COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY-AMERICAN WATER COMPANY TO INCREASE ITS RATES	))	CASE NO. 2000-120

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O R D E R

On April 28, 2000, Kentucky-American Water Company ("Kentucky-American") filed a rate application with the Commission using a forecasted test period, pursuant to 807 KAR 5:001, Section 10(1)(b).[1] Kentucky-American proposed an increase to its rates effective May 29, 2000, to generate additional annual revenues of $5,034,349, an overall increase of approximately 12.56 percent over existing revenues. Kentucky-American revised its requested annual increase to $4,684,988,[2] or 11.69 percent.

To determine the reasonableness of the request, the Commission suspended the proposed rates for 6 months from their effective date pursuant to KRS 278.190(2). The AG, through his Utility and Rate Intervention Division ("AG"), Lexington-Fayette Urban County Government ("LFUCG"), Community Action Council for Lexington-Fayette, Bourbon, Harrison, and Nicholas Counties, and N.O.P.E., Inc. ("NOPE") intervened. A procedural schedule was established, the parties engaged in extensive discovery, and

[1] At Kentucky-American's request and with the agreement of all other parties, the Commission directed that all documents be submitted in electronic format. This use of electronic filing has reduced the number of copies submitted to the Commission and enhanced the parties' ability to manage the documents within this docket. The Commission has learned valuable lessons regarding electronic filing that we intend to apply to other Commission proceedings. We express our appreciation to the parties for their cooperation and assistance in this endeavor.

[2] Brief of Kentucky-American Water Company at 6.

the intervenors filed testimony. A public hearing was held on October 3 and 4, 2000, to receive evidence relating to Kentucky-American's rate application. Following this hearing, the parties submitted written briefs.

This Order addresses the Commission's findings and determinations on the issues presented and disclosed upon the investigation of Kentucky-American's revenue requirement. Based on those findings, the Commission approves herein new rates to produce an increase in annual operating revenue of $2,517,651, an overall increase of approximately 6.49 percent.

ANALYSIS AND DETERMINATION

Test Period

As authorized by KRS 278.192(1), Kentucky-American utilized the 12 months ending November 30, 2001 as its forecasted test period. The base period used was the 12 months ending July 31, 2000.

Rate Base

Kentucky-American has proposed a forecasted net investment rate base of $142,427,511.[3] This forecasted rate base is accepted with the following exceptions:

Utility Plant In Service - Slippage. Kentucky-American used construction budgets to determine its forecasted utility plant in service ("UPIS") amount of $232,598,563. Its construction budget is segregated into two categories: (1) investment projects, normal recurring plant investment; and (2) special budget projects, non-recurring plant investment. In prior forecasted test period cases, the Commission has adjusted UPIS to

[3] Rate Base Summary as of November 30, 2001, Schedule B-1 at 2 of 2.

reflect 10-year historical trend percentages.[4] These "slippage factors" serve as an indicator of Kentucky-American's accuracy in predicting the cost of its utility plant additions and dates that new plant will be placed into service.

The parties disagree on the use of "slippage factors." Kentucky-American opposes their use and contends that this adjustment requires the Company to manage its operations to meet rate regulation.[5] The AG, in contrast, contends that historical information indicates that the Company's projections in past proceedings have been unreliable and that previous applications of the slippage factor were therefore necessary to correct for these inaccuracies.[6]

In Case No. 95-554,[7] the Commission found that "Kentucky-American's recent history of budget forecasting is not a precise indicator of its future construction expenditures and that [t]he 10 year slippage factor . . . produces a more reliable estimate of the construction projects Kentucky-American will have in service or under construction in the forecasted period." We affirmed these findings in subsequent rate proceedings.[8]

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[4] See e.g., Case No. 97-034, The Application of Kentucky-American Water Company to Increase its Rates (September 30, 1997) at 3.

[5] Brief of Kentucky-American at 7.

[6] Brief of the AG at 4-5.

[7] Case No. 95-554, Notice of the Adjustment of Rates of Kentucky-American Water Company (September 11, 1996) at 5.

[8] See Case No. 97-034, Order of September 30, 1997 at 6.

As Kentucky-American has not changed its budget assumptions, policies and procedures since its last rate proceeding,[9] we find no evidence that Kentucky-American's proposed budgeted amount will be more reliable or that the need for application of slippage factors will be less than in prior cases.

Kentucky-American recalculated UPIS using slippage factors of 97.23 percent for investment projects and 74.871 percent for budgeted projects, resulting in adjusted UPIS of $231,344,013.[10] Accordingly, an adjustment has been made to decrease Kentucky-American's forecasted UPIS by $1,254,550 to account for slippage.

Utility Plant in Service – Boonesboro Water & Sewer Association. In Case No. 97-320[11] the Commission approved Kentucky-American's acquisition of the assets of the Boonesboro Water Association ("BWA"). As a result of that acquisition, Kentucky-American's forecasted UPIS includes $67,945[12] related to BWA's sewer plant. The AG

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[9] Kentucky-American's Response to the Commission's Order of April 13, 2000, Item 3.

[10] Kentucky-American's Response to the Commission's Order of June 2, 2000, Item 5.

[11] Case No. 97-320, The Verified Joint Application of Boonesboro Water Association, Inc. and Kentucky-American Water Company for Approval of the Transfer of the Ownership of the Assets of Boonesboro Water Association, Inc. to Kentucky-American Water Company, Order issued October 16, 1997.

[12] Kentucky-American's Response to the AG's Data Request No. 1, Item 76.

Structures & Improvements	$40,126.87
Pumping Equipment	10,707.91
CWIP	17,110.77
Total	$67,945.55

contends that BWA's sewer operations are not relevant to Kentucky-American's water operations and that all related costs should be removed from water operations.[13]

In support of the plant's inclusion, Kentucky-American argues that inclusion would have a minimal effect on Kentucky-American's total revenue requirement and would reduce the level of potential increases in the rates that Kentucky-American must assess for sewer service.[14]

The Commission finds that inclusion of the BWA sewer plant would result in Kentucky-American's water customers subsidizing the operation of the sewer plant and that such subsidy is inappropriate. We, therefore, have eliminated it from Kentucky-American's UPIS.

Utility Plant Acquisition Adjustments. Kentucky-American proposes to amortize over a 10-year period an acquisition adjustment of $184,568 related to its purchase of the BWA assets. The acquisition adjustment includes the following costs:

Purchase Price In Excess of Book Value	$ 33,800
Company Labor	46,350
Legal Fees	87,320
Other	17,188
Total	$184,560

Kentucky-American included a 13-month average balance of the acquisition adjustment of $175,340 in forecasted UPIS.

In Case No. 97-320, the Commission approved Kentucky-American's acquisition of BWA's facilities but took no action upon the rate-making treatment of any acquisition

[13] Brief of the AG at 5.

[14] T.E., Vol. I at 135 – 136.

adjustment that Kentucky-American might record as a result of the transaction.[15] At the time, Kentucky-American advised the Commission that it intended to record an acquisition adjustment of $35,812. Since then Kentucky-American has revised the adjustment to reflect additional expenditures related to the acquisition.[16]

In Case No. 9059,[17] the Commission declared that “the net original cost of plant devoted to utility use is the fair value for rate-making purposes, unless the utility can prove, with conclusive evidence, that the overall operations and financial condition of the utility have benefited from acquisitions at prices in excess of net book value.” The Commission further held that the utility seeking the adjustment bears the burden to justify its purchase decision based “on economic and quality of service criteria.”[18] These criteria include:

> the purchase price was established upon arms-length negotiations, the initial investment plus the cost of restoring the facilities to required standards will not adversely impact the overall costs and rates of the existing and new customers, operational economies can be achieved through the acquisition, the purchase price of utility and non-utility property can be clearly identified, and the purchase will result in overall benefits in the financial and service aspects of the utility's operations.

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[15] See Final Order.

[16] In December 1997 Kentucky-American recorded an acquisition adjustment of $33, 800. See Kentucky-American’s Response to the AG’s Data Request No. 2, Item 2. It subsequently revised this amount to $184,568 to reflect additional expenses incurred after the transfer. Kentucky-American’s Response to the AG’s Data Request No. 1, Item 81.

[17] Case No. 9059, An Adjustment of Rates of Delta Natural Gas Company, Inc. (Ky. PSC Sep. 11, 1985) at 3.

[18] Id.

Kentucky-American contends that its acquisition of BWA meets these criteria. It states that the rates of BWA customers were reduced as a result of the acquisition. It contends that it achieved significant operation savings, that BWA employees filled vacant Kentucky-American job positions, and that no direct increase in the cost of providing service occurred. Moreover, the acquisition increased the number of Kentucky-American's ratepayers and its annual revenues.

Objecting to the proposed adjustment, the AG contends that the purchase of BWA's facilities was merely to enhance shareholder value and that significant benefits did not accrue to Kentucky-American customers as a result of the acquisition. He further argues that several of the proposed adjustment's components are inappropriate as they relate to the acquisition of wastewater facilities or to labor costs that are more appropriately booked as labor expenses.

Based upon our review of the evidence, the Commission finds that Kentucky-American has failed to prove the established criteria for an acquisition adjustment. Aside from increasing the utility's customer base, a feat that virtually every utility acquisition achieves, the BWA acquisition has achieved few benefits. It did not result in any significant labor or operational savings. No Kentucky-American employee positions were eliminated. As Kentucky-American was not connected to portions of BWA's system, it was forced to construct new distribution facilities to connect its system to the former BWA system. Kentucky-American, moreover, has incurred significant legal expenses related to BWA's wastewater facilities and BWA's water supply agreements with Winchester Municipal Utilities ("WMU").

The acquisition has not resulted in any significant increase in the quality of service provided to BWA's former customers. These customers continue to receive water that is purchased from WMU. While they will shortly be receiving their water directly from Kentucky-American, both water suppliers meet state and federal drinking water standards. While slight differences in the quality of the water supplied may exist, they are not significant enough to justify the proposed acquisition adjustment. Moreover, at the time of the acquisition, BWA was providing a reasonable service to its customers.

Our decision not to permit the proposed acquisition adjustment in this matter should not be considered as a retreat from our previous announcements encouraging the development of regional water suppliers and the acquisition of smaller and less efficient utility systems.[19] Our position on that issue remains unchanged. We continue to encourage larger water suppliers to expand their facilities and absorb smaller water systems that are incapable of meeting the rising costs of providing quality water service. We fail to find in the case at bar, however, any facts to suggest that regionalization efforts were advanced by Kentucky-American's acquisition of BWA or that our decision regarding the proposed acquisition adjustment will hinder regionalization efforts in the future.

Accumulated Depreciation. Kentucky-American proposed no adjustment to its forecasted test period accumulated depreciation of $45,671,737. Accumulated

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[19] See e.g., Case No. 89-348, The Notice of Adjustment of the Rates of Kentucky-American Water Company Effective on January 28, 1990 (June 28, 1990).

depreciation, when adjusted for the slippage factor, is $45,636,543,[20] a decrease of $35,194.

The elimination of the BWA's Sewer Plant accumulated depreciation will further reduce this amount by $35,830.[21] Based on these adjustments, the Commission has decreased forecasted accumulated depreciation by $71,024.

Construction Work in Progress ("CWIP"). Kentucky-American proposed no adjustment to its forecasted test period CWIP of $5,454,134. CWIP, when adjusted for the slippage factor, is $4,963,029.[22] Therefore, the Commission has reduced forecasted CWIP by $491,105.

Working Capital Allowance. Kentucky-American proposed forecasted working capital allowance of $1,176,000 based on a lead/lag study. The AG proposed that the company's overall weighted revenue collection lag should be 35.80 days rather than 36.63 days.[23] Kentucky-American agreed with this adjustment and stated that working capital should be decreased by $90,000.[24]

The Commission has further decreased working capital allowance by $31,070 for adjustments made to Kentucky-American's forecasted operation and maintenance

[20] Kentucky-American's Response to the Commission's Order of June 2, 2000, Item 5.

