COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

NOTICE OF KENTUCKY WATER SERVICE COMPANY, INC., OF ADJUSTMENT OF WATER RATES IN SOMERSET, MIDDLESBORO, AND CLINTON, KENTUCKY, AND ENVIRONS, ON NOVEMBER 9, 1981	)	CASE NO. 8370

O R D E R

On October 20, 1981, Kentucky Water Service Company, Inc., ("Kentucky Water Service") filed with this Commission its notice of an adjustment of rates in the communities of Somerset, Middlesboro, and Clinton, Kentucky, to become effective November 9, 1981. The proposed rates would produce additional revenue of approximately $607,200 annually, an increase of 22.2 percent over normalized annual revenue. Kentucky Water Service stated that the proposed rates were just and reasonable and were necessary in order to adequately render service and maintain its financial integrity. Based on the evidence of record the Commission has granted an increase in revenue of $251,123.

On October 20, 1981, the Commission suspended the proposed increase in rates for a period of 5 months, until April 9, 1982. On January 7, 1982, the Commission scheduled a hearing for February 9, 1982, and directed Kentucky Water Service to provide statutory notice to its consumers of the proposed rate increase and the scheduled hearing.

On October 23, 1981, the Division of Consumer Protection in the office of the Attorney General filed a motion to intervene in this proceeding, which was sustained. No other parties of interest formally intervened herein; however, the water districts and associations of Pulaski County, Kentucky, which purchase water for resale from Kentucky Water Service, were represented at the hearing and made known their objections to the proposed increase.

COMMENTARY

Kentucky Water Service is an investor-owned water service utility engaged in the distribution and sale of water to approximately 11,370 customers in the Kentucky counties of Pulaski, Bell, and Hickman. Kentucky Water Service has its own source of supply in Pulaski and Hickman counties and purchases water in Bell County from Fern Lake Company.

Test year water sales include sales for resale to 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.

TEST PERIOD

Kentucky Water Service proposed and the Commission has accepted the 12-month period ending July 31, 1981, as the test period for determining the reasonableness of the proposed rates. In utilizing the historic test period, the Commission has given full consideration to appropriate known and measurable changes.

VALUATION

Kentucky Water Service presented its net orginal cost rate base 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.

Net Original Cost

Kentucky Water Service proposed a net orginal cost rate base of $7,202,020. The Commission has accepted the items of value included therein with the following exceptions:

Kentucky Water Service included as a part of working capital one-eighth of operation and maintenance expenses. The Commission has made certain adjustments to these expenses. Accordingly, the Commission has based the amount included for this component of working capital on the adjusted operation and maintenance expenses found fair herein.

Kentucky Water Service did not deduct Job Development Investment Tax Credit ("JDITC") in computing the rate base. Instead it seeks in this proceeding as it did in Case No. 7867 to retain all the benefits of JDITC for its stockholders. Consistent with its decision in Case No. 7867 the Commission has deducted JDITC in computing rate base. The House and Senate Committee Reports provide ample evidence of Congress's intent that the cost savings resulting from enactment of this legislation be shared by the stockholders and the ratepayers. The Revenue Act of 1971 placed certain limitations on regulatory authorities with regard to the treatment of JDITC. Thus the application of Section 46(f) of the Internal Revenue Code ("IRC") in the fixing of rates permits the Commission to allocate the benefits of the reduction in cost of service over the life of the property additions giving rise to the credit between stockholders and ratepayers. The Commission has adopted this approach since it is fair to both the ratepayers and stockholders and is consistent with Congressional intent. Based on these adjustments, the Commission finds the net orginal cost rate base to be $6,810,306 as follows:

Utility Plant in Service	$9,814,459
Construction Work in Progress	4,563
Total Utility Plant	$9,819,022
Add:	
Materials and Supplies	$ 148,279
Prepayments	19,223
Cash Working Capital	161,310
Total Working Capital	$ 328,812
Deduct:	
Depreciation Reserve	$2,176,417
Contributions in Aid of Construction	384,454
Customer Advances for Construction	387,717
Accumulated Deferred Investment Tax Credit	388,940
Sub-total	$3,337,528
Net Orginal Cost	$6,810,306

Capital Structure

Kentucky Water Service proposed a capital structure of $7,447,179 as follows:

