COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF DELTA NATURAL GAS COMPANY, INC. FOR AN ADJUSTMENT OF RATES	)))	CASE NO. 2004-00067

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O R D E R

Delta Natural Gas Company, Inc. ("Delta") is a Kentucky corporation that purchases, sells, stores, and transports natural gas to approximately 39,700 consumers in 23 counties in Kentucky.[1] Delta has three wholly-owned unregulated subsidiaries that are engaged in the purchase and sale of natural gas.[2]

BACKGROUND

On March 1, 2004, Delta filed notice of its intent to apply for an increase in its gas rates to produce additional annual revenues of $4,277,471, an increase of 7.41 percent. On April 5, 2004, Delta filed its application, which included new rates to be effective May 5, 2004, and proposals to revise its small non-residential tariff and to add a Gas Technology Institute for Research and Development rider ("GTI Rider"). Finding that

[1] The 23 counties are Bath, Bell, Bourbon, Clark, Clay, Estill, Fayette, Fleming, Garrard, Jackson, Jessamine, Knox, Laurel, Lee, Leslie, Madison, Mason, Menifee, Montgomery, Powell, Robertson, Rowan, and Whitley.

[2] The three subsidiaries are Delta Resources, Inc. ("Delta Resources"); Delgasco, Inc. ("Delgasco"); and Enpro, Inc. ("Enpro"). Delta Resources buys gas and resells it to industrial or other large use customers on Delta's system. Delgasco buys gas and resells it to Delta Resources and to customers not on Delta's system. Enpro owns and operates production properties and undeveloped acreage that produces a small amount of natural gas and oil that is sold on the unregulated market.

additional proceedings were necessary to determine the reasonableness of the request, the Commission, pursuant to KRS 278.190(2), suspended the proposed rates for 5 months up to and including October 4, 2004.

The Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention ("AG"), and the Lexington-Fayette Urban County Government ("LFUCG") requested, and were granted, full intervention in this proceeding.

On April 23, 2004, the Commission issued a procedural schedule that provided for discovery, intervenor testimony, and rebuttal testimony by Delta. A public hearing was held on August 18, 2004. Following the hearing, Delta and the AG filed written briefs. LFUCG submitted a written brief stating its adoption of the AG's brief as its own. All information requested at the public hearing has been filed and the case now stands submitted for a decision.

TEST PERIOD

Delta proposed the 12-month period ending December 31, 2003 as the test period for determining the reasonableness of its proposed gas rates. The AG also proposed the use of this 12-month period. The Commission finds the use of the 12-month period ending December 31, 2003 as the test period in this proceeding is reasonable. In utilizing a historic test period, the Commission has given full consideration to appropriate known and measurable changes.

RATE BASE

Delta proposed a rate base of $111,071,658,[3] while the AG proposed a rate base of $111,715,945.[4] Both calculations reflected the approach that the Commission has generally used to determine the rate base. However, the AG disagreed with Delta's inclusion of the PSC Assessment in the balance included for Prepayments.

Delta's proposed balance for Prepayments in its rate base determination included $39,440 for its PSC Assessment. While conceding that the Commission has not included the PSC Assessment in calculating the Prepayments balance, Delta urged the Commission to reconsider that position. Noting the timing of the notice of the assessment and required payment, Delta argued that because the PSC Assessment cannot be used to pay operating expenses of the Commission unless it is collected prior to the period to which the assessment applies, the assessment must in fact be a prepayment.[5]

The AG argued that the Commission has in previous cases excluded the inclusion of the PSC Assessment in the balance for Prepayments used in the determination of rate base. Based on this previous treatment of the assessment, the

[3] Application, Tab 27, Schedule 7. In its rebuttal testimony, Delta recalculated the rate base to recognize the correction of errors included in the application. The corrected rate base was $111,078,214. While Delta calculated a revised revenue increase based on this corrected rate base, it did not make a formal request seeking the revised increase.

[4] Henkes Direct Testimony, Schedule RJH-3.

[5] Delta Post-Hearing Brief at 5.

AG excluded the PSC Assessment from the balance of Prepayments that he used in determining his proposed rate base.[6]

Delta's arguments are similar to the reasoning offered by The Union Light, Heat and Power Company ("ULH&P") in Case No. 2001-00092.[7] Rejecting ULH&P's arguments for inclusion in that case, the Commission stated:

> In three previous ULH&P cases, the Commission has rejected the inclusion of the PSC Assessment in the determination of rate base, and we are not persuaded by ULH&P's current argument. In its current argument, ULH&P notes that the PSC Assessment is a maintenance tax levied on its gross receipts. ULH&P is notified on or before July 1 of each year of the amount assessed against it, and the assessment is due and payable on or before July 31 of that same year. As such, the annual assessment is a liability that ULH&P must pay each year, not unlike its state and federal income taxes. ULH&P's payment of this liability does not constitute the prepayment of an expense.
>
> The assessment is due by a specific date, which is no less than a month after ULH&P is notified of the current year's assessment. ULH&P appears to be arguing that since the assessment provides the funding of the Commission's ongoing operations, this establishes the payment of the assessment as a prepayment. The proper accounting classification of this transaction should be dependent upon what the payment of the PSC Assessment represents to ULH&P and not the fact that the Commission's ongoing operations are funded by it.[8]

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[6] Henkes Direct Testimony at 8.

[7] Case No. 2001-00092, Adjustment of Gas Rates of The Union Light, Heat and Power Company, final Order dated January 31, 2002.

[8] Case No. 2001-00092, January 31, 2002 Order at 8-9 and footnote 23.

The Commission has excluded the PSC Assessment for the Prepayments balance in other cases.[9]

The Commission is not persuaded by Delta's arguments for modifying this position and finds that the PSC Assessment should be excluded from the balance for Prepayments included in the determination of Delta's rate base.

The Commission has determined Delta's rate base following the approach used in previous rate cases. The accumulated depreciation reflects an adjustment to recognize the decrease in test-year depreciation expense discussed later in this Order. The cash working capital allowance has been adjusted to reflect the accepted pro forma adjustments to operation and maintenance expenses as discussed later in this Order. The inclusion of the unrecovered Statement of Financial Accounting Standards ("SFAS") No. 143 costs relates to a new accounting treatment required for assets that have legal obligations associated with the future retirement of those assets. These assets would have been included in rate base prior to the SFAS No. 143 requirements, and it is appropriate to continue to include these items in rate base. Delta and the AG both included the unrecovered SFAS No. 143 costs in their proposed rate bases.

Accordingly, we find Delta's rate base for rate-making purposes as of December 31, 2003 to be as follows:

[9] See Case No. 1998-00474, The Application of Kentucky Utilities Company for Approval of an Alternative Method of Regulation of its Rates and Service, final Order dated January 7, 2000 at 52 and footnote 134; Case No. 2000-00080, The Application of Louisville Gas and Electric Company to Adjust its Gas Rates and to Increase its Charges for Disconnecting Service, Reconnecting Service and Returned Checks, final Order dated September 27, 2000 at 16-17.

Total Utility Plant in Service	$165,994,418
Add:	
Materials & Supplies	478,139
Prepayments	312,436
Gas in Storage	6,363,748
Unamortized Debt Expense	4,185,070
Unrecovered SFAS No. 143 Costs	30,133
Cash Working Capital Allowance	1,279,109
Subtotal	$ 12,648,635
Deduct:	
Accumulated Depreciation	52,667,059
Customer Advances for Construction	105,692
Accumulated Deferred Income Taxes	14,697,866
Subtotal	$ 67,470,617
Rate Base	$111,172,436

CAPITALIZATION

In its application, Delta proposed an adjusted capitalization of $115,396,935.[10] Included in Delta's capitalization was an adjustment to remove its equity investment in subsidiaries. Delta's capitalization also reflects the exclusion from its balance of common equity its minimum pension liability, which was recorded as Other Comprehensive Income pursuant to the requirements of SFAS No. 130. As of test-year end, Delta's minimum pension liability was $2,050,636. After discovering an error in its original calculations,[11] Delta proposed an adjusted capitalization of $117,447,571,[12] which includes its minimum pension liability in the balance for common equity. Delta stated that adding back its minimum pension liability to its common equity balance was

[10] Application, Tab 27, Schedule 9.

[11] Brown Rebuttal Testimony at 4-5.

[12] Hall Rebuttal Testimony, Application Tab 27, Schedule 9.

consistent with the Commission's decisions in Case Nos. 2003-00433[13] and 2003-00434.[14]

The AG proposed an adjusted capitalization of $115,396,935.[15] While he agreed with Delta's proposed adjustment to remove the equity investment in subsidiaries, the AG did not agree with Delta's proposal to add its minimum pension liability back to the common equity balance. The AG asserted that the minimum pension liability was excluded from common equity throughout the test year and was still excluded through at least May 2004. He argued that the adjustment proposed in Delta's rebuttal testimony is based upon the invalid assumption that the minimum pension liability was of a temporary nature and would not be on the books during the time the proposed rates are in effect.[16]

A minimum pension liability occurs when, as of a measurement date, the discounted benefits previously earned by participants in the pension plan exceed the market value of the pension trust assets, thus representing an unfunded pension benefit earned by plan participants to date. Under SFAS No. 130, *Reporting Comprehensive Income*, the minimum pension liability is classified as an Other Comprehensive Income item. The liability is fully recognized on the balance sheet but not yet on the income statement, because the financial impact that unrealized changes in value may

[13] Case No. 2003-00433, An Adjustment of the Gas and Electric Rates, Terms, and Conditions of Louisville Gas and Electric Company.

[14] Case No. 2003-00434, An Adjustment of the Electric Rates, Terms, and Conditions of Kentucky Utilities Company.

[15] Henkes Direct Testimony, Schedule RJH-2.

[16] Transcript of Evidence ("T.E."), August 18, 2004, at 242-243.

eventually cause have not occurred and have not been included in the income statement under generally accepted accounting principles.

Delta's proposed treatment of the minimum pension liability is consistent with an accounting decision the Federal Energy Regulatory Commission ("FERC") issued permitting the establishment of a minimum pension liability regulatory asset for utilities with cost-based regulated rates.[17] Under this accounting decision, the entry to record the minimum pension liability as Other Comprehensive Income is reversed and a regulatory asset is created. The minimum pension liability-related regulatory asset is not amortized over future periods. At each measurement date, the entry recorded for the previous measurement date is reversed and the computation is redone. A new minimum pension liability and regulatory asset would be recognized at the new measurement date, if required.[18]

The Commission finds that Delta's proposal to reclassify its minimum pension liability from Other Comprehensive Income to a regulatory asset is reasonable. The write-down of common equity due to the minimum pension liability is not a permanent event, with the adjustment recalculated at the measurement date of the pension plan.[19]

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[17] FERC Docket No. AI04-2-000, accounting decision issued March 29, 2004 by the Deputy Executive Director and Chief Accountant. See Response to the AG's Second Data Request dated June 9, 2004, Item 11.