[21] Kentucky-American's Response to the AG's Data Request No. 1, Item 76.

[22] Kentucky-American's Response to the Commission's Order of June 2, 2000, Item 5.

[23] Kentucky-American's Response to the AG's Data Request No. 1, Item 101.

[24] Kentucky-American's Response to the AG's Data Request No. 1, Item 205 (Update 1).

expenses. The decrease was calculated based on the percentage of forecasted working capital allowance to forecasted operation and maintenance expenses of 5.97 percent,[25] applied to Commission approved forecasted operation and maintenance expenses of $17,683,938.

Other Working Capital Allowance. Kentucky-American proposed forecasted other working capital allowance of $485,820, based on the 13-month average plant materials and chemicals account balance for the period ending February 29, 2000. The AG proposes other working capital of $445,679, a decrease of $40,141, based on the average account balance for the 24-month period ending May 31, 2000. He contends that a 24-month average is consistent with prior Commission Orders and with Kentucky-American's approach to determining most of the balances included in Other Rate Base Elements by using a 24-month period.[26] Objecting to these arguments, Kentucky-American contends that a 24-month average reflects an older balance and does not recognize the need for the increasing volume and prices of plant materials and chemicals required for good operations.[27]

The Commission finds that a 24-month average produces a more reliable trend by minimizing the effect of abnormally high and low months. Kentucky-American has not provided sufficient evidence to persuade the Commission that utilization of the 13-

[25] $1,086,000 ÷ $18,204,761 = .05965

[26] Brief of the AG at 12.

[27] Brief of Kentucky-American at 21.

month average would be a more reliable indicator. Accordingly, we have decreased Other Working Capital Allowance by $24,559. [28]

Contributions in Aid of Construction ("CIAC"). Kentucky-American proposed no adjustment to its forecasted test period CIAC of $23,864,445. CIAC, when adjusted for the slippage factor, is $23,851,122.[29] Therefore, the Commission has reduced forecasted CIAC by $13,323.

Kentucky-American proposed to establish a tapping fee in the amount of $500 for residential service, $900 for one-inch service, and $3,300 for two-inch service. Connections larger than two inches would be made at the actual cost of installation. Kentucky-American included the proposed tap fees in CIAC for the forecasted test period. The proposed tap fees included additional costs related to automatic meter reading ("AMR") in the amount of $193,191.[30] The Commission has included these fees in net operating revenues as a customer charge; therefore, an adjustment has been made to decrease forecasted CIAC.

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[28] This differs from the reduction proposed by the AG based on the Commission's calculation of the average plant materials and chemicals account balance for the 24-month period ending May 31, 2000. See Kentucky-American's Response to the AG's Data Request No. 1, Item 90.

[29] Kentucky-American's Response to the Commission's Order of June 2, 2000, Item 5.

[30] Reflects a 3-year average of proposed tap fee collections.

During this proceeding, Kentucky-American made a net adjustment to decrease forecasted test period CIAC by $377,000 based on changes in construction schedules.[31] The Commission accepts this adjustment.

Customer Advances. Kentucky-American proposed forecasted customer advances of $12,411,002. Based on the Commission's application of slippage factors to capital construction budgets, adjustments have also been made to apply slippage factors to customer advance receipts and customer advance refunds. Kentucky-American calculated the appropriate slippage factors to be 93.73 percent and 107.86 percent,[32] respectively. These factors are specific to customer advances and differ from those used for plant in service. Based on these slippage factors, Kentucky-American calculated adjusted forecasted customer advances of $11,841,290.[33]

The AG argues that Kentucky-American should use the same factors used for plant in service because of the Company's failure to provide independent calculations to support the customer advance slippage factors. He further argues that the use of different slippage factors for customer advances is inconsistent with prior Commission decisions.

The Commission finds that the actual slippage factors for customer advance receipts and customer advance refunds should be used. Kentucky-American identified these factors in its responses to discovery requests and provided additional evidence of

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[31] Kentucky-American's Response to the AG's Data Request No. 2, Items 11 & 12 (Update 2).

[32] Kentucky-American's Response to the Commission's Order of June 2, 2000, Item 5.

[33] Id., Sch. B-1 at 2.

these factors in response to requests for production of documents made during the hearing in this matter.[34] Moreover, it presented and used specific customer advance slippage factors in its last rate adjustment proceeding.[35] Therefore, the Commission has included an adjustment to decrease customer advances by $569,712.

Deferred Income Taxes. Kentucky-American included forecasted deferred income taxes of $23,598,127 in rate base. The following adjustments have been made to this account as a result of other rate base adjustments:

KRS II Costs	$ 184,265
KRS Residuals	226,772
BWP Pipeline Costs	1,355,464
Community Education Costs	182,482
Deferred Debits & Acquisition Adjustment	328,445
Slippage	(8,491)
Total Adjustment	$ 2,268,937

Deferred Debits. Kentucky-American included the 13-month average balance of the following deferred debits in rate base[36] and requested amortization of each:

AMR Study	7,050
Disinfection By-product Study I	3,430
Lake Ellerslie Dam Study	1,003
Meter Deviation Application	14,106
Cost-of-Service Study	35,100
Cost of Demand Study	54,000
Sludge Removal I	36,000
Sludge Removal II	30,769
Disinfection By-product Study II	80,370
Deferred Acquisition Costs	32,088
Rockwell WWTP Improvement Study	3,490
Cost Containment Program	20,092
Y2K Compliance	106,802

[34] Kentucky-American's Response to Hearing Data Request No. 1.

[35] Rebuttal Testimony of Edward J. Grubb at 9–10.

[36] W/P 1-12 at 3–4.

Graphical Interface Study	52,892
Automation of KRS	25,442
Reorganization Costs	164,469
Deferred Legal/Settlement Costs	173,750
Deferred Relocation Expenses	43,394
Easement Encroachment	15,980
Total Forecasted Deferred Debits	$900,227

The Commission has permitted the requested rate treatment for the AMR Study, Disinfection By-product Study I, Lake Ellerslie Dam Study, and the Meter Deviation Application in previous cases. The AG has not proposed additional adjustments to these amounts. In light of our previous treatment of these items, no adjustment has been made to eliminate these items from rate base.

Moreover as the Cost-of-Service Study, Cost of Demand Study, Sludge Removal I, Sludge Removal II, and Disinfection By-product Study II are similar in nature to items previously approved, the Commission has made an adjustment to include the unamortized portion of these deferred debits in rate base.

Kentucky-American also included in deferred debits deferred acquisition costs related to its investigation of the acquisition of East Clark County Water District ("East Clark and Logan/Todd"), Logan and Todd County Water Systems, and Georgetown Municipal Water System ("Georgetown"). The AG proposed, and Kentucky-American agreed, to eliminate the costs involving Georgetown because these costs have been recovered through existing rates.[37] The Commission, therefore, has reduced deferred acquisition costs by $14,190.

[37] Brief of the AG at 14.

The Commission has also eliminated expenses of $17,898 related to failed acquisitions of the East Clark County Water District and Logan and Todd County Water Systems. These expenses are prior period expenses whose inclusion would violate the basic principles of forecasted test year rate-making. Contrary to Kentucky-American's contentions,[38] no evidence has been found to indicate that preliminary costs of failed utility acquisitions have been specifically addressed in a prior Commission Order.

Kentucky-American has included in forecasted deferred debits the Rockwell Improvement Study, which is directly related to the Boonesboro Sewer System, at a cost of $3,490. The AG proposes,[39] and the Commission agrees, that these costs should be removed since the study has no relevance to Kentucky-American's water operations.

The remaining deferred debits are prior period expenses that Kentucky-American has singled out for deferral treatment and are summarized below.

<u>Other Deferred Debits</u>

<u>Cost Containment Program</u>. In April 1998, Kentucky-American included the 13-month average balance of $20,092 for a study to assist it in reducing its expenses by changing vendors or negotiating with vendors. Kentucky-American contends that this expenditure represents a prudent decision that has resulted in the reduction of current and future costs. It further contends that its ratepayers only will benefit from the program because the savings delayed the timing of this rate case filing and are reflected

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[38] Kentucky-American's response to the AG's Data Request No. 2, Item 25.

[39] Brief of the AG at 14.

in the expenses of the forecasted test period.[40] Rejection of the proposed treatment would discourage Kentucky-American from pursuing efforts to reduce its cost-of-service.

In contrast, the AG argues that these deferred items and related amortization should be disallowed primarily because the corresponding cost savings from the program have more than offset the cost.[41]

Year 2000 ("Y2K") Compliance Costs, Graphical Interface Study ("GIS"), and Automation of Kentucky River Station ("KRS"). Kentucky-American has included, as forecasted deferred debits, costs incurred for Y2K Compliance, completion of the GIS Study, and the Automation of KRS Study in the amount of $185,136. The Y2K Compliance costs involved the company's performance of comprehensive system checks of all critical resources to ensure Y2K readiness.[42] The GIS study reviewed all departmental processes that might benefit from a GIS and the estimated costs associated with integration over the next 5 years. The Automation of KRS Study examined the feasibility of automating the Kentucky River Station.

The AG argues that these costs benefit both ratepayers and stockholders and therefore should be amortized but not included in rate base. Kentucky-American argues that rate base treatment is appropriate because it encourages minimized costs and

[40] Brief of Kentucky-American at 22.

[41] Brief of the AG at 14-15.

[42] Direct Testimony of Edward J. Grubb at 16.

improved service quality.[43] Ultimately, ratepayers benefit through lower utility bills and better service.[44]

Reorganization Costs. Kentucky-American has proposed to include $164,469 in rate base for costs incurred as a result of its reorganization efforts from October 1997 through June 1998.[45] Of the total cost, $47,099 represents the cost of a study to determine whether Kentucky-American should continue to receive full services from an American Water Works Regional Service Company or rely more on local resources to perform certain functions. The remainder of the cost was for the relocation of two associates to Lexington to fill the positions of Vice-President of Operations and Comptroller. The company claims that the savings it has realized as a result of the PeopleTech Study have already offset the costs. Kentucky-American proposes to amortize this expense over a period of 5 years with rate base treatment of the unamortized balance.

The AG's position is that the accumulated cost savings achieved by Kentucky-American as a result of the reorganization more than offset the deferred cost. Therefore, no rate recognition is required.[46]

Kentucky-American argues that the AG is attempting to apply the concept of single-item and retroactive ratemaking in this instance. The savings realized helped to lower Kentucky-American's current and forecasted test year utility operating income,

[43] Testimony of Robert J. Henkes at 35.

[44] Rebuttal Testimony of Edward J. Grubb at 7–8.

[45] Kentucky-American's response to the AG's Data Request No. 1, Item 117.

[46] Testimony of Robert J. Henkes at 31–32.

which directly benefits only the ratepayers. Disallowing rate base recovery of these costs would suggest to Kentucky-American that it should not pursue opportunities to save costs.[47]

With the formation of the Southeast Region in April 2000, it appears that the goal Kentucky-American was trying to achieve through reorganization was, for all practical purposes, eliminated. Kentucky-American states that approximately 8 years ago the American System began a strategy of staffing some water companies with resources, which would eliminate the need for the use of the services of a regional service company.[48] Based on this strategy Kentucky-American went through a reorganization that was completed in June 1998. Less than 2 years later, Kentucky-American moved some of its functions back to a newly formed service company, the Southeast Region. According to Kentucky-American, things change.[49] The Southeast Region is not a full movement away from the recommendations made in the PeopleTech Study but rather a partial movement toward more policy and direction and overview for a region. [50]

The Commission recognizes that Kentucky-American's organizational structure has seen many changes in recent history. Changes of this nature can create operating efficiencies that benefit both the shareholder and ratepayer. Kentucky-American should provide assurance to this Commission that management of operations and policy

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[47] Brief of Kentucky-American at 24-25.

