COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

PROPOSED ADJUSTMENT OF THE WHOLESALE SERVICE RATES OF HOPKINSVILLE WATER ENVIRONMENT AUTHORITY	)))	CASE NO. 2009-00373

ORDER

Asserting that our Order of July 2, 2010 fails to articulate sufficient findings of fact to support the Commission's conclusion that Hopkinsville Water and Environment Authority's ("HWEA") proposed wholesale rate is reasonable, Christian County Water District ("Christian District") has petitioned for rehearing. We grant the petition to provide further explanation of our Order of July 2, 2010.

In determining whether HWEA's proposed rate is reasonable, the Commission must determine the reasonable level of revenue that HWEA requires to provide wholesale service to Christian District, ascertain whether the proposed rates will produce that level of revenue, and revise the proposed rates in those instances in which the proposed rates would produce revenues in excess of the reasonable revenue requirement. Generally, a utility is permitted to earn revenues sufficient to meet its reasonable expenses to provide service and a reasonable rate of return.[1] As it relates

[1] *See* 64 Am.Jur.2d *Public Utilities* § 133 (2010).

to municipal utilities, the debt service coverage method is generally used to determine a reasonable rate of return on net revenues.[2]

The evidence in the record indicates that, based upon adjusted test-period operations, HWEA's total water operations require annual revenues of $7,848,663. Of this annual requirement, $4,577,154 is related to utility operating expenses, including $1,348,086 of depreciation expense, and $3,271,509 is related to debt service.

As a utility's operating expenses are presumed to be reasonable[3] and the record contains no evidence to challenge this presumption,[4] our determination is based upon HWEA's actual operating expenses during the test period.[5] HWEA proposes, and we accept, adjustments to actual operating expense levels to normalize depreciation expense for assets placed into service during the test period and to remove expenses associated with benefits paid for labor on HWEA's Pembroke and Crofton systems. We have further increased HWEA's depreciation expense by $2,217 to eliminate the effects of the erroneous accounting treatment for a gain on the sale of a fixed asset.[6]

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[2] *See* Case No. 2002-00022, *City of Pikeville*, at 28 (Ky. PSC Oct. 18, 2002). In this aspect, municipal utilities are very similar to water districts. *See Public Service Commission of Kentucky v. Dewitt Water District*, 720 S.W.2d 725, 731 (Ky. 1987) ("[W]ater districts . . . are nonprofit utilities organized under Chapter 74 of the Kentucky Revised Statutes. The owners and consuming ratepayers are essentially the same individuals because the districts are political subdivisions of county government. They have no private capital and no corporate investors who must be satisfied as to traditional profits. Their rates do not generate a return on rate base. The water districts are permitted to earn net revenues based on a debt service formula or on an operating ratio computed in accordance with a percentage of operating expenses.")

[3] *W. Ohio Gas Co. v. Pub. Utils. Comm'n*, 294 U.S. 63, 72 (1935).

[4] In addition to the lack of evidence challenging the reasonableness of HWEA's experience, we are unable to locate in the record any specific instance where Christian District asserted that an incurred expense was unreasonable.

[5] The test period ran from July 1, 2008 through June 30, 2009.

[6] The Commission's Uniform System of Accounts for Class A and B utilities requires the gain or loss from the disposition of utility property to be recorded in Account 414 Gains (Losses) from the Disposition of Utility Property.

As to HWEA's debt service requirements, we find that, using the average of HWEA's annual principal and interest payments on long-term debt for fiscal years 2010-2012, HWEA's annual debt service is $2,650,707.[7] HWEA's bonded debt requires a debt service coverage ratio of 1.3. Applying this ratio to the principal and interest payments associated with HWEA's bonded debt produces a total debt service component of $3,271,509.[8]

Based upon HWEA's adjusted test-period operations and the cost allocation factors set forth in HWEA's cost-of-service study, we find that HWEA's wholesale water service to Christian District has a total revenue requirement of $1,511,448. Our review of HWEA's cost-of-service study and the evidence of record indicate that allocation factors used to allocate adjusted test-period expenses and debt service between retail and wholesale functions were reasonable. We found no evidence to suggest that direct expenses attributable to HWEA's fire protection service were allocated to wholesale customers.

We further find that the HWEA cost-of-service study considered and reflected the limited capacity available to Christian District as a result of the quantity restrictions set forth in the parties' water purchase agreement. The allocation of maximum-hour extra-

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[7] For a breakdown of HWEA's principal and interest payments, see HDR Engineering, Inc., *Cost of Service Study: Hopkinsville Water Environmental Authority* (March 2010) ("*Cost of Service Study*"), App. F.

[8] In 2005, HWEA issued $27.18 million in revenue bonds to finance the construction of two water infrastructure projects. These bonds provide for a debt service coverage ratio of 1.3. Given that the average principal and interest payment on these bonds for the next three fiscal years (2010-2012) is $2,069,475, the application of a debt service coverage ratio of 1.3 on these payments produces a coverage requirement of $620,843. *Id.* In its calculation of the debt service component, HWEA has not applied a debt service coverage to its long-term loans from the Kentucky Infrastructure Authority. Generally, when determining the debt service component, the Commission uses a five-year average of principal and interest payments and considers all long-term debt. For this case only, we have accepted HWEA's more restrictive approach.

capacity costs is expressly based upon the contract limitations.[9] The study allocates only two million gallons of HWEA treatment plant capacity to Christian District.[10]

Notwithstanding a revenue requirement of $1,511,448, HWEA has proposed wholesale service rates that, based upon test-period sales to Christian District, will generate only $1,085,830. As noted in our Order of July 2, 2010, we are not required to establish rates to produce a level of revenue that will cover all reasonable expenses to provide wholesale water service and produce a reasonable rate of return if the applicant does not request such rates and the quality of service will not suffer as a result of granting the requested rates.[11] As the proposed rates are not excessive and the record contains no evidence to suggest that the quality of wholesale water service provided to Christian District will suffer as a result of their assessment, we find the proposed wholesale service rates are reasonable.

IT IS THEREFORE ORDERED that:

1. Christian District's Petition for Rehearing is granted for the purpose of clarifying our Order of July 2, 2010.

2. Our Order of July 2, 2010 is amended to include the findings set forth in this Order.

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[9] Item B-3, *Cost of Service Study*, at E6.

[10] We note that the study's use of average daily usage during the highest-usage month to determine Christian District's maximum-day usage tends to understate the water district's actual maximum-day usage.

[11] Order of July 2, 2010 at 5, n.8.

By the Commission

ENTERED

AUG - 9 2010

KENTUCKY PUBLIC SERVICE COMMISSION

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