[18] Id.

[19] The Commission notes that Delta's actuary states that, as of March 31, 2004, Delta does not have a minimum pension liability and no Other Comprehensive Income needs to be recognized as of March 31, 2004. See Response to Hearing Data Request of the Commission Staff dated August 18, 2004, Item 4, Actuarial Valuation as of April 1, 2004.

The regulatory asset accounting treatment prescribed by FERC establishes that the regulatory asset will not be amortized and recognized as a current operating expense.

The Commission has determined that Delta's test-year-end capitalization is as follows:

Long-Term Debt	$ 54,824,000
Short-Term Debt	17,707,889
Common Equity	44,977,907
Total Capitalization	$117,509,796

The capitalization reflects the removal of the equity investment in Delta's subsidiaries and the addition of the minimum pension liability, adjustments that affected common equity only. Although Account No. 212, Installments Received on Capital Stock, appears in the equity section of Delta's balance sheet, neither Delta nor the AG included the balance of this account in their recommended capitalization. The Commission is unaware of any basis for excluding the amount and has included it in our calculation of total capitalization.

REVENUES AND EXPENSES

For the test year, Delta reported actual net operating income of $6,686,837.[20] Delta proposed a series of adjustments to revenues and expenses to reflect more current and anticipated operating conditions, resulting in an adjusted net operating income of $6,905,785.[21] The AG also proposed numerous revenue and expense adjustments, resulting in adjusted net operating income of $7,712,598.[22] The

[20] Application, Tab 42, page 3 of 4.

[21] Id.

[22] Henkes Direct Testimony, Schedule RJH-5.

Commission finds that four of the adjustments proposed in Delta's application and accepted by the AG are reasonable and should be accepted. These four adjustments are set forth in detail in Appendix B.

The Commission makes the following modifications to the remaining proposed adjustments:

Gas Cost Adjustment ("GCA") – Adjustment for Current Factor

In its application, Delta used its then current GCA of $8.2193 per Mcf. On June 28, 2004, Delta filed Case No. 2004-00264,[23] which revised its GCA to $8.3941, effective August 1, 2004. On September 24, 2004, Delta filed Case No. 2004-00377,[24] which revised its GCA to $7.6957, effective November 1, 2004. Due to Delta's implementation of its proposed rates effective October 7, 2004, discussed later in this Order, the Commission has reflected the GCA amount approved in Case No. 2004-00264 in both the gas cost revenues and expenses.[25]

[23] Case No. 2004-00264, Notice of Purchased Gas Adjustment Filing of Delta Natural Gas Company, Inc., Order dated July 20, 2004.

[24] Case No. 2004-00377, Notice of Purchased Gas Adjustment Filing of Delta Natural Gas Company, Inc., Order dated October 28, 2004.

[25] On October 28, 2004, the Commission approved the GCA application filed by Delta in Case No. 2004-00377. This revised GCA became effective on and after November 1, 2004. However, since Delta elected to place its proposed rates into effect as of October 7, 2004, the GCA amount approved in Case No. 2004-00264, which was in effect in October of 2004, has been used in this Order. Since the impact of recognizing the November 1, 2004 GCA would be to change gas cost revenues and expenses by the same amount, the fact that a more recent GCA has gone into effect will have no effect on the revenue increase granted in this Order.

Customer Growth Adjustment.

Delta proposed no customer growth adjustment since a comparison of customers at the beginning and end of the test year showed a 417 customer decrease during the year. Delta stated that comparing the year-end number of customers and the test-year average number of customers would be deceptive since it would show customer growth. The AG proposed two possible year-end adjustments.[26] The first adjustment compared year-end customers to the 13-month test-year average number of customers, resulting in a net increase in revenues of $209,654.[27] The second adjustment applied a 5-year compound growth rate to the 13-month test-year average number of customers.[28]

The Commission finds that a customer growth adjustment is appropriate and should be calculated based on information in the record. Our adjustment compares test-year-average customers and test-year-end customers but also recognizes the

[26] Objecting to these proposals, Delta argued that the AG's adjustments do not recognize weather-normalized volumes or Delta's declining block rates and fail to reflect the decrease in the number of interruptible transportation customers that occurred during the test year. The AG stated that he had asked for the information upon which Delta based its criticism and that Delta had refused to provide it, claiming the information needed to calculate the adjustment was already in the record. The AG moved to strike this portion of Delta's rebuttal testimony and the Commission granted the motion at the public hearing.

[27] Henkes Direct Testimony, Schedule RJH-6A.

[28] The Commission recently rejected this second method in Case No. 2003-00433. See Case No. 2003-00433, June 30, 2004 Order at 27-28.

reduction, during the test year, in the number of interruptible transportation customers.[29] Such an adjustment produces a revenue increase of $132,811 and an expense increase of $17,212, with the overall adjustment being a $115,599 net increase in revenues.

Reconnect Charge

Delta proposed to increase its reconnect charge from $40 to $48 and to recognize the resulting $15,392 increase in its miscellaneous revenues. The AG opposed the increase, arguing that this charge represents a direct hardship on customers who were disconnected initially as a result of financial hardship. He claims that the proposed charge will increase the level of hardship experienced by those customers.

The Commission finds that Delta's proposed increase is reasonable and should be approved. Delta provided sufficient cost support for the proposed increase. This action is consistent with the principle that the cost causer should bear the costs related to his actions – a principle to which the Commission has historically adhered. Moreover, we find no evidence in the record to support the AG's assertion that all disconnections for non-payment are due to financial hardship.

[29] The Commission's adjustment is the AG's proposed adjustment, as shown in Henkes Direct Testimony, Schedule RJH-6A, expanded to include interruptible customers. Interruptible customer information was taken from the Response to the Commission Staff's First Data Request dated March 17, 2004, Item 44; the Response to the AG's First Data Request dated May 11, 2004, Item 30; and Seelye Direct Testimony, Exhibit 9.

Payroll Expense

Delta proposed a net decrease in its payroll expense of $283,168. The net decrease reflected an increase to its payroll expense of $120,697 to reflect a wage and salary increase that occurred during the test year and the removal of a $403,865 employee bonus paid during the test year. Subsequent to filing its application, Delta determined that the $403,865 reduction included the portion of the employee bonus that had been allocated to its unregulated subsidiaries. Delta stated that the correct bonus adjustment for its regulated operations was $317,865, which resulted in a revised net decrease to payroll expense of $197,168.[30] The AG did not object to Delta's original or revised payroll expense adjustment.

The Commission has examined Delta's proposed adjustment to test-year payroll expense and finds the revised employee bonus reduction of $317,865 is reasonable and that portion of the payroll expense proposal should be accepted. A review of Delta's calculations to normalize the wage and salary increase, however, revealed four errors. First, Delta failed to normalize the salaries for several new full-time employees hired during the test year. Second, Delta included the test-year expense for several full-time employees who were terminated during the test year. Third, Delta failed to remove the test-year level expense for three part-time employees who were hired to full-time positions during the test year. Finally, Delta did not normalize the part-time hours worked by a customer service representative employee who replaced an outside consultant during the test year.

[30] Response to the Commission Staff's Third Data Request dated June 9, 2004, Item 12(b), page 3 of 9.

Delta stated that it had not normalized the salaries for the new full-time employees, but instead only included as an expense the portion of the year since the hiring date. Delta contended that including the employees terminated during the test year in the expense was a reasonable approach to determine its normalized payroll expense.[31] Delta used similar reasoning concerning the payroll expense associated with the customer service representative employee. Delta argued that since this was an expense that would be incurred for the entire year, it was reasonable to include the outside consultant's expense for part of the year and the new part-time employee's wages for the remainder of the year as the normalized payroll expense.[32] Delta did not specifically discuss its treatment of the part-time employees who became full-time employees, but the treatment was consistent with Delta's overall approach to payroll expense normalization.

Delta's approach is not consistent with the Commission's generally used approach for determining payroll expenses for rate-making purposes. The Commission finds that the reasonable approach is to normalize the payroll expense to reflect the level of employees at the end of the test year, priced at the test-year-end level of wages. This approach results in a payroll expense that is more reflective of the on-going level of expense than Delta's blended approach.

The Commission has recalculated Delta's payroll expense to reflect our findings. New full-time employee salaries were normalized to a full year, terminated employees were excluded, and employees moving from part-time to full-time status were

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[31] Id., Item 2(f).

[32] Id., Item 18.

normalized based on their full-time salaries. For the new part-time employee who replaced an outside consultant, Delta provided the total hours the employee worked for the 12-month period July 1, 2003 through June 30, 2004.[33] The Commission normalized this employee's wages using the test-year-end wage rate and the hours worked in the 12-month period. After normalizing the total payroll cost, the Commission determined the portion to be capitalized following the approach utilized by Delta.[34] The result was an increase in payroll expense of $133,167. This increase was offset by the adjustment to remove the test-year employee bonus of $317,865 noted previously. Based on these components, the Commission reduces Delta's test-year payroll expense by $184,698.[35]

Payroll Taxes

Delta proposed a decrease in its payroll taxes[36] of $15,766 based on its proposed normalized wages and salaries and the removal of the test-year employee bonus. After discovering the error in the amount of employee bonuses to be removed,

[33] Response to Hearing Data Request of the Commission Staff dated August 18, 2004, Item 5.

[34] Delta's approach to capitalizing its wages and salaries was provided in the Response to the Commission Staff's Second Data Request dated May 1, 2004, Item 6.

[35] The normalization increase of $133,167 less the bonus removal of $317,865 results in a net reduction of $184,698.

[36] Payroll taxes include the Federal Insurance Contribution Act ("FICA"), Medicare, and Federal and State Unemployment.

Delta revised its adjustment to a decrease of $11,503.[37] The AG did not oppose Delta's original or revised adjustment to payroll tax expense.

Delta's proposed adjustment did not recognize the increase in the FICA base wage limit from $87,000 to $87,900, which took effect on January 1, 2004. The Commission finds that the change in the FICA base wage limit should be recognized in the determination of Delta's payroll taxes, as the higher base wage limit will be experienced by Delta on a going forward basis. The Commission has regularly recognized the increases in the FICA base wage limit when determining a utility's revenue requirements.[38]

The Commission has recalculated this adjustment, basing this calculation on the level of normalized wages and salaries found reasonable herein and using the FICA base wage limit of $87,900. This results in a reduction in payroll taxes of $8,921, which the Commission finds reasonable.

401(k) Plan Expense

In its application, Delta did not propose to adjust its 401(k) plan test-year expense. During the proceeding, Delta discovered that its test-year expense was understated by $23,833 due to the timing of plan invoices being received and

[37] Response to the Commission Staff's Third Data Request dated June 9, 2004, Item 12(b), page 4 of 9.