[48] Direct Testimony of Edward J. Grubb at 17.

[49] T.E., Vol. I at 253.

[50] Id. at 256.

decisions will remain under local control and that decisions are made in the best interest of its ratepayers in Kentucky.

Deferred Legal/Settlement Costs. Kentucky-American included $173,750 in forecasted deferred debits for litigation and settlement costs resulting from a lawsuit filed against the Company by two former employees. Kentucky-American proposes to amortize these costs over a period of 5 years with rate base treatment of the unamortized balance. Kentucky-American states that it pursued the least cost solution and did not practice discrimination in either case but took responsible action to solve a business problem. These costs were incurred to improve customer service.[51]

The AG asserts that shareholders, not ratepayers should bear the cost of settlement awards and legal fees associated with lawsuits involving illegal business practices. The investors are being reimbursed for this type of business risk in their authorized return on equity. The AG further states that these costs have nothing to do with the provision of safe, adequate and reliable water service.

In Kentucky-American's rebuttal testimony it states that its actions were in the best interest of its customers and investors and the resulting costs should be recognized in the ratemaking process.[52] Kentucky-American states that it has never been found guilty of discrimination in any form and that it pursued the least cost solution to these lawsuits.[53]

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[51] Direct Testimony of Coleman Bush at 13.

[52] Rebuttal Testimony of Edward J. Grubb at 5.

[53] Brief of Kentucky-American at 25.

Deferred Relocation Expenses. During 1999 Kentucky-American incurred relocation costs to fill two management positions with associates who did not reside in the Lexington area. It included these costs in forecasted rate base at the 13-month average level of $43,394. Kentucky-American claims that it advertised locally and interviewed a number of applicants for the positions but the most qualified individuals were not local residents. Kentucky-American believes the costs are fair and reasonable and the experience and expertise of these two individuals brought benefits to the ratepayers that could not be found locally. The Company is proposing to amortize the total cost of $52,073 over a 3-year period with rate base treatment of the unamortized balance.[54]

The AG disagrees with Kentucky-American's proposed treatment of relocation expenses. From 1989 to 1999, Kentucky-American experienced only four other management relocations, two of which were a result of the 1998 reorganization. It is his position that the costs were non-recurring and should have been expensed when incurred rather than deferred.[55] This treatment is consistent with Kentucky-American's treatment of previous relocations and it is the AG's position that the company has not demonstrated a sound basis for altering the treatment for these costs.[56]

Easement Encroachment. Kentucky-American included easement encroachment costs of $15,980 in its forecasted test year deferred debits. These costs were related to the investigation of various easement encroachments on Company

[54] Testimony of Edward J. Grubb at 15.

[55] Testimony of Robert J. Henkes at 33–34.

[56] Brief of the AG at 15.

property. “The purpose of the investigation was to identify the easement encroachments and to protect the Company’s assets and to identify any possible liability.”[57] Kentucky-American proposed to amortize these costs over three years and to include the unamortized balance in rate base.

The AG proposes to deny any rate recognition for these costs. The AG states that Kentucky-American incurred these costs between 1991 and 1995 (at least 5 years prior to the forecasted test period in this case) and never requested rate recognition for the deferred costs in prior cases. Kentucky-American said it is not likely to have any similar costs for at least 3 more years.[58] Therefore, the AG asserts that the costs are non-recurring in nature. Had Kentucky-American wished to recover these costs through rates, it should have done so in a prior, more timely, proceeding.[59]

Kentucky-American argues that these deferred expenses represent reasonable, prudent expenditures initiated to investigate potential advancements by others onto Company property. The time lapse between the cash outlay and the proposal for inclusion in rates was due to the possibility that additional costs could have been incurred related to the investigation.

The Commission does not agree with Kentucky-American’s proposed rate treatment of the aforementioned expenses included as other deferred debits and the deferred acquisition adjustment. The Commission finds that these deferrals are contrary to forecasted test year methodology, may constitute retroactive ratemaking or

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[57] Direct Testimony of Edward J. Grubb at 17.

[58] Kentucky-American’s response to the AG’s Data Request No. 1, Item 114.

[59] Testimony of Robert J. Henkes at 34–35.

single-issue ratemaking, and should therefore be eliminated from forecasted operations entirely.

When using a historical test period, operations are adjusted to reflect a typical or normal 12-month operating period. Under that approach, amortization of expenses is a common way to normalize test year operations for abnormal or non-recurring items. For example, had Kentucky-American filed this case using a historical test year wherein any one of these deferred items were incurred, amortization of the expense would have been appropriate. However, in this case Kentucky-American filed a forecasted test year. The sole purpose of a forecasted test period is to match rates with the expected revenue requirements for a specific future 12-month operating period. In this case the 12-month period is December 1, 2000 through November 30, 2001. Kentucky-American utilized construction and expense budgets to forecast its cost of operations for that 12-month period. The deferred costs are expenses for prior periods. They should have been recognized fully when incurred and not carried forward to the forecasted operations.

Including prior period expenses in current rates constitutes retroactive ratemaking. The items deferred are clearly expenses and not capital items. A utility, pursuant to FASB 71, is entitled to accrue a "regulatory asset" (an expense carried on the books as an asset) if it is probable that the cost will be allowed in rates and the revenue allowed is to recover the previously incurred cost rather than to provide for expected levels for similar future costs. None of these items warrant deferred treatment under FASB 71 due to their immateriality. The largest item listed is the reorganization costs which were initially recorded at a cost of $197,362 and represent only .1386 percent of the proposed rate base of $142,427,511.

By selecting individual expenses to record as deferred debits and subsequently recover in a later rate case, Kentucky-American is, in effect, isolating single issues. Kentucky-American argues, in reference to regulatory expenses, "That the over or under collection of any specific item awarded or not awarded by the Commission historically should have no bearing on the setting of the rates for a forecasted test year."[60] According to Kentucky-American's analysis, expenses incurred historically, whether they were considered by the Commission in a previous case or not, should have no bearing on the rates for a forecasted test year. Kentucky-American goes on to state that single item or retroactive ratemaking is neither fair, just, reasonable nor constitutional.[61] The Commission agrees with Kentucky-American's position and feels that it is applicable, not only to regulatory expenses, but also to certain deferred expenses. Therefore, an adjustment has been made to decrease rate base by $620,719 to reflect the removal of other deferred debits and deferred acquisition costs related to East Clark and Logan/Todd.

The Commission is concerned with Kentucky-American's present practice of deferring expenses as regulatory assets. In the future Kentucky-American shall formally apply for Commission approval before accruing an expense as a regulatory asset, regardless of the ratemaking treatment that the Commission has afforded such expense

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[60] Brief of Kentucky-American at 32.

[61] Id.

in previous rate case proceedings. The Commission will consider each expense independently and with particular regard to materiality.

KRS II Costs. Kentucky-American proposed to include the amortization and rate base treatment of costs for design work associated with Kentucky River Treatment Plant No. 2. These costs were included in forecasted rate base at a 13-month average level of $456,521. In Case No. 89-348,[62] the Commission authorized Kentucky-American to amortize a portion of the costs associated with that project over a period of 5 years without rate base treatment of the unamortized balance. The costs currently in question were deferred at that time due to the possibility of being used in the expansion of the Richmond Road Station.

Kentucky-American's position is that, due to changed water quality regulations and improved technology, the design work can no longer be used. Therefore, the $507,245[63] balance should be amortized over 5 years with rate base treatment.

The AG accepts Kentucky-American's position that the design is not likely to be used and agrees with the 5-year amortization period to be consistent with Commission precedent for this project. However, the AG feels that it is inappropriate to authorize rate base treatment for the unamortized portion because this project has no value to ratepayers, and is not used and useful.[64]

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[62] The Notice of Adjustment of the Rates of Kentucky-American Water Company Effective on January 28, 1990 (June 28, 1990).

[63] W/P 1-13 at 1 of 4.

[64] Brief of the AG at 16.

The Commission agrees with the AG's proposed treatment, has eliminated these costs from rate base, and has included a provision for 5-year amortization. This treatment is consistent with the Commission's Order in Case No. 89-348. In addition, since the design work was never used, this would allow a sharing of the cost between ratepayers and shareholders.

KRS Residuals Project Costs. Kentucky-American incurred costs of $624,258 for design work related to future KRS residuals handling facilities. These costs were included in forecasted rate base at a 13-month average level of $561,834. The Commission granted a certificate for the facilities in Case No. 99-299;[65] however, the facilities were never constructed due to persistent requests from Kentucky-American to the Division of Waste Management to allow Kentucky-American to continue its current method of disposal without dewatering.[66] It is Kentucky-American's opinion that these costs were incurred in response to a government directive and that the ratepayers were the exclusive beneficiaries as a result of the project being abandoned because, had the facilities been built, Kentucky-American would have spent $5,000,000 rather than $624,258. Accordingly, abandonment saved the ratepayers a return on $5,000,000.

Kentucky-American declared the project to be abandoned[67] but feels that ratepayers will benefit from these costs if the project is ever undertaken in the future.

[65] The Application of Kentucky-American Water Company for a Certificate of Convenience and Necessity Authorizing the Construction of Additional Residuals Processing Facilities at the Kentucky River Station (September 15, 1999).

[66] Direct Testimony of Linda Bridwell at 10.

[67] Kentucky-American's Response to the Commission's Order of June 2, 2000 Order, Item 33.

Kentucky-American proposes to amortize these costs over a period of 5 years with rate base treatment of the unamortized balance.

The AG agrees that Kentucky-American should be allowed rate amortization of the total cost but asserts that it should be over a period of 10 years rather than 5. The AG disagrees with including the unamortized balance in rate base because it is abandoned.[68]

The Commission finds that these costs are reasonable and were prudently incurred by Kentucky-American and should therefore be recovered through amortization. However, these costs will never fully benefit the ratepayers as the project has been abandoned. Therefore, the costs should be shared between the ratepayers and the shareholders through rate base exclusion.

The Commission utilized a 5-year amortization period, as this will provide for a reasonable recovery of these costs with minimal effects on rates.

Bluegrass Water Project – Pipeline. Kentucky-American incurred costs of $3,534,975 for the design and development of a proposed pipeline to bring treated water from the Ohio River to the Kentucky-American service area in order to address the water supply problem. However, in December of 1999, Kentucky-American fully supported the resolution of the LFUCG council to look to the Kentucky River for an additional increment of raw water supply and, in effect, abandoned its efforts to construct the pipeline.[69] Kentucky-American now proposes to amortize this cost over 10 years with rate base treatment of the unamortized balance or that the cost be recovered

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[68] Brief of the AG at 17.

[69] Brief of Kentucky-American at 10.

through a surcharge with interest at a reasonable rate.[70] Kentucky-American contends that "it was ordered to find a solution to the source of supply deficit and any solution would directly benefit the ratepayers with only minor, incidental benefits of a non-monetary nature to the shareholder."[71]

Opposing this proposal, the AG argues that as Kentucky-American declared its pursuit of the pipeline solution to be abandoned, rate base treatment on the unamortized balance is inappropriate.[72] Exclusion of these costs from rate base would properly assign a sharing of the costs to the shareholders. He further proposes to amortize the cost over 20 years rather than 10 years.

NOPE argues that Kentucky-American's actions with regard to the pipeline were neither reasonable nor prudent and that ratepayers should not have to bear any costs associated with the pipeline.[73] It requests that all costs related to the pipeline be excluded in this case or that the Commission dismiss without prejudice the portion of this rate proceeding dealing with the pipeline and Kentucky-American's compliance with the Commission's Order in Case No. 93-434 until Kentucky-American has fully complied with that Order and has resolved the source of supply issue.

The Commission rejects the contention that it directed Kentucky-American to pursue the pipeline option. In our Order of September 30, 1997 in Case No. 93-434, we

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[70] Id. at 14.