Common Stock	$ 640,000	8.59%
Unappropriated Surplus	2,832,179	38.03
Total Equity	$3,472,179	46.62%
First Mortgage Bonds	$1,675,000	22.49%
Bank Notes	2,300,000	30.89
Total Debt	$3,975,000	53.38%
Total Capital	$7,447,179	100.00%

A review of the financial statements filed in this proceeding by Kentucky Water Service shows that, in disregard of the decision by this Commission in Case No. 7867, Kentucky Water Service has flowed through JDITC as income to retained earnings and reported it as equity in its books of account. The Commission finds this treatment of JDITC to be inconsistent with the rate-making treatment in section 46(f)(1) of the IRC for companies not making an election as to the treatment of JDITC. Such companies are Option 1 companies and therefore the general rule of IRC section 46(f)(1) applies for rate-making purposes. As stated in 26 CFR 176 59 Section 1.46-6(a)(3), "The provisions of section 46(f)(1) and (2) are limitations on the treatment of the credit for rate-making purposes and for purposes of the taxpayer's regulated books of account only. Under the provisions of section 46(f)(1), the credit may not be flowed through to income but in certain circumstances may be used to reduce rate base." Under the general rule, the credit cannot be used to reduce tax expense for rate-making purposes or for accounting purposes in the company's regulated books of account. It must be deferred and then restored to income ratably over the life of the property giving rise to the credit. Instead of recording deferred income tax expense and the deferred tax credit in its books of account Kentucky Water Service recorded its actual tax liability. Thus while the Commission normalized the credit as required by Section 46(f)(1) of the IRC for rate-making purposes Kentucky Water Service in its books flowed the credit directly through to retained earnings.

The flow through treatment which Kentucky Water Service contends it followed would result in loss of the credit; and if the Commission flowed through JDITC for rate-making purposes Kentucky Water Service would have an immediate liability to the Internal Revenue Service for any credit realized.

The Commission has determined that Kentucky Water Service has accounted for JDITC in a manner which is inconsistent with the treatment set out in the IRC and followed by this Commission for rate-making purposes. Thus, Kentucky Water Service's unappropriated surplus reported at the end of the test year is overstated by $388,940. This amount should be debited to unappropriated surplus and credited to accumulated deferred investment tax credit and then restored ratably to surplus and rate base over the life of the property giving rise to the credit. The proper accounting treatment for JDITC is set out in the NARUC Uniform System of Accounts for Class A Water Utilities which has been adopted by this Commission. The Commission concludes that Kentucky Water Service should, for purposes of its regulated books of account, restate its retained earnings to reflect the proper treatment of JDITC. Further, the affected financial statements contained in its annual reports filed with the Commission for the years ended December 31, 1979, 1980 and 1981 should be corrected and refiled with the Commission. For rate-making purposes, the Commission has adjusted unappropriated surplus by $388,940 to reflect the cumulative effect of the treatment in section 46(f)(1) of the IRC. This adjustment to equity results in the following capital structure:

Common Stock	$ 640,000
Unappropriated Surplus	2,443,239
Total Equity	$3,083,239
First Mortgage Bonds	$1,675,000
Bank Notes	2,300,000
Total Debt	$3,975,000
Total Capital	$7,058,239

REVENUES AND EXPENSES

On Exhibit 10 of its application, Kentucky Water Service proposed several pro forma adjustments to revenues and expenses to reflect current and anticipated operating conditions. The Commission is of the opinion that the proposed adjustments are generally proper and acceptable for rate-making purposes with the following exceptions:

Operating Revenue

Kentucky Water Service proposed an adjustment to increase revenues by $169,933 to reflect the level of revenue that would be generated from the rates in effect at the time the application was filed based on the test year volume of sales. The Commission has reduced this adjustment by $21,980 to reflect the reduction in the rates for Middlesboro which were authorized in Case No. 8165-A as a result of a rate reduction by Fern Lake Company, Kentucky Water Service's wholesale supplier at Middlesboro.

Source of Supply

The Commission has also reduced Kentucky Water Service's source of supply expense by $21,980 to reflect the reduced rate currently being paid to Fern Lake Company.

