

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF NORTHERN KENTUCKY	)	
WATER DISTRICT FOR (A) AN ADJUSTMENT OF	)	
RATES; (B) A CERTIFICATE OF PUBLIC	)	CASE NO.
CONVENIENCE AND NECESSITY FOR	)	2002-00105
IMPROVEMENTS TO WATER FACILITIES IF	)	
NECESSARY; AND (C) ISSUANCE OF BONDS	)	

ORDER

Northern Kentucky Water District ( Northern District ) has applied for a Certificate of Public Convenience and Necessity ( Certificate ) to construct improvements to its water facilities, for authority to issue \$30,000,000 in revenue bonds, and for authority to adjust its rates to increase its normalized revenues from water sales by \$5,758,204 to \$26,322,904.<sup>1</sup> By this Order, we grant the requested financing and requested rate relief, but establish rates that reflect a different allocation of costs than those that Northern District proposes.<sup>2</sup>

BACKGROUND

Northern District, a water district organized pursuant to KRS Chapter 74, is a utility subject to Commission jurisdiction. KRS 278.010(3)(d); KRS 278.015; KRS 278.040. It provides retail water service to 63,286 customers in Kenton and Campbell

---

<sup>1</sup> Application, Exhibit N, Cost-of-Service Study at 3.

<sup>2</sup> Northern District identified in its application several construction projects that it planned for 2002. Northern District had already received a Certificate for many of the projects and requested a declaration that the remaining projects were ordinary extensions in the usual course of business. On October 21, 2002, the Commission entered an Order stating that the remaining projects identified for construction in 2002 did not require a Certificate.

counties, Kentucky and wholesale water service to Bullock Pen Water District ( Bullock District ), Pendleton County Water District ( Pendleton District ), the city of Taylor Mill, Kentucky ( Taylor Mill ), and the city of Walton, Kentucky ( Walton ).<sup>3</sup>

Northern District was formed on January 1, 1997 from the merger of Kenton County Water District No. 1 and Campbell County Kentucky Water District.<sup>4</sup> This is the first application for a rate adjustment that has been submitted by Northern District since the 1997 merger. The most recent application for an adjustment in rates submitted prior to the merger was by Kenton County Water District No. 1 in 1994.<sup>5</sup>

#### PROCEDURE

Northern District filed written notice of its intent to file an application for an adjustment of rates on March 28, 2002. It subsequently tendered its application on April 30, 2002. Because this application failed to comply with Administrative Regulation 807 KAR 5:001, Section 10, in several respects, the Commission rejected it. On June 3, 2002 and June 11, 2002, Northern District submitted additional information, requesting a blanket deviation from the filing requirements of 807 KAR 5:001 if the Commission

---

<sup>3</sup> Northern District s Application, Exhibit C, Annual Report of Northern District to the Public Service Commission of the Commonwealth of Kentucky for the Calendar Year Ended: December 31, 2001 ( 2001 Annual Report ) at 29 and 31.

<sup>4</sup> See Case No. 1996-00234, The Joint Application of Kenton County Water District No. 1 and Campbell County Kentucky Water District for Authority to Merge into Northern Kentucky Water Service District, and for Authority for the Combined District to Operate (August 22, 1996).

<sup>5</sup> See Case No. 1994-00056, Application of Kenton County Water District No. 1 (A) for Authority to Issue Parity Revenue Bonds in the Approximate Principal Amount of \$7,315,000 for the Purpose of Refunding Bond Anticipation Notes and for Other Needs; and (B) Notice of an Adjustment in Water Rates: An Increase of Approximately \$1,834,000 Effective May 1, 1994 (January 27, 1995).

determined that the construction projects require a Certificate and a deviation from 807 KAR 5:001, Section 10(3).

In reviewing the customer notification given by Northern District and considering the cost to republish, the Commission found that good cause existed to grant the deviation from 807 KAR 5:001, Section 10(3). Finding that all filing deficiencies on the rate portion of the application were cured, the Commission found that the application was filed as of July 1, 2002. Northern District's request for a blanket deviation from all filing requirements of 807 KAR 5:001 regarding the construction of the projects identified in its application was deferred until the Commission could determine whether the projects required a Certificate. As a result, the Certificate portion and financing portion of the application were not considered filed on that date.

Upon review of the 2002 construction projects designated as extensions in the usual course of business on revised Exhibit R and Northern District's responses to the September 16, 2002 Commission Staff's data request, the Commission found, pursuant to KRS 278.020, that the projects identified do not require a Certificate. Northern District's application for approval of financing was considered filed as of October 21, 2002.

On July 1, 2002, the Commission established a procedural schedule to review Northern District's application. To investigate the reasonableness of the proposed rates, the Commission scheduled a hearing for November 25, 2002. On October 22, 2002, Northern District filed a motion to reschedule the hearing. On November 18, 2002 the Commission granted Northern District's motion, suspended the proposed rates

for 5 months from their effective date pursuant to KRS 278.190(2),<sup>6</sup> and continued generally the financing request.

The Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention ( Attorney General ), Taylor Mill, Bullock District, Pendleton District, and Walton intervened. The parties engaged in extensive discovery, and the intervenors filed testimony. A public hearing was held on January 9 and 10, 2003, to receive evidence relating to Northern District's rate and financing application. Northern District and the Attorney General filed briefs on February 14, 2003. Taylor Mill, Walton, and Bullock District (collectively Intervenor ) filed a joint brief on the same date.

The witnesses that appeared on behalf of Northern District were James C. Sparrow, Certified Public Accountant and partner in the firm Rankin, Rankin, and Company; Richard Spoor, Bond Counsel from the firm Hemmer Spoor Pangburn DeFrank, PLLC; Terrell Ross, Chairman and Secretary to Ross, Sinclair and Associates, Inc.; Ronald Barrow, Vice President of Finance of Northern District; Richard Harrison, Vice President of Engineering/Distribution of Northern District; Ron Lovan, President and Chief Executive Officer of Northern District; and Peggy L. Howe, Senior Project Consultant for Black & Veatch. Appearing on behalf of the Intervenor was Jane Brown, Project Manager for HMB Professional Engineers. Bobby Burgess, Chairman of Bullock District, appeared on behalf of Bullock District at the hearing. Appearing on behalf of Taylor Mill were Jill C. Bailey, City Administrator, and Derrick E. Coppage, Maintenance Director.