[71] Id. at 10 (Emphasis in original).

[72] Brief of the AG at 17.

[73] Brief of NOPE at 10.

directed Kentucky-American to take “the necessary and appropriate measures to obtain sources of supply” to meet its supply deficit. No solution was prescribed. In fact, the Commission went to great effort to suggest that no method was preferred. In several prior rate case proceedings we consistently refused to sanction the use of the pipeline by allowing its costs into rate base. Kentucky-American, moreover, incurred a portion of these expenses associated with the pipeline long before our decision in Case No. 93-434. The decision to pursue the pipeline solution was ultimately a management decision.

The Commission also notes that there is no evidence that Kentucky-American incurred these expenses in bad faith. Since December 1992, it has openly displayed its preference for a pipeline solution. It has postponed its efforts towards such solution to allow for additional studies of the issue. During this entire period, it had no evidence that LFUCG objected or criticized this proposal or indicated a strong preference for a particular solution.

The Commission has given Kentucky-American adequate notice that in Case Nos. 92-452, 95-554, and 97-034, it ruled that costs associated with the pipeline should be accounted for in Account 183 – Preliminary Survey and Investigation Charges, and excluded from rate base. Preliminary construction costs recorded in that account should remain there until actual construction begins. In this instance, the project was abandoned and there is no intent for construction to begin.

In addition, Kentucky-American claims that any benefits to the shareholder from these costs are minor, incidental benefits of a non-monetary nature. It is the Commission’s opinion that the shareholders will directly benefit from a solution to the source of supply problem in that, without an adequate supply of water, Kentucky-American would not have the means to provide service to all of its customers. This would ultimately result in lower earnings for its shareholders. Therefore, the Commission finds it is appropriate that there be a sharing of the costs between ratepayers and shareholders by disallowing the inclusion of these costs in rate base. An adjustment has been made to decrease rate base by $3,358,227, the 13-month average balance included in the forecasted period.

The Commission finds that Kentucky-American's project costs should be recovered through amortization. We further find that a 10-year amortization period should be used. A 10-year period closely coincides with the duration of time the costs were accrued on Kentucky-American's books. We find that this period is not unduly burdensome on shareholders.

We further find that the unamortized portion of these costs should not be included in rate base. By allowing recovery of the expenses but providing no ratemaking treatment of the unamortized portion, we have ensured that both ratepayers and shareholders share equally in the pipeline costs.

Bluegrass Water Project – Community Education. Kentucky-American began a public education campaign in late 1997 after the completion of Case No. 93-434.[74] Kentucky-American accrued community education costs in the amount of $684,870, which it later revised to $655,744.[75] The Company states that the campaign coincided

[74] T.E., Volume II at 33.

[75] Kentucky-American's Response to the LFUCG's Data Request No. 1, Item 16 at 9.

with the Bluegrass Water Project because of the source of supply situation and not to promote the pipeline.[76] Kentucky-American requests that $481,576[77] of those costs be amortized over 5 years with the unamortized balance included in rate base. These costs are included in forecasted rate base at a level of $452,112. Kentucky-American is not requesting rate recovery for the remaining balance of $177,920 as it describes those costs as potentially controversial.[78] They could be construed as political advertising because those expenditures included promotion of the pipeline as the solution to the source of supply problem. [79]

The AG has proposed that the entire amount be eliminated from forecasted operations saying that Kentucky-American has not made a "sufficiently compelling case that the spending should not be considered as political advertising." [80] He states that Kentucky-American has been evasive in presenting evidence relating to the costs in question and that, had these costs been strictly conservation efforts, Kentucky-American would have expensed them when incurred rather than deferring them along with the other Bluegrass Water Project costs.[81]

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[76] Brief of Kentucky-American at 17.

[77] Id. at 16.

[78] Kentucky-American's Response to the AG's Data Request No. 1, Item 132.

[79] Kentucky-American's Response to the Commission's Order of June 30, 2000 Order, Item 5.

[80] Brief of the AG at 23.

[81] Id. at 45 – 46.

NOPE‘s position is that the disparity in pre-pipeline and post-pipeline advertising expenses infers that the vast majority of these expenditures were made to influence public policy and promote the failed pipeline strategy. Therefore, the costs cannot reasonably be passed on to the ratepayers and should be disallowed.[82]

The entire $655,744 was expended after issuance of the Commission’s Order in Case No. 93-434 in 1997. During this time period Kentucky-American was using advertising to heighten public awareness of the water deficit, to promote conservation, and to promote the pipeline as the solution. The entire cost in question was incurred as a part of this campaign.

While some ads of this campaign did not expressly promote the pipeline, all were part of a single, coordinated effort to create the atmosphere that construction of the pipeline was necessary and to build public support for that project. We do not find credible Kentucky-American’s arguments that the expenses in question were unrelated to the proposed pipeline.

The Commission notes that the expenses in question were well in excess of the level that Kentucky-American expended for routine conservation advertising for the prior seven years. Kentucky-American’s witness testified that adequate amounts were spent during that period on conservation advertising and that amounts budgeted for the forecasted test period for routine water conservation advertising are adequate. These amounts were less than 1/30 of the amount expended during the two years of Kentucky-American’s advertising campaign. The massive amount expended in that short period

[82] Brief of NOPE at 10–11.

is at total variance with Kentucky-American's historical and budgeted conservation advertising efforts.

Based on the evidence of record, the Commission finds that the community education costs represent costs incurred to influence public opinion that fall within the prohibition of Administrative 807 KAR 5:016. Kentucky-American was put on notice in Case No. 97-034[83] that such costs would not be allowed for ratemaking purposes. The Commission has removed them from forecasted operations.

Our action should not be misconstrued. The Commission commends Kentucky-American on its continued efforts to promote conservation by including a provision for conservation advertising in its annual budget. However, Kentucky-American should evaluate its current conservation education programs with the goal of developing a comprehensive approach to encouraging water conservation. Water is a finite resource and every effort should be made to promote conservation on a consistent, continuing basis.

Based on the aforementioned adjustments, the Commission has determined Kentucky-American's net investment rate base to be as follows:

[83] Case No. 97-034, Order dated September 30,1997 at 17.

	Kentucky-American Proposed 13-month Avg.	Commission Adjustments	Commission Approved
Utility Plant in Service	232,598,563	(1,254,550)	
		(67,945)	231,276,068
Utility Plant Acquisition Adjustments	175,340	(175,340)	-
Accumulated Depreciation	(45,671,737)	35,194	
		35,830	(45,600,713)
Accumulated Amortization	(7,674)		(7,674)
Net Utility Plant in Service	187,094,492	(1,426,811)	185,667,681
Construction Work in Progress	5,454,134	(491,105)	4,963,029
Working Capital Allowance	1,176,000	(90,000)	
		(31,070)	1,054,930
Other Working Capital Allowance	485,820	(24,559)	461,261
Contributions in Aid of Construction	(23,864,445)	13,323	
		193,191	
		377,000	(23,280,931)
Customer Advances	(12,411,002)	569,712	(11,841,290)
Deferred Income Taxes	(23,598,127)	2,268,937	(21,329,190)
Deferred Investment Tax Credits	(152,717)		(152,717)
Deferred Maintenance	3,671,619		3,671,619
Deferred Debits	900,227	(638,399)	261,828
Other Rate Base Elements	(1,157,187)		(1,157,187)
KRS II Costs	456,521	(456,521)	-
KRS Residuals Project Costs	561,834	(561,834)	-
Bluegrass Water Project - Pipeline	3,358,227	(3,358,227)	-
Community Education Costs	452,115	(452,115)	-
Total	142,427,511	(4,108,477)	138,319,034

Utility Operating Income

Kentucky-American reported base period and forecasted period utility operating income of $11,216,691 and $10,661,141, respectively.[84] Kentucky-American's forecast

[84] Overall Financial Summary, Schedule C-2.

is reasonable and has been accepted for rate-making purposes with the following exceptions:

Operating Revenues

Residential Sales. Both Kentucky-American and the AG agreed that 239 monthly residential bills should be added to each month of the forecasted test year. The Commission has increased annual residential bills by 2,868 resulting in an increase in operating revenue from water sales in the amount of $24,325[85] and an increase in net operating revenue of $14,507.

Industrial Sales. Kentucky-American based its forecasted industrial sales of 1,421,899 ccf on actual sales for 1999. Kentucky-American, in its 2000 Business Plan, estimated that it would sell 1,461,315 ccf during the year 2000. The AG argues that Kentucky-American should base its forecasted industrial sales on the usage estimated in its 2000 Business Plan, which would increase Kentucky-American's test year revenue from water sales in the amount of $46,292.[86]

Kentucky-American offered no compelling argument that the forecasted sales used in the 2000 Business Plan should not be used in this case. The Commission has based forecasted industrial sales on usage of 1,461,315, which is the level set out in the 2000 Business Plan and proposed by the AG. This adjustment results in an increase to net operating income of $27,607.

Other Public Authorities. Kentucky-American proposed to use weather normalized projections made by Dr. Edward Spitznagel for all Other Public Authority

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[85] Direct Testimony of Robert J. Henkes, Schedule RJH-11.

[86] Direct Testimony of Robert J. Henkes, Schedule RJH-12.

("OPA") customers with the exception of the Bluegrass Army Station ("BAS"), the University of Kentucky ("UK") and the Federal Medical Center ("FMC"). Kentucky-American used the 1999 sales level for these three customers with a minor adjustment to BAS due to a billing irregularity.

The AG proposes to use a 10-year average for UK and FMC sales and an average of the past 3 year's usage for BAS. The AG contends that it is inappropriate to use a single year in forecasting other public authority sales.

Kentucky-American reported other public authority sales of 1,949,109 ccf in 1998, sales of 1,908,289 ccf in 1999, and 1,855,301 during the base year in this case.[87] Public authority sales have always been difficult to estimate. Based on sales during the past three years it appears that other public authority sales are decreasing. Based on this decline in sales, the Commission accepts Kentucky-American's projected sales of 1,836,074 ccf.

Sales for Resale. Kentucky-American forecasted sales of 567,837 ccf in the sales for resale customer classification. Kentucky-American considered the fact that water usage decreased during 1999 due to warm, dry weather conditions and that almost half the wholesale customers had alternative sources of supply.[88]

The AG contends that sales for resale usage should be based on sales to these customers during the 12 months ending June 30, 2000. This adjustment would result in sales for the sales for resale class of 757,193 ccf.

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[87] Brief of Kentucky American at 28.

[88] Rebuttal Testimony of Jerry L. Ware at 5.

Sales for resale have increased each year since 1995.[89] While it is difficult to forecast sales in this classification, there is no indication that sales will decrease as forecasted by Kentucky-American. The Commission recognizes that weather will play a role in the amount of usage, and therefore bases usage for this classification on the average annual usage for the past 3 calendar years. This results in a forecasted usage of 667,437, a decrease to forecasted revenue from sales of $15,333, and a decrease to net operating income of $9,144.

Boonesboro Sewer Operations. As a result of the Commission's decision to remove all revenues and costs associated with the Boonesboro sewer plant from Kentucky-American's water operations, an adjustment has been included to decrease forecasted operating revenues by $28,376.[90] This results in a decrease to net operating income of $16,923.

Kentucky River Authority Withdrawal Fee. Kentucky-American has requested revisions to its Kentucky River Authority Withdrawal Fee to permit an automatic adjustment of that rate annually without customer notice. This rate recovers, as a separate line item on customer bills, the charges assessed to Kentucky-American by the Kentucky River Authority ("KRA") for withdrawals from the Kentucky River. The proposed revisions would dispense with customer notice of changes in the rate and would require the rate to reflect over and under recovery of the rate billed. Currently customer notice of rate changes is required and the KRA Withdrawal Fee makes no

[89] Kentucky-American's Response to the AG's Data Request No. 2, Item 33.