Depreciation

Kentucky Water Service proposed an adjustment of $6,333 to depreciation expense to reflect the amortization of new utility plant placed in service during the test year and additions subsequent to the test year. The Commission will allow $2,920 of the proposed adjustment to include depreciation on plant in service at the end of the test period. The Commission is of the opinion that plant additions subsequent to the test year should produce additional revenues as well as expenses; however, Kentucky Water Service's proposed adjustment would reflect only the increase in one expense item. Therefore, the Commission finds that in the absence of adjustments to reflect other expenses and revenues associated with plant additions made subsequent to the test year, the additional depreciation expense should not be considered for rate-making purposes.

Income Taxes

Kentucky Water Service's proposed adjustment to income taxes was not based on normalized revenues and expenses, but rather on pro forma revenues reflecting the full amount of the proposed increase. The Commission has made an adjustment of $29,539 to increase income taxes which reflects only the normalized levels of revenues and expenses. The additional taxes resulting from the increase allowed herein are included in determining the total revenue requirements.

The effect on net income of the revised pro forma adjustments, including the tax effect thereof, is as follows:

	Actual Test Period	Pro Forma Adjustments	Adjusted Test Period
Operating Revenues	$ 2,568,436	$ 147,953	$ 2,716,389
Operating Expenses	1,738,023	135,608	1,873,631
Operating Income	$ 830,413	$ 12,345	$ 842,758

RATE OF RETURN

Kentucky Water Service requested a rate of return on common equity of 18 percent while its witness, Mr. Stites, recommended a return on common equity of 19 percent. In its application, Kentucky Water Service did little to support its requested return other than to point out the cost rate on short-term debt at the time the application was filed. Mr. Stites testified that his recommendation was based on a comparison of returns granted to large gas and electric utilities outside the jurisdiction of this Commission which, in his opinion, were less risky than Kentucky Water Service. Based on returns to these gas and electric utilities in the range of 16 to 17 percent, Mr. Stites recommended a return of 19 percent in order to compensate Kentucky Water Service for its greater relative risk.

Mr. Stites did not perform a discounted cash flow analysis, nor did he perform a comparable earnings analysis of utilities that could be considered similar to Kentucky Water Service. His comparison of Kentucky Water Service to large energy utilities outside the Commission's jurisdiction is of minimal relevance in the determination of a reasonable return in this proceeding. The Commission is not convinced that Kentucky Water Service is a relatively high-risk utility or that water utilities are riskier than other utilities. It finds that the adoption of Mr. Stites' recommendation as to rate of return would provide excessively high rates which would not be fair, just and reasonable to the ratepayers.

Unfortunately in this case, as in some others, the Commission did not have the direct benefit of a second expert's opinion. However, the Commission is aware of the rates of return which it[1] and other state commissions have granted in comparable cases. It is also aware of the recent substantial drop in the rate of inflation and a reduction of several points in prime interest rates. Therefore, the Commission is of the opinion that a return on common equity of 14 to 15 percent is fair, just and reasonable. A return on equity in this range

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(1) Case No. 8314, Kentucky-American Water: 14.0%.
Case No. 8256, Delta Natural Gas: 15.5%.
Case No. 8281, Columbia Gas: 14.75%.

would not only allow Kentucky Water Service to attract capital at reasonable costs to insure continued service and provide for necessary expansion to meet future requirements, but also would result in the lowest possible cost to the ratepayer. Within this range of returns the Commission finds that a return on common equity of 14.5 percent will allow Kentucky Water Service to meet its operating expenses and best attain the above objectives.

REVENUE REQUIREMENTS AND ALLOCATION

The Commission, having determined an acceptable level of expenses and a reasonable rate of return, finds that Kentucky Water Service requires additional annual operating income of $127,470 to produce a rate of return on common equity of 14.5 percent. After the provision for state and federal income taxes of $123,653 there is an overall revenue deficiency of $251,123 which is the amount of additional revenue granted herein. The increase granted herein has been allocated to the various cities in the proportions proposed in the application. Therefore, the rates granted herein should generate the following revenues in the respective cities:

Somerset	$1,789,626
Middlesboro	995,935
Clinton	181,951

SUMMARY

The Commission, having considered the evidence of record and being advised, is of the opinion and finds that:

1. Kentucky Water Service has not properly accounted for JDITC in its regulated books of account, resulting in an overstatement of equity for book purposes and rate-making purposes.