[38] See Case No. 2001-00244, Adjustment of Rates of Fleming-Mason Energy Cooperative Corporation, final Order dated August 7, 2002, at 11-12; Case No. 2000-00373, The Application of Jackson Energy Cooperative Corporation for an Adjustment of Rates, final Order dated May 21, 2001, at 13.

recorded.[39] Delta stated that its test-year 401(k) plan expense should be increased by this amount. The AG recommended that this error be corrected and, after recognizing that a portion of the expense should be capitalized, proposed an increase in the plan expense of $18,456.[40] The Commission agrees with the AG and finds that Delta's 401(k) plan expense should be increased $18,456.

Pension Expense

In its application, Delta did not propose an adjustment to its test-year pension expense of $497,034. In responses to data requests, Delta indicated that its actuary had determined the net periodic pension expense for the 2003-2004 fiscal year would be $725,434.[41] Delta subsequently submitted a more current analysis from its actuary that showed that the net periodic pension expense for the 2004-2005 fiscal year would be $555,560.[42]

The AG opposed the suggestion that Delta's test-year pension expense be increased to $725,434. The AG argued that this level of expense did not reflect recent upswings in the equity markets and the associated impact on Delta's pension plan assets. He further argued that Delta was inappropriately attempting to lock into base rates an abnormally high level of pension expense that would probably decline over

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[39] Response to the Commission Staff's Second Data Request dated May 11, 2004, Item 25(aa).

[40] Henkes Direct Testimony, Schedule RJH-8.

[41] Response to the Commission Staff's Second Data Request dated May 11, 2004, Item 25(z). Delta's fiscal year runs from July 1 to June 30 of the following year.

[42] Updated Response to the AG's First Data Request dated May 11, 2004, Item 27, filed June 29, 2004.

time. The AG recommended that the test-year level of the expense be used for rate-making purposes.[43]

The Commission has previously recognized the results of current actuarial studies in determining the reasonable level of pension expense for rate-making purposes.[44] Delta has provided two actuarial reports that both indicate its pension expense should be increased. The results from the most recent of the actuarial reports support the AG's argument that improvements in the equity markets have had a positive effect on Delta's pension plan assets and have resulted in a lower net periodic pension expense, but still show that Delta's pension expense is $58,526 higher than the level of expense included in the test year.

The Commission finds that Delta's pension expense should be increased $58,526. The pension expense recorded by a utility is based upon the results of its actuarial studies. The pension expense identified in the actuarial report for the 2004-2005 fiscal year reflects the reasonable, on-going level of expense, and is known and measurable.

Consultant Expense

At the beginning of the test year, Delta retained an outside consultant to provide customer service representative services. As noted previously in this Order, in July 2003 Delta discontinued using the outside consultant and hired a part-time employee to

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[43] Henkes Direct Testimony at 17-18.

[44] See Case No. 2000-00373, May 21, 2001 Order at 13-14; and Case No. 2001-00244, August 7, 2002 Order at 15-16.

perform this work. Delta did not normalize the wages for the new part-time employee and did not remove the outside consultant's expense for rate-making purposes.

The Commission has normalized the new part-time employee's wages in its determination of Delta's payroll expense. Consequently, it is not reasonable to also include the test-year expense for the outside consultant. The expense for this outside consultant is also a non-recurring expense for Delta. Therefore, the Commission finds that test-year expenses should be reduced by the amount the outside consultant was paid for the first six months of the test year, which was $4,900.

Rate Case Expense

Delta estimated that the total cost of the rate case would be $250,000. Delta proposed that its actual rate case expense should be amortized over a 3-year period, consistent with the Commission's treatment in recent rate cases.[45] Using its estimated total rate case cost, Delta proposed an adjustment for rate case expense of $83,333.

While the AG agreed that Delta's actual rate case expenses should be amortized, he proposed an amortization period of 4 years. He argued that the amortization period should be based on the normal interval of time between Delta's rate cases. The AG determined that the average rate case interval between Case No. 1997-00066,[46] Case No. 1999-00176,[47] and this case is approximately 4 1/2 years, and thus recommends a 4-year amortization. Although the AG contended that only actual rate

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[45] Delta's Post-Hearing Brief at 9.

[46] Case No. 1997-00066, An Adjustment of General Rates of Delta Natural Gas Company, Inc., final Order dated December 8, 1997.

[47] Case No. 1999-00176, An Adjustment of the Rates of Delta Natural Gas Company, Inc., final Order dated December 27, 1999.

case expenses should be recognized in the adjustment, he proposed a rate case expense adjustment based on estimated total costs of $150,000, which is an adjustment of $37,500 using a 4-year amortization period.[48]

Delta's most recent report of actual rate case expenses covers expenses through August 31, 2004 and shows actual rate case expenses to date of $219,767.[49] As correctly noted by Delta and the AG, the Commission in previous decisions has based its allowed rate case expense amortization on the actual rate case expenses supplied by the utility through periodic updates.

While the Commission's decision in Case No. 1997-00066 did state the amortization period would reflect the interval between Delta's rate filings, the Commission also noted that Delta's actual rate case expenses in that proceeding had exceeded the estimated expense by approximately 33 percent.[50] While exceptions existed, the Commission generally has permitted the amortization of a utility's actual rate case expenses over a 3-year period.[51] The AG has failed to persuade us that

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[48] Henkes Direct Testimony at 19-20.

[49] Response to the Commission Staff's First Data Request dated March 17, 2004, Item 51(c), updated response filed September 10, 2004. The updated response shows a total rate case expense of $230,367; however, Delta included expenses of $10,600 identified as estimated and which have not been documented as actual expenses.

[50] Case No. 1997-00066, December 8, 1997 Order at 13. Delta's estimated rate case expense had been $75,000 and its actual rate case expense was $101,349.75.

[51] See Case No. 2001-00092, January 31, 2002 Order at 37. In this ULH&P gas rate case, the AG proposed that rate case expenses be amortized over 3 years, consistent with the Commission's previous decisions concerning the amortization of rate case expenses.

circumstances in this rate case warrant the use of a 4-year amortization period for the actual rate case expenses.

Accordingly, the Commission finds that Delta's updated actual rate case expenses should be amortized over a 3-year period for rate-making purposes. We further find that the first year of a 3-year amortization of the actual rate case expenses is $73,256 and that operating expenses should be increased by this amount.

Lobbying Expenses

Delta proposed to remove $16,063 in operating expenses related to its lobbying activities. The amount reflected payments to an outside firm as well as expenses for a Delta employee who was engaged in lobbying activities. The proposed adjustment was recorded in several accounts within Delta's chart of accounts.[52]

While accepting Delta's proposed adjustment, the AG also identified an additional $758 in lobbying expenses.[53] The AG contended that additional lobbying expenses were included with economic development and community relations expenses.[54] The AG argued that these additional lobbying expenses had no relation to the provision of safe and reliable gas service and produced no material benefit to ratepayers.[55]

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[52] Application, Tab 27, Schedule 4 and Hall WP-4.3.

[53] Response to the AG's First Data Request dated May 11, 2004, Item 37.

[54] Henkes Direct Testimony, Schedule RJH-13, Items 8 and 9. The AG grouped a series of expense categories together as an overall "miscellaneous" expense adjustment. To the extent that a particular category of expense is separately discussed in this Order, those expenses will be addressed as part of the specific category, rather than lumped into the miscellaneous expense adjustment.

[55] Id. at 28-29.

The Commission has reviewed the numerous transactions that Delta and the AG have identified as lobbying expenses. Based on this review, we find that the $16,063 in expenses identified by Delta and the $758 in expenses identified by the AG are lobbying expenses and should be excluded from the test-year expenses for rate-making purposes.

Concerning the lobbying expenses the AG asserts were included with economic development and community relations expenses, it is difficult to determine from the data responses cited by the AG which expenses were associated exclusively with lobbying activity. For many of the transactions identified by the AG, the transaction description cited other activities along with lobbying or did not clearly distinguish that the transaction was associated with lobbying activities, making it impossible to determine what portion of the transaction was related to lobbying activities. The Commission has carefully examined these transactions and, based upon the information contained in this record, concluded that an additional $347 is related to lobbying activities.[56]

Lastly, Delta was requested at the public hearing to provide a calculation of the employee taxes and benefits associated with the Delta employees' time spent on lobbying activities. Delta determined that the lobbying-related employee taxes and benefits would total $1,289.[57] The Commission concludes that if a portion of a Delta

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[56] Response to the AG's First Data Request dated May 11, 2004, Item 45(b), lines 29 and 56 and Response to the Commission Staff's Third Data Request dated June 9, 2004, Item 24(a). In the response to Item 24(a), Delta identified meal expenses associated with lobbying activity from transactions that had been provided in the Response to the AG's First Data Request dated May 11, 2004, Item 45(c).

[57] Response to Hearing Data Request of the Commission Staff dated August 18, 2004, Item 2.

employee's salary is allocated to lobbying activities, which Delta has proposed to exclude for rate-making purposes, then a corresponding portion of the employee taxes and benefits should also be excluded.

Accordingly, the Commission finds that Delta's operating expenses should be reduced by $18,457 to reflect the removal of expenses associated with lobbying activities.

Public and Community Relations Expenses

Delta proposed to remove $25,645 from operating expenses related to public and community relations.[58] The $25,645 was the test-year balance for Account No. 930.10, Public and Community Relations. Delta provided information that showed these expenses reflect numerous social and charitable donations.[59]

The AG accepted Delta's proposed adjustment, but further argued that additional community relation expenses were recorded in Account No. 921.29, Company Business Meals and Entertainment.[60] The AG argued that these additional community relation expenses were unrelated to the provision of safe and reliable gas service and produced no material benefit to ratepayers.[61]

The Commission has reviewed these transactions. Noting that these donations enhance the utility's corporate image and should be borne by shareholders, the

[58] Application, Tab 27, Schedule 4.

[59] Response to the Commission Staff's First Data Request dated March 17, 2004, Item 27, pages 14 through 20 of 25.

[60] Henkes Direct Testimony, Schedule RJH-13, Item 9.

[61] Id. at 28-29.

Commission in previous rate cases has excluded social and charitable donations for rate-making purposes. Consequently, we agree that the $25,645 removed by Delta should be excluded from test-year expenses for rate-making purposes.

Concerning the additional community relations expenses, it is difficult to determine from the data responses that the AG cites the specific nature of some of the transactions. Our review indicated that several of the transactions related to activities that clearly served to enhance Delta's corporate image and were unrelated to the provision of utility service. We find that those transactions should be excluded for rate-making purposes.[62] Based upon this analysis, the Commission finds that an additional $1,246 should be excluded from test-year operating expenses.

Based on these findings, the Commission has determined that Delta's operating expenses should be reduced by $26,891.

Marketing Expenses

Delta proposed to remove $15,239 from operating expenses related to marketing activities.[63] The $15,239 was the test-year balance for Account No. 930.04, Marketing. The AG accepted Delta's proposed adjustment and further proposed that the entire test-year balance of $44,200 in Account No. 930.11, Conservation Program, be excluded for rate-making purposes. He noted that Delta agreed to the exclusion of this account.[64]

[62] See Response to the AG's First Data Request dated May 11, 2004, Item 45(c). The Commission has excluded $900 for tickets to Keeneland (lines 99 and 288); $208 for attending Kiwanis and Rotary Club meetings (lines 234, 243, 299, and 330); and $138 for greens fees (line 248). Delta identified the greens fees in its Response to the Commission Staff's Third Data Request dated June 9, 2004, Item 24(c).