[90] Testimony of Robert J. Henkes, Schedule RJH-19.

provision for the under or over recovery of charges. No party has objected to the proposed revisions.

The Commission finds that Kentucky-American's proposed revisions should be approved. Previous adjustments to the KRA Withdrawal Fee have not been significant. Moreover, given the small amount of such increases, the expense of publishing notice, the limited response to such notice, and the general nature of the rate in question, the Commission finds that publication of changes in the rate may be safely dispensed. The Commission believes that Kentucky-American should, however, publish the proposed fee and the manner in which it was calculated on its internet web site and should include with any tariff revision filing, a statement showing how the revised fee was calculated.

<u>Allowance for Funds Used During Construction ("AFUDC")</u>. In the forecasted test period Kentucky-American included $2,000,162 in CWIP related to the Bluegrass Water Project – Source of Supply Costs. In previous cases Kentucky-American has presented all costs associated with source of supply and the pipeline project as one total project cost. In this proceeding Kentucky-American classified the Bluegrass Water Project costs into three categories: (1) Pipeline, (2) Source of Supply, and (3) Community Education. The source of supply costs represent those costs which deal with the general source of supply and treatment plant deficit issue and which would have been incurred regardless of the selected alternative to the source of supply problem.[91] It includes such expenses as the Aquatic Study, monitoring of the Kentucky River water

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[91] Direct Testimony of Linda Bridwell at 20.

quality, Kentucky-American's contribution to the HARZA Study, and Kentucky-American's contribution to the current stability analysis of Dam 10.

Kentucky-American has been carrying these costs on its books for 11 years with no recovery through rates. Kentucky-American recommends the Commission discontinue the booking of AFUDC on the project and thereby approve a current return on these costs.[92] Kentucky-American states that it is important that the Company recover not only its capital but also the carrying charges on that capital for four reasons: (1) it represents investor-provided capital that has a return component, i.e., interest on the debt and earnings on the equity; (2) it provides a positive signal of regulatory support for the Company's financial condition; (3) it provides payment for the use of capital that will not diminish the Company's cash flow, which allows Kentucky-American to raise capital for future expansions; and (4) it is necessary to compensate the Company for 100 percent of its prudently incurred costs.[93]

The AG's position is that the accrual of AFUDC should be continued. The Commission has previously ruled that these same expenditures should not receive rate recognition until completion of the related solution to the source of supply deficit.[94]

Kentucky-American asserts that "continuing to accrue AFUDC on the project until completion of the source of supply solution would result in higher costs for the

[92] Rebuttal Testimony of Edward J. Grubb at 10.

[93] Direct Testimony of Coleman Bush at 5.

[94] Testimony of Robert J. Henkes at 19–20.

ratepayers in future periods through increased return components, depreciation and property taxes."[95]

Both parties make reference to prior Commission Orders as a basis for their arguments. Case No. 93-434 was established to investigate the sources of supply and demand projections of Kentucky. The final Order in that proceeding was issued on August 21, 1997, and stated, "It is therefore ordered that Kentucky-American shall take the necessary and appropriate measures to obtain sources of supply so that the quantity and quality of water delivered to its distribution system shall be sufficient to adequately, dependably, and safely supply the total reasonable requirements of its customers under maximum consumption through the year 2020." As a direct result of that Order, Kentucky-American proceeded to implement the design and attendant issues relating to the construction of the Bluegrass Water Project.[96]

In its final Order issued in Case No. 97-034, dated September 30, 1997, the Commission states, "Until a final decision is rendered on the need for the Ohio River pipeline or an alternative project, the Commission finds that all costs associated with the source of supply are preliminary costs of construction." It is Kentucky-American's position that the "need" for a project to solve the source of supply deficit was determined in Case No. 93-434. The AG contends that the solution to Kentucky-American's source of supply deficit must be completed before these costs can receive rate recognition.

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[95] Rebuttal Testimony of Edward J. Grubb at 10.

[96] Direct Testimony of Roy Mundy at 11.

The Commission, in Case No. 97-034,[97] clearly states that a final decision has not yet been rendered on the need for the Ohio River pipeline or an alternative project. This Order was issued after the Order in Case No. 93-434, which established that there was, in fact, a source of supply deficit. To be consistent with its prior ruling, the Commission agrees with the AG that all costs associated with the source of supply are preliminary costs of construction and should accrue AFUDC until a project is undertaken and completed to resolve the source of supply problem.

Based on the Commission's adjustments to Kentucky-American's forecasted test period, the forecasted AFUDC balance should be $516,444. This results in an increase of $178,426 over the forecasted level, or an increase to net operating income of $106,409.

While this Order addresses the ratemaking treatment for issues relating to source of supply, it has not addressed the issue of source of supply, itself, which continues to grow in importance. In our Order of August 21, 1997 in Case No. 93-434, we noted that "additional steps must be taken and financial resources will have to be committed to develop an adequate and reliable source of water supply, not only for the customers of Kentucky-American, but for all the citizens served by the Kentucky River."[98] As of this date no concrete action has been taken to remedy the supply deficit. We remind Kentucky-American that "[t]he responsibility to develop an adequate and reliable source of water supply for Kentucky-American's customers is . . . [its] direct obligation." It should act promptly to develop and implement a viable plan for addressing this problem.

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[97] Case No. 97-034, Order dated September 30, 1997 at 16.

[98] Case No. 93-434, Order of August 21, at 6.

We encourage the other parties to this proceeding to work with Kentucky-American in a cooperative effort to resolve this problem in a manner acceptable to the entire community.

Operation and Maintenance Expenses

Labor Expense. Kentucky-American included labor expense of $6,117,348 in its forecasted operating expenses. The AG proposed an adjustment to this expense to eliminate two full-time equivalent positions that are currently vacant and are not expected to be filled.[99]

Kentucky-American did not agree with the specific adjustment proposed by the AG but it did concede that two vacant associate positions, senior financial analyst and part-time accountant, will not be filled and that, accordingly, expenses should be reduced by $90,069.[100] The AG concurs with that adjustment.

The Commission has included an adjustment to decrease labor expense by $90,069, which results in an increase to net operating income of $53,715.

Incentive Compensation. Kentucky-American proposed to include in the forecasted test year $124,200 of expenses for the annual incentive plan and $32,147 for the long-term incentive plan.[101] Kentucky-American later revised the long-term incentive plan to $9,502.[102] This resulted from a change in the long-term incentive plan

[99] Testimony of Robert J. Henkes at 61.

[100] Pre-hearing Memorandum of Kentucky-American at 7.

[101] W/P 3-1 at 44, Kentucky-American's Response to the AG's Data Request No. 1, Item 205 (Update 2).

[102] Kentucky-American's response to the AG's Data Request No. 1, Item 205 (Update 2).

of adopting the use of stock options as a part of the incentive compensation.[103] The AG and the Commission agree with this adjustment. Accordingly, an adjustment has been included to decrease incentive plan expense by $22,645, resulting in an increase to net operating income of $13,505.

In Case No. 97-034, the costs for these two plans were $14,100 and $1,770, respectively.[104] The increase in annual incentive plan expense of $110,100 was due to the addition of seven directors to the plan as a result of Kentucky-American's reorganization.[105] Kentucky-American also included an allocation of incentive costs in forecasted management fees from the Corporate Office in Voorhees, New Jersey and the Southeast Region in Charleston, West Virginia. These costs were $38,028 and $28,518, respectively. This results in total forecasted incentive plan expense of $200,248.

The AG contends that this expense should be shared equally by the ratepayers and shareholders, a position he also held in Case No. 97-034.[106] He states the following reasons to support his recommendation: (1) the size of the incentive compensation claim in this case, (2) the growth in these expenses from the prior case, (3) the fact that these large incentive compensation awards are being given to Kentucky-American officers who have already averaged annual salary increases of 5

[103] Kentucky-American's Response to the Commission's Order of June 30, 2000, Item 26.

[104] Testimony of Robert J. Henkes, Schedule RJH-16.

[105] T.E., Vol. I at 154.

[106] Brief of the AG at 29.

percent from 1998 through the forecasted period, and (4) 50 percent of the incentive pay is based on meeting financial goals which benefit the shareholders and 50 percent is based on meeting customer service and operational goals that benefit the ratepayers.

Kentucky-American's position is that the Commission approved this expense for ratemaking purposes in prior cases and that there is no difference between this case and prior cases. In Case No. 97-034, the Commission stated that Kentucky-American has shown that it implemented the incentive package in response to a recommendation made in a Commission-mandated management audit. In Case No. 95-554, the Commission found that Kentucky-American had met its burden of proof by showing the cost of its incentive bonus plan as appropriate for ratemaking purposes.

Kentucky-American states that, "The purpose of the Annual Incentive Plan is to ensure Kentucky-American's ability to attract and retain key executive talent capable of successfully managing the operations in a manner that is beneficial to its customers, associates and <u>investors</u> who have provided the capital for Kentucky-American. It has been the trend in the utility industry to provide a portion of the total compensation package for key officers in a performance based, at risk situation. This type of package reinforces AWW's performance-oriented culture and encourages performance at the levels expected by <u>all stakeholders</u>. . . . The goals established under the incentive plan are based on market expectations, industry performance, and reward results that benefit all stakeholders."[107] Kentucky-American testified that "stakeholders" includes both ratepayers and shareholders.[108]

In Case No. 95-554, Kentucky-American demonstrated that it implemented the incentive package in response to a recommendation made in a Commission-mandated audit. In this proceeding Kentucky-American testified that all companies in the American system have identical incentive compensation plans.[109] For this reason, the Commission believes that Kentucky-American would have implemented the compensation plan with or without the management audit recommendation and that recommendation should have no bearing on whether or not the expense should be allowed in rates.

To be consistent with prior Commission Orders, no adjustment has been made to incentive compensation expense. However, based on the evidence of this proceeding, the Commission is reconsidering its position on this issue and is hereby placing Kentucky-American on notice that, in future rate proceedings, it must demonstrate fully why shareholders should not bear a portion of these costs.

Insurance Other Than Group. For the forecasted test period Kentucky-American projected insurance other than group expense of $324,820. For the past eight years Kentucky-American has recorded retroactive adjustments to offset this expense.

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[107] Kentucky-American's Response to the Commission's Order of June 30, 2000, Item 25.

[108] T.E., Vol. I at 65.

[109] Id. at 165.

However, no expense credit has been included in the forecasted test period. The AG proposed to include a retroactive adjustment of $100,000 in forecasted operations.[110]

Insurance other than group is administered on a total American Water System basis, the same as group insurance and pensions. The premiums for this coverage are based on an estimate of losses, the charges of the carrier to administer the program, and the cost to insure against individual and total claims above certain limits. The carrier holds the funds until claims are paid and, in the interim, the companies are credited with interest on that money. As losses develop, claims are paid out of these funds.

Kentucky-American's position is that an increase in losses has recently moved the American system from excess to a deficit funding position. This change has eliminated retro refund adjustments for the foreseeable future.[111]

The Commission finds that Kentucky-American has provided sufficient evidence to support its position. Therefore, no adjustment has been made to insurance other than group expense.

Group Insurance Expense. Kentucky-American included group insurance expense of $1,392,281 in its forecasted operations. In the calculation of the forecasted expense Kentucky-American took into consideration a projected increase in group insurance rates. The anticipated increase was delayed due to an increase in the reserves in the trust fund for Kentucky-American's group insurance plan.[112]

[110] Testimony of Robert J. Henkes at 66-67.

[111] Rebuttal Testimony of Michael Miller at 27.

[112] Kentucky-American's Response AG Data Request No. 1, Item 194.

Accordingly, Kentucky-American has adjusted group insurance by a decrease of $91,103.[113] Both the AG and the Commission are in agreement with this adjustment. This results in an increase to net operating income of $54,332.