---

<sup>6</sup> Northern District's proposed rate schedules had a January 1, 2003 effective date. The rates were suspended up to and including April 30, 2003.

## ISSUANCE OF REVENUE BONDS

Northern District identified approximately \$30 million of projects that were to be constructed in 2002.<sup>7</sup> These construction projects are part of a 5-year plan of improvements that will allow Northern District to repair and replace deteriorated or inadequate infrastructure and to make improvements to the treatment and distribution system.<sup>8</sup> Northern District proposes to fund the total cost of these projects from the issuance of \$30,270,000 in parity revenue bonds that it estimates will have a 25-year term with an effective interest rate of 5.25 percent per annum.<sup>9</sup>

## TEST PERIOD

Northern District proposes to use the 12-month period ending December 31, 2001 as the test period to determine the reasonableness of its proposed rates. We find the use of this period reasonable. In using a historic test period, the Commission gives full consideration to appropriate and known and measurable changes.

## INCOME STATEMENT

For the test period, Northern District reports actual operating revenues of \$24,860,664 and actual operating expenses of \$19,363,391.<sup>10</sup> In its application, Northern District proposed several adjustments to revenues and expenses to reflect current and anticipated operating conditions. These proposed adjustments result in pro

---

<sup>7</sup> Northern District's Application, Exhibit O.

<sup>8</sup> Id., at 3.

<sup>9</sup> Id., Exhibit A, Plan of Financing.

<sup>10</sup> Id., Exhibit C, 2001 Annual Report at 12.

forma operating revenues of \$21,702,900<sup>11</sup> and pro forma operating expenses of \$19,470,277.<sup>12</sup> Our review of these proposed adjustments is set forth below.

The City of Newport

The Commission authorized Northern District to use \$17,100,000 of its bond proceeds to purchase the city of Newport's (Newport) water facilities.<sup>13</sup> In this proceeding, Northern District proposes to recover the debt service associated with its purchase of the Newport facilities, but has not made the corresponding pro forma adjustments to reflect the revenues and expenses. Northern District claims that when the application was filed, the acquisition of Newport had not been finalized. The District further claims that even after operating the Newport system for 6 months, the financial information is not sufficiently reliable, and does not provide a reliable representation of the actual revenues and expenses that will be generated by operating Newport. According to Northern District, the bonds used to purchase Newport were issued in conjunction with a refinancing; accordingly, they allege, the overall debt service

---

<sup>11</sup> Northern District's Application, Exhibit N	
Schedule 5, Revenues Not Subject to Rate Increase	\$ 1,138,200
Schedule 7, Test Year Revenue under Existing Rates	+ 20,564,700
Pro Forma Operating Revenue	<u>\$ 21,702,900</u>

<sup>12</sup> Northern District's Application, Exhibit N	
Schedule 2, Test Year Operation and Maintenance Exp.	\$ 15,116,846
Schedule 1, Summary of Test Year Revenue Requirements	+ 4,353,431
Pro Forma Operating Expenses	<u>\$ 19,470,277</u>

<sup>13</sup> See Case No. 2002-00066, Application of Northern Kentucky Water District for Approval of Financing the Acquisition of the City of Newport Waterworks (April 16, 2002).

remained the same. Therefore, Northern District claims that there is no new debt service associated with the Newport purchase in this proceeding.<sup>14</sup>

The Intervenor s argue that Northern District s failure to reflect all of the revenues and expenses of its recent acquisitions (Newport and city of Bromley) violates 2 key rate-making principles: (1) that the adjustments are known and measurable and (2) that they match. According to the Intervenor s, the cost-of-service study includes the Newport debt service, as well as other expenses associated with Newport. In support of this position the Intervenor s point to Barrow s testimony that approximately one-third of the expenses listed in Hearing Exhibit 6 can be attributed to the acquisition of the Newport system. The Intervenor s state that Northern District has 6 months of revenues and expenses for Newport that are verifiable, reliable, known, and measurable. The Intervenor s position is that Newport s revenues will have a substantial impact on the cost-of-service study and that Newport s impact upon the revenue requirement cannot simply be made up for in the next rate case, as suggested by Northern District.<sup>15</sup>

The Commission agrees with the Intervenor s that Northern District s proposal to reflect only the debt service associated with the purchase of Newport is a violation of the matching principle. However, Barrow s testimony regarding Hearing Exhibit 6 concerns the operating expense projections for 2003, which are not included in Northern District s pro forma operations. Throughout the discovery portion of this proceeding Northern District provided neither actual nor projected operating revenues

---

<sup>14</sup> Brief of Northern District at 38 - 41.

<sup>15</sup> Brief of Intervenor s at 18 - 22.

and expenses for Newport. Finally, at the hearing Northern District agreed to provide 12 months of financial data, including usage information, for Newport.

The Newport information provided by Northern District includes 6 months of actual and 6 months of projections.<sup>16</sup> The Commission finds this information inaccurate and unreliable. Consequently, it should not be used in this proceeding. Northern District stated its intent to file a new rate application in early 2003 that will reflect the revenues and expenses associated with operating Newport. The Commission finds that the debt service associated with the purchase of Newport should be disallowed for rate-making purposes until all of the revenues and expenses associated with operating Newport can be accurately reflected in Northern District's pro forma operations.

The Commission strongly urges Northern District to file a rate application on or before September 1, 2003 to include the revenues and expenses associated with serving the customers of Newport and to unify Northern District's rates. In the alternative, Northern District should file a statement explaining why a rate application cannot be filed by this date.

#### Forecasted Revenue Adjustments

Northern District's actual operating revenue account balances including its proposed pro forma adjustments are set forth in Table I.<sup>17</sup> Northern District provided no workpapers, calculations or pre-filed testimony to support or explain its proposed adjustments.

---

<sup>16</sup> Transcript of Evidence ( T.E. ), Volume I at 120 and 121.

<sup>17</sup> These adjustments result in a net increase of \$8,803 to income available for debt service.



**TABLE I**

<u>Account Title</u>	<u>Actual Balances</u>	<u>Pro Forma Adjustments</u>	<u>Pro Forma Balances</u>
Forfeited Discounts	\$366,475	\$ 3,625	\$ 370,100
Rents from Property	\$277,893	\$ 2,807	\$ 280,700
Meter Tests	\$ 60	\$ 40	\$ 100
Returned Check Charges	\$ 13,624	\$ 176	\$ 13,800
Turn-on Fees	\$209,845	\$ 2,155	\$ 212,000

Administrative Regulation 807 KAR 5:001, Section 10(1), provides that all applications for a general rate adjustment shall be supported by either a twelve (12) month historical test period which may include adjustments for known and measurable changes or a fully forecasted test period. When an applicant bases its application upon a historical test period, it must provide a complete description and quantified explanation for all proposed adjustments with **proper support for any proposed changes** in price or activity levels, and any other factors which may affect the adjustment.<sup>18</sup> That support should, at a minimum, include some documentary evidence to demonstrate the certainty of some expected change or event.

In Case No. 2001-00211,<sup>19</sup> Hardin County Water District failed to provide such documentary evidence to support its proposed adjustments that were based upon budgetary projections. In that proceeding the Commission made the following finding:

While such projections may be acceptable when an applicant bases its application upon a forecasted test period, they are not when the basis for the proposed rate adjustment is a historical test period. Assuming arguendo that the projections were permissible support for Hardin District's application, the utility's failure to produce the calculations and assumptions used to develop these projections makes it impossible for the

---

<sup>18</sup> Administrative Regulation 807 KAR 5:001, Section 10(6) (**emphasis added**).

<sup>19</sup> See Case No. 2001-00211, The Application of Hardin County Water District No. 1 for (1) Issuance of Certificate of Public Convenience and Necessity; (2) Authorization to Borrow Funds and to Issue its Evidence of Indebtedness Therefor (3) Authority to Adjust Rates; and (4) Approval to Revise and Adjust Tariff (March 1, 2002).

Commission to assess the validity and reasonableness of such projections.<sup>20</sup>

Northern District has not presented any evidence in this proceeding that would persuade the Commission to reverse its prior finding that pro forma adjustments based on budgetary projections in a historical test period should be disallowed. Accordingly, we find that the pro forma adjustments contained in Table I should be denied.

#### Operating Revenues from Water Sales

Northern District reports test-period operating revenues of \$24,860,664. Of this amount, revenue from retail water sales is \$19,100,981, revenue from bulk sales is \$3,970, and revenue from wholesale water sales is \$4,826,772.<sup>21</sup> Total test-period revenue from water sales, therefore, is \$23,931,723.

On November 9, 2000, the Commission approved the Termination Agreement between Northern District, the city of Florence ( Florence ), and Boone County Water District ( Boone District ).<sup>22</sup> Northern District states that it received notice from Florence and Boone District that they will terminate service with Northern District in March 2003.<sup>23</sup> Northern District proposes to adjust its test-period revenues from wholesale water sales to reflect the loss of Florence and Boone District as wholesale customers

---

<sup>20</sup> Id. at 8.

<sup>21</sup> Northern District's Application, Exhibit N, Schedule 7, Test Year Revenue Under Existing Rates.

<sup>22</sup> See Case No. 2000-00206, An Investigation of Boone County Water District's Decision to Change Water Suppliers and of the Amendment of Water Supply Agreements between Northern Kentucky Water Service District and Boone County Water District and the City of Florence, Kentucky (November 9, 2000).

<sup>23</sup> Brief of Northern District at 5.

and projected increases in sales to its remaining wholesale water customers.<sup>24</sup> These adjustments result in a pro forma level of \$857,800, a reduction of \$3,968,972.<sup>25</sup>

Given the Commission's decision in Case No. 2000-00206, and given Florence and Boone District's notice that they would cease purchasing water from Northern District in March 2003, Northern District's proposed adjustment to revenues to reflect the loss of Florence and Boone District as wholesale customers meets the rate-making criteria of being known and measurable. However, the adjustments to reflect projected increases in sales to the wholesales customers has not been sufficiently supported, and future budgetary adjustments are not allowable in a historical test period rate case. Accordingly, the Commission has reduced test-period revenues from wholesale water sales by \$3,942,737 to reflect the removal of the test-period sales to Florence of \$1,486,731 and test period sales to Boone District of \$2,456,006.<sup>26</sup>

Northern District proposed to increase test-period revenues from its retail customers by \$231,819.<sup>27</sup> Northern District stated at the hearing that the adjustment to the retail revenue was for growth, based on historical review of the number of accounts realized by the utility.<sup>28</sup> The Commission again denies Northern District's proposed adjustment because it is a budgetary adjustment based upon projected customer

---

<sup>24</sup> T.E., Volume II at 91 and 92.

<sup>25</sup> Northern District's Application, Exhibit N, Schedule 7.

<sup>26</sup> Id., Exhibit C, 2001 Annual Report at 32.

<sup>27</sup> Id., Exhibit N, Schedule 7.

<sup>28</sup> T.E., Volume II at 8 - 12.

growth. In recognition of these adjustments, the Commission finds that Northern District's normalized test-year revenue from water sales is \$20,220,805.

### Tap-on Fees

Northern District proposes to increase its service applications or tap-on fees of \$564,419 by \$5,581 to a pro forma level of \$570,000.<sup>29</sup> In its 2001 Annual Report tap-on fees are reported as a Contribution in Aid of Construction ( CIAC ) on the Balance Sheet. However, in this proceeding, Northern District has chosen to include tap-on fees as a revenue not subject to rate increase,<sup>30</sup> which acts as a reduction to its revenue requirement from water sales.<sup>31</sup> Northern District also includes tap-on fees as revenue<sup>32</sup> when determining if it is in compliance with the debt service coverage requirement of the bond resolutions.<sup>33</sup>

According to KRS 278.0152(2), a tap-on fee is established by a water utility to recover the costs for service tap, meter, meter vault, and installation. According to 807 KAR 5:01, Section 10, non-recurring charges, such as tap-on fees, are intended to be limited in nature and to recover the specific cost of the activity.