[63] Application, Tab 27, Schedule 4.

[64] Response to the AG's First Data Request dated May 11, 2004, Item 43.

Delta subsequently reversed its position and argued that the incentive payments recorded in Account No. 930.11 are valid business expenses. It contended that these expenses have increased its customer base, that the revenues from those customers have been included for rate-making purposes and, therefore, fairness requires the inclusion of the expenses for rate-making purposes.[65]

The payment of incentives to market gas service and promote the selection and installation of gas appliances clearly is "promotional advertising" as defined in Commission regulations.[66] Promotional advertising is not considered as producing a material benefit to ratepayers and expenditures for such advertising are expressly disallowed for rate-making purposes. The Commission has examined samples of the materials provided to participants in programs associated with Account No. 930.11 expenses. These materials clearly promote the selection and use of gas appliances over other appliances.[67] Consequently, Administrative Regulation 807 KAR 5:016, Section 4, requires exclusion of the expenses for rate-making purposes. That these expenses are valid business expenses of Delta does not provide any legal basis for the inclusion of these expenses.

The Commission agrees with Delta and the AG that the test-year balance in Account No. 930.04 should be excluded for rate-making purposes. Further, the Commission agrees with the AG that the test-year balance in Account No. 930.11

[65] Delta's Post-Hearing Brief at 12.

[66] Administrative Regulation 807 KAR 5:016, Section 4.

[67] Response to the Commission Staff's Third Data Request dated June 9, 2004, Item 15.

should also be excluded for rate-making purposes. Therefore, the Commission finds that Delta's operating expense should be reduced $59,439.

Depreciation Expense

Prior to the filing of its rate case, Delta had a depreciation study performed on its utility plant in service as of December 31, 2003, which resulted in new depreciation rates for most of the items of utility plant. Delta's last depreciation study had been undertaken in 1986, but the depreciation rates from that study were never implemented.[68] The new depreciation rates were calculated using the average service life depreciation procedure, the straight-line method, and the remaining life basis, with the exception that the rates for storage plant were determined using the whole life basis. Delta proposed to normalize its depreciation expense by applying the new proposed depreciation rates to its utility plant in service as of test-year end. Delta proposed to reduce its depreciation expense by $145,431[69] and recognized a similar reduction to its accumulated depreciation balance in its proposed rate base.

The AG reviewed Delta's depreciation study and recommended adjustments to Delta's proposed depreciation rates. The AG then applied his revised depreciation rates to Delta's utility plant in service as of test-year end. The AG proposed to reduce

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[68] Response to the AG's First Data Request dated May 11, 2004, Item 69. Delta was uncertain when the current depreciation rates were developed, but stated they had been in use since the 1970s. See Response to the AG's First Data Request dated May 11, 2004, Item 71. Delta noted that between 1985 and 1991, the Commission had revised the depreciation rates for certain specific utility plant accounts.

[69] Application, Tab 27, Schedule 5.

depreciation expense by $905,175.[70] The AG included this reduction in the accumulated depreciation balance that he used in determining his proposed rate base.

The Commission has identified six areas that need to be addressed regarding Delta's and the AG's depreciation proposals. These are discussed below.

Remaining Life or Whole Life. Delta's depreciation study used the remaining life basis when determining depreciation rates, with the exception of storage plant. Noting the newness of its storage plant and the lack of adequate historical data, Delta asserted that use of the whole life basis was reasonable.[71] The AG criticized Delta for using the whole life basis for this portion of the utility plant, stating that Delta had used remaining lives to calculate whole life rates.[72] In response to these criticisms, Delta argued that use of the remaining life basis would result in depreciation rates being too low and that the AG was placing too much weight on the reasonableness of using the remaining life basis to determine storage plant depreciation rates. Delta stated that it did not have a strong objection to using the remaining life basis to determine the depreciation rates for its storage plant.[73] Delta provided depreciation rates for its storage plant using the remaining life basis in response to a hearing data request.[74]

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[70] Henkes Direct Testimony, Schedule RJH-14.

[71] Seelye Rebuttal Testimony at 13.

[72] Majoros Direct Testimony at 12.

[73] Seelye Rebuttal Testimony at 13-14.

[74] Response to Hearing Data Request of the Commission Staff dated August 18, 2004, Item 10.

The Commission finds that the same basis should be used for all plant accounts in the depreciation study. We further find that Delta's reasons for use of the whole life basis for its storage plant are not persuasive and do not require a change in basis. We find that Delta's depreciation rates should be based on the remaining life basis for all plant accounts.

Service Lives. To determine the proposed service lives, Delta and the AG used the Geometric Mean Turnover ("GMT") Method and the Simulated Plant Record Balance ("SPR") approach. Delta's and the AG's analyses on service lives produced similar results, with the exception of three accounts – Account No. 369, Measuring and Regulation Station Equipment; Account No. 376, Distribution Mains; and Account No. 382, Meter and Regulator Installations. For each of these accounts, the AG proposed longer service lives.

Delta argued against the AG's proposed service lives for the three accounts primarily on grounds of due process. It asserts that the AG refused to provide his SPR computer model to permit Delta to verify the reasonableness of the AG's SPR results. Delta also contended that the AG did not properly handle certain cost transfers that occurred in 1989.[75]

The AG asserted that his SPR results could be verified without access to his SPR model by using a calculation described at the hearing.[76] He also noted that Delta did not express concerns about the 52-year life his GMT methodology produced for

[75] Delta's Post-Hearing Brief at 25-27.

[76] T.E., August 18, 2004, at 288-289.

Account No. 376. The AG was also critical of certain assumptions that Delta made to develop the depreciation rate proposed for Account No. 376.[77]

The Commission has concerns about the AG's refusal to provide his SPR model to Delta for an analysis of that model's output. Notwithstanding the AG's contention that through a series of mathematical calculations his SPR results can be verified, a party should have a meaningful opportunity to test the model and its underlying assumptions. The AG's refusal to provide the model deprives Delta of such opportunity. The Commission notes that out of 46 utility plant accounts included in the depreciation study, the parties disagree over only three accounts, which make up almost 39 percent of Delta's total utility plant in service at test-year end. The AG has stated that after performing his GMT and SPR analyses, he was able to eliminate "certain disagreements" for several accounts, but not for Account Nos. 369, 372, and 382.[78]

The Commission is well aware that a depreciation study involves the analysis of a significant amount of information and the preparer's judgment and experience. After considering the arguments and the evidence of record, the Commission finds that Delta has proposed reasonable service lives for the three accounts in dispute and will use those service lives to determine Delta's depreciation rates.

Negative Net Salvage Values. The AG argued that Delta had incorporated excess negative net salvage into its proposed depreciation rates. The AG contended that Delta has included approximately $45,000 of negative net salvage expense into its proposed rates without performing any studies to support this level of expense. The AG

[77] AG's Post-Hearing Brief at 10-11.

[78] Majoros Direct Testimony at 20.

stated that Delta's actual negative net salvage expense over the past 5 years was $11,274. The AG recommended that the 5-year level of actual negative net salvage expense should be included in depreciation rates.[79] The AG originally indicated that the negative net salvage expense should not be included in the depreciation rates, but instead included as a separate component of total depreciation expense.[80] He subsequently amended his position, stating that while it was not necessary to separate the net salvage component from depreciation rates, it was necessary to separate the net salvage component within the depreciation rates and accrual.[81] Delta did not directly respond to the AG's argument concerning negative net salvage expense. However, Delta did provide a data response that contained records of all actual salvage and cost of removal data back to 1986.[82]

The Commission has considered the AG's argument and reviewed Delta's salvage and cost of removal data. Based on this information, the Commission finds that Delta has adequately supported the negative net salvage expense incorporated into its proposed depreciation rates. While Delta has not conducted a formal study or analysis of the historic salvage and cost of removal data, the Commission is not persuaded that the lack of such a study requires rejection of Delta's negative net salvage expense and finds the records of actual salvage and cost of removal sufficient in this instance to

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[79] AG's Post-Hearing Brief at 11.

[80] Majoros Direct Testimony, Exhibit MJM-2, page 5 of 7.

[81] AG's Response to the Commission Staff's First Data Request dated July 16, 2004, Item 5(b). Salvage costs minus the cost of removal equals net salvage expense.

[82] Response to the AG's First Data Request dated May 11, 2004, Item 52. The response contains 462 pages of plant retirement, salvage, and cost of removal data.

support Delta's proposal. The Commission finds that the negative net salvage expense proposed by Delta should be included in the depreciation rates.

Construction Work in Progress ("CWIP"). In the determination of the proposed depreciation expense adjustments, Delta and the AG included depreciation expense on CWIP. Neither offered any explanation or justification as to why depreciation on CWIP was included in the proposed depreciation expense adjustments.

CWIP represents the total of the balances of work orders for gas plant under construction. As such, this gas plant is not available for or providing service to customers. Depreciation, as defined in the Uniform System of Accounts, means the loss in service value not restored by current maintenance, which is incurred in connection with the consumption or prospective retirement of the gas plant.[83] Consequently, the Commission generally does not calculate depreciation expense on CWIP. In the event a utility proposed to recognize new plant additions occurring after test-year end, it might be appropriate to recognize a level of depreciation expense on the new plant additions. However, in this case, Delta did not propose the recognition of any new plant additions occurring after test-year end.[84] Accordingly, the Commission finds that depreciation expense on CWIP should not be included for rate-making purposes.

Amortization of Acquisition Adjustments. When Delta determined its proposed depreciation expense adjustment, it failed to include the amortization of plant acquisition

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[83] 18 CFR 1.201 at 507.

[84] Application, Tab 43.

adjustments currently on Delta's books.[85] Noting that Delta had failed to include the amortization of the acquisition adjustments, the AG recognized this item in his proposed depreciation adjustment.[86] Delta agreed this item should have been included in the determination of the depreciation expense adjustment.[87]

The Commission agrees with Delta and the AG and finds that the depreciation expense adjustment should include the amortization of these acquisition adjustments.

Accretion Expense for SFAS No. 143 Assets. In its post-hearing brief, Delta proposed an increase of $2,800 in its depreciation expense related to the accretion expense on SFAS No. 143 assets.[88] The AG did not address this proposal.

The Commission notes that Delta has stated that the recovery of this expense could be accomplished through either an adjustment to its depreciation expense or by allowing it to earn a return on the unrecovered SFAS No. 143 adoption costs by including the unrecovered costs in Delta's rate base. Further, Delta stated that it had no preference as to the mode of recovery.[89] Both Delta and the AG included the unrecovered SFAS No. 143 costs as a component in the respective rate base proposals. As we have included this item in Delta's rate base, we find that it is

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[85] Response to the AG's Second Data Request dated June 9, 2004, Item 2. Delta acquired the TranEx pipeline in 1989 and the Mt. Olivet gas system in 1999.