Regulatory Expense Adjustment. Kentucky-American projected regulatory expense of $180,705 for the forecasted test period. This represents the amortization of the following expenses:[114]

Rate Case Expense – Case No. 2000-120 ($310,420 amortized over 2 years)	$ 155,210
Cost-of-service Study ($39,000 amortized over 5 years)	7,800
Demand Study ($60,000 amortized over 5 years)	12,000
Depreciation Study (Remaining balance of $5,695 amortized for 9 months – until 8/2001.)	5,695
Total Regulatory Expense	$ 180,705

The AG's position is that Kentucky-American has over-collected prior rate case expenses in instances "where the amounts have been fully amortized yet the collection for the expenses continued."[115] This theoretically occurs when a utility is authorized to amortize an expense over a certain time period and then does not file for another rate adjustment until after that time has expired. The AG proposes to offset forecasted rate

[113] Kentucky-American's Response to the AG's Data Request No. 1, Item 205 (Update 3).

[114] Kentucky-American's Response AG Data Request No. 1, Item 155.

[115] Brief of the AG at 30 – 31.

case expense in this case with over-collections that occurred since Kentucky-American's last rate filing.[116]

Kentucky-American's position is that "The over or under collection of any specific item awarded or not awarded by this Commission historically should have no bearing on the setting of rates for a forecasted test year."[117] This would constitute single-item or retroactive ratemaking and is neither fair, just, reasonable, nor constitutional.[118]

The Commission agrees with Kentucky-American's position and has made no adjustment to forecasted regulatory expense.

Boonesboro Sewer Operations Adjustment. As a result of the Commission's decision to remove all revenues and costs associated with the Boonesboro Sewer from Kentucky-American's water operations, adjustments have been included to decrease forecasted operating expenses by a total of $79,380 to eliminate operation and maintenance expenses and property taxes associated with the sewer operations.[119] This equates to an increase in net operating income of $47,340.

Programmed and Non-Programmed Maintenance. In the past, Kentucky-American has classified routine maintenance expenses as programmed and non-programmed. The Commission, in prior future test period cases, has made adjustments to reduce programmed maintenance expense based on a 10-year average of the actual programmed maintenance to its budgeted level. The assumption was made that

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[116] Id. at 31.

[117] Brief of Kentucky-American at 32.

[118] Id.

[119] Testimony of Robert J. Henkes, Schedule RJH-19.

Kentucky-American's budgeted forecast would be as reliable as the historical 10-year average. In Case No. 95-554 the percentage decrease applied was 82.74 percent, and in Case No. 97-034 it was 80 percent. The non-programmed maintenance was never adjusted as the budget variances were never material.

During discovery Kentucky-American was asked to provide the required information to update the historical 10-year average. In response Kentucky-American explained that, as of the end of 1998, with the implementation of the JD Edwards accounting system, the company no longer differentiates between programmed and non-programmed maintenance.[120] All maintenance is grouped together in various accounts. As a result, the costs of actual and budgeted programmed maintenance are no longer available in a format comparable to that of prior years or conducive to the calculation of a variance between budgeted and actual.

In light of this change in Kentucky-American's accounting system, the Commission's ability to review this expense has been severely restricted to the extent that no adjustment has been made. The Commission finds that Kentucky-American should develop and implement a methodology for tracking the costs of actual and budgeted programmed maintenance. The Commission places Kentucky-American on notice that its failure to develop and implement such methodology will be considered at any future rate proceeding when determining whether the Company has adequately demonstrated the reasonableness of its maintenance expense.

[120] Kentucky-American's Response to the Commision's Order of June 2, 2000, Item 74 and Kentucky-American's Response to the AG's Data Request No. 1, Item 102.

Service Company Fees. Kentucky-American included in its forecasted operations, service company fee expense of $1,021,021. These fees are currently allocated to Kentucky-American based upon an agreement entered with American Water Works Service Company in 1989 ("1989 Agreement"). In previous proceedings, the Commission found that Kentucky-American has failed to demonstrate the reasonableness of this Agreement and therefore, the Commission relied upon the provisions of an earlier contract executed between the companies in 1971 ("1971 Agreement"). Kentucky-American now urges the Commission to recognize for ratemaking purposes the 1989 Agreement. As a result of acquisitions and reorganizations by AWW subsidiaries, Kentucky-American asserts the differences between the 1989 Agreement and the 1971 Agreement's allocations have been significantly reduced. In future years the 1971 Agreement will likely produce higher allocations to Kentucky-American than the 1989 Agreement on a consistent basis.[121]

The Commission finds that Kentucky-American has not presented any significant evidence to disturb its earlier decisions or to warrant the use of the 1989 Agreement. Using the 1971 Agreement, the Commission has reduced operating expenses by $32,499, resulting in an increase to net operating income of $19,382.

Depreciation Expense. Kentucky-American included depreciation expense of $5,409,393 in its forecasted operations. Based on the Commission's treatment of forecasted rate base with regard to slippage and the Boonesboro Sewer Operations, adjustments have been made to decrease forecasted depreciation expense by $35,578

[121] Kentucky-American's Response to the Commission's Order of June 2, 2000, Item 64.

and $2,544, respectively. These adjustments result in a net increase in net operating revenue of $22,735.

Amortization Expense. Kentucky-American included amortization expense of $661,956 in its forecasted operations. Based on the elimination from rate base of the Boonesboro acquisition adjustment, an adjustment has been included to reduce amortization expense by $18,456 for the Boonesboro Acquisition Adjustment. This results in an increase in net operating income of $11,007.

Amortization of Deferred Debits. Kentucky-American included amortization expense for deferred debits in its forecasted operating expenses. Based on the elimination from rate base of certain deferred debits an adjustment has been included to reduce forecasted expenses by $205,484.

Deferred Acquisition Costs	$ 12,835
Rockwell WWTP Improvement Study	1,396
Cost Containment Program	8,037
Y2K Compliance	23,734
Graphical Interface Study	21,157
Reorganization Costs	65,787
Automation of KRS	10,177
Deferred Legal/Settlement Costs	38,611
Deferred Relocation Expenses	17,358
Easement Encroachment	6,392
Total Forecasted Deferred Debits	$205,484

This results in an increase to net operating income of $122,546.

Deferred Tax Expense. Kentucky-American included deferred tax expense associated with community education costs of $8,292 in its forecasted operations. In its pre-hearing memorandum, the Company corrected that amount to be $32,268, an increase of $23,976. The correction of this error increases net operating income by $14,299.

Interest Synchronization. Kentucky-American proposed a forecasted interest expense of $5,739,829 based on forecasted rate base and weighted cost of debt. The Commission has recalculated this expense to be $5,588,089[122] based on the rate base and weighted cost of debt found reasonable herein. This results in a decrease to net operating income of $61,246.

The Commission, after consideration of the forecasted revenues and expenses and applicable tax effects, has determined Kentucky-American's adjusted operating income to be as follows:

	Ky-American Proposed	Commission Adjustments	Commission Approved
Operating Revenues	$ 40,087,019	$ 122,456	$ 40,209,475
Operating Expenses	29,425,878	(297,615)	29,128,263
Net Operating Income	$ 10,661,141	$ 420,071	$ 11,081,212

Rate of Return

Capital Structure. Kentucky-American proposed a capital structure based on the projected 13-month average balances for the forecasted test period. The capital structure consisted of short-term debt of $1,113,427 or .788 percent, long-term debt of $72,418,300 or 51.244 percent, preferred stock of $6,930,821 or 4.904 percent, and common equity of $60,856,850 or 43.063 percent. The costs assigned to these capital components was 6.525, 7.77, 7.77, and 12 percent, respectively.

[122]

Commission Approved Rate Base	$138,319,034
Commission Approved Weighted Cost of Debt	4.04%
Interest	$ 5,588,089

Short-Term and Long-Term Debt. The AG disputed Kentucky-American's forecasted short-term debt balance but accepted the cost rate. The AG's position is that Kentucky-American should maintain a higher level of short-term debt than proposed in the forecasted test year because short-term debt costs are traditionally lower than other forms of external capital. The AG proposed that the short-term debt balance approved in this case be equal to the average outstanding balance for the year 2000, $6,450,000. Kentucky-American's forecasted short-term debt balance is significantly lower than the proposed average due to a planned conversion to long-term debt in December 2000 and January 2001.

The AG proposed a decrease in the forecasted long-term debt balance to correspond with the short-term debt adjustment. The AG also adjusted the long-term debt cost rate. It argues that Kentucky-American should refinance the 9.37 percent series bonds and utilize the yield to maturity method to determine the cost of long-term debt.

The AG states that refinancing the 9.37 bonds would result in savings of $23,882 if refinanced at 8.4 percent. The AG selected 8.4 percent as the refinanced cost rate because it was the rate on Baa bonds at the end of April 2000.

The AG argues that the yield to maturity method should be used in determining the cost of long-term debt because it considers the present value of issuance cost amortization and it uses the principal amount outstanding as the base.

On rebuttal, Kentucky-American states that it accrues short-term debt to finance construction and other working capital needs until levels have been reached to make it economical and feasible to issue long-term debt. Such a refinancing is scheduled early in the forecasted test year. Kentucky-American argues that the short-term debt balance proposed by the AG ignores this refinancing and is not reflective of the capital that will be deployed during the forecasted test year.

Kentucky-American agreed with the AG that the 9.37 bonds should be refinanced. It further proposed to reflect the refinancing of the 9.83 bonds. Kentucky-American assigned a cost rate of 8.22 percent to these refinancings.[123] Kentucky-American also included an additional long-term debt issue of $4,000,000 to be released on September 15, 2001. A cost rate of 8.22 percent was also assigned to this issue.

Kentucky-American refuted the AG's proposed yield to maturity calculation of debt costs stating that this method does not permit the Company to recoup its true cost-of-service and is contradictory to prior Commission practice. Kentucky-American states that the weighted cost method as used in the application allows for the recovery of debt issuance costs on a dollar-for-dollar basis and has been historically used by this Commission for calculating long-term debt costs.

In conjunction with the amendments to the forecasted long-term debt, Kentucky-American revised the average short-term debt balance for the forecasted test year to be $3,843,000. The cost rate for short-term debt was revised to 6.9 percent to reflect interest rates as of September 1, 2000.

Kentucky-American noted that short-term interest rates fluctuate continually and suggested that the Commission utilize the most current interest rates available when setting rates for the forecasted test period. Kentucky-American states that the current cost of short-term debt is now 6.945 percent (6.62 percent LIBOR + 32.5 basis points),

[123] Brief of Kentucky-American at 38.

which is higher than the short-term debt rate at the time the application was filed. Kentucky-American states that the increase is due to the tightening of credit by the Federal Reserve.

The AG maintains that the short-term interest rates as included in the original application are adequate. The AG states that LIBOR rates do fluctuate but Kentucky-American has never identified the appropriate date for forecasting short-term debt costs. The AG further argues that Kentucky-American has never made an actual adjustment to the rates requested in this case reflecting the 6.9 percent rate and therefore review is not warranted.

In this case Kentucky-American filed a forecasted capital structure that is designed to meet capital requirements for the forecasted test year. The Commission recognizes that Kentucky-American's capital requirements continually change. When setting rates for a forecasted period, the most current information should be utilized to properly match rates with the cost-of-service. Since the application was filed, changes to Kentucky-American's projected capital structure have been noted. These changes should be reflected in the rates approved in this case. Therefore, to determine the weighted cost of capital, the Commission utilized the 13-month average balance of short-term and long-term debt of $3,843,000 and $72,751,207 at cost rates of 6.9 and 7.69 percent, respectively, as determined by Kentucky-American.

The Commission has reduced the short-term and long-term debt amounts by $258,006 and $1,279,786, respectively, to reflect plant slippage factors.

The Commission finds no merit in the use of the Yield To Maturity calculation of debt costs. The weighted cost method allows for a dollar-for-dollar recovery of debt costs and has been used in prior Kentucky-American cases brought before this Commission and has been utilized in this case.

Preferred Stock. In rebuttal, Kentucky-American adjusted the 13-month average balance of preferred stock included in capital to $6,042,630 as a result of the financing changes referred to previously. The cost rate changed to 7.72 percent.

The AG accepted the amounts related to Preferred Stock as included in the original application and filed no comment to the subsequent adjustments made by Kentucky-American.

The Commission finds that the adjustments included in Kentucky-American's rebuttal are reasonable and are reflected in the rates approved herein.

Return on Common Equity. In its application, Kentucky-American estimated its required return on equity ("ROE") using four methods: the discounted cash flow ("DCF") method, the capital asset pricing model ("CAPM"), a risk premium analysis, and a comparable earning analysis. Taking the results of these methods, Kentucky-American determined its return on equity as 12.0 percent.[124]

Since Kentucky-American issues no publicly traded stock, the company used seven water companies covered by The Value Line Investment Survey as proxies in its DCF and CAPM analyses. The company included its parent, American Water Works ("AWW"), as one of the seven proxy companies. Kentucky-American proposed the use of proxy companies for the analysis, rather than relying solely on AWW's stock,

[124] Direct Testimony of Paul R. Moul at 2.

because it believed that use of group average data minimized the effect of any background noise in the market data for an individual company.[125]

Kentucky-American proposed that the Commission allow the Company an opportunity to earn a rate of return that would support an A bond credit rating. The Company argued that the ROE is a critical component considered by bond rating agencies that examine items such as debt leverage and pre-tax interest coverage. The Company further argued that it is the equity return that provides the margin whereby an interest coverage multiple greater than one is realized.[126]

Kentucky-American also discussed the business risks it faces that it believed increased the Company's risk in the eyes of an investor. The main risk centered around the source of supply issue and the recovery of the costs of the now abandoned plan to construct a pipeline to the Louisville Water Company. The Company advocated allowing it to recover the pipeline cost plus its carrying charges because investors expect prudently incurred costs to be included in customer charges. [127]

The Company proposed adding a leverage adjustment of .45 percent to its DCF results in order to compensate the Company for the difference in risk attributable to the Commission's use of the book value of equity when calculating the rate of return. The Company argued that the market price of its stock exceeded the book value, creating a situation where the debt was priced by the market as a much smaller portion of the capitalization. Because of this, market models, such as the DCF, reflect a lower level of

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[125] Id. at 5.

[126] Id. at 7.

[127] Id. at 15-6.

risk compared to that shown by book capitalization. The Company contended that failure to adjust for this difference would result in a mismatch of the lower financial risk related to market value used to measure the ROE and the higher financial risk of the book value capital structure used in the rate setting process.[128]

The Company also proposed a flotation adjustment of 20 basis points to its risk premium analysis and CAPM analyses. The Company argued that although it did not incur flotation costs itself, its parent, AWW, did incur flotation costs when it issued equity.[129] The Company also advocated adding an additional size premium of 84 basis points to the CAPM return in addition to the flotation cost adjustment.[130]

The AG criticized Kentucky-American's use of AWW in the proxy group of water companies. The AG argued that Kentucky-American's use of the parent Company was inappropriate because AWW is more than 29 times larger than Kentucky-American. In addition, AWW operates over multiple states thereby reducing its water supply risk through geographic diversification. The AG advocated the use of companies more similar to Kentucky-American.[131] The AG also disagreed with the companies used in the comparable earnings approach. The AG argued that the approach should have used companies with similar P/E ratios.[132]

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[128] Id. at 40-44.

[129] Id. at 45.

[130] Id. at 53-57.

[131] Direct Testimony of Carl G. K. Weaver at 46.

[132] Id.

The AG also contested the financial leverage adjustment that the Company proposed. The AG pointed out that making an adjustment for the difference between book and market value of the equity creates a problem because every time the stock price changed or an interest rate changed, the capital structure changed. Therefore, market value capital structures are unstable. In addition, if the capital structure is based on market value of debt, windfall gains would occur to the equity investors because utilities pay interest based on the book value of the debt, not on its market value. The AG stated that if the cost of capital associated with new investment projects are allowed and if regulatory lag is minimal, the utility will realize an appropriate compensatory return on incremental investment. The AG felt that this eliminated the argument in favor of market value weights discussed by the Company.[133]

Finally, the AG concluded that Kentucky-American should not include flotation costs in its cost of capital because it does not issue its own debt and therefore does not incur any flotation costs.[134]

Responding to the AG's criticisms, Kentucky-American felt that the AG erred when it did not include AWW, Philadelphia Suburban and Southwest Water in its comparison group. The Company referred to a prior Kentucky-American case in 1995 where the AG had included AWW and Suburban in its proxy companies.[135]

The Company reiterated its position that a flotation cost adjustment is always required to compensate a utility for the cost of raising equity. Kentucky-American

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[133] Id. at 44-45.

[134] Id. at 33-34.

[135] Rebuttal Testimony of Paul K. Moul at 6.

argued that flotation costs were present in the proxy group and therefore should have been included in this case. The Company further contended that AWW experiences flotation costs when it issues its stock and will incur them in the future when it will have to issue substantial amounts of capital to expand Kentucky-American's water treatment facilities.[136]

Kentucky-American also addressed the AG's criticism of the Comparable Earnings approach. The Company stated that the approach was established in the *Bluefield* & *Hope* decisions, which set forth comparability as one of the requirements for a fair return. The Company argued that the actual returns earned by non-regulated companies must be considered by the regulators to ensure that regulated companies can compete effectively in the capital markets.[137]

The AG recommended an ROE range of 9.75 percent to 10.75 percent. The AG relied upon several different methods to estimate Kentucky-American's ROE: two versions of the DCF model, the CAPM, and the bond-yield-plus-risk premium ("bond-risk premium") approach.

Since Kentucky-American does not have publicly traded stock, the AG utilized a sample of other water companies as proxies to represent Kentucky-American in the DCF and CAPM calculations. The proxy companies were judged to possess characteristics similar to Kentucky-American. Unlike the Company, the AG did not include Kentucky-American's parent, AWW, in the sample.

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[136] Id. at 13-14.

[137] Id. at 20-22.

The AG used a constant growth and a two stage DCF analysis. A range of constant growth DCF calculations was calculated based upon historical and forecasts for earnings per share, dividends per share, and book values per share. The results ranged from 6.26 percent–11.69 percent. High and low estimation results were eliminated as being unreasonable.[138] The final range was from 8 percent to 9 percent and resulted in an average of 8.43 percent for the four sample companies. The two stage DCF yielded an ROE range for the proxy companies of 10.8 percent to 11.2 percent, with an average ROE of 11.0 percent. [139]

The AG ran 36 CAPM calculations in an attempt to capture the various assumptions that investors might use in estimating ROE. The estimates ranged from 7.38 percent to 13.32 percent, with an average of 10.31 percent. The AG concluded that, after eliminating the unreasonably high and low results, the proper ROE range should be from 9.5 percent to 10.5 percent.[140]

For the bond-risk-premium method, the AG calculated combinations of one year through 9 year holding periods using a composite of long-term interest rates on government securities. The average risk premium for the proxy companies was 5.9 percent. The AG then added this premium to a current 10-year constant maturity government bond rate, a Congressional Budget Office 10-year projected rate and a

[138] Direct Testimony of Carl G.K. Weaver at 33.

[139] Id. at Schedule 23.

[140] Id. at Schedule 24 and 37.

Congressional Budget Office 2-year projected rate. The results were 12.02 percent, 11.81 percent, and 12.34 percent, respectively.[141]

In recommending an ROE in the range of 9.75 percent to 10.75 percent, the AG placed greater emphasis on the constant growth DCF results and the CAPM results. He argued that the two-stage DCF and the bond-risk-premium methods are more difficult for an investor to use and the required data is not as readily available. The AG also made some allowance for the fact he determined that Kentucky-American was slightly less risky than the four proxy companies.[142]

Kentucky-American criticized the AG's ROE estimations on several grounds. First, it argued that the AG mischaracterized its true risk relative and that it was actually a little more risky than the proxy companies. This, in and of itself, justified finding the ROE in the upper portion of the AG's range of ROE estimates.[143] After making what it believes to be justifiable corrections and alterations to the AG's DCF calculations, Kentucky-American obtained an ROE range of 9.59 percent to 11.88 percent, with an average of 10.18 percent.[144] For the two-stage DCF calculation, Kentucky-American argued that the AG failed to use the growth rate appropriate to the size of the proxy companies and that the two additional companies should be added to the proxy group.

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[141] Id. at 37-38.

[142] Id. at 38-39.

[143] Rebuttal Testimony of Paul R. Moul at 5-9.

[144] Id. at 12.

Making these adjustments, Kentucky-American obtains an average ROE for the proxy group of 12.2 percent.[145]

Kentucky-American also found several problems with the AG's CAPM and Risk Premium methods of ROE analysis. It argued that the AG inappropriately included short-term yields on government securities as the risk free rate and used unadjusted betas along with adjusted betas in his CAPM calculations. After making adjustments to the AG's calculations of total market returns and correcting for the other perceived shortcomings, Kentucky-American obtains an average return of 11.84 percent for its six proxy companies.[146] Kentucky-American argued that the AG improperly applied the yield on 10-year government bonds as the benchmark and the selected time period was arbitrarily selected. After making adjustments to the AG's calculations, Kentucky-American obtains an average ROE of 13.61 percent for the proxy companies using the risk premium method.[147]

The Commission agrees with the AG's arguments against adjusting the ROE for flotation costs and for a leverage adjustment. The Commission does not ordinarily require customers to pay for flotation costs when the Company does not actually incur them. The instability of the market value of equity creates problems in calculating an adjustment. In addition, investors familiar with the utility industry are also familiar with the Commission's ratemaking policies and practice and therefore should have already incorporated the difference between book and market valuation in its price.

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[145] Id. at 14.

[146] Id. at 14-16.

[147] Id. at 17-19.

The Commission agrees with the Company's arguments regarding awarding an ROE at the bottom of the AG's range. The low end of the range is below bond returns and would not be appropriate for determining the cost of equity. However, taken as a whole, the Commission finds that the upper end of the range produced by the AG's analysis is more reasonable for setting the cost of common equity for Kentucky-American. The Commission finds the Company's recommended ROE is in excess of the return needed to sufficiently allow Kentucky-American to adequately compete for investment capital. Therefore, the Commission finds a range of 10.5 percent to 11.5 percent, with a midpoint of 11 percent to be reasonable.

Weighted Cost of Capital. Applying the rates of 7.69 percent for long-term, 7.72 percent for preferred stock, .069 percent for short-term debt, and 11 percent for common equity to the adjusted capital structure produces an overall cost of capital of 9.09 percent, which the Commission finds to be fair, just, and reasonable.

Authorized Increase

The net operating income found fair, just, and reasonable is $12,573,200.[148] To achieve this level of income Kentucky-American would be entitled to increase its rates and charges to produce additional annual operating revenues of $2,517,651 determined as follows:

Net Operating Income Found Reasonable	$ 12,573,200
Less: Adjusted Net Operating Income	(11,081,210)
Operating Income Deficiency	$ 1,491,990
Multiplied by: Gross-up Factor	1.687445
Required Revenue Increase	$ 2,517,651

[148] $138,319,034 x 9.09 % = $12,573,200.

COST-OF-SERVICE STUDY

Boonesboro Sewer

Both Kentucky-American and the AG agreed that wastewater costs should be excluded from the cost-of-service study. In accordance with the Commission's disallowance of expenses associated with providing service to Boonesboro Sewer, those expenses have been removed from the cost-of-service study.