When determining if it is in compliance with the debt service coverage requirements of its bond ordinances, Northern District uses total revenues, which it

---

<sup>29</sup> Northern District's Application, Exhibit N, Schedule 5.

<sup>30</sup> Id., at 7.

<sup>31</sup> Id., Schedule 1.

<sup>32</sup> T.E., Volume 1 at 119.

<sup>33</sup> Section 726-subsection (iii) of the 1985 General Bond Resolution (as amended November 17, 1987) requires that the net annual income and revenues, as adjusted, be equal to at least one and twenty hundredths (1.2) times the annual debt service requirement.

interprets as including tap-on fees.<sup>34</sup> However, Northern District capitalizes the cost of the meter installations,<sup>35</sup> and they are not reflected as an expense in the debt service coverage calculation.

The Commission has long viewed tap-on fees as a form of cost-free capital to the water utility rather than as a source of operating revenue. The Uniform System of Accounts for Class A and B Water Districts and Associations requires tap-on fees to be recorded in an income account, Account No. 432 - Proceeds from Capital Contributions. This account is transferred at the close of the year to Account No. 215.2 Donated Capital, a sub-account of unappropriated retained earnings, and is not reflected on the Income Statement. If tap-on fees are listed as a revenue in the debt service calculation, then the corresponding costs should likewise be included. Since Northern District's fees are cost based, the costs would offset the fees and there would be nothing available to apply to debt service. Consequently, the Commission denies the proposed adjustment to include tap-on fees as an operating revenue.

Salaries and Wages Employees, Salaries and Wages - Officers, Employee Pensions and Benefits, Taxes Other Than Income

Northern District increased test-period operating expenses by \$310,000 to reflect employee pay increases made effective during 2002. The average pay increase was 5.9 percent. This adjustment meets the known and measurable criteria for adjusting test-period operations. The Commission accepts Northern District's proposed

---

<sup>34</sup> T.E., Volume I at 120.

<sup>35</sup> Id., at 119.

adjustment and has increased test-period Salaries and Wages, Employee Pensions, and Taxes Other Than Income, accordingly.

Employee Health Insurance

Northern District reported \$716,879 in health insurance expense for the test period. Northern District proposed to increase that amount by \$120,000 to reflect a 16.7 percent increase in health insurance costs. Northern District based its adjustment on estimates received from its insurance provider at the time the rate application was being developed.

Since preparing its application, Northern District has received actual insurance statements that prove its monthly health insurance premium to be \$73,373.<sup>36</sup> Northern District's employees will contribute \$8,843<sup>37</sup> of that amount. Based on this information, the Commission finds that test period operating expenses should be increased by \$57,481.<sup>38</sup>

Insurance – Auto, General Liability and Workers Compensation

Northern District reported the following test-period insurance expenses in its 2001 annual report and general ledger:

<sup>36</sup> Response to Item 2(c) of Commission Staff's First Set of Interrogatories and Requests for Production of Documents to Northern District issued July 29, 2002.

<sup>37</sup> Response to Item 14 of Commission Staff's Second Set of Interrogatories and Requests for Production of Documents to Northern District issued September 3, 2002.

<sup>38</sup> Monthly Premium	\$ 73,373
Less: Employee Contribution	- (8,843)
Monthly Expense to Northern	\$ 64,530
Annualize	x 12
Pro forma	\$ 774,360
Less: Test year	- (716,879)
Increase	<u>\$ 57,481</u>

Auto	\$ 28,815
General Liability	118,634
Workers Compensation	+ 72,774
Total	<u>\$ 220,223</u>

Northern District proposed to increase test-period expenses by \$112,266 to reflect estimated increases in these accounts. Since the application was compiled, actual insurance premium information has been made available and presented to the Commission in a statement from Northern District's insurance provider.<sup>39</sup> Included in that statement are the following premium amounts:

Auto	\$40,056
General Liability	167,873
Worker's Compensation	<u>110,442</u>
Total	<u>\$318,371</u>

Based on this information, the Commission, finds that Northern District's proposed adjustment should be denied and that test-period expenses should instead be increased by \$98,148 (2002 premium \$318,371 - \$220,223 reported in general ledger).

#### Amortization of Rate Case Expense

Rate case expense for the application filed in this case totaled \$271,065. The Commission finds that test period expenses should be increased by \$90,355 (\$271,065 ÷ 3 years) to reflect the 3-year amortization of this expense.

#### Cost of Service to Florence and Boone District

During the test period Northern District sold 2,727,797,300 gallons of water to Florence and Boone District. Northern District informed the Commission that service to these two entities would cease in March 2003.<sup>40</sup> To reflect the decrease in expenses

---

<sup>39</sup> Response to Item 17 of Commission Staff's Second Set of Interrogatories and Requests for Production of Documents to Northern District issued September 3, 2002.

<sup>40</sup> Brief of Northern District at 5.

that will result, Northern District proposed to eliminate test period variable cost totaling \$1,091,120 (2,727,797,300 gallons / 1,000 x \$.40).<sup>41</sup> Variable costs were determined to be \$.40 per 1,000 gallons and include purchased power, chemicals, sludge handling, and purchased water. The Commission finds that Northern District's adjustment is reasonable and that it should be accepted.

### Depreciation

Test-period depreciation was \$3,636,840. Northern District proposes to increase that amount by \$716,591 for a proposed pro forma level of depreciation expense of \$4,353,431. The adjustment includes a decrease of \$70,902 for depreciation taken on assets that were fully depreciated as of December 31, 2002 and an increase of \$787,493 for depreciation of plant to be placed into service during the year 2002.

The decreasing adjustment of \$70,902 is known and measurable and should be reflected in the rates approved in this case. The increase of \$787,493 has been adjusted by the Commission to reflect only those costs determined to be known and measurable. To meet this criterion the plant's cost must have been substantiated by original cost data or contractor bids.

In reviewing Northern District's Schedule 4.1R<sup>42</sup> and Schedule 4.1R Clarification,<sup>43</sup> the Commission finds that the following items should be removed from

---

<sup>41</sup> Response to Item 6 of Commission Staff's First Set of Interrogatories and Requests for Production of Documents to Northern District issued July 29, 2002.

<sup>42</sup> Response to Item 6, Workpaper 6.1, of the Commission's July 1, 2002 Order.

<sup>43</sup> Northern District's Response to Commission Staff's Hearing Information Requests filed January 21, 2003, Item 9.



Northern District s adjustment as they are not in service and have not been bid:

<u>Description</u>	<u>Depreciation</u>
Fourth Street Water Main	\$ 2.75
Turkeyfoot Road Relocation	108.12
SCADA Master Plan	60,000.00
Sodium Hypochlorite Stations	1,392.32
Regulatory Evaluation	9,412.00
Ultra Violet Disinfection Study	+ 3,136.20
Total	<u>\$ 74,051.39</u>

Also included in Northern District s adjustment is \$10,375.80 for a portion of the cost to purchase the city of Newport s water system. As previously discussed, the Commission has found that all costs associated with the Newport purchase should be eliminated when determining Northern District s pro forma operations in this case. The Commission has therefore reduced Northern District s depreciation adjustment by \$10,375.80.

There was included on Schedule 4.1R a provision of \$1,056.64 for recovery of a 24 inch Main US 27 to Sunset US 2; however, this item was not included on Schedule 4.1R Clarification. The Commission was unable to determine the status of this project and has eliminated it from pro forma operations.

The Commission therefore finds that Northern District s test-period depreciation expense should be increased by \$631,107.<sup>44</sup>

At the hearing, Mr. Harrison of Northern District testified that he does not know what a depreciation study is and does not know when Northern District last performed a

---

<sup>44</sup> Northern District s proposed increase	\$ 716,591
Less: Portion not known and measurable	(74,051)
City of Newport	(10,376)
Not included on 4.1R Clarification	+ (1,057)
Commission s increase to test year expenses	<u>\$ 631,107</u>

study.<sup>45</sup> In its responses to the data requested at the hearing, Northern District states that a depreciation study has not been performed since its formation in 1996 and that its independent auditors have stated that the current depreciation method meets the requirements of accounting standards.<sup>46</sup>

Water utilities operating under the Commission's jurisdiction are required to use, upon prior Commission approval, either the straight-line remaining life method or the straight-line method to compute depreciation expense.<sup>47</sup> The Commission requires a utility to perform a depreciation study to ensure that the remaining depreciation lives of the recorded assets are correct and that the level of annual depreciation expense is adequate. In this instance, Northern District has not recently performed such a study, and is unsure how its current depreciation lives were developed. Further complicating the issue is Northern District's purchase of Newport and the inadequate record keeping of that entity. Therefore, the Commission finds that Northern District should perform a depreciation study.

#### Amortization of Utility Plant Acquisition Adjustment and Loss on Debt Refinancing

Northern District reported amortization expense for utility plant acquisition adjustment and loss on debt refinancing in the amounts of \$3,409 and \$57,442, respectively. Northern District did not request recovery of either of these items. The Commission has eliminated them in determining pro forma operations.

---

<sup>45</sup> T. E. at 240 and 241.

<sup>46</sup> Northern District's Response to Commission Staff's Hearing Information Request filed January 24, 2003, Item 12.

<sup>47</sup> The Uniform System of Accounts for Class A and B Water Districts and Associations at 35.

### Interest and Miscellaneous Income

Test period Interest and Miscellaneous Income were reported at \$1,263,833 and \$53,969, respectively. Northern District proposes to adjust those amounts to \$1,391,300 and \$0, respectively, based on budgeted projections. The Commission finds that these adjustments are not known and measurable and should not be included in pro forma operations.

### Main Repair, Replacement and Extension Fund

Northern District proposes to include in its proposed revenue requirement a \$1,000,000 main repair, replacement and extension fund. Originally Northern District stated that this fund would provide money for the replacement of undersized mains and for extensions into unserved areas. However, Northern District later stated that the fund would be used solely for replacement of undersized mains for 3 to 5 years. At the hearing Northern District presented Hearing Exhibit 7 identifying three projects that Northern District will construct with the proceeds from the initial year of the fund.

The Attorney General argues that Northern District fails to demonstrate that it has a current need to begin a special program to replace undersized mains and that a 20-year time frame for the replacement program is reasonable. The Attorney General further argues that Northern District failed to establish guidelines and criteria for the administration of the main replacement program or to identify and prioritize the mains subject to replacement for the next 3 to 5 years. According to the Attorney General, Northern District expressed a desire to reduce system breaks, but the district failed to identify specific goals for accomplishing this task.<sup>48</sup>

---

<sup>48</sup> Brief of the Attorney General at 8.

The Intervenor's contend that the main replacement fund is unnecessary and that the projects it will fund are discretionary. Moreover, the Intervenor's argue that funding for these projects can be derived from issuing bonds or applying a surcharge pursuant to KRS 74.395. Because none of the projects identified by Northern District will provide a benefit to the wholesale customer class, the Intervenor's argue that the Cost-of-Service study should be revised to eliminate recovery of this fund from the wholesale water rate.<sup>49</sup>

The Commission finds that Northern District has not adequately explained why it needs to establish a main replacement fund, how Northern District or the Commission will track the fund collections, how Northern District or the Commission will track how the funds are used, or what criteria will be used to decide the main replacement order. Therefore, the Commission finds that Northern District's proposal to include the fund in its general rates should be denied. If Northern District wishes to fund the replacement of undersized mains, it may file an application for approval of a surcharge pursuant to KRS 74.395.

#### Boone/Florence Reserve

As a result of the Termination Agreement to which this Order has previously referred, Northern District has established a reserve fund of approximately \$3,700,000 that was initially funded through payments from Boone District and Florence. These payments were to reimburse Northern District for its invested capital to provide water service to Boone District and Florence. Northern District proposes to apply \$2 million of the reserve account to offset the revenue requirement in this proceeding and to use the

---

<sup>49</sup> Brief of the Intervenor's at 14.

remaining \$1.7 million as a revenue requirement offset in the next rate proceeding that Northern District intends to file in 2003. In addition to the reserve fund, Northern District is to receive an early termination payment of approximately \$685,842.<sup>50</sup>

The Intervenors argue that Northern District has been fully compensated by Boone District for the lost revenue. The Intervenors request that the Cost-of-Service study be amended to include all money received in the settlement of the termination and to exclude all requests for any further compensation for the lost revenue from Boone District and Florence.<sup>51</sup>

The Commission finds it appropriate to offset revenue requirements with this revenue; however, the 2-year amortization period requested by Northern District has too drastic an impact on rates and is, therefore, unreasonable. In approving the Termination Agreement between Northern District, Boone District, and Florence, the Commission determined that Northern District had constructed system improvements to meet its obligation to provide water service to Florence and Boone District throughout the terms of their respective water supply contracts. The Commission also determined that while Florence and Boone District remain customers, Northern District recovered the debt service payments associated with the system improvements through the water sales. The Commission viewed the termination payments as compensation to Northern District for the lost debt service payments that would result upon the early termination of the contracts.

---

<sup>50</sup> Brief of Northern District at 4 and 5.

<sup>51</sup> Brief of the Intervenors at 17.

The water supply contract between Boone District and Northern District was to be in effect until December 2010 and the contract with Florence was to expire in 2006. The Commission finds that a 10-year amortization period would better serve Northern District and its ratepayers, as a 10-year amortization better coincides with the depreciable lives of the assets the revenues are designed to cover. The Commission has increased test-period income by \$438,584<sup>52</sup> to reflect a 10-year amortization.

The Commission, after considering the pro forma adjustments found reasonable herein, has determined that Northern District's pro forma operations would be as follows:

	<u>Test-Period Operations</u>	<u>Pro Forma Adjustments</u>	<u>Pro Forma Operations</u>
Operating Revenues	\$ 24,860,664	\$ (3,942,737)	\$ 20,917,927
Operating Expenses	<u>19,363,391</u>	<u>35,120</u>	<u>19,398,511</u>
Net Operating Income	\$ 5,497,273	\$ (3,977,857)	\$ 1,519,416
Interest Income	1,263,833	0	1,263,833
Nonutility Income	53,969	0	53,969
Boone & Florence Reserve	<u>0</u>	<u>438,584</u>	<u>438,584</u>
Income Available for Debt Service	<u>\$ 6,815,075</u>	<u>\$ (3,539,273)</u>	<u>\$ 3,275,802</u>

#### REVENUE REQUIREMENT DETERMINATION

Northern District's proposed debt service of \$10,382,846<sup>53</sup> reflects all debt outstanding at the time the application was prepared, as well as the proposed \$30 million bond issuance. Since filing its application, Northern District has refinanced the

---

<sup>52</sup> \$3,700,000 (Reserve Balance) + \$685,842 (Termination Fee) = \$ 4,385,842  
 Divided by: Amortization Period ÷ 10 years  
 Annual Amortization \$ 438,584

<sup>53</sup> Northern District's Application, Exhibit N, Schedule3, Debt Service.

Kenton County Water District No. 1, 1992 Series B Bonds<sup>54</sup> and the 1995 United States Department of Agriculture Bonds.<sup>55</sup> By reflecting the savings from Northern District's bond refinancings and eliminating the debt service associated with the purchase of Newport, the Commission calculates a debt service of \$9,141,688 as shown in Appendix A.

Appendix B of this Order is a comparison of the revenue requirement from rates as requested by Northern District of \$25,952,803 to the revenue requirement from rates calculated by this Commission of \$27,737,179. The requested revenue requirement is sufficient to pay the pro forma cash expenses and meet the 1.2x debt service requirements of Northern District's bond ordinances as delineated in Appendix C. Therefore, the Commission finds that Northern District should be allowed to increase its rates to generate the requested revenue requirement from water sales of \$25,952,803. Should Northern District decide to further increase rates to generate the \$27,737,179 revenue requirement as determined by the Commission, it shall provide written confirmation to the Commission and publish notice of those rates pursuant to 807 KAR 5:011, Section 8.

#### Rate Design

Northern District's present rate design consists of two separate rate designs as a result of the merger of the two former districts. Customers served in the Campbell

---

<sup>54</sup> See Case No. 2002-00363, Application of Northern Kentucky Water District for Approval to Refinance Revenue Bonds in the Approximate Amount of \$10,765,000 (November 26, 2002).

<sup>55</sup> See Case No. 2002-00468, Application of Northern Kentucky Water District for Approval to Refinance Revenue Bonds in the Approximate Amount of \$1,585,000 (January 16, 2003).

County area receive a minimum charge based on meter size, which includes a volume allowance amount. Usage exceeding the volume included in the Minimum Charge is then charged on a per 1,000 gallon basis. Customers in the Kenton County area receive a minimum charge based on meter size, which includes a volume allowance amount. Usage exceeding the volume included in the minimum charge is then charged through a three step declining block commodity charge. Wholesale customers are presently charged a flat commodity charge that varies among wholesale customers.

Northern District proposed in the application a unified rate for all customers in its service area. The proposed rates consist of a service charge by meter size, without reference to volume allowance, and a three-step declining block commodity charge. The proposed rates were developed through a Cost-of-Service Study performed by Black & Veatch on behalf of Northern District. The Commission finds that a unified rate is a more equitable method to produce revenues to meet financial needs and associate costs to various customer classes that receive service.

#### Cost-of-Service Study

Northern District filed in its application a Cost-of-Service Study performed by the engineering firm of Black & Veatch. The American Water Works Association ( AWWA ) in its Water Rates Manual M-1 Fifth Edition for the Base-Extra Capacity Method sets out the guidelines and procedures that are to be followed in performing a cost-of-service study for a water utility.<sup>56</sup> Northern District's study was performed pursuant to these recommended guidelines. The Commission recognizes the AWWA Manual M-1 recommendations are proper rate making guidelines for water systems. We also

---

<sup>56</sup> Northern District's Application, Exhibit Q, and Prefiled Testimony of Peggy L. Howe, at 2 - 6.



recognize that the manual permits a utility discretion in allocating the cost associated with smaller mains to its wholesale customers.

The Intervenors question certain cost allocations made in the study. The Intervenors point to the Commission's prior Order prohibiting allocation to wholesale customers of the costs associated with distribution mains 10 inches or smaller. The Intervenors dispute Northern District's contention that the wholesale customer base has changed dramatically since the Commission's decision in 1995. The only change that has occurred in relation to the existing wholesale customers is the addition of an 8-inch main at Mills Road to serve Taylor Mill.<sup>57</sup> The Intervenors further argue that Black & Veatch's pamphlet, *Water Rates for Wholesale Service, Are They Fair* comments that, in general, the wholesale customer should be allocated only those costs associated with larger mains.<sup>58</sup>

Northern District states that the characteristics of the wholesale class have changed due to the departure of Boone District and Florence from the system. Boone District and Florence represented 80 percent of the wholesale customer class. Northern District further claims that the remaining wholesale customers rely on the smaller mains for service.<sup>59</sup>

Pursuant to Commission Order, Northern District filed a revised Cost-of-Service Study February 17, 2003, that did not allocate costs associated with mains smaller than ten inches to the wholesale customer. The Commission has ordered in a recent

---

<sup>57</sup> T.E., Volume II at 144.

<sup>58</sup> Id., at 68 - 70.

<sup>59</sup> Id., at 55 - 70.

case involving wholesale rates that the costs associated with mains that do not benefit the wholesale customer are not to be included in the wholesale rate.<sup>60</sup> The Commission finds that costs associated with mains smaller than 10 inches should not be allocated to the wholesale class.

The Intervenors also argue that Northern District's Cost-of-Service Study fails to allow for an offsetting benefit from its wholesale customers' distribution mains. Water flows in both directions in certain lines, therefore benefiting Northern District by providing pressure and eliminating a dead end situation, which may cause stagnant water.<sup>61</sup> Northern District stated that its customers could be served without the wholesale customers' lines and, therefore, Northern District received no benefit.<sup>62</sup> However, at the hearing, Northern District's engineer stated that the district does receive a benefit from a flushing standpoint.<sup>63</sup> The Commission finds that Northern District does benefit from the wholesale customer distribution mains. The exclusion of costs associated with mains that do not benefit the wholesale customer should in part address the Intervenors' concern.

Northern District's Cost-of-Service Study was performed using peaking factors developed by Black & Veatch based on industry standards and acceptable practices.<sup>64</sup> The Intervenors contend that Northern District should have performed a formal demand

---

<sup>60</sup> See Case No. 2002-00022, Proposed Adjustment of the Wholesale Water Service Rates of the City of Pikeville, Kentucky (October 18, 2002) at 35.

<sup>61</sup> Brief of Intervenors at 14.

<sup>62</sup> T.E., Volume II at 64.

<sup>63</sup> Id., at 150-151.

<sup>64</sup> Brief of Northern District at 32.

study to determine the peaking factors of the wholesale class. They argue that the peaking factors were estimated in the Cost-of-Service Study and that estimates are simply insufficient. Further, the Intervenor's argue that the Commission requires that a formal demand study be performed to obtain precise peaking factors.<sup>65</sup> Northern District counters that the cost of a formal demand study would be significant and that such cost would be passed on to the ratepayers. It further argues that the AWWA has modified its standard on demand studies and has recognized that estimates of demand are an acceptable surrogate for the studies.

The Commission agrees that a formal demand study would be costly for all customers of Northern District. The Commission does not require utilities to perform formal demand studies to determine peaking factors. The Commission Order cited by the Intervenor's merely recognizes the importance of accurate peaking factors in a Cost-of-Service Study. Furthermore, the Intervenor's did not demonstrate that the peaking factors developed in the Cost-of-Service Study were unreasonable. Therefore, The Commission accepts the peaking factors developed by Northern District.

The Commission, subject to the adjustments discussed in this Order, accepts Northern District's revised Cost-of-Service Study.

### CONCLUSION

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

---

<sup>65</sup> Brief of Intervenor's at 2 5.

1. Northern District proposes to fund the total cost of the construction projects from the issuance of \$30,270,000 in parity revenue bonds that it estimates will have a 25-year term with an effective interest rate of 5.25 percent per annum.

2. The proposed issuance of \$30,270,000 in parity revenue bonds is for lawful objects within Northern District's corporate purposes, is necessary and appropriate for and consistent with the proper performance by Northern District of its service to the public, and will not impair its ability to perform that service.

3. Based upon adjusted test-period operations, Northern District's total revenue requirement from water sales is \$27,737,179.

4. Northern District's requested revenues from water sales of \$25,952,803 are sufficient to meet adjusted test-period operating expenses and the debt service requirements of its bond ordinances.

5. Northern District's allocation of costs are unreasonable and inequitable; therefore, the proposed rates should be denied.

IT IS THEREFORE ORDERED that:

1. Northern District is authorized to issue approximately \$30,270,000 in parity revenue bonds.

2. The proceeds of the issuance authorized herein shall be used only for the purposes set forth in Northern District's application.

3. Northern District's proposed rates are denied.

4. The rates set forth in Appendix D are approved for service rendered by Northern District on and after the date of this Order.

5. Northern District shall provide to the Commission written notice, within 10 days from the date of this Order, if it wishes to adopt the rates in Appendix E that

produce annual revenues from rates of \$27,737,179. Otherwise, Northern District shall file with the Commission its revised tariff sheets setting out the rates approved herein within 30 days from the date of this Order.

6. Within 3 calendar years from the date of this Order, Northern District shall file with its Annual Report an income statement, along with any pro forma adjustments, in sufficient detail to demonstrate that the rates approved herein are sufficient to meet Northern District's operating expenses and annual debt service requirements. Northern District shall include workpapers, assumptions, and calculations to support its pro forma adjustments and debt service determination.

7. Northern District shall perform a depreciation study and file it with its next rate case application.

8. Northern District shall file an application for an adjustment of rates on or before September 1, 2003 or, in the alternative, a statement explaining why a rate application cannot be filed by this date.

