COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION FOR ALTERNATIVE RATE FILING OF FERN LAKE COMPANY	))	CASE NO. 2013-00172

ORDER

The parties to this proceeding have jointly moved for acceptance of their "Second Stipulation, Settlement Agreement, and Recommendation" ("Second Stipulation") and authorization to assess rates to produce the stipulated revenue requirement. By this Order, we accept the Second Stipulation and authorize rates for Fern Lake Company that will produce annual revenues from water sales of $123,200, an increase of $38,000 or 44.6 percent over adjusted test-period revenues.

Fern Lake Company, a Kentucky corporation, owns Fern Lake, a reservoir that straddles the Kentucky-Tennessee border and that serves as the water source for Middlesboro, Kentucky and its environs. Fern Lake Company sells raw water to Water Service Corporation of Kentucky ("WSKY"), which treats the water and sells it to its customers in Middlesboro.

On April 30, 2013, Fern Lake Company applied pursuant to 807 KAR 5:076 for an adjustment in its rates for water service. It proposed rates that, based upon its operations for the 2012 calendar year, would generate annual revenues of $149,796, or $64,596 more than its present rates. The proposed adjustment represented the first revision in its general rates since 1986.

Pursuant to our Order of May 29, 2013, Commission Staff conducted a review of Fern Lake Company's application and records and prepared a report of its findings and recommendations regarding the proposed rate adjustment. On July 29, 2013, Commission Staff issued its report in which it questioned whether all of Fern Lake Company's reported test period expenses should be allocated to its sole customer, WSKY. Commission Staff found that, if the Commission determined that all of these expenses should be allocated to WSKY, then Fern Lake Company's proposed rates should be approved.

Shortly after the issuance of the Commission Staff's report, the parties[1] entered into a Stipulation, Settlement Agreement and Recommendation ("First Stipulation") in which they agreed that Fern Lake Company should be authorized rates to produce additional annual revenues of $54,905 and recommended to the Commission that we enter an order establishing rates to produce such a level of revenue. On September 10, 2013, the Commission conducted a hearing on the First Stipulation at which witnesses testified on behalf of Fern Lake Company and Commission Staff. All provided testimony that supported the revenue requirement level to which the parties had stipulated.

On November 14, 2013, we issued an Order in which we rejected the First Stipulation. We took this action because the parties had failed to demonstrate that the stipulated revenue requirement was reasonable. More specifically, they failed to demonstrate that the level of compensation Fern Lake Company provided to its employees —which made up a sizable portion of Fern Lake Company's expenses —

[1] The Attorney General ("AG") and WSKY were permitted to intervene in this proceeding.

was reasonable.[2] Fern Lake Company's employees were related by birth or marriage to Fern Lake Company's two shareholders.[3]

The burden of proof falls upon a utility to demonstrate the reasonableness of its expenses.[4] Generally, a utility management decision to incur an expense will be presumed reasonable absent evidence that the expense is unreasonable, inefficient, or an abuse of management discretion.[5] This presumption, however, does not apply to related-party transactions. The transaction between Fern Lake Company and its employees is similar to that of a transaction between a utility and an affiliated company. Courts have long "recognized that expenses incurred in transactions between utilities and their affiliates deserve special scrutiny, given the potential lack of arms-length bargaining and improper subsidization of the affiliate's unregulated operations through the utility's rates" and that regulatory commissions "need not assume that the fees charged to a utility by its affiliate are fair."[6] Accordingly, in those instances where the utility is employing family members to perform services, the utility must demonstrate the reasonableness of the wages and benefits provided to those employees.

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[2] Test-period wage expense and employee insurance benefits totaled $109,048, or 74.9 percent of test-period operating expenses.

[3] Gary Asher and Larry Asher each own 50 percent of Fern Lake Company's outstanding stock. They are brothers. Fern Lake Company employee Shelly Lewis is Gary Asher's daughter. Fern Lake Company employee Thomas Lewis is Shelly Lewis's spouse and Gary Asher's son-in-law. Fern Lake Company employee Josh Lewis is Thomas Lewis's son and Shelly Lewis's stepson.

[4] *See* KRS 278.190(3).

[5] *See, e.g., West Ohio Gas Co. v. Ohio Pub. Util. Comm'n*, 294 U.S. 63 (1935); *Pennsylvania Pub. Util. Comm'n v. Philadelphia Electric Co.*, 561 A.2d 1224 (Pa. 1989); Case No. 89-014, *City of Newport v. Campbell County Kentucky Water District* (Ky. PSC Jan. 31, 1990).

[6] *Midland Cogeneration Venture Ltd Partnership v. Public Service Comm'n*, 501 N.W.2d 573, 586 (Mich. 1993). *See also Attorney General v. New Mexico Public Service Comm'n*, 685 P.2d 957 (N.M. 1984); *Washington Water Power Co. v. Idaho Public Utilities Comm'n*, 668 P.2d 1007 (Id. 1983).

With regard to the First Stipulation, the utility and the parties supporting the stipulated revenue requirements failed to demonstrate the reasonableness of these expenses. Using wage estimates that U.S. Department of Labor's Bureau of Labor Statistics compiled for the East Kentucky nonmetropolitan area,[7] the Commission compared Fern Lake Company's test-period wages with the wages for similar positions and found that Fern Lake Company's wages were considerably higher.[8] We found no reasonable explanation in the record to explain these higher wages.

Similarly, the record shows that Fern Lake Company provides family insurance coverage to one of the employees at a cost of $15,939. It further shows that this employee could obtain similar insurance coverage from her other employer at a cost of $7,200. The parties failed to demonstrate why a payment of $7,200 to this employee to permit her to obtain such coverage would not be more reasonable than providing the coverage.

Following our rejection of the First Stipulation, the parties entered the Second Stipulation. Under the terms of this document, the parties agree[9] that Fern Lake Company's annual revenue requirement is $38,000 greater than current rates produced during the test period, or approximately $123,200. The parties have requested that the

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7 U.S. Bureau of Labor Statistics, "May 2012 Metropolitan and Nonmetropolitan Area Occupational Employment and Wage Estimates - East Kentucky nonmetropolitan area" (Mar. 29, 2013), http://www.bls.gov/oes/current/oes_2100004.htm (last visited Dec. 9, 2013).

8 In its report, Commission Staff stated that Fern Lake Company's wages were comparable to those paid by Northern Kentucky Water District and, therefore, were reasonable. Staff Report at 3. It also relied upon the results of a survey that the Kentucky Rural Water Association conducted to reach its conclusion that Fern Lake Company's wage rates were reasonable. VR: 09/10/13; 13:24:05 – 13:38:38. As the estimates of the Bureau of Labor Statistics specifically cover the area in which Fern Lake Company operates and contain a larger set of data points, the Commission has afforded this information much greater weight.

9 While the AG is a signatory to the Second Stipulation, he has not agreed to the proposed increase in Fern Lake Company's revenