COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF WATER SERVICE CORPORATION OF KENTUCKY FOR AN ADJUSTMENT OF RATES	)))	CASE NO. 2008-00563

<u>O R D E R</u>

Water Service Corporation of Kentucky ("Water Service") filed an application requesting approval to increase its water rates, to establish several new nonrecurring charges, and to make changes to certain existing nonrecurring charges. Water Service proposes to adjust its water rates to increase its operating revenues from $1,631,079 to $2,438,085, an increase of 50.08 percent increase or $807,006.[1] By this Order, the Commission modifies the proposed tap-on fee, approves the remaining nonrecurring charges, and establishes water rates that will produce annual revenues of $2,104,261. The increase will impact a customer's monthly bill, using an average of 5,000 gallons, in Middlesboro by $5.12 (from $17.58 to $22.70) and in Clinton by $8.54 (from $29.46 to $38.00).

<u>BACKGROUND</u>

Water Service, a Kentucky corporation, is a utility subject to Commission jurisdiction.[2] It owns and operates facilities that treat and distribute water to

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[1] Application, Exhibit 9, Calculation of Revenue Requirement (filed Mar. 5, 2009).

[2] KRS 278.010(3)(d).

approximately 7,305 residential customers in Bell and Hickman counties.[3] Water Service last applied for a rate adjustment in 2005.[4]

Water Service is a wholly-owned subsidiary of Utilities, Inc. ("Utilities"), which owns approximately 90 other water and sewer utilities in 15 states.[5] Utilities also owns a service company named Water Service Corporation.[6] The service company manages the water and sewer operations for Utilities subsidiaries and operates without profit.

PROCEDURE

On December 30, 2008, Water Service notified the Commission in writing of its intent to apply for an adjustment of rates using a historical test period. It subsequently filed its application on March 5, 2009. Finding that further proceedings were necessary to determine the reasonableness of the request, the Commission suspended the proposed rates for five months, from April 14, 2009 up to and including September 14, 2009, and initiated this proceeding.[7] We granted the Attorney General, through his Utility and Rate Intervention Division ("AG") leave to intervene in this proceeding.

After the parties engaged in extensive discovery, the Commission held an evidentiary hearing in this matter on August 19, 2009 in Frankfort, Kentucky. The

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[3] Annual Report of Water Service to the Public Service Commission of the Commonwealth of Kentucky for the Calendar Year Ended December 31, 2008 at 5 and 30.

[4] Case No. 2005-00325, Application of Water Service Corporation of Kentucky for an Adjustment of Rates (Ky. PSC Feb. 28, 2007).

[5] Appliction, Testimony of Lena Georgiev, at 1.

[6] Confusion is likely to occur based on the similarities of names. Throughout this order, we refer to the Kentucky utility as "Water Service" and Utilities' service company as Water Service Corporation.

[7] See KRS 278.190(2).

following persons pre-filed Direct Testimony and testified at the hearing on behalf of Water Service: Pauline M. Ahern, Principal of AUS Consultants; John D. Williams, Director of Governmental Affairs at Utilities; Martin Lashua, Regional Director of Operations at Utilities; and Lena Georgiev, Manager of Regulatory Affairs at Utilities. Following the hearing, all parties submitted written briefs.

The Commission held local public meetings in Middlesboro on August 12, 2009 and Clinton on August 13, 2009. Approximately 40 individuals attended the public meeting in Middlesboro, and over 100 individuals attended the meeting in Clinton. At both locations, community residents spoke respectfully and eloquently as to their concerns about a water rate increase.

ANALYSIS AND DETERMINATION

Test Period

Water Service proposes to use the 12-month period ending June 30, 2008 as the test period to determine the reasonableness of its proposed rates. The Commission finds the use of this test period to be reasonable. In using a historic test period, the Commission gives full consideration to appropriate known and measurable changes.

Rate Base

Water Service proposed a net investment rate base of $6,139,342.[8] This net investment rate base is accepted with the following exceptions:

Project Phoenix. In 2006, Utilities began Project Phoenix, an internal and external evaluation of its accounting and billing software and computer systems.[9] The

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[8] Application, Exhibit 4, Schedule C, Rate Base and Rate of Return.

[9] Id., Exhibit 5, Prepared Direct Testimony of John D. Williams, at 5.

evaluation culminated in a business case presentation by Deloitte to Utilities in September 2006.[10] After evaluating the potential solutions identified by Deloitte, Utilities selected JD Edwards as the financial system and Oracle's Customer Care and Billing System ("Oracle") as the customer information system.[11]

On December 3, 2007, Utilities placed the JD Edwards system into service at a total cost of $14,544,020.[12] Utilities placed the Oracle system into operation on June 2, 2008, at a total cost of $7,077,652.[13] Using an allocation factor based upon the equivalent residential connections, Utilities allocated $367,498[14] of the total cost of the JD Edwards system and $178,715[15] of the Oracle cost to Water Service. The allocated cost of JD Edwards is included in Utility Plant In Service ("UPIS"), and the Oracle allocation is reported as a separate item in Water Service's pro forma rate base.

Water Service describes JD Edwards as "a web-based software system that allows easy access from multiple locations."[16] According to Water Service, the JD Edwards system includes enhanced tracking and integration components that will improve Utilities' ability to record and retrieve data.[17] Water Service claims that

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[10] Id.

[11] Id.

[12] Id. at 8.

[13] Id. at 14.

[14] Id. at 9.

[15] Id. at 14.

[16] Id. at 6.