Nothing contained herein shall be deemed a warranty or finding of value of securities or financing authorized herein on the part of the Commonwealth of Kentucky or any agency thereof.

Done at Frankfort, Kentucky, this 30<sup>th</sup> day of April, 2003.

By the Commission

ATTEST:

  
Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE  
COMMISSION IN CASE NO. 2002-00105 DATED APRIL 30, 2003

DEBT SERVICE AS DETERMINED BY THE COMMISSION

Bond Title	1993	1994	1995
Series 1993 A	\$ 160,466	\$ 156,828	\$ 157,972
Series 1995 A	561,747	564,065	565,527
Series 1995 B	1,269,978	1,267,678	1,268,838
Series 1995 C (FmHA)	60,543	0	0
Series 1997	1,086,080	1,087,357	1,086,989
Series 1998	722,687	721,999	720,836
2000 USDA	134,750	135,600	134,400
Series 2001 A	984,637	981,324	963,099
Series 2002 A	2,558,041	2,537,403	2,536,540
Series 2002 A (Newport)	(981,243)	(975,168)	(973,980)
Series 2002B	806,979	825,881	846,706
Series 2003 A	25,200	100,528	100,078
Proposed Bonds	793,669	2,215,406	2,215,624
Totals	<u>\$ 8,183,534</u>	<u>\$ 9,618,901</u>	<u>\$ 9,622,629</u>
	1993	\$ 8,183,534	
	1994	9,618,901	
	1995	<u>9,622,629</u>	
Subtotal		\$ 27,425,064	
Divide by: 3 Years		÷ 3 Years	
Average Debt Service		<u>\$ 9,141,688</u>	

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE  
COMMISSION IN CASE NO. 2002-00105 DATED APRIL 30, 2003

COMPARISON OF REVENUE REQUIREMENT CALCULATIONS

	Northern District's Requested	Commission's Requirement
3-Year Average Debt Service	\$ 10,382,126	\$ 9,141,688
Multiplied by: Debt Service Coverage	<u>0.0</u>	<u>0.2</u>
Coverage	\$ 0	\$ 1,828,338
Add: 3-Year Average Debt Service	10,382,126	9,141,688
Operating Expenses	14,726,061	14,721,287
Depreciation	4,353,431	4,267,947
Main Repair, Replacement, & Ext. Reserve	1,000,000	0
Taxes Other Than Income	<u>390,785</u>	<u>409,277</u>
Total Revenue Requirement	\$ 30,852,403	\$ 30,368,537
Less:		
Interest & Dividend Income	1,391,300	1,263,833
Boone & Florence Reserve	<u>2,000,000</u>	<u>438,584</u>
Revenue Requirement from Operations	\$ 27,461,103	\$ 28,666,120
Less:		
Other Operating Revenues	<u>1,508,300</u>	<u>928,941</u>
Revenue Requirement from Water Sales	\$ 25,952,803	\$ 27,737,179
Less: Pro Forma Revenue - Water Sales	<u>20,220,805</u>	<u>19,988,986</u>
<b>Requested/Recommended Increase</b>	<b><u>\$ 5,731,998</u></b>	<b><u>\$ 7,748,193</u></b>

APPENDIX C

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE  
COMMISSION IN CASE NO. 2002-00105 DATED APRIL 30, 2003

DETERMINATION OF BOND ORDINANCE REQUIREMENTS

Requested Revenue from Rates	\$	25,952,803
Add:		
Other Operating Revenues		928,941
Interest & Dividend Income		1,263,833
Boone & Florence Reserve		438,584
		<hr/>
Revenue Available for "Cash" Expenses & Debt Service	\$	28,584,161
Less:		
Operating Expenses		14,721,287
Taxes Other Than Income		409,277
		<hr/>
Net Available for Debt Service	\$	13,453,597
Divided by: Debt Service Allowed	÷	9,141,688
		<hr/>
Debt Service Coverage		<u>1.472</u>



APPENDIX D

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC  
COMMISSION IN CASE NO. 2002-00105 DATED APRIL 30, 2003

The following rates and charges are prescribed for the customers in the area served by Northern Kentucky Water District. 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 Charges

<u>Meter Size</u>	<u>Monthly</u>	<u>Quarterly</u>
5/8	\$ 11.46	\$ 15.78
3/4"	\$ 11.68	\$ 16.43
1	\$ 12.32	\$ 18.37
1 1/2"	\$ 13.19	\$ 20.96
2	\$ 15.56	\$ 28.09
3	\$ 33.06	\$ 80.58
4	\$ 39.54	\$ 100.02
6	\$ 54.66	\$ 145.38
8	\$ 71.94	\$ 197.22
10 and larger	\$ 91.38	\$ 255.54

Commodity Charges

	<u>Monthly Block</u>		<u>Quarterly Block</u>	
	ccf		ccf	
First	15		45	\$ 2.33 per ccf
Next	1,635		4,905	\$ 2.03 per ccf
Over	1,650		4,950	\$ 1.92 per ccf
Wholesale				\$ 1.60 per ccf

APPENDIX E

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC  
COMMISSION IN CASE NO. 2002-00105 DATED APRIL 30, 2003

Service Charges

<u>Meter Size</u>	<u>Monthly</u>	<u>Quarterly</u>
5/8	\$ 11.68	\$ 16.43
3/4"	\$ 11.92	\$ 17.14
1	\$ 12.63	\$ 19.28
1 1/2"	\$ 13.58	\$ 22.13
2	\$ 16.20	\$ 29.98
3	\$ 35.48	\$ 87.73
4	\$ 42.62	\$ 109.12
6	\$ 59.28	\$ 159.03
8	\$ 78.32	\$ 216.07
10 and larger	\$ 99.74	\$ 280.24

Commodity Charges

	<u>Monthly Block</u>		<u>Quarterly Block</u>	
	ccf		ccf	
First	15		45	\$ 2.51 per ccf
Next	1,635		4,905	\$ 2.18 per ccf
Over	1,650		4,950	\$ 2.02 per ccf
Wholesale				\$ 1.72 per ccf