The

Commission is of the opinion that this method provides greater recognition of the changing conditions in which a utility operates.

Based on these modifications to the Applicant's proposal, we find the Net Original Cost rate base to be as follows:

Utility Plant in Service	$ 9,127,521
Construction Work in Progress	275,046
Total Utility Plant	$ 9,402,567
Add:	
Materials and Supplies	$ 164,482
Prepayments	20,868
Working Capital	142,477
Sub-total	$ 327,827
Deduct:	
Depreciation Reserve	$ 1,913,654
Contributions in Aid of Construction	355,764
Customer Advances for Construction	270,204
Accumulated Deferred Investment Tax Credit	335,843
Sub-total	$ 2,875,465
Net Original Cost	$ 6,854,929

Capital Structure

The Company submitted as evidence in this matter the following capital structure:

Common Stock	$ 640,000	8.88%
Unappropriated Surplus	2,536,350	35.20
First Mortgage Bonds	1,730,000	24.00
Bank Notes	2,300,000	31.92
	$ 7,206,350	100.00%

The Commission's review of the financial data revealed that in its annual reports filed with the Commission, and financial statements prepared by the Company's independent auditors, the Company has reported JDITC as retained earnings.

The Company did not make an election as to the treatment of JDITC for rate-making purposes. Under Code Section 46 of the Revenue Act of '71, if a company does not make an election, for rate-making purposes, the Commission must follow what is referred to by the Code as Option 1 treatment for the credit. Thus, for rate-making purposes the Commission has in its past rate orders permitted normalization of this credit.

The accounting treatment followed by the Company does not conform to the rate-making treatment followed by this Commission in past rate cases nor does it conform to the treatment prescribed by the NARUC Uniform System of Accounts adopted by this Commission

for Class "A" water utilities. The practice followed on the Company's books of account has resulted in the Company recording the entire credit as a reduction in federal income tax expense and thus flowing the entire amount of the credit directly to retained earnings in the year it was realized. If the accounting treatment followed by the Company in its regulated books had been consistent with the rate-making treatment required by the Code Section 46(f) which has been followed by this Commission in past cases and in the instance case, the retained earnings reported by the Company would be reduced by $335,843. In other words, in its regulated books of account, the Company should have recorded any JDITC realized by debiting Account 412.1 Investment Tax Credits, Utility Operations, Deferred to Future Periods and crediting Account 255 Accumulated Deferred Investment Tax Credit. The amount recorded in Account 255 should be restored ratably to rate base and capital by debiting Account 255 and crediting Account 412.3 Investment Tax Credits, Utility Operations, Restored to Nonoperating Income.

The Company, in response to an oral request by staff, provided the Commission with the unamortized balance of JDITC currently recorded as a part of retained earnings. The Company filed this information through its counsel under objection and protest. The Commission believes it should respond to the objections raised by the Company.

The basic objection is that removal of the JDITC from retained earnings would result in a restatement or reformation of past and present balance sheets which would be unfair and prejudicial to Company creditors and impair the Company's financial integrity. The Company further states that the request is untimely, that the adjustment was not made in past cases or raised during hearings in the instant case concerning the treatment of JDITC. In its itemized list of reasons the Company states that Commission acceptance of past annual reports and actions in past rate cases constitute approval of the Company's treatment of JDITC; that a change in treatment of JDITC would be retroactive, a repudiation of past policy and constitute retroactive rate making.

The Commission does not find these objections persuasive. First of all in its current deliberations on cost of debt and equity capital and the overall rate of return required for total capital, the ability of this Company to attract debt capital weighed heavily in the Commission's decision making process. In setting those cost rates, the Company's financial integrity was given full consideration. For this reason the Commission fails to see how removal of this JDITC from retained earnings would put the financial integrity of the Company in jeopardy. On the contrary, it is the customer's right to share in the benefits derived from JDITC, that is placed in jeopardy. It is obvious that the practice employed by the Company for financial accounting and reporting purposes results in funds derived from JDITC being reported as investor rather than customer supplied capital. The federal law permits and basic fairness requires that under the method elected by the Company, the customer should not be required to pay a return on JDITC. Finally, the Company makes the contention that this change represents retroactive rate making. The Commission believes such a contention is without merit since the removal of JDITC from retained earnings would only affect rates approved in the current case. As for the claim that such a change represents a repudiation of past policy, the Commission would point out that the test year in the Company's last case ended July 31, 1977. A review of the schedule provided by the Company shows clearly that the JDITC accumulated to that point was not significant when compared to the amount at March 31, 1980. The Commission finds such a claim without substance since continuation of a policy for this Company which is inconsistent with the policy employed for other utilities selecting Option 1 treatment for JDITC would perpetuate on this utility's customers an inequity not born by customers of other utilities in this State.

Based on the above analysis, the Commission has adjusted Unappropriated Surplus by $335,843 to reflect its opinion concerning treatment of the Company's Investment Tax Credit. The Commission feels the credit should be amortized over the life of

the property giving rise to the credit and that the unamortized portion should be removed from retained earnings and recorded in Account 255 Accumulated Deferred Investment Tax Credit. This adjustment to equity results in the following capital structure:

Common Stock	$ 640,000	9.32%
Unappropriated Surplus	2,200,507	32.03
First Mortgage Bonds	1,730,000	25.18
Bank Notes	2,300,000	33.47
	$ 6,870,507	100.00%

REVENUES AND EXPENSES

Applicant proposed several pro forma adjustments to revenues and expenses as reflected on the Comparative Income Statement. The adjustments were proposed to normalize increases in revenue, salaries and wages, electric power costs, chemical costs, insurance and pension costs, taxes, auditors' fees, and interest expense on short-term debt. The Commission is of the opinion that the adjustments are generally proper and accepted for rate-making purposes with the following exceptions:

1. The Applicant proposed to adjust pumping expense by $24,500 to reflect the increased cost of energy. The Commission has reduced this adjustment by $3,836. This reduction results from (1) utilizing the average monthly kilowatt-hours for electricity metered at the sludge building in Somerset for the seven months the facility was fully operative; (2) utilizing the average monthly kilowatt-hours at all other metered points in Somerset and Middlesboro rather than the bill from a month in which the usage was an approximation of the monthly average; and (3) the decision rendered in Case No. 7804 before the Kentucky Energy Regulatory Commission in which the electric supplier, Kentucky Utilities, was granted approximately ninety percent of the rate increase it had requested.

2. The Applicant's adjustment to normalize the interest expense on short-term debt has been increased by $19,750 based on a cost rate of 13.5%. The Commission feels this increase is warranted inasmuch as the Company's adjustment was based on rates in effect at a point in time when interest rates in general were at their lowest levels in recent months; and during the interim, interest rates have increased significantly.

The effect on Net Income of the revised pro forma adjustments is as follows:

	Actual Test Period	Pro Forma Adjustments	Adjusted Test Period
Operating Revenues	$2,206,716(1)	$ 37,947	$2,244,663(3)
Operating Expenses	1,355,333(1)	247,969	1,603,302
Net Operating Income	$ 851,383(1)	$ (210,022)	$ 641,361
Interest Expense	281,922(2)	163,478	445,400
Net Income	$ 569,461	$ (373,500)	$ 195,961

RATE OF RETURN

The rate of return on Applicant's Net Original Cost, established herein for the test year, was 12.42%, while Applicant's return on adjusted common equity was 20.05%. After taking into consideration the pro forma adjustments to revenues and expenses, the Company would realize a return on Net Original Cost of 9.36% and a return on common equity of 6.90%. The Commission is of the opinion and finds the revised rates of return are inadequate and would impair Applicant's financial integrity. In order to remain on a sound financial basis, Applicant should be allowed to increase its annual revenue by approximately $341,420, which would result in a return on Net Original Cost of 11.88% and a return on common equity of 13.0%. This additional revenue will provide Net Income of approximately $369,266, which is sufficient to meet Applicant's needs concerning the liquidation of its long-term debt.

RATE DESIGN AND RATES

Kentucky Water Service proposed to modify its existing rate structures at Somerset and Middlesboro to be consistent with the current rate structure at Clinton. The Commission concurs with Applicant's proposal to modify the rate design and has adjusted the rates accordingly in the attached Appendix "A." The rates granted herein have been designed to generate revenues of approximately $2,586,200. In determining the revenue requirements of each locality, the Commission has reallocated Income Taxes in proportion to the ratios of operating expenses per city to total operating expenses of the Company. The rates granted herein and set out in

(1) Applicant's Exhibits 5 and 6.
(2) Applicant's Exhibit 6.
(3) Applicant's Response to Staff Request, Item 2b, Page 2.

Appendix A should generate the following revenues in the respective cities:

Somerset	--	$1,523,100
Middlesboro	--	890,300
Clinton	--	172,800

SHORT-TERM FINANCING

The Commission, being aware of the current financial climate, realizes the Company is in an unfavorable position relative to the amount of short-term debt it presently has outstanding. The Commission is also aware of the relationship that exists between Applicant and its primary lender, Lincoln National Life Insurance Company. The Commission is of the opinion that the Applicant should continue its short-term financing of $2,300,000 until such time as long-term funds are available. Further, the Commission feels, due to present economic conditions, that the Company should no longer be held to the 10.5% maximum interest rate on long-term borrowings ordered by the Public Service Commission of Kentucky in Case No. 6904. However, the Commission feels that Applicant should make every possible effort to obtain long-term financing at the lowest rate available and that Applicant should keep the Commission apprised of its efforts and progress toward that goal by submitting quarterly reports of said progress beginning December 31, 1980.

SURCHARGE MOTION

On October 9, 1980, Applicant submitted a motion requesting that a surcharge provision for its Middlesboro service area be included in this proceeding. This request was a direct result of the application of Fern Lake Company, Applicant's supplier in Middlesboro, for an increase in rates in Case No. 7982 before this Commission. The Commission is presently considering, in a generic proceeding, the subject of increases in the cost of purchased water as it applies to water utilities in general for the purpose of determining the feasibility of a purchased water adjustment clause. These proceedings should be concluded prior to the effective date of the decision in the Fern Lake case. Furthermore, any action of the Commission affecting Applicant taken in Case No. 7982 is beyond

the scope of this proceeding. Therefore, the Commission is of the opinion that Applicant's motion for a surcharge provision should be denied without prejudice in this matter.

SALES FOR RESALE

The Intervenors in this matter requested that a separate rate be established for the sales to water districts and associations. The Commission requested, at the hearing of June 25, 1980, that a cost of service study be provided to determine a reasonable rate for these sales. In determining the cost of service, Applicant attempted to establish a per unit cost for all sales in excess of 100,000 gallons per month. The Commission is of the opinion that the cost of service study provided by Applicant is not an accurate reflection of the costs associated with the sales for resale within the Somerset service area for the following reasons: Applicant made the assumption that all of the value of water production facilities should be allocated to sales in excess of 100,000 gallons per month; Applicant did not support its position that sales for resale could not be separated from all sales in excess of 100,000 gallons per month; Applicant did not justify the exclusion of certain costs from the determination of the cost of service to these consumers; and Applicant was not consistent in utilizing one volume of sales to determine the ratio used to allocate costs and another volume of sales to recover the total cost of service. Furthermore, the Commission finds that the cost of service study does not justify the proposed increase in rates for the water districts and associations served by Applicant. Therefore, the Commission is of the opinion that a separate rate classification should be established for these consumers and that the rate shall be established as set out in Appendix "A" attached hereto.

SUMMARY

The Commission, after consideration of the evidence of record and being fully advised, is of the opinion and so finds that the rates and charges set out in Appendix "A," attached hereto and made a part hereof, will produce gross annual revenues of $2,586,200 and are the fair, just, and reasonable rates for Applicant.

The Commission further finds that the rates and charges proposed by the Applicant are unfair, unjust and unreasonable in that they produce revenues in excess of those deemed reasonable herein.

IT IS THEREFORE ORDERED that the rates set out in Appendix "A," attached hereto and made a part hereof, are approved for service rendered on and after the date of this Order.

IT IS FURTHER ORDERED that the rates proposed by Kentucky Water Service Company, Inc., are unfair, unjust, and unreasonable and are hereby denied.

IT IS FURTHER ORDERED that Kentucky Water Service Company, Inc., is hereby granted an extension of time to convert its short-term borrowings to long-term for a period of two years from the date of this Order.

IT IS FURTHER ORDERED that the provision of the Commission's Order of April 17, 1978 in Case Number 6904 establishing a maximum interest rate of 10.5% is hereby rescinded.

IT IS FURTHER ORDERED that Kentucky Water Service Company, Inc., shall obtain the long-term financing approved in Case Number 6904 at the lowest possible cost and shall submit quarterly reports to this Commission of its efforts toward this directive beginning December 31, 1980.

IT IS FURTHER ORDERED that the motion by Kentucky Water Service Company, Inc., for a surcharge provision for its Middlesboro service area be and is hereby denied without prejudice.

IT IS FURTHER ORDERED that Kentucky Water Service Company, Inc., shall file with this Commission within thirty (30) days from the date of this Order its revised tariff sheets setting out the rates approved herein.

Done at Frankfort, Kentucky, this 12th day of November, 1980.

UTILITY REGULATORY COMMISSION

_____
Chairman

_____
Vice Chairman

_____
Commissioner

ATTEST:

_____
Secretary

APPENDIX "A"

Appendix to an Order of the Utility Regulatory Commission in Case No. 7867 dated November 12, 1980.

The following rates are prescribed for the customers in the area served by Kentucky Water Service Company. 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 date of this Order.

Rates: Monthly

Somerset

First	1,000 gallons used per month	$4.50 (Minimum)
Next	9,000 gallons used per month	1.95 per M gallons
Next	15,000 gallons used per month	1.75 per M gallons
Next	25,000 gallons used per month	1.65 per M gallons
Next	50,000 gallons used per month	1.50 per M gallons
Over	100,000 gallons used per month	1.17 per M gallons

MINIMUM MONTHLY CHARGES

5/8 or 3/4 inch meter	$ 4.50
1 or 1 1/4 inch meter	13.00
1 1/2 inch meter	25.00
2 inch meter	38.00
3 inch meter	103.50
4 inch meter	178.50
6 inch meter	365.50

Middlesboro

First	1,000 gallons used per month	$ 5.00 (Minimum)
Next	9,000 gallons used per month	1.95 per M gallons
Next	15,000 gallons used per month	1.80 per M gallons
Next	25,000 gallons used per month	1.65 per M gallons
Next	50,000 gallons used per month	1.50 per M gallons
Over	100,000 gallons used per month	1.40 per M gallons

MINIMUM MONTHLY CHARGES

5/8 or 3/4 inch meter	$ 5.00
1 or 1 1/4 inch meter	14.50
1 1/2 inch meter	27.50
2 inch meter	42.00
3 inch meter	115.00
4 inch meter	198.00
6 inch meter	406.00

Clinton

First	1,000 gallons used per month	$5.75 (Minimum)
Next	9,000 gallons used per month	2.70 per M gallons
Next	15,000 gallons used per month	2.55 per M gallons
Next	25,000 gallons used per month	2.35 per M gallons
Next	50,000 gallons used per month	2.10 per M gallons
Over	100,000 gallons used per month	1.75 per M gallons

MINIMUM MONTHLY CHARGES

5/8 or 3/4 inch meter	$ 5.75
1 or 1 1/4 inch meter	18.00
1 1/2 inch meter	34.50
2 inch meter	51.00
3 inch meter	147.00
4 inch meter	250.00
6 inch meter	511.00

Wholesale Water Rates

Applicable to Pulaski County Water District #1, Pulaski County Water District #2,Nelson Valley Water District, Pleasant Hill Water District, Oak Hill Water Association, Barnesburg Water Association, Elihu-Rush Branch Water Association and the City of Eubank Water System

Metered Monthly Rate	Rate per 1,000 Gallons
For all water used	$1.10

Minimum Charges

None