[86] Henkes Direct Testimony at 29.

[87] T.E., August 18, 2004, at 87.

[88] Delta's Post-Hearing Brief at 28.

[89] Response to the Commission Staff's Second Data Request dated May 11, 2004, Item 41(b).

inappropriate to include this expense in the determination of Delta's total depreciation expense and that Delta's proposal should be denied.

Summary. The Commission finds that Delta has provided sufficient evidence of how its depreciation rates were developed and further finds that Delta's depreciation study and the resulting depreciation rates are reasonable and should be approved, subject to the modifications discussed above.

The Commission further finds that modified depreciation rates for Delta should be applied to utility plant in service as of test-year end to determine Delta's depreciation expense adjustment. The Commission has calculated Delta's depreciation expense and finds that the depreciation expense should be reduced by $296,967.[90] The Commission has also included a corresponding adjustment to the accumulated depreciation balance used in the Commission's determination of Delta's rate base.

Prior to the current proceeding, Delta last undertook a depreciation study in 1986. The Commission finds that length of time between the two studies is unreasonable and may result in distorted rates. We find that Delta should undertake a new depreciation study within 5 years of the date of this Order, or in conjunction with its next general rate case, whichever event occurs first. If this new depreciation study is not performed in conjunction with a general rate case, the new study should be based on Delta's utility plant in service as of December 31, 2008. In addition, Delta should file the depreciation study with the Commission for approval prior to using any new depreciation rates for accounting or rate-making purposes.

[90] Consistent with the discussion of depreciation topics, no depreciation expense has been included for Delta's test-year-end balance of CWIP.

Directors' Fees and Expenses

For the test year, Delta's directors' fees and expenses totaled $225,369.[91] This total expense included $149,500 of monthly retainers, $22,820[92] of common stock, $51,440 of bonus payments, and several miscellaneous expenses. Delta did not propose an adjustment to its directors' fees and expenses, contending that the test-year level was the minimum amount that would be experienced on a going forward basis.[93]

Delta raised the directors' monthly retainer in June 2003, during the test year, and again in March 2004. A committee of the board of directors, the Nominating and Compensation Committee, recommended the increases, based upon its review of information concerning other companies' director compensation. At least for the March 2004 increase, no formal report in conjunction with its proposal to raise the monthly retainer was released.[94] As to the stock issued to its directors, Delta stated that this practice had been in effect for several years and it continued the practice in 2004.[95] Concerning the bonus payment, Delta originally indicated that this payment was a non-

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[91] Delta has 10 directors.

[92] The $22,820 reflects the value of 100 shares of Delta common stock provided to each director. Nine of the directors accepted the stock, valued at $20,538, and one director received cash in lieu of the stock, which equaled $2,282. See Response to the AG's Second Data Request dated June 9, 2004, Item 14(a).

[93] Delta's Post-Hearing Brief at 17.

[94] T.E., August 18, 2004, at 30-32.

[95] Jennings Rebuttal Testimony at 2 and Response to Hearing Data Request of the Commission Staff dated August 18, 2004, Item 1. On August 26, 2004, Delta's board of directors voted to give each director an amount of cash equal to the value of 100 shares of Delta common stock.

recurring expense.[96] However, it subsequently contended that the bonus was intended to compensate directors for their increased responsibilities, such as compliance with the provisions of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley").[97] Included in the miscellaneous expense was $686 for a director Christmas dinner and Christmas gifts. Delta argued that this expense was a necessary expense to retain high quality directors. It further contended that this expense was a valid and appropriate business expense that should be considered for rate-making purposes.[98]

Noting the significant increase in the total directors' fees and expenses, from $87,460 in 1999 to $225,369 in 2003, the AG proposed two adjustments to the test-year level of directors' fees and expenses. First, he proposed that the bonus be excluded for rate-making purposes as a non-recurring expense. Second, the AG recommended that the expenses associated with the Christmas dinner and gifts be excluded, as these expenses did not produce a material benefit to customers.[99] Although Delta did not propose an adjustment to recognize the March 2004 increase in the monthly retainer, the AG opposed the recognition of the increase contending that Delta had not met its burden of proof.[100]

The Commission finds that the bonus and expense of the Christmas dinner and gifts should be excluded for rate-making purposes. However, our exclusion of the

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[96] Response to the AG's First Data Request dated May 11, 2004, Item 9.

[97] Delta's Post-Hearing Brief at 17.

[98] Id. at 18.

[99] Henkes Direct Testimony at 22-23.

[100] AG's Post-Hearing Brief at 6.

bonus is not based on a conclusion that this expense is a non-recurring expense. Rather, we find that Delta has failed to adequately explain why this bonus payment is necessary in addition to the monthly retainer.[101] We are similarly not persuaded by Delta's arguments regarding the Christmas dinner and gifts. Every valid and necessary business expense should not necessarily be borne solely by ratepayers. Delta's shareholders also benefit from the retention of high quality directors. The Commission has in previous cases determined that Christmas dinners and gifts, for both employees and directors, should be borne by shareholders and not ratepayers. Delta has offered no convincing arguments to alter our position.

To determine the reasonable, on-going level of directors' fees and expenses, the Commission finds that the monthly retainer fee should be normalized using the increase awarded during the test year. This was the level of monthly retainer fee in effect at test-year end. This approach is consistent with the approach used to normalize employees' wages and salaries. The monthly retainer levels approved in March 2004 will not be used for this normalization of expense. Delta has not provided adequate evidence to demonstrate that the March 2004 increase was necessary and reasonable. The Nominating and Compensation Committee did not provide a report summarizing its review of directors' compensation. As members of the board of directors make up the Nominating and Compensation Committee, no independent verification of their findings exists.

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[101] The Commission notes that Delta has paid a bonus, or "cash supplement," and awarded common stock to directors every year since 2000. Neither practice was in effect during Delta's last rate case. See Response to the AG's First Data Request dated May 11, 2004, Item 38(a).

Delta began awarding common stock to its directors as part of its overall compensation in 2000. It has not provided any justification to explain why this additional compensation is necessary or reasonable in light of the overall directors' compensation. Absent such justification, the Commission finds that this expense is not reasonable and should be excluded for rate-making purposes.

Based upon the above discussion, the Commission finds that the amount of test-year operating expenses claimed by Delta for directors' fees and expenses should be reduced. The reduction should reflect the normalization of the monthly retainer fee using the June 2003 increase and the removal of the expense of the bonus, stock award, and Christmas dinner and gifts. Therefore, the Commission finds that test-year operating expenses should be reduced by $68,447.

The Commission is concerned about the significant increase in the total directors' fees and expenses since 1999, especially with two increases in the monthly retainer within a 9-month period. While the Commission recognizes that Delta must attract and retain quality directors, Delta has not performed a formal analysis to determine an adequate and reasonable level of compensation for its directors. Therefore, the Commission will require Delta to submit, in conjunction with its next general rate case, a thorough analysis of the total compensation provided to its directors and to justify the levels of compensation provided. Delta is strongly encouraged to have this analysis prepared by an independent third party.

Sarbanes-Oxley Expenses

During the test year Delta incurred $240,727 in expenses associated with its compliance with Sarbanes-Oxley. These expenses were categorized as project

planning, process documenting, test plans and testing, and portal installation. Delta indicated that 30 percent of the project planning expenses and 100 percent of the test plans and testing expenses would be recurring. Based on these percentages, Delta calculated that $163,328 of its test-year expense for Sarbanes-Oxley compliance would be non-recurring. However, Delta also stated that it would incur approximately $80,000 for an external audit of internal controls beginning in March 2005.[102]

The AG recommended that Delta's test-year level of Sarbanes-Oxley compliance expenses be reduced $163,328, contending that the non-recurring expense should not be included for rate-making purposes. The AG argued against recognizing the March 2005 audit expense, citing that this expense was not known or measurable and was occurring 15 months after the end of the test year.[103]

Opposing the AG's proposed adjustment, Delta contended that the adjustment to this expense should only be $83,748. Delta noted the on-going nature of its Sarbanes-Oxley compliance expenses and stated that in the first six months of 2004 it had expenses of $111,618.[104] Delta provided an analysis of its 2004 Sarbanes-Oxley compliance expenses, using the same format as its analysis of its test-year compliance expenses.[105]

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[102] Response to the Commission Staff's Second Data Request dated May 11, 2004, Item 25(u).

[103] Henkes Direct Testimony at 24-25.

[104] Brown Rebuttal Testimony at 2.

[105] Response to Hearing Data Request of the Commission Staff dated August 18, 2004, Item 9.

In its brief, Delta argued for the first time that any portion of the test-year Sarbanes-Oxley compliance expenses declared non-recurring should be amortized over a 3-year period. Delta contended that a finding that an expense is non-recurring does not support the denial of recovery of the expense in base rates. In support of its argument for amortization of the non-recurring portion of the Sarbanes-Oxley compliance expenses, Delta cited the Commission's decision in a 1990 Louisville Gas and Electric Company ("LG&E") rate case concerning the treatment of downsizing expenses.[106]

We first note that Delta's proposal for amortization of non-recurring compliance costs is untimely raised. We find the introduction of new rate-making proposals in a post-hearing brief is not only inappropriate but deprives opposing parties of a meaningful opportunity to comment and present argument.

We now turn to the merits of the proposal. At no time in this proceeding has any party asserted that Delta's test-year Sarbanes-Oxley compliance expenses were imprudently incurred. Delta's imprudence argument does not adequately address the treatment of non-recurring expenses. In rate-making, the Commission attempts to establish rates based upon the reasonable, on-going level of expenses necessary to provide the regulated utility service. If the utility does not continually incur a certain level of expense, inclusion of this non-recurring expense for rate-making purposes is neither fair, just, nor reasonable. Delta does not address the need to establish reasonable, on-going levels of expenses nor why the inclusion of non-recurring expenses for rate-making purposes is fair, just, or reasonable.

[106] Delta's Post-Hearing Brief at 19-23.

Concerning its citation to the 1990 LG&E rate case, Delta has failed to note or ignored certain important considerations regarding the amortization of non-recurring expense. We stated:

> The Commission finds that, for rate-making purposes, amortization of some of the downsizing costs is appropriate. The Commission remains convinced that, in general, non-recurring costs which are expensed should not be considered for rate-making purposes. However, in this instance the Commission is recognizing the material nature of the costs, the future benefits of downsizing which should be available to the ratepayers and shareholders of LG&E, and the matching of those benefits with the costs.[107]

In the present case, Delta has not argued that the non-recurring portion of its Sarbanes-Oxley compliance expenses constitutes a material portion of its total operating expenses. It has not identified any benefits to its ratepayers resulting from the non-recurring compliance expenses. Delta's present situation is not analogous to that of LG&E in its 1990 rate case.

The Commission recognizes that Delta's situation regarding the Sarbanes-Oxley compliance expenses is unique. While the act was enacted in 2002, Delta did not begin incurring compliance expenses until the test year. The goal of rate-making for this type of expense is to establish a reasonable, on-going level of expense. In this case, it is difficult to establish a reasonable level of expense since there are no prior years of expense activity to review. The extensive compliance activities associated with Sarbanes-Oxley, moreover, make it difficult to compare this expense with other similar expenses.

[107] Case No. 1990-00158, Adjustment of Gas and Electric Rates of Louisville Gas and Electric Company, Rehearing Order dated September 30, 1991, at 14.

The Commission finds that the estimated internal control audit expense of approximately $80,000 cannot be considered in the determination of the reasonable, on-going level of compliance expense. The audit expense is neither known nor measurable. It occurs too far beyond the end of the test year to be considered. However, in light of the expense information provided by Delta, the AG has not adequately supported his proposal that $77,399 is a reasonable, on-going level of compliance expense to include for rate-making purposes.

The Commission has reviewed the information concerning the Sarbanes-Oxley compliance expenses for the test year and the first 6 months of 2004. Our review reveals that Delta incurred compliance expenses between August 2003 and March 2004, a period of only 8 months. The Commission has calculated an on-going level of compliance expense using the 8 months of actual expenditures and only including the categories of project planning and test plans and testing. The recurring percentages of 30 percent and 100 percent were applied to the totals for project planning and test plans and testing, respectively. The Commission finds that the reasonable, on-going Sarbanes-Oxley compliance expense is $189,016,[108] which results in a reduction of test-year operating expenses of $51,711.

Computer Expenses

Delta indicated that $42,404 in test-year expenses associated with image scanning services, provided by a computer service vendor, was non-recurring in

[108] The Commission notes that this amount is based on 8 months of actual activity and has not been annualized to reflect a comparable level of expense for a 12-month period.

nature.[109] The AG argued that this non-recurring expense should not be included for rate-making purposes.[110] Delta responded that while the specific test-year expense with the particular vendor may be non-recurring, similar expenses with other computer service vendors will be incurred. Delta also described several projects under consideration, the cost of which would exceed the $42,404 adjustment proposed by the AG.[111] In its brief, Delta also argued that a non-recurring expense should be deferred and amortized over a 3-year period, citing the same reasoning provided for the Sarbanes-Oxley compliance expenses.[112]

We are not persuaded by Delta's arguments. Delta's list of projects under consideration does not constitute known or measurable costs. Delta has not provided any meaningful evidence to support its claims of the reasonable, on-going level of computer expenses. As to Delta's arguments for the amortization of the non-recurring portion of computer expenses, the reasons given for our rejection of Sarbanes-Oxley non-recurring compliance expenses are applicable. Consequently, the Commission agrees with the AG that this non-recurring expense should not be included for rate-making purposes and finds that Delta's operating expenses should be reduced by $42,404.

[109] Response to the Commission Staff's Second Data Request dated May 11, 2004, Item 36(g).

[110] Henkes Direct Testimony at 26.

[111] Brown Rebuttal Testimony at 2-3.

[112] Delta's Post-Hearing Brief at 23-24.

American Gas Association ("AGA") Dues

Based on Delta's responses to data requests, the AG recommended that 27.09 percent of Delta's AGA membership dues should be excluded for rate-making purposes, a reduction in expense of $7,389.[113] The AG stated that the 27.09 percent reflected the AGA expense categories of public affairs and advertising.[114] The AG argued that the public affairs category of expense was actually lobbying activities, and that the advertising category was promotional and institutional in nature.[115] The AG cited information provided in Case No. 2003-00433 in support of his understanding of what activities were classified as public affairs.[116]

Delta opposed the AG's recommendation, stating that the AGA had indicated to Delta that less than 2 percent of the membership dues were attributed to lobbying activities.[117] Delta also argued that because of the importance of trade associations to it and other small utilities, the full membership dues should be included for rate-making purposes.[118]

Based upon our review of the information cited by the AG, we find insufficient evidence to support the AG's claim that the public affairs category of expense is exclusively lobbying activity. Lobbying activity was one of several activities listed in the

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[113] Henkes Direct Testimony, Schedule RJH-13, Item 2.

[114] Response to the AG's First Data Request dated May 11, 2004, Item 39(c).

[115] Henkes Direct Testimony at 27.

[116] T.E., August 18, 2004, at 225-229.

[117] Id. at 38-39.

[118] Delta's Post-Hearing Brief at 11-12.

description of the category. Concerning the AG's claim that the advertising category reflected promotional and institutional advertising, the AG has not provided any evidence to support his claim.

The Commission also is not persuaded by Delta's argument that the portion of its AGA membership dues associated with lobbying activity should be included for rate-making purposes. The Commission has previously held that lobbying activities are a form of political advertising, which is expressly excluded from rate-making by Administrative Regulation 807 KAR 5:016, Section 4. Moreover, while Delta was unable to obtain a more accurate estimate from AGA, the Commission is of the opinion that 2 percent of the fee is a reasonable amount of membership dues that should be excluded as lobbying activities. Accordingly, the Commission finds that 2 percent of Delta's AGA membership dues should be excluded for rate-making purposes and has reduced operating expenses by $546.

Economic Development Expenses

The AG recommended that $4,914 in expenses recorded in Account No. 930.09, Customer and Public Information, should be excluded for rate-making purposes. The AG argued that these promotional and economic development expenses were not related to the provision of safe and reliable gas service and produced no material benefit to Delta's ratepayers.[119] Disagreeing with the AG's recommendation, Delta contended that assisting economic development in its service area strengthens the

[119] Henkes Direct Testimony at 28 and Schedule RJH-13, Item 5.

economy and helps provide jobs. Delta reasoned that this activity helps all of its customers and its service area.[120]

While the Commission affirms its support of economic development activities, we are of the opinion that sufficient evidence must be presented to demonstrate that the expenses in question are actually related to economic development. Based upon our review of the expense transactions challenged by the AG, the Commission finds sufficient evidence has been presented that several transactions are in support of economic development activity and should be included for rate-making purposes. We find that the majority of the challenged expense transactions, however, are forms of promotional advertising and are prohibited from inclusion for rate-making purposes. Accordingly, the Commission finds that operating expenses should be reduced by $3,432 to remove promotional items for rate-making purposes.[121]

Miscellaneous Expenses

The AG proposed to reduce test-year operating expenses by $22,899 to exclude items relating to employee gifts, employee awards, employee social events, employee memberships, and employee spousal expenses. He argued that these expenses are not related to the provision of safe and reliable gas service and that their exclusion was consistent with previous Commission decisions.[122]

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[120] Jennings Rebuttal Testimony at 4.

[121] See Response to the AG's First Data Request dated May 11, 2004, Item 42. The Commission's adjustment reflects the expenses reported for lines 5, 31, 42, 45, and 49.

[122] Henkes Direct Testimony at 27-28 and Schedule RJH-13, Items 4, 6, and 7.

Disagreeing with the AG, Delta contended that these expenses are "legitimate business expenses in the competitive world and should be considered legitimate expenses for rate making purposes in the regulated world."[123] Delta argued that many of the questioned expenses boost employee morale and assist in employee retention, thus enabling it to provide customers with safe and reliable service. Concerning community involvement, Delta argued that it was important for it to support organizations involved in the communities that it serves.[124]

The Commission is not persuaded by Delta's argument that legitimate business expenses in the competitive world should by default be considered legitimate expenses for rate-making purposes. Some legitimate expenses benefit ratepayers and shareholders and should be borne by both groups. We are of the opinion that Delta's shareholders have some responsibility for maintaining good employee morale, employee retention, and good community relations.

Having reviewed the expense transactions challenged by the AG, we find that, with the exception of employee service and safety awards, these expenses should be excluded for rate-making purposes. The Commission has previously determined that expenses relating to employee social events, employee gifts, spousal expenses, and employee memberships in civic and social organizations are not related to the provision of safe and reliable gas service. Delta has not set forth any reasons to justify a different rate-making treatment in this case. The Commission further finds that the expenses for employee service and safety awards should be included for rate-making purposes as a

[123] Delta's Post-Hearing Brief at 13.

[124] Jennings Rebuttal Testimony at 4-5.

strong relationship exists between awards recognizing employee service and safety and the provision of safe and reliable gas service.

Based on these considerations, the Commission finds that expenses associated with employee gifts, employee awards, employee social events, employee memberships, and employee spousal expenses should be excluded for rate-making purposes, with the exception of employee service and safety awards. Therefore, the Commission finds that operating expenses should be reduced by $20,301.[125]

Income Tax Expense

Delta proposed to increase its income tax expense by $274,125 to reflect the impact of its proposed adjustments on its taxable income and income tax expense. Delta included in this proposed adjustment the normalization of its long-term and short-term debt interest expense, since interest expense is an income tax deduction.[126] The AG used the same approach as Delta and, based upon his proposed adjustments, determined that income tax expense should be increased by $782,256.[127] The approach reflects the parties' proposed rate bases and capital structures.

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[125] The Commission notes that, in its data responses, Delta did not consistently identify the same amount for these types of expenses. The Commission's adjustment is based on information gathered from three data responses. See Response to the AG's First Data Request dated May 11, 2004, Item 26; Response to the Commission Staff's Second Data Request dated May 11, 2004, Item 30; and Response to the Commission Staff's Third Data Request dated June 9, 2004, Item 14. The Commission has included for rate-making purposes $3,876 for employee safety and service awards. See Response to the AG's First Data Request dated May 11, 2004, Item 26, lines 6 through 10, 15, and 16.

[126] Application, Tab 27, Schedule 8.

[127] Henkes Direct Testimony, Schedule RJH-15.

The Commission finds the proposed approach is reasonable. The Commission has calculated an income tax expense adjustment reflecting the adjustments to revenues and expenses discussed in this Order and using the rate base and capital structure found reasonable herein. Therefore, the Commission finds that income tax expense should be increased by $427,428.

Pro Forma Net Operating Income Summary

After consideration of all pro forma adjustments and applicable income taxes, the adjusted net operating income for Delta is as follows:

Operating Revenues	$58,567,723
Operating Expenses	51,431,798
Adjusted Net Operating Income	$ 7,135,925

RATE OF RETURN

Capital Structure

Delta proposed an adjusted test-year-end capital structure containing 47.51 percent long-term debt, 15.35 percent short-term debt, and 37.15 percent common equity.[128] As discussed previously in this Order, Delta's proposed capital structure reflects the removal of its equity investment in subsidiaries. In its rebuttal testimony, Delta revised its capital structure to add back its minimum pension liability to its common equity balance. After reflecting this adjustment, Delta determined its capital structure as 46.68 percent long-term debt, 15.08 percent short-term debt, and 38.24 percent common equity.[129]

[128] Application, Tab 27, Schedule 9.

[129] Hall Rebuttal Testimony, Application Tab 27, Schedule 9.

The AG proposed the same test-year-end capital structure as Delta proposed in its application.[130] As noted previously in this Order, the AG opposed Delta's proposed treatment of its minimum pension liability.

As discussed previously in this Order, the Commission has recognized the adding back of Delta's minimum pension liability to its common equity balance and the inclusion of the balance in Account No. 212, Installments Received on Capital Stock. After including these two items, the Commission finds that Delta's capital structure is as follows:

	Percent
Long-Term Debt	46.65
Short-Term Debt	15.07
Common Equity	38.28
Total Capital Structure	100.00

Cost of Debt

Delta proposed a cost of long-term debt of 7.422 percent and short-term debt of 2.478 percent.[131] The AG used Delta's cost of long-term and short-term debt as proposed in Delta's application.[132] At the hearing, Delta indicated that while the cost of its long-term debt is fixed, the cost of its short-term debt is variable and the current cost of short-term debt was 2.51375 percent.[133]

[130] Henkes Direct Testimony, Schedule RJH-2.

[131] Application, Tab 27, Schedule 9. Delta's cost of short-term debt reflects a weighted average calculation that recognizes the stated cost of short-term debt and a 0.300 percent cost associated with Delta's unused line of credit balance.

[132] Henkes Direct Testimony, Schedule RJH-2.

[133] T.E., August 18, 2004, at 59-60.

The Commission finds it appropriate to recognize the most current cost rates for debt when determining the overall cost of capital for Delta. Revisions to Delta's debt cost rates constitute known and measurable adjustments. Using these updates, rather than the test-year-end cost rates, is more representative of the period in which the rates established in this Order will be in effect. These cost rates will be applied to the capital structure determined herein. Therefore, the Commission finds the cost of long-term debt to be 7.422 percent and the cost of short-term debt to be 2.891 percent.[134]

Return on Equity

Delta estimated its required return on equity ("ROE") using three methods: the capital asset pricing model ("CAPM"), the discounted case flow method ("DCF") and a risk premium analysis. Based on the results of these three methods, Delta recommends an ROE of 12.50 percent, which includes both a leverage adjustment and a small company adjustment, or "adder."

Delta compared its results to a group of publicly traded, investor-owned natural gas distribution companies chosen from a 2003 report issued by Edward Jones Company.[135] The comparison indicated that Delta had the third lowest capitalization and the second lowest percentage of equity.[136] Delta also demonstrated that it had not earned its allowed ROE since 1995 and asserted that Delta's rates did not provide an

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[134] The Commission has calculated this cost of short-term debt following the same approach as Delta outlined in Tab 27, Schedule 9 of the Application.

[135] Blake Direct Testimony at 6.

[136] Id.

opportunity to earn an adequate return.[137] Delta also states that the low equity ratio and rural service area contribute to its inability to earn its awarded ROE. In addition, Delta states that these issues make it a riskier investment than other gas distribution companies and indicate that a high ROE is necessary. Delta suggests a leverage premium to adjust for Delta's high level of debt. Delta cites additional factors to support its recommendation such as its rural customer base, competition with local electric utilities, its low capitalization compared to other gas distribution companies, its high debt to capital percentage, and the carrying costs for its under-recoveries from its GCA mechanism.

The AG estimated his recommended ROE using two methods: the DCF and the CAPM. Based on the results of these two models, the AG recommends an ROE of 10.30 percent. The AG's recommendation does not include a leverage adjustment.

The AG performed his DCF and CAPM analyses on both Delta and a peer group of companies. The AG explains that he performed his analysis on a peer group since Delta's small size leads fewer investment analysts to intensively study it.[138] The AG chose its peer group from *Value Line's* 19 gas distribution companies. Out of those 19 companies, he excluded 2 companies that *Value Line* rated below "B" for financial strength and 2 that did not issue dividends and that had no published *Value Line* earnings forecast.

[137] Blake Direct Testimony, Exhibit MJB-4, Historical Comparison of Allowed and Actual ROE, Delta Natural Gas Company.

[138] Corrected King Direct Testimony at 4.

The AG criticized Delta's contention that it is more leveraged than other gas distribution companies and provided his own company comparisons for the periods ending September 30, 2003, December 31, 2003, and March 31, 2004. The AG's comparison included the 15 companies in his peer group and 2 companies that Delta included in its exhibits and compared the capital structures, with and without short-term debt. The AG argues that, by March 31, 2004, Delta's equity proportion had increased above the average for the comparison companies when short-term debt was included and it approached the average when short-term debt was excluded.[139] Therefore, the AG argues, Delta does not need a leverage adjustment for its capital structure.

The AG also disagrees with Delta's small company adder, stating that Delta's earnings do not exhibit enough volatility in its earnings to justify increasing the ROE. The AG recommends using the small company adder only in the development of the range of the ROE. Finally, the AG believes that the monthly weather normalization adjustment ("WNA") mechanism approved in Delta's last rate case has stabilized Delta's earnings and has lowered any risk that resulted from its rural service territory.

In rebutting the AG's recommendation, Delta reiterated its argument that it needed a small company adjustment, referring to the AG's own testimony to show his agreement in theory with the adjustment.[140] Delta criticized the AG's use of the geometric mean in making his own size adjustment in the DCF analysis, the application of the adjustment in the aggregate rather than on a company-by-company basis and the comparison companies that the AG included in his analysis. Delta recalculated the

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[139] Id. at 10.

[140] Blake Rebuttal Testimony at 1.

AG's results, excluding five of his companies and applying the small-company adjustment company by company.

Delta expressed in rebuttal its disagreement with the AG's statement that it is not more leveraged than other comparable companies. Delta argued that the AG's comparison should have measured the other companies' equity at the same points in time, rather than updating Delta's equity percentage but not the percentage of the comparison companies. Even with these problems, Delta contended that the comparison still shows that it has a relatively low equity position, which justifies its proposed leverage adjustment.

Finally, Delta disagreed with the AG's CAPM calculations. Delta criticized the use of a one-year Treasury rate for the risk free rate and the size adjustment used in the CAPM calculations. Delta again recalculated the CAPM analysis as it would have done the analysis, which produced results similar to Delta's original calculations.

The Commission takes note of several issues that both Delta and the AG raise in their testimony. Delta does have some risk from its rural service territory and its equity percentage. We agree with the AG, however, when he states that Delta's WNA mechanism and its improvement in its equity position have mitigated some of this risk. The Commission believes that the additional risk issues that Delta cites, namely the competition from electric companies and the under-recoveries it experiences through its GCA mechanism, are not properly addressed through its ROE. Increasing the ROE will increase the price paid by Delta's customers, but will do nothing to help its competitive position with other forms of energy. The under-recoveries Delta experiences can be

addressed more readily through its GCA mechanism, with a revision of the GCA clause to include the carrying costs of any under-recoveries that Delta experiences.

While the Commission is not convinced that Delta's risks are as great as it claims, we are of the opinion that Delta has risks that should be recognized, such as its small size and its equity position. The Commission finds that the AG's recommended ROE does not fully reflect these risks, and that Delta's recommended ROE overstates them. Having considered and weighed the ROE evidence, the Commission finds a range of 10.0 percent to 11.0 percent, with a midpoint of 10.5 percent, to be reasonable. Therefore, Delta's revenue requirement and approved rates will be based on a 10.5 percent ROE.

Rate of Return Summary

Applying the rates of 7.422 percent for long-term debt, 2.891 percent for short-term debt, and 10.500 percent for common equity to the capital structure produces an overall cost of capital of 7.917 percent. The Commission finds this overall cost of capital to be fair, just, and reasonable.

REVENUE REQUIREMENTS

The Commission has determined, based upon a rate base of $111,172,436 and an overall cost of capital of 7.917 percent, that the net operating income found reasonable for Delta's operations is $8,801,522. Delta's pro forma net operating income for the test period is $7,135,925. Thus, Delta needs additional annual operating income of $1,665,597. After the provision for the PSC Assessment and state and federal taxes, there is a revenue deficiency of $2,755,576, which is the amount of additional revenue granted herein. The net operating income found reasonable for

Delta's operations will allow it the opportunity to pay its operating expenses and fixed costs and have a reasonable amount for equity growth.

The calculation of the overall revenue deficiency is as follows:

Net Operating Income Found Reasonable	$ 8,801,522
Pro Forma Net Operating Income	7,135,925
Net Operating Income Deficiency	1,665,597
Gross Up Revenue Factor[141]	.6044461
Overall Revenue Deficiency	$ 2,755,576

The additional revenue granted will provide a rate of return on rate base of 7.917 percent. The $2,755,576 increase represents an increase of 4.70 percent over the normalized gross operating revenues.[142]

The rates and charges in Appendix A are designed to produce gross operating revenues, based on the adjusted test year, of $61,105,732.[143] The gas operating revenues reflect the GCA adjustment approved in Case No. 2004-00264.

PRICING AND TARIFF ISSUES

Cost-of-Service Study

Delta filed an embedded, fully allocated cost-of-service study in order to determine the contribution that each customer class was making toward its overall rate

[141] The gross up revenue factor recognizes the impact the overall revenue deficiency will have on the PSC Assessment, Kentucky income taxes, and federal income taxes.

[142] The normalized operating revenues reflect the impact of Delta's most recent gas cost recovery adjustment.

[143] The gross operating revenues of $61,105,732 do not include the additional $217,567 in miscellaneous revenues that Delta anticipated would be generated after recognition of the requested increase in its Reconnect Charge.

of return and as an indicator of whether its rates reflected the cost to serve each customer class. Within the cost-of-service study, distribution mains costs were classified as customer costs or demand costs using the zero-intercept method. Delta's study, which includes a standard regression analysis based on 11 different sizes or types of distribution mains, classifies 56.5 percent of the costs of distribution mains as customer costs. The level of customer costs formed the basis for Delta's proposal to increase its residential customer charge from $8.00 to $12.50.

The AG voiced concern over the use of the zero-intercept method to determine the customer portion of distribution mains costs. While the AG does not advocate using the other common method, the minimum system method, he argues that the customer portion is too high when compared to the customer portion of mains costs determined for other utilities. The AG proposed an alternative regression analysis based on only two main sizes, which results in a customer portion of 20.1 percent. Based on this analysis, the AG recommended a $9.00 residential customer charge.

Delta rebutted the AG's position, stating that the AG had developed a statistically meaningless result by performing a regression analysis using only 2 data points. Delta also explained why a rural utility system, such as Delta, with less customer density, will have a larger share of mains costs classified as customer costs than less rural systems. The Commission has accepted the zero-intercept method in numerous prior rate cases and has recognized it as more consistent and less subjective than other methods, such as the minimum system method, for classifying distribution mains costs. The Commission finds that Delta's cost-of-service study, with distribution mains costs

allocated based on the zero-intercept method, should be accepted and treated as the starting point for determining Delta's revenue allocation and rate design.

The Commission has accepted Delta's cost-of-service study. However, the revenue increase we are granting is approximately 65 percent of Delta's requested increase. With this reduction in the revenue increase and, giving appropriate recognition to the rate-setting concepts of gradualism, rate continuity, and revenue stability which it has long espoused, the Commission will increase Delta's residential customer charge from $8.00 to $9.80. Similarly, we will increase the small non-residential customer charge from $17.00 to $20.00 and increase the large non-residential customer charge from $50.00 to $72.00

Revenue Allocation

Delta's cost-of-service study indicates that the rates of return for all customer classes are below its proposed system average rate of return, with the exception of its interruptible transportation customers and off-system transportation customers. Delta proposed to allocate the revenue increase to all classes with below average rates of return, including residential, small non-residential and large non-residential customers, but not special contract customers.

Delta put forth two reasons for not allocating any of the increase to its special contract customers. First, it asserts that these contracts include fixed prices for the terms of the contracts and therefore cannot be changed prior to expiration of their respective terms. Second, it states that these customers represent a bypass threat and that increasing their rates might cause them to bypass Delta and connect directly to a transmission pipeline. Without the contribution by special contract customers to its fixed

costs, Delta states that $631,225 in revenues would have to be re-allocated and recovered from its remaining customers.

The AG argues that $63,636 of Delta's proposed revenue increase should be allocated to the special contract customers, resulting in a smaller revenue increase to the residential customers. The AG argues that Delta's focus should be on preventing the loss of residential customers rather than the loss of special contract customers.

The Commission finds that none of the increase granted herein should be allocated to special contract customers. Delta has previously lost customers to by-pass and it has the potential to lose others. Because of the number of interstate pipelines located in Kentucky, all jurisdictional gas distribution utilities face the threat of bypass on economic grounds. Although it would be ideal to more closely reflect costs in setting rates for large volume customers, ideal circumstances do not often exist. In less than ideal circumstances, if revenues from large volume customers cover a utility's variable cost of service and make a contribution to its fixed costs, the remaining customers benefit from retaining these large volume customers. In Delta's case, the effect on the residential customers of bearing the additional $63,636 in revenue, as advocated by the AG, is far less than the $631,225 they could have to bear if the four special contract customers were to bypass Delta.

Rate Design

Delta proposed two rate design changes. The first change reduces the number of steps in the rates for the small non-residential customer class from three steps to a single step distribution rate for all Mcf. The AG did not oppose this proposal. Given that less than 5 percent of the volumes sold to this class occur in the second and third rate

steps, we find that the proposal to move to a single step rate is reasonable and should be approved.

Delta's second rate design proposal is to add a GTI Rider to collect 0.3 cents per Mcf from sales customers to fund approximately $12,300 in voluntary contributions to the GTI. Delta proposed a rider so it could easily remove the charge from its tariff if it decided in the future that it no longer wished to fund GTI research.

The AG opposed the GTI Rider, arguing that residential customers who make up the bulk of Delta's customers would provide the majority of the funds collected under the rider, but receive little or no benefit from the research. He also takes issue with the rider not being charged to Delta's transportation customers because he believes that those customers could benefit from the research. If the Commission does approve funding for GTI, the AG proposes that the cost be collected through base rates, rather than a rider, in order to apply the charge to all rate classes.

The Commission agrees with Delta's proposal to recover monies to voluntarily fund GTI research through a tariff rider. The Commission has provided a clear signal to jurisdictional gas utilities in the past that it supports research and development efforts in the gas industry. Allowing recovery via a rider is consistent with Commission decisions for two other gas utilities, Atmos Energy and Columbia Gas of Kentucky. The Commission finds that collecting the contribution through a rider, rather than base rates, is reasonable. The Commission agrees with the AG, however, that the rider should be applicable to all tariff customer classes, meaning all customers with the exception of special contract customers and off-system transportation customers. This will increase the volumes to which the rider will be applied from approximately 4.1 million to

approximately 6.4 million Mcf. Based on the level of funding proposed by Delta, this increase in volumes results in reducing the rider charge from 0.3 to 0.2 cents per Mcf.

OTHER ISSUES

Tariff and Refund Requirements

On October 7, 2004, Delta gave notice, pursuant to KRS 278.190(2), that it intended to place its proposed rates into effect. In the Commission's October 15, 2004 Order, the Commission stated that Delta's proposed rates could not be effective prior to October 7, 2004 and should be collected subject to refund.[144] Given the difference in the increase granted herein and the amounts proposed, the Commission finds that Delta should refund to its customers all rates and charges exceeding the rates and charges prescribed in this Order. The Commission notes that the rates approved herein are for service rendered on and after October 7, 2004. Delta shall not retroactively apply such rates for service rendered prior to October 7, 2004. Billings based upon meter readings taken on October 7, 2004 or earlier clearly involve gas service received before October 7, 2004 and should not be based upon the rates approved in this Order. Any amount of excess revenues collected from October 7, 2004 through the date of this Order should be refunded with interest based on each customer's usage while the proposed rates were in effect.

On November 3, 2004, Delta filed revised tariffs including the rates placed in effect subject to refund and the GCA approved in Case No. 2004-00377 by Order dated October 28, 2004, to be effective November 1, 2004. With the approval herein of base

[144] On October 20, 2004, Delta filed its revised tariffs reflecting the rates it had placed in effect subject to refund.

rates that differ from the proposed rates it placed in effect, Delta will be required to file revised tariffs that supersede the tariffs filed October 20, 2004 as well as the tariffs filed November 3, 2004.

Future Rate Applications

The Commission notes that Delta organized its filing using the requirements of Administrative Regulation 807 KAR 5:001, Section 10, as an outline and guide. This approach allowed for a prompt determination of Delta's compliance with the filing requirements and organized the application in a systematic fashion. The Commission compliments Delta on its use of this approach.

However, throughout this proceeding, Delta has acknowledged numerous errors and oversights in its application, concerning issues that had significant impact on the processing of this case. The Commission also notes the instances where Delta was requested a second time to provide information that had not been previously provided. As a result, the Commission, its staff, and the parties had to commit additional time and resources to reviewing and analyzing the reasonableness of Delta's proposals. The Commission finds that in future rate cases Delta needs to more accurately verify the information contained in its application and respond completely and thoroughly to data requests submitted during discovery.

SUMMARY

The Commission, after consideration of all matters of record and being otherwise sufficiently advised, finds that:

1. The rates set forth in Appendix A are the fair, just, and reasonable rates for Delta to charge for service rendered on and after October 7, 2004. With the GCA

level approved in Case No. 2004-00377 substituted for the GCA shown in Appendix A, these will also be the fair, just, and reasonable rates for Delta to charge for service rendered on and after November 1, 2004.

2. The rates proposed by Delta would produce revenue in excess of that found reasonable herein and should be denied.

3. The depreciation rates contained in Delta's depreciation study filed in this case, as modified herein, are reasonable and should be approved for use as of the date of this Order.

IT IS THEREFORE ORDERED that:

1. The rates in Appendix A are approved for service rendered on and after October 7, 2004.

2. The rates proposed by Delta are denied.

3. Delta shall, within 20 days of the date of this Order, file its revised tariff sheets setting out the rates approved herein, for the period October 7, 2004 through October 31, 2004, to reflect the GCA in effect therein. Delta shall, within 20 days of the date of this Order, file its revised tariff sheets setting out the rates approved herein, for the period beginning November 1, 2004, to reflect the GCA that became effective on that date.

4. The proposed revision to the Small Non-Residential Tariff is approved.

5. The proposed GTI Rider is approved, as modified herein.

6. The proposed increase in the Reconnect Charge is approved.

7. The depreciation rates contained in Delta's depreciation study filed in this case, as modified herein, are approved for use as of the date of this Order.

8. Within 30 days of the date of this Order, Delta shall file with the Commission a report on the amount of excess revenues collected from October 7, 2004 through the date of this Order and a plan for refunding these revenues. This plan shall include interest for the period the excess revenues were collected at the average of the Three-Month Commercial Paper Rate as reported in the Federal Reserve Bulletin and the Federal Reserve Statistical Release. The refunds will be based on each customer's usage while the proposed rates were in effect and shall be made as a one-time credit to the bills of current customers and by check to customers that have discontinued service since October 7, 2004.

9. Delta shall undertake a new depreciation study of its utility plant in service within 5 years of the date of this Order or in conjunction with its next general rate case, whichever event occurs first. If the new depreciation study is not prepared in conjunction with a general rate case, Delta shall prepare and submit the new depreciation study to the Commission for review and approval in accordance with the approach described herein.

10. Delta shall file with its next general rate case a thorough analysis of the total compensation provided to its board of directors and shall justify the levels of compensation provided.

Done at Frankfort, Kentucky, this 10th day of November, 2004.

By the Commission

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2004-00067 DATED November 10, 2004

The following rates and charges are prescribed for the customers in the area served by Delta Natural Gas Company, Inc. 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. The Gas Cost Recovery Rate of $8.3941 shall be in effect for final meter readings from October 7, 2004 through and including October 31, 2004. The Gas Cost Recovery Rate of $7.6957 approved in Case No. 2004-00377 shall be in effect for final meter readings on and after November 1, 2004.

RATE SCHEDULES

AVAILABILITY

Available for general use by residential, commercial, and industrial customers.

RATES

	Base Rate	+	Gas Cost Recovery Rate	=	Total Rate
Residential					
Monthly Service Charge	$ 9.80				
All Mcf	$ 4.1592		$8.3941		$ 12.5533
Small Non-Residential					
Monthly Service Charge	$ 20.00				
All Mcf	$ 3.7950		$8.3941		$ 12.1891

Large Non-Residential				
Monthly Service Charge		$ 72.00		
First 200	Mcf	$ 3.7950	$8.3941	$12.1891
Next 800	Mcf	2.1461	8.3941	10.5402
Next 4,000	Mcf	1.3500	8.3941	9.7441
Next 5,000	Mcf	.9500	8.3941	9.3441
Over 10,000	Mcf	.7500	8.3941	9.1441

Reconnection Charge	$ 48.00

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2004-00067 DATED November 10, 2004

Schedule of Adjustments

The following adjustments were proposed by Delta in its application, accepted by the AG, and have been found reasonable and accepted by the Commission. The "+" indicates an increase while "-" indicates a decrease.

	Description	Reference Application, Tab 27	Change to Revenues	Change to Expenses
1.	GCA – Adjustment for Test-Year Revenues.	Schedule 2 & 3	-$27,856,035	0
2.	Temperature Normalization Adjustment.	Schedule 2 & 3	+$115,746	0
3.	Advertising Expense.	Schedule 4	0	-$2,204
4.	Interest on Customer Deposits.	Schedule 4 and Hall Rebuttal Testimony	0	0

Delta had originally proposed an adjustment to recognize its interest expense on customer deposits as an operating expense. In its rebuttal testimony, Delta acknowledged its proposal was not consistent with previous Commission decisions and withdrew the adjustment. The AG had opposed the adjustment.