[17] Id. at 7.

enhanced record keeping and retrieval functions will simplify the production of financial and regulatory reports.[18] Water Service adds that JD Edward's enhanced functions coupled with the reduction in manual effort and the reliance on spreadsheets will result in improved report accuracy.[19]

According to Water Service, the previously-used Legacy customer care and billing system was a customized program for Utilities that had become unsupported.[20] The Oracle software is a web-based system that allows for a quicker return of information and speedier fixes if the system goes down voluntarily or goes down for routine maintenance.[21]

The AG states that "[c]entral to understanding the Project Phoenix cost allocation is the fact that the focus of Project Phoenix was the needs of Utilities, Inc., including its non-regulated operations."[22] According to the AG, Water Service failed to produce evidence to show that Utilities examined the potential benefits Project Phoenix would have for Water Service.[23] The AG argues that Utilities was concerned with its needs and not whether a system of comparable size to Water Service would require an information technology package that cost $367,498.[24] The AG contends that Water

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[18] Id.

[19] Id.

[20] Id. at 10.

[21] Id. at 9.

[22] AG's Post-Hearing Brief, at 3 (filed August 31, 2009).

[23] Id.

[24] Id. at 4.

Service failed to show that Project Phoenix is cost-effective and also failed to "carry its burden of proof that the allocation of project Phoenix costs are reasonable."[25]

Based upon the evidence of record, it is apparent that Utilities did not perform a benefit analysis of Project Phoenix to ascertain the potential financial impact or to identify any benefits Project Phoenix would provide to each of its operating subsidiaries, in particular Water Service. As pointed out by the AG, it is Water Service's burden to document that the cost of Project Phoenix is reasonable and to identify the benefits the computer software will provide to the ratepayers of Water Service. The Commission believes that Water Service failed to meet this burden. Further, John Williams, a Water Service witness with 30 years of experience working for the Florida Public Service Commission, testified that he was not aware of any utility of comparable size to Water Service in Florida that would have spent a half-million dollars on software similar to JD Edwards and Oracle.[26]

For these reasons, the Commission finds that Water Service has failed to demonstrate that the allocated Project Phoenix costs are reasonable and, therefore, has reduced UPIS by $389,537,[27] the cost of JD Edwards, and has reduced rate base by $178,715 to remove the allocation of Oracle costs.

Post-Test Period Plant Additions. Water Service proposed in its filing to increase UPIS by $103,527 to reflect post-test period plant additions. Water Service argues that the post-test year plant additions are known and measurable and that their completion

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[25] Id. at 3, 4.

[26] Transcript of Evidence ("TE") at 52.

[27] Application, Exhibit 4, Depreciation Expense, w/p(f). $425,915 (Computers) - $36,378 (WSC/Regional Rate Base Adjustment) = $389,537.

so near the end of the test period makes them more appropriate for inclusion in this historical case, even though some of the additions were completed almost a year after the test period.

In a prior decision, the Commission found that, for utilities under its jurisdiction, "[a]djustments for post test-period additions to utility plant in service should not be requested unless all revenues, expenses, rate base and capital have been updated to the same period as the plant additions."[28]

In addition, 807 KAR 5:001, Section 10(1), provides that all applications for a general rate adjustment shall be supported by either a 12-month historical test period, which may include adjustments for known and measurable changes, or a fully forecasted test period.

Water Service had the option of filing a forecasted test period if it wanted to include plant additions beyond the test period, as well as other inflationary adjustments. Water Service made vague statements that it had appropriately adjusted revenues, expenses, rate base, and capital to the same period as the plant additions. Nevertheless, in reviewing Water Service's pro forma adjustments, the Commission is unable to identify any adjustments that complied with the prior Commission finding regarding post-test period plant additions. Accordingly, the Commission denies Water Service's proposed adjustment for the post-test year plant additions and has reduced

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[28] See Case No. 10481, Notice of Adjustment of the Rates of Kentucky-American Water Company Effective on February 2, 1989, at 5 (KY. PSC Aug. 22, 1989).

pro forma UPIS by an additional $103,527, for a combined UPIS reduction of $493,064.[29]

Accumulated Depreciation. The Commission has decreased Water Service's forecasted accumulated depreciation of $3,334,993[30] by $45,120[31] to remove the depreciation for JD Edwards.

Cash Working Capital Allowance. Water Service determined its cash working capital allowance using the 45 day or 1/8th formula methodology, reflecting the impacts of Water Service's proposed adjustments to operation and maintenance expenses. While the Commission finds that approach is reasonable and should be permitted, the cash working capital allowance included in the Commission's determination of net investment rate base has been adjusted to reflect the accepted pro forma adjustments to operation and maintenance expenses, as discussed later in this Order.

Based on the aforementioned adjustments, the Commission has determined Water Service's net investment rate base to be as shown in Table I below.

Table I: Net Investment Rate Base

	Water Service	Commission	
	Pro Forma Rate Base	Pro Forma Adjustments	Pro Forma Rate Base
Utility Plant In Service	$ 9,683,927	$ (493,064)	$ 9,190,863
Deduct:			
Accumulated Depreciation	(3,334,994)	45,120	(3,289,874)
Net Utility Plant in Service	$ 6,348,933	$ (447,944)	$ 5,900,989
Construction Work In Progress	0	0	0
Working Capital Allowance	207,275	(26,932)	180,343
Contributions In Aid of Construction	(45,090)	0	(45,090)
Customer Advances	(84,684)	0	(84,684)

[29] $389,537 (JD Edwards) + $103,527 (Post-Test Period Plant Additions) = $493,064.

[30] Application, Exhibit 4, Schedule C, Rate Base and Rate of Return.

[31] Id., Plant Restatement through Complete Rate Case.

Deferred Income Taxes	(313,316)	0	(313,316)
Customer Deposits	(109,546)	0	(109,546)
Capitalized Time	0	0	0
Reduction - Transportation Equipment	(6,036)	0	(6,036)
Regional Rate Base Adjustment	(36,911)	0	(36,911)
Oracle - Billing System	178,715	(178,715)	0
Net Original Cost Rate Base	$ 6,139,340	$ (653,591)	$ 5,485,749

Income Statement

For the test period, Water Service reported operating revenues and expenses of $1,666,792 and $1,635,642, respectively.[32] Water Service proposed revenues and expenses to reflect current and expected operating conditions, resulting in pro forma operating revenues and expenses of $1,667,522 and $1,609,731, respectively.[33] The Commission makes the following modifications to Water Service's pro forma operating revenues and expenses:

Service Revenues - Sewer. Water Service included service revenues from sewer operations of $404 in its pro forma operating revenues. The Commission is reducing operating revenues by that amount to remove the misclassified sewer revenues.

Consumer Price Index ("CPI"). Water Service proposed approximately 12 separate CPI adjustments to its operating expenses that totaled $22,592.[34] According to Water Service, its adjustments are based upon a 3.514 percent CPI that is to

[32] Id., Schedule B, Income Statement.

[33] Id.

[34] Id.

"account for the increase in the consumer price index since acquisition."[35] Water Service's CPI adjustments are listed in Table II below.

Table II: Proposed CPI Adjustments		
Purchased Power	$	2,526
Purchased Water	$	3,026
Maintenance & Repair	$	4,530
Maintenance Testing	$	1,806
Meter Reading	$	148
Chemicals	$	4,114
Transportation	$	1,252
Outside Services - Other	$	145
Office Supplies & Other Office Exp.	$	2,993
Rent	$	609
Office Utilities	$	1,399
Miscellaneous	$	44

Water Service states that the change in the purchasing power of the dollar measured by the CPI is a reasonable estimate of the changes in the cost of providing water service to its ratepayers.[36] According to Water Service, the cumulative increase in its operational costs that occurred from 2006 through 2008 was in excess of 8 percent.[37] Water Service argues that it is reasonable for it to use a general, publicly-available measure because its operating expenses and ratepayers are subject to the purchasing power fluctuations measured by the CPI.[38] Water Service further argues

[35] Id., Explanation of Adjustments to Income Statement, Adjustments J.

[36] Water Service's Response to the Commission Staff's Second Information Request item 4 (filed May 15, 2009).

[37] Id.

[38] Id.

that, because of the widely accepted use of the CPI, it can be considered a "known and measurable" change in expenses that will occur from year to year.[39]

The AG states that the Commission should reject Water Service's adjustments using the CPI.[40] The AG contends that the use of the CPI is contrary to Kentucky's regulatory scheme and past Commission practice.[41] According to the AG, Water Service did not offer a compelling basis or justification to support its proposed CPI adjustments.[42]

In a prior decision, this Commission disallowed any adjustments based on the CPI finding that:

> The CPI is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. This basket contains 8 major categories of goods and services: food and beverages; housing; apparel; transportation; medical care; recreation; education and communication; and other goods and services. Several of these categories are unrelated to the provision of water service. Their presence in the basket limits the CPI's accuracy as an adjustment mechanism. For example, increases in the cost of food and beverages, apparel and education would produce a positive increase in the CPI but have no effect on the cost of goods and services that are used to provide water service. An automatic adjustment mechanism must provide an accurate measurement of changes in the cost of providing water service. It, therefore, should be based principally on those goods and services that are reasonably likely to be used to provide water service.[43]

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[39] Id.

[40] AG's Post-Hearing Brief, at 10 (filed August 31, 2009).

[41] Id.

[42] Id.

[43] See Case No. 2006-00067, Proposed Adjustment of the Wholesale Water Service Rate of the City of Lawrenceburg, Kentucky, at 3-4 (KY. PSC Nov. 21, 2006).

Administrative Regulation 807 KAR 5:001, Section 10(1), provides that all applications for a general rate adjustment shall be supported by either a "twelve (12) month historical test period which may include adjustments for known and measurable changes" or a "fully forecasted test period." When an applicant bases its application upon a historical test period, it must provide a "complete description and quantified explanation for all proposed adjustments with proper support for any proposed changes in price or activity levels, and any other factors which may affect the adjustment."[44] That support should, at a minimum, include some documentary evidence to demonstrate the certainty of some expected change or event.

Revenue and expense adjustments based upon the CPI are widely used by utilities when they are preparing annual budgets or rate applications that use forecasted test periods. Regarding budgetary adjustments, the Commission has previously found that "[w]hile such projections may be acceptable when an applicant bases its application upon a forecasted test period, they are not when the basis for the proposed rate adjustment is a historical test period."[45]

Water Service has not presented any evidence in this proceeding that would persuade the Commission to reverse its prior findings regarding pro forma adjustments based upon the CPI or the disallowance of budgetary projections in a historical test

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[44] 807 KAR 5:001, Section 10(6).

[45] See Case No. 2001-00211, The Application of Hardin County Water District No. 1 for (1) Issuance of Certificate of Public Convenience and Necessity; (2) Authorization to Borrow Funds and to Issue its Evidence of Indebtedness Therefor; (3) Authority to Adjust Rates; and (4) Approval to Revise and Adjust Tariff, at 8 (KY. PSC Mar. 1, 2002).

period. Accordingly, we find that the pro forma adjustments contained in Table II should be denied.

Indirect Expense Allocations. Water Service Corporation, Utilities' service company affiliate, manages the water and sewer operations for Utilities' subsidiaries. Water Service Corporation costs that are not directly assignable to a specific subsidiary are booked to Water Service Corporation and are allocated to the Utilities' subsidiaries at year-end, based on the proportion of active Equivalent Residential Customers ("ERCs") served by an operating company to the total number of active ERCs served by Utilities and its affiliates.[46]

The AG points to the fact that Water Service's agreement with Water Service Corporation, the service company affiliate, does not allow Water Service the authority to contest the reasonableness of any expense allocated to it by Water Service Corporation.[47] For this reason, the AG claims that the agreement with Water Service Corporation is not an arm's-length transaction and that it enables Water Service Corporation to "spend and allocate at will [and] is *per se* unreasonable."[48] The AG cites the following indirect expense allocations as examples of costs that either have no connection to providing water service or are excessive:

> An Expense Report Form (Doc 50130) reflects charges for drinks after Leadership meeting as well as other charges for which there is no description of the business purpose of the expense (Appendix 1).
>
> Business Expense Reports (Larry Schumacher, 4/01/07 to 6/20/07) reflects before dinner drinks (Appendix Item 5) as well as a dinner in which

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[46] Application, Testimony of Lena Georgiev, at 8-9.

[47] AG's Post-Hearing Brief, at 4 (filed August 31, 2009).

[48] Id. at 4-5.

Mr. Schumacher apparently paid for the meal of a person's spouse and a separate charge of $3,625 for "Dinner/appetizers for entire group BOD, HS" (Appendix Item 6).

The Business Expense Report (John Williams, 5/12/07 to 5/20/07) includes expenses for picking up multiple dinners for "other NARUC faculty and NAWC executives (Appendix Item 8).

The Business Expense Report (Steven M. Lubertozzi, 7/08/07 to 8/31/07) contains numerous charges for drinks and appetizers (and these are not modest charges) as well as lunches for which there is no indication of the purpose for the lunch Appendix Item 9).

A Business Expense Report (Larry Schumacher, 9/07/07 to 12/14/07) reflects a Board of Directors' meeting held in Las Vegas, Nevada (a meeting that lasted less than 3 hours (WSCK Response to OAG 1 - 24) and a Board dinner costing $2,433.89 (Appendix Item 11).

A Business Expense Report (Steven M. Lubertozzi, 9/01/07 to 10/09/07) shows the purchase of tickets to see the Chicago Bears (Appendix Item 13).[49]

The AG argues that the above expenses show "an unmistakable pattern of excessive charges in tandem with a lack of documentation necessary to conclude that the expenses were reasonably related or beneficial to WSCK's provision of water service."[50] The position of the AG is that Water Service has the burden of proof, that there is no presumption of benefit or reasonableness, and that the agreement between Water Service and Water Service Corporation shows that there is an abuse of discretion.[51] Accordingly, the AG requests the Commission disallow for rate-making

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[49] Id. at 5-6.

[50] Id. at 6.

[51] Id. at 7-8.

purposes all of the allocated indirect costs from Water Service Corporation to Water Service.[52]

Water Service agrees with the AG, in that the review and rejection power of allocated costs is not included in the Allocation Manual.[53] According to Water Service, if each operating unit of Utilities was able to reject the allocation of expenses that it believed to be unrelated to its operations, the system of allocations would be self-defeating.[54] Water Service concludes that "each operating company benefits from the economies of scale of UI and each must share in the costs."[55]

The Commission agrees with Water Service in that there is a benefit derived from the economies of scale of being associated with a larger corporation such as Utilities. Nevertheless, Water Service should only share in those costs incurred by Water Service Corporation that are reasonable and that provide a benefit to Water Service's rate payers. At the onset, the Commission recognizes that the Allocation Manual is the product of a less-than-arm's-length transaction that allocates all of the indirect costs incurred by Water Service Corporation without a review clause that would serve as a check and balance system to allow only those reasonable costs that relate to the Water Service operations to be allocated to Water Service.

Other jurisdictional water systems note the importance of the ability of the water subsidiaries to review and question costs that are being charged by related subsidiaries.

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[52] Id. at 8.

[53] Water Service's Post-Hearing Brief, at 20 (filed August 31, 2009).

[54] Id.

[55] Id.

The following is an example of the oversight clauses contained in the agreement between Kentucky-American Water Company and the American Water Works Service Company, Inc.:

> 4.2 Service Company agrees to keep its books and records available at all times for inspection by representatives of Water Company or by regulatory bodies having jurisdiction over Water Company.
>
> 4.3 Service Company shall at any time, upon request of Water Company, furnish any and all information required by Water Company with respect to the services rendered by Service Company hereunder, the costs thereof, and the allocation of such costs among Water Companies. [56]

The Commission finds that Water Service has failed to meet its burden of proof that the indirect cost allocations from Water Service Corporation are reasonable, are directly related to providing water service, or benefit the ratepayers of Water Service. The Commission further finds that the indirect cost allocations from Water Service Corporation should be eliminated from Water Service's pro forma operating expenses. In the last two quarters of 2007, Water Service was allocated $65,484, of indirect costs from Water Service Corporation. Water Service presented the expenses for the first two quarters of 2008 in such a manner that it was difficult for the Commission to determine the indirect expense allocations for this period. The allocation agreement was revised in 2008 and the cost allocation schedules were presented in a different format. Given that Water Service did not provide adequate documentation for the Commission to determine the correct allocations for the second half of the test period, the Commission will annualize the first half allocations of the test period to determine the full year test-

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[56] See Kentucky-American Water Company's Response to the Commission's November 15, 1991 Order, Item 49, Case No. 1991-00361, Notice of Adjustment of the Rates of Kentucky-American Company, at 11 (filed Nov. 27, 1991).

period allocations. The annualization results in a test-period allocation of indirect expenses of $130,968, which results in an expense reduction of that amount.

Rate Case Expense. Water Service proposed to increase its pro forma operating expenses by $39,379 to reflect amortizing its projected rate case cost of $118,137 over three years.[57] In responding to the post-hearing information requests, Water Service provided invoices showing the actual cost of this current case to be $145,604. Amortizing the actual rate case cost of $145,604 over three years, the Commission calculates a pro forma rate case amortization expense of $48,535. Accordingly, the Commission has increased Water Service's pro forma operating expenses by $9,156 to reflect the actual rate case amortization.

Depreciation Expense. Water Service proposed a pro forma depreciation expense of $258,932 based upon UPIS in service as of June 31, 2008 and post test-period plant additions. The Commission finds that depreciation expense should be decreased by $48,692 to eliminate depreciation on Project Phoenix.

Bad Debt Expense. Water Service reported a test-period bad debt expense of $18,156.[58] Using Water Service's uncollectible rate of 1.11 percent and operating revenues from water sales of $1,631,079, the Commission calculates a bad debt expense of $18,105, which is $51 below the amount reported. Accordingly, the Commission finds that bad debt expense should be decreased by $51.[59]

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[57] Application, Exhibit 4, Rate Case Expense, w/p(d).

[58] Id., Schedule B, Income Statement.

[59] Water Service reported bad debt expense as a reduction to operating expenses. Therefore, the Commission's adjustment is an increase to operating revenues.

General Taxes. Water Service reported a pro forma general tax expense of $77,751.[60] Using the current millage rate of $0.001538 and water service revenues of $1,631,079, the Commission calculates a "PSC Assessment" of $2,509, which is $178 above the amount reported. Accordingly, the Commission finds that the pro forma general tax expense should be increased by $178.

Income Tax Expense. Based upon its pro forma operating revenues and expenses, Water Service calculated a current income tax expense credit of $(168,782).[61] Using Water Service's pro forma operating revenues and expenses, the Commission calculates a current income tax expense credit of $(93,107) as shown in Table III below. Accordingly, the Commission has increased income tax expense by $75,675 to reflect its pro forma level.

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60 Id.

61 Id. $(150,356) (Fed. Income Tax Exp.) + $(18,426) = $(168,782).

Table III: Income Taxes		
Account Titles	Amount	Taxes
Operating Revenues	$ 1,667,169	
Operating Expenses and Interest Expense:		
Operation and Maintenance Expenses	$ 1,436,049	
Depreciation & Amortization	210,240	
CIAC Amortization	(3,181)	
General Taxes	77,928	
Interest Expense	191,409	
Total Expenses Net of Income Taxes	$ 1,912,445	
State Taxable Income	$ (245,276)	
Multiplied by the State Tax Rate[62]	6.00%	
State Income Tax	$ (14,717)	$ (14,717)
Federal Taxable Income	$ (230,559)	
Multiplied by the Federal Tax Rate	34.00%	
Federal Income Tax	$ (78,390)	(78,390)
Total Income Taxes		$ (93,107)

Interest Expense. To reflect interest synchronization, Water Service proposed a pro forma interest expense of $214,217 based on forecasted rate base and weighted cost of debt. The Commission has recalculated this expense to be $191,352[63] based on the rate base and weighted cost of debt found reasonable herein.

Based on the aforementioned adjustments to Water Service's pro forma revenues and expenses, the Commission has determined Water Service's pro forma net operating income at present rates to be $174,681 as shown in Table IV.

[62] The Commission's past practice has been to use the highest tax rate applicable. Citing KRS 141.040(1), Water Service claimed that the applicable state tax was a graduated rate from 4% to 8%. The tax rates identified by Water Service, however, were for tax years 1990 through 2004. KRS 141.040(3). The tax rate for tax years beginning on or after January 1, 2007 ranges from 4% to 6%. KRS 141.040(6).

[63] $5,484,135 (Commission Approved Rate Base) x 3.4892% (Commission Approved Weighted Cost of Debt) = $191,352.

Table IV: Pro Forma Income Statement			
	Water Service	Commission	
Account Titles	Pro Forma Operations	Pro Forma Adjustments	Pro Forma Operations
Operating Revenues	$ 1,667,522	$ (353)	$ 1,667,169
Operating Expenses			
Operation & Maintenance Expenses	$ 1,580,453	$ (144,404)	$ 1,436,049
Depreciation & Amortization	258,932	(48,692)	210,240
General Taxes	77,750	178	77,928
Income Tax Expense	(168,782)	75,675	(93,107)
Deferred Income Tax Expense	(64,208)	0	(64,208)
Expense Reduction - Clinton Sewer	(71,233)	0	(71,233)
Amortization CIAC & AIAC	(3,181)	0	(3,181)
Total Operating Expenses	$ 1,609,731	$ (117,243)	$ 1,492,488
Net Operating Income	$ 57,791	$ 116,890	$ 174,681
Interest Income/Expense			
Interest Expense - Long-Term Debt	214,217	(22,808)	191,409
Net Income	$ (156,426)	$ 139,698	$ (16,728)

Rate of Return

Capital Structure. Water Service proposes an end-of-test-period capital structure containing 53.03 percent long-term debt, and 46.97 percent common equity.[64] The AG did not state a position on Water Service's proposed capital structure.

The Commission agrees with Water Service, and finds that the capital structure is as shown in Table V below.

Table V: Capital Structure	
	Percent
Long-Term Debt	53.03
Common Equity	46.97
Total Capital	100.00

[64] Application, Exhibit 4, w/p [b-1], Capital Structure as of June 30, 2008.

Long-Term Debt. Water Service proposes an embedded long-term debt rate of 6.58 percent.[65] The AG did not state an opinion on Water Service's long-term debt rate. We find the proposed cost of debt is reasonable and should be accepted.

Return on Equity. When Water Service's application was filed in January 2009, it recommended a return on equity ("ROE") of 11.85 percent, from a range of 11.60 percent to 12.10 percent.

Water Service obtained its results from applying four ROE estimation methodologies to two different proxy groups: a group of seven water companies and a group of ten natural gas transmission and distribution companies. The criteria used for selecting utilities to be included in each group was (1) they are included in the AUS Utility Reports, (2) they have Value Line or Reuters consensus five-year earnings per share growth rate projections, (3) they have a Value Line adjusted Beta, (4) they have not cut or omitted their common dividends during the last five years ending in 2007 or through when the testimony was prepared, (5) they have at least 60 percent of total net operating income derived from and at least 60 percent of total assets devoted to regulated water or regulated gas distribution operations, and (6) they have not publicly announced involvement with merger or acquisition activity.[66]

Water Service applied four different ROE estimation methodologies to both the water utility proxy group and the natural gas distribution proxy group to arrive at its recommendation. The Discounted Cash Flow ("DCF") model uses the current dividend yield on common equity plus a growth component to estimate the total return expected

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[65] Id.

[66] Application, Direct Testimony of Pauline M. Ahern, at 18-21.

by investors.[67] The Capital Asset Pricing Model ("CAPM") and the Risk Premium Model ("RPM") models are similar in that both theorize that the return on common equity is equal to the return on long-term debt plus a risk premium to shareholders for being willing to invest in unsecured securities and being behind debt holders for claims on the companies' assets and earnings. For the RPM analysis, the company used expected bond yields for the company proxy groups. Historical risk premium studies and proxy group betas were used to obtain a beta-adjusted market equity risk premium. Beta is a measure of variability of a company's stock relative to the market. Combining the expected bond yields and the risk premium yields the common equity cost rate.[68] The CAPM model added a beta-adjusted risk premium for the proxy groups to the yield on long-term government bonds to obtain the estimated return on equity.[69] The Comparable Earnings Model works on the principle that the cost of an investment is equal to the cost of the next-best alternative. In this case, Water Service chose two new proxy groups of domestic non-price-regulated firms using regression analysis to reflect both the systematic and unsystematic risks of the seven water and ten natural gas utilities. Two hundred firms were selected as being similar in risk to the water proxy group and thirty-five companies were selected as being similar to the gas proxy group. The returns on book common equity, net worth, or partner's capital were for the most recent and/or projected five-year period as reported in Value Line.[70]

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[67] Id. at 23-27.

[68] Id. at 27-33.

[69] Id. at 33-38.

[70] Id. at 40-44.

Because Water Service is so much smaller than the companies in either the water or the natural gas distribution proxy groups, size premium is included in the recommended return on equity. The company argues that such a premium is necessary to equalize the business risk between itself and the proxy group companies. The company argues that a size adjustment of 362 basis points (3.62 percent) is justified considering the water utilities proxy group and an adjustment of 432 basis points (4.32 percent) is justified when compared to the natural gas proxy group. The company, however, only adds 35 basis points (0.35 percent) to its cost of equity range.[71]

In his brief, the AG argues that Water Service does not demonstrate an understanding of the Kentucky regulatory framework applicable to water utilities.[72] Moreover, the AG argues that Water Service is not sufficiently similar to the companies in the two proxy groups and that the risks associated with those groups of companies have not been sufficiently reconciled to Water Service's specific situation.[73] The AG ultimately argues that the company's ROE evidence is undependable. For a company of Water Service's size, the "operating ratio" methodology is a widely accepted standard and should be used to fairly establish an equity target.[74]

The Commission agrees with the AG that the operating ratio is the most commonly used methodology in determining the return of a company the size of Water

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[71] Id. at 13-15, 45-49; Water Service's Post-Hearing Brief, at 9-10 (filed August 31, 2009).

[72] AG's Post-Hearing Brief, at 13 (filed August 31, 2009)

[73] Id. at 13-14.

[74] Id. at 14.

Service, and is highly preferable to a full ROE analysis such as the company has presented. The Commission will accept the use of ROE analysis in determining Water Service's return in this case, but encourages the company to use the more appropriate operating ratio methodology in the future. Having considered the analysis provided by Water Service, as well as the comments of the AG, the Commission finds a reasonable return on equity range to be 10.1 to 11.1, with a mid-point of 10.6. The approved 10.6 percent ROE includes a size adder as proposed by the company.

Weighted Cost of Capital. Applying the rates of 6.58 percent for long-term, and 10.6 percent for common equity to the adjusted capital structure produces an overall cost of capital of 8.468 percent. We find this cost to be reasonable.

Authorized Increase

The Commission finds that Water Service's net operating income for rate-making purposes is $464,533. We further find that this level of net operating income requires an increase in forecasted present rate revenues of $473,182, as shown in Table VI below.

Table VI: Authorized Increase		
Net Investment Rate Base	$	5,485,749
Multiplied by: Weighted Cost-of-Capital	x	8.468%
Net Operating Income	$	464,533
Less: Forecasted Operating Income	-	174,681
Operating Income Deficiency	$	289,852
Multiplied by: Gross-up Factor	x	1.6324947
Revenue Requirement Increase	$	473,182

Rate Determination

Monthly Water and Fire Protection Rates. Water Service has requested its monthly water rates and monthly fire protection rates be increased across the board by approximately 50.8 percent for all classes of customers. This method of increasing rates has been accepted by the Commission in the past, and nothing has been demonstrated in this case that would persuade the Commission that this methodology is not appropriate in this instance. Therefore, the Commission accepts Water Service's proposed method of setting the monthly water and fire protection rates.

The revenue requirement determined reasonable herein is an approximate 29.01 percent increase over Water Service's normalized revenues. The Commission finds that this percentage increase should be used to calculate Water Service's monthly water rates and fire protection rates.

Nonrecurring Charges: Water Service has asked to add a charge for New Customer Accounts, Non Sufficient Funds and a Tampering Fee, as well as to increase their charges for Service Connection, Service Charge, and Meter Testing. With one exception, the proposed charges are supported by the expenses being incurred to serve the customer. Accordingly, the Commission approves the new charges for New Customer Accounts, Non Sufficient Funds, Tampering Fee, and the increase in the charge for the Service Charge and Meter Testing. We also approve an increase in the Service Connection charge, but we do not allow the increase requested by Water Service.

Water Service has proposed a new service connection fee of $1,434 for five-eighths inch and three-quarter inch meters. If approved, this would be the most expensive connection charge for any jurisdictional utility. One reason that the proposed nonrecurring charge is higher than other utilities is because Water Service has included $486.75 in costs for dense grade gravel, concrete, and asphalt. Martin Lashua testified at the hearing that most connections required road construction that would necessitate using these materials.

The Commission questions the reliability of this testimony. Other than Mr. Lashua's general statement, Water Service has produced no evidence that demonstrates why Water Service would have to reconstruct roadways for most connections. For new developments, utility infrastructure is generally in place before roadways are constructed, and therefore, there would be no damage to roads when infrastructure is properly placed. In addition, most distribution lines are located next to roadways, and only connections on opposite sides of the road would be likely to require road repair. Moreover, we are unaware of any other utility that adds the cost of gravel, concrete, and asphalt to its connection charges for residential meter sizes. Accordingly, the Commission reduces the Service Connection fee by $486.75.

The Commission also finds it appropriate to eliminate $27 from the Service Connection fee for establishing a new account and billing record. Water Service is also proposing (and the Commission is approving) an account set-up, nonrecurring charge of $27, and therefore, this cost is redundant. Mr. Lashua testified that customers would not be charged the $27 new account fee in addition to the full $1,434 Service Connection fee.

Therefore, the proposed connection fee shall be reduced by $513.75, and we approve a Service Connection fee of $920.75. The Commission shall permit Water Service to recover gravel, asphalt, and concrete expenses on a case-by-case basis only when those costs are incurred when good engineering practices require it. In order to collect those additional expenses, Water Service must place language in its tariff on the same page as the Service Connection fee that states that a customer shall be responsible for actual costs of gravel, asphalt, and concrete in addition to the Service Connection fee when good engineering practices require road work in the scope of the service connection.

Credit Card Fee. Water Service proposes to add language to its tariff so that it may collect an additional fee if it permits customers to pay their bills by credit card. The proposed language states:

> The Company may allow payments to be made with cash, check, credit/debit card. Customers who choose to pay by credit/debit card or online shall be charged a per transaction fee plus a fee of a percentage of amount to be paid. The fees shall be based on the bank fees billed to the Company for such payments.

The Commission finds that the proposed credit/debit card language is too vague. We have previously allowed utilities to collect an additional fee from its customers that is identical to the fee the utility is being charged by a credit card company or an acquirer bank. We have also required that the utility inform its customers of the formula used to calculate the credit/debit card fee prior to any transaction. Mr. Lashua testified that Water Service would be willing to disclose that information to its customers before each credit/debit card transaction.[75]

Although the Commission does not approve the tariff language proposed by Water Service regarding credit/debit card transactions, we find that Water Service should be allowed to collect an additional fee from its customers that is identical to the fee the utility is being charged by a credit card company or an acquirer bank for

[75] Transcript of August 19, 2009, Hearing, at 130.

customers paying their bills by credit or debit cards. The utility shall amend its proposed tariff and use the following language:

> The Company may allow payments to be made with cash, check, or credit/debit cards. If, on the bill due date, an attempt to pay the credit card or debit card is made and the card is declined for any reason, payment is still due in full on that date and will be considered late after that date. All late charges and penalties will be applied. If a customer is paying on our disconnect day and the card is denied, the same rules as above apply, in addition to service being disconnected.
>
> When a customer makes a payment by credit card, the utility will assess a fee equal to that charged to the utility by the credit or debit card processing company to process the transaction. This fee is generally calculated using a formula applied to the balance of the amount charged to the credit or debit account but may be a flat fee per transaction. Prior to processing the transaction, the customer will be informed of the fee amount and, upon request by the customer, the formula employed to arrive at this fee amount.

City of Clinton - Sewer Rates. The City of Clinton owns sewer facilities, and its city council has set its sewer rates to be 133% of the customer's water bill.[76] Because KRS 278.010 specifically exempts cities from the definition of public utilities, the Commission has no jurisdiction to regulate Clinton's sewer facilities or operations.

Water Service operates Clinton's wastewater facilities and provides billing services. At the hearing, Mr. Lashua testified that Water Service receives a flat fee from the city for providing those services. He specifically stated that Water Service would not generate additional revenue from its contract with the city if Water Service's water rates were increased.[77]

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[76] Clinton, Ky. Code § 50.20 (2007).

[77] Transcript of August 19, 2009, Hearing, at 122.

In its post-hearing brief, Water Service corrected Mr. Lasuha's testimony.[78] Based on the contract, the City of Clinton pays Water Service $15,000 annually (plus automatic increases based on CPI) and 3 percent of gross revenues plus costs. Based on these provisions, it appears that Water Service would generate additional revenues from Clinton if its water rates increased. These additional revenues, however, are based on operations outside the Commission's jurisdiction and, therefore, do not impact the revenue requirement for Water Service's water operations.

As a governmental agency, the Commission is concerned with the interests of the general public. As an agency specializing in utility regulation, we encourage utilities to set rates that are based on the cost of providing that utility service. In viewing Clinton's sewer rate at a distance, we are concerned that, if Clinton's sewer rate was set at 133 percent of the water bill because those rates were based on the cost of sewer service at that time, an increase in sewer rates resulting from an increase in water rates would produce additional revenues that are not necessarily based on the cost of providing sewer service.

We must make it clear that the Commission has no knowledge as to how the Clinton City Council set its rate or about the costs associated with its sewer facilities. It is entirely possible that the City Council set rates that were lower than the actual cost of

[78] Water Service's Post-Hearing Brief, at 22 (filed August 31, 2009).

providing sewer service and are subsidizing the sewer operations with other funding. It is also possible that the sewer rate increase that will occur as the water rate increases will no longer be cost-justified. The Commission encourages Clinton's public officials to consider these concerns in the interest of its citizens.

Customer Bills for Average Usage. At the public meetings in Middlesboro and Clinton, numerous customers of Water Service described their high bills and how a rate increase would affect them. The customers also generally commended their local Water Service staff for providing exemplary service. The Commission understands the plight of the two communities that are served by Water Service, particularly in these times of economic distress. As with all rate cases, the Commission must balance the consumer interests of safe, reliable service with reasonable cost, and we believe that we have accomplished that goal in these proceedings.

The Commission typically uses a monthly average of 5,000 gallons of water to reflect the average usage for a residential customer. The increase that the Commission is authorizing Water Service will increase an average residential customer's bill in Middlesboro by $5.12 (from $17.58 to $22.70) and in Clinton by $8.54 (from $29.46 to $38.00). Undoubtedly, some customers will be affected more appreciably. We recognize that this increase is not insignificant; nevertheless, the increase is necessary in order for Water Service to maintain adequate service to all its customers.

SUMMARY

The Commission, after consideration of the evidence of record and being otherwise sufficiently advised, finds that:

1. Water Service's proposed rates would produce revenue in excess of that found reasonable herein and should be denied.

2. The rates and nonrecurring charges set forth in the Appendix attached to this Order are fair, just, and reasonable rates for Water Service to charge for service rendered on and after the date of this Order.

IT IS THEREFORE ORDERED that:

1. The water rates proposed by Water Service are denied.

2. The rates and nonrecurring charges in the Appendix to this Order are approved for service rendered by Water Service on and after the date of this Order.

3. Within 20 days of the date of this Order, Water Service shall file new tariff sheets setting forth the rates and charges approved herein and reflecting their effective date and that they were authorized by this Order.

By the Commission

ENTERED
NOV - 9 2009
KENTUCKY PUBLIC
SERVICE COMMISSION

ATTEST:

Executive Director

APPENDIX

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2008-00563 DATED NOV - 9 2009

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

Monthly Water Rates

CLINTON

5/8" x 3/4" Meter:

First	1,000	gallons	$ 11.64	Minimum bill
Next	9,000	gallons	6.59	per 1,000 gallons
Next	15,000	gallons	6.05	per 1,000 gallons
Next	25,000	gallons	5.51	per 1,000 gallons
Next	50,000	gallons	4.89	per 1,000 gallons
All Over	100,000	gallons	4.27	per 1,000 gallons

1" Meter:

First	5,300	gallons	$ 39.98	Minimum bill
Next	3,700	gallons	6.59	per 1,000 gallons
Next	15,000	gallons	6.05	per 1,000 gallons
Next	25,000	gallons	5.51	per 1,000 gallons
Next	50,000	gallons	4.89	per 1,000 gallons
All Over	100,000	gallons	4.27	per 1,000 gallons

1 1/2" Meter:

First	11,200	gallons	$ 78.23	Minimum bill
Next	13,800	gallons	6.05	per 1,000 gallons
Next	25,000	gallons	5.51	per 1,000 gallons
Next	50,000	gallons	4.89	per 1,000 gallons
All Over	100,000	gallons	4.27	per 1,000 gallons

2" Meter:

First	17,600	gallons	$ 116.95	Minimum bill
Next	7,400	gallons	6.05	per 1,000 gallons
Next	25,000	gallons	5.51	per 1,000 gallons
Next	50,000	gallons	4.89	per 1,000 gallons
All Over	100,000	gallons	4.27	per 1,000 gallons

6" Meter:

First	250,500	gallons	$1,186.60	Minimum bill
All Over	250,500	gallons	4.27	per 1,000 gallons

MIDDLESBORO

5/8" x 3/4" Meter:

First	1,000	gallons	$ 8.70	Minimum bill
Next	9,000	gallons	3.50	per 1,000 gallons
Next	15,000	gallons	3.19	per 1,000 gallons
Next	25,000	gallons	3.03	per 1,000 gallons
Next	50,000	gallons	2.71	per 1,000 gallons
All Over	100,000	gallons	2.48	per 1,000 gallons

1" Meter:

First	6,000	gallons	$ 26.18	Minimum bill
Next	4,000	gallons	3.50	per 1,000 gallons
Next	15,000	gallons	3.19	per 1,000 gallons
Next	25,000	gallons	3.03	per 1,000 gallons
Next	50,000	gallons	2.71	per 1,000 gallons
All Over	100,000	gallons	2.48	per 1,000 gallons

1 1/2" Meter:

First	13,000	gallons	$ 49.72	Minimum bill
Next	12,000	gallons	3.19	per 1,000 gallons
Next	25,000	gallons	3.03	per 1,000 gallons
Next	50,000	gallons	2.71	per 1,000 gallons
All Over	100,000	gallons	2.48	per 1,000 gallons

2" Meter:

First	21,400	gallons	$ 76.49	Minimum bill
Next	3,600	gallons	3.19	per 1,000 gallons
Next	25,000	gallons	3.03	per 1,000 gallons
Next	50,000	gallons	2.71	per 1,000 gallons
All Over	100,000	gallons	2.48	per 1,000 gallons

3" Meter:

First	68,400	gallons	$ 213.60	Minimum bill
Next	31,600	gallons	2.71	per 1,000 gallons
All Over	100,000	gallons	2.48	per 1,000 gallons

4" Meter:

First	127,500	gallons	$ 367.33	Minimum bill
All Over	127,500	gallons	2.48	per 1,000 gallons

6" Meter:

First	281,500	gallons	$ 748.79	Minimum bill
All Over	281,500	gallons	2.48	per 1,000 gallons

Monthly Fire Protection Rates for Water Service Corporation

Private Sprinkler	19.35	per sprinkler
Private Hydrant	19.35	per hydrant
Municipal Hydrant	4.30	per hydrant

Nonrecurring Charges for Water Service Corporation

Service Connection/Tap-on Fee	
5/8" x ¾"Meter	$920.75
All other meter sizes	Actual Cost
Tampering Fee	$27.00
Non-Sufficient Funds Charge	$15.00
Service Reconnection Charge	$27.00
New Customer Account Setup Fee	$27.00
Service Charge	$27.00
Meter Testing Fee	$20.00
Credit/Debit Card Fee:	

The Company may allow payments to be made with cash, check, or credit/debit cards. If, on the bill due date, an attempt to pay the credit card or debit card is made and the card is declined for any reason, payment is still due in full on that date and will be considered late after that date. All late charges and penalties will be applied. If a customer is paying on our disconnect day and the card is denied, the same rules as above apply, in addition to service being disconnected.

When a customer makes a payment by credit card, the utility will assess a fee equal to that charged to the utility by the credit or debit card processing company to process the transaction. This fee is generally calculated using a formula applied to the balance of the amount charged to the credit or debit account but may be a flat fee per transaction. Prior to processing the transaction, the customer will be informed of the fee amount and, upon request by the customer, the formula employed to arrive at this fee amount.

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