2. Kentucky Water Service did not adjust its net investment rate base to reflect the rate-making treatment followed by this Commission for JDITC, the intent of which is to achieve a sharing of the benefits of the credit between ratepayers and investors.

3. Kentucky Water Service should restate its financial statements for the years 1979, 1980, and 1981 to reflect the accounting treatment for JDITC in section 46(f)(1) of the IRC and in the NARUC Uniform System of Accounts for Class A Water Utilities.

4. The revised financial statements should be filed with this Commission and made a part of the annual reports of Kentucky Water Service on file at the Commission.

5. The rates in Appendix A are the fair, just and reasonable rates for Kentucky Water Service and will produce gross annual revenue sufficient to pay its operating expenses, service its debt, and provide a reasonable surplus for equity growth.

6. The rates proposed by Kentucky Water Service would produce revenue in excess of that found reasonable herein and should be denied upon application of KRS 278.030.

IT IS THEREFORE ORDERED that Kentucky Water Service shall restate its financial statements for the years 1979 through 1981 to reflect the accounting treatment found to be proper for JDITC as referenced in Findings No. 1 and 2 herein.

IT IS FURTHER ORDERED that Kentucky Water Service shall file these revised financial statements with the Commission, such statements to be made a part of its annual reports for the years 1979 through 1981 on file with the Commission.

IT IS FURTHER ORDERED that the rates in Appendix A are approved for service rendered by Kentucky Water Service on and after the date of this order.

IT IS FURTHER ORDERED that the rates proposed by Kentucky Water Service be and they hereby are denied.

IT IS FURTHER ORDERED that within 30 days from the date of this order Kentucky Water Service shall file with the Commission its revised tariff sheets setting out the rates approved herein.

Done at Frankfort, Kentucky, this 9th day of April, 1982.

PUBLIC SERVICE COMMISSION

Marlin M. Volz

Chairman

Katherine Randall

Vice Chairman

Commissioner

ATTEST:

Secretary

APPENDIX A

Appendix to an Order of the Public Service Commission in Case No. 8370 dated April 9, 1982

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	$ 5.15 (Minimum)
Next	9,000	gallons used per month	2.20 per M gallons
Next	15,000	gallons used per month	1.90 per M gallons
Next	25,000	gallons used per month	1.80 per M gallons
Next	50,000	gallons used per month	1.65 per M gallons
Over	100,000	gallons used per month	1.29 per M gallons

MINIMUM MONTHLY CHARGES

5/8 or 3/4 inch meter	$ 5.15
1 or 1 1/4 inch meter	14.75
1 1/2 inch meter	28.15
2 inch meter	42.25
3 inch meter	113.80
4 inch meter	196.35
6 inch meter	402.50

Middlesboro

First	1,000	gallons used per month	$ 5.15 (Minimum)
Next	9,000	gallons used per month	2.00 per M gallons
Next	15,000	gallons used per month	1.85 per M gallons
Next	25,000	gallons used per month	1.70 per M gallons
Next	50,000	gallons used per month	1.55 per M gallons
Over	100,000	gallons used per month	1.45 per M gallons

MINIMUM MONTHLY CHARGES

5/8 or 3/4 inch meter	$ 5.15
1 or 1 1/4 inch meter	15.15
1 1/2 inch meter	28.85
2 inch meter	44.20
3 inch meter	121.90
4 inch meter	210.80
6 inch meter	434.20

Clinton

First	1,000 gallons used per month	$ 6.60	(Minimum)
Next	9,000 gallons used per month	3.05	per M gallons
Next	15,000 gallons used per month	2.90	per M gallons
Next	25,000 gallons used per month	2.65	per M gallons
Next	50,000 gallons used per month	2.35	per M gallons
Over	100,000 gallons used per month	2.00	per M gallons

MINIMUM MONTHLY CHARGES

5/8 or 3/4 inch meter	$ 6.60
1 or 1 1/4 inch meter	20.45
1 1/2 inch meter	39.10
2 inch meter	57.90
3 inch meter	166.15
4 inch meter	281.80
6 inch meter	580.10

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	$ 1.25

Minimum Charges

None