Community Education Costs

Kentucky-American maintains that community education costs should be allocated based on the number of customers served and their meter size. Kentucky-American's witness stated that the community education costs were related to the Bluegrass Water Project and should be allocated based on the number of customers.[149]

The AG argued that community education costs were associated with the Bluegrass Water Project and that if these costs are allowed to be recovered, they should be allocated based on the consumption of water in the same manner as other costs associated with the project.[150]

The Commission agrees with Kentucky-American that all customers need to be educated on water conservation regardless of the amount of water used. It would be unfair for customers who use a large amount of water but are trying to conserve to pay more for community education costs than the customers who may use less water but do not attempt to conserve. To the extent that community education costs have been

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[149] Kentucky-American's Response to the AG's Data Request No. 1, Item 28(L).

[150] Direct Testimony of Scott J. Rubin at 5.

allowed in this case they have been allocated based on the number of customers served by meter size.

Maximum Day and Maximum Hour Ratios

Kentucky-American contracted with the engineering firm of Burgess and Niple to prepare a customer class water demand study for the year 1999. The study was completed in April 2000 at an approximate cost of $60,000.

Kentucky-American also contracted with Gannett Fleming Valuation and Rate Consultants, Inc. to prepare a cost-of-service study. In preparing the cost-of-service study Kentucky-American's witness chose to not use the factors shown in the demand study. He implied that the study was flawed due to an estimated 10 percent failure of recording devices used in the study and because the study made no mention of how the sample sizes were selected or if the study was statistically valid. Mr. Herbert also questioned whether a one year study is representative of the demands placed on a system.[151]

Kentucky-American's witness stated that he used information from studies completed in Pennsylvania and demand factors found in the AWWA Manual M1, as well as the 1999 demand study, to determine his proposed factors.[152]

The AG's witness maintains that the 1999 demand study is valid and that the authors of the study made adjustments for water use restrictions in place when the study was being conducted. The AG further contends that demand studies prepared in Pennsylvania are not necessarily relevant to Kentucky-American. For example,

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[151] Rebuttal Testimony of Paul J. Herbert at 4.

[152] Id. at 6.

average monthly consumption is different, and percentages of multi family dwellings can affect average water usage.[153] The AG also notes that the factors used in the AWWA Manual M1 are not intended for a specific water utility but are shown as an example.

The Commission has reviewed the demand study and finds that most areas of concern raised by the AG have been addressed in the study. For residential customers the average maximum day demand was shown to be 165 percent; however, the study noted that normally residential maximum day demand is around 200 percent. The authors contributed this low demand factor to the water use restrictions in place during 1999 and recommended a demand factor of 190 percent.

The authors of the study noted that both maximum day and maximum hour factors will vary from year to year. Because of this variance and the drought of 1999, demand factors were based on the average of the five highest demand factors calculated.[154]

The Commission agrees with the AG that the AWWA Manual M1 is to be used as a guideline when preparing revenue requirements and a cost-of-service study. The Manual M1 states: "For purposes of illustrating the various principles and techniques of ratemaking discussed in this and the following chapters, an elementary example for a hypothetical utility has been developed."[155]

The Commission finds that the AG did not make a compelling argument to deviate from the recommendations set out in the 1999 demand study. While total

[153] Brief of the AG at 47.

[154] 1999 Customer Class Water Demand Study at 4.

[155] AWWA Manual M1, Chapter 1 at 4 and 5.

average monthly usage may be similar for residential customers in Pennsylvania and Kentucky, the Commission is not convinced that those customers place the same demands on a system. Nor is the Commission convinced that weather patterns, income levels and growth are the same in Lexington, Kentucky as in Pittsburgh, Pennsylvania or in Fayette County, Kentucky as in Montgomery County, Pennsylvania.

The factors used by Kentucky-American in its last rate case, and based on its prior demand study, are not significantly different. Based on the closeness of these factors and the lack of a compelling argument by Kentucky-American, the Commission has used the adjusted factors produced by the demand study and recommended by the AG.

Service Line Installations

Kentucky-American's witness used standard cost data for installing service lines as the basis to allocate service line costs.[156] The Company stated that this eliminates any distortion in costs due to line size, terrain or other factors. The AG's witness used actual costs to allocate the cost of installing meters and services.[157] The AG argues that the data shows that it costs 7 times as much to install a 2-inch service line as it does to install a 3-inch service line. However, Kentucky-American's use of generic pipe ratios assumes that it costs only 2 times as much to install the service.[158]

Kentucky-American agreed with using actual costs for the basis of service line installation as long as logical results are produced. The Commission has historically

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[156] Rebuttal Testimony of Paul R. Herbert at 7.

[157] Direct Testimony of Scott J. Rubin at 15.

[158] Id. at 15.

used actual costs to allocate service and finds that this method should be used in this case.

RATE DESIGN

Both Kentucky-American and the AG agreed that public and private fire protection rates should not be increased at this time. The Commission agrees and no increase to these rates has been made in this case.

Kentucky-American's current customer charge for a 5/8 inch connection is $6.83 per month and its proposed customer charge for a 5/8-inch connection is $7.50. Kentucky-American acknowledges that this rate recovers excessive revenue from customer charges because the rates for meter sizes larger than 5/8 inch were based on meter capacity ratios applied to the 5/8 inch charge.[159]

TAPPING FEES

Kentucky-American proposed to establish a tapping fee in the amount of $500 for residential service, $900 for one-inch service, and $3,300 for two inch-services. Connections larger than two-inch would be made at the actual cost of installation.

Kentucky-American proposed to base its connection fees on a 3-year average, due to an increase in the number of installations in 1999. Kentucky-American maintained that as the number of installations increase the cost of installing the meters decreases. Kentucky-American also included the purchase cost of an AMR meter in its calculations.

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[159] Rebuttal Testimony of Paul R. Herbert at 9.

The AG argued that the tapping fee should be based on the average cost for 1999 instead of a 3-year average.[160] Kentucky-American proposed using a 3-year average to balance the increase in the cost of meter installation with a decrease in overhead costs per installation.[161]

Kentucky-American installed 174 3/4-inch meters in 1997 at an average cost of $381. In 1998, 132 meters were installed at an average cost of $459, and 199 meters were installed in 1999 at an average cost of $331. Based on these average annual costs, the cost per installation decreases as the number of installations increases. The Commission is of the opinion that using a 3-year average of installation costs to determine tapping fees is reasonable and should be approved.

Kentucky-American proposed to include the cost of AMR meters in its connection fee. While all customers will not receive an AMR meter, Kentucky-American contends that all customers will benefit from the AMR meters since meter reading costs will be decreased.

The AG contends that under Kentucky-American's proposal customers who receive AMR meters will have lower meter reading costs yet continue to pay the same customer charge as those without AMR meters. Therefore, the AG argues that AMR costs should not be included in the tapping fee.[162]

The Commission agrees that all customers should receive some benefit from the installation of AMR meters. However, it is unfair to include the cost of these more expensive meters in the connection fee and not make a corresponding adjustment to

[160] Direct Testimony of Scott J. Rubin, p. 30.

[161] Brief of Kentucky-American at 33 - 34.

the customer charge of those customers who pay for an AMR meter. Since having different customer charges for customers with AMR meters is impractical, the Commission finds that the cost of AMR meters should be included in the customer charge for all customers. All customers will contribute equally in the transition to AMR meters and will receive an equal benefit when meter reading costs decrease.

The Commission finds that Kentucky-American's tapping fees should be as follows:

Connection Size	3-Year Average Cost	Less AMR cost	Add Traditional Meter Cost	Tapping Fee*
5/8	500	103	40	440
1	900	197	58	765
2	3,300	412	284	3,175

*Tapping Fees have been rounded

The Commission finds that in order for Kentucky-American to recover the costs of installing AMR meters $193,191 should be added to the customer charge. This will allow all customers to contribute to the cost of installing AMR meters and to receive any benefits derived from the installations. The recovery of $193,191 was determined as follows:

Connection Size	3-Year Average Number of Connections	AMR Cost Less - Traditional Cost	Under Recovery
5/8	2,611	103-40=63	$ 164,493
1	142	197-58=139	19,738
2	70	412-284=128	8,960
Total			$ 193,191

[162] Direct Testimony of Scott J. Rubin at 32.

OTHER ISSUES

Performance Based Regulation

During this proceeding, Kentucky-American officials stated that the Company had not explored the use of performance based regulation as an alternative to traditional ratemaking approaches. The Commission believes that, at minimum, Kentucky-American should consider whether such regulatory approaches may be beneficial to the Company and other stakeholders. We place Kentucky-American on notice that, in its next general rate case proceeding, it will be questioned on its efforts in this area and it will be required to explain why performance based rate-making is not appropriate in its case.

IT IS HEREBY ORDERED that:

1. Except as noted in Ordering Paragraph 2, the rates proposed by Kentucky-American, are denied.

2. Kentucky-American's proposed revisions to its Kentucky River Authority Withdrawal Fee are approved as of the date of this Order.

3. The rates set forth in Appendix A, which is attached hereto and incorporated herein, are approved for service rendered on and after the date of this Order.

4. When making annual revisions to its Kentucky River Withdrawal Fee, Kentucky-American shall include with its revised tariff sheets a detailed statement showing how revisions to the fee were calculated.

5. At the time of filing revisions to its Kentucky River Withdrawal Fee, Kentucky-American shall post upon its Internet Website notice of the proposed revisions and an explanation of how these revisions were calculated.

6. Prior to accruing an expense as a regulatory asset, Kentucky-American shall formally apply to the Commission for approval of such accrual.

7. Within 180 days of the date of this Order, Kentucky-American shall develop and implement a methodology that permits the tracking of its actual and budgeted programmed - maintenance costs.

8. Within 20 days of the date of this Order, Kentucky-American shall file its revised tariff sheets setting forth the rates approved herein.

Done at Frankfort, Kentucky, this 27th day of November, 2000.

By the Commission

ATTEST:

Thomas M Dorman

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2000-120 DATED NOVEMBER 27th, 2000

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

SERVICE CLASSIFICATION NO. 1

Meter Rates

The following shall be the rates for consumption, in addition to the service charges provided herein.

Customer Category	Rate Per 1,000 Gallons All Consumption	Rate Per 100 Cubic Feet All Consumption
Residential	$2.25394	$1.69046
Commercial	2.06730	1.55048
Industrial	1.71666	1.28750
Municipal and Other Public Authority	1.97144	1.47858
Sales for Resale	1.93105	1.44829

Service Charges

All metered general water service customers shall pay a service charge based on the size of meter installed. The service charge will not entitle the customer to any water.

Size of Meter	Monthly Service Charge
5/8 Inch	$ 7.26
¾ Inch	10.88
1 Inch	18.14
1-1/2 Inch	36.28
2 Inch	58.05
3 Inch	108.85
4 Inch	181.42
6 Inch	362.83
8 Inch	580.53

SERVICE CLASSIFICATION NO. 3

AVAILABILITY OF SERVICE

Available for municipal or private fire connections used exclusively for fire protection purposes.

Fire Service Rates

Size of Service	Rate Per Month	Rate Per Annum
2 Inch Diameter	$ 4.00	$ 48.00
4 Inch Diameter	16.00	192.00
6 Inch Diameter	35.96	431.52
8 Inch Diameter	63.92	767.04
10 Inch Diameter	99.88	1198.56
12 Inch Diameter	143.85	1726.20
14 Inch Diameter	195.82	2349.84
16 Inch Diameter	255.70	3068.40

Rates for Public Fire Service

	Rate Per Month	Rate Per Annum
For each public fire hydrant Contracted for or ordered by Urban county, county, state, Or federal government Agencies or institutions	$24.00	$288.00

Rates for Private Fire Service

	Rate Per Month	Rate Per Annum
For each private fire hydrant Contracted for by industries Or private institutions	$35.96	$431.52

HIDDEN LEAK ADJUSTMENT: A charge of twenty-five percent (25%) of the applicable tariffed rate will be applied to all water usage determined to be the result of a hidden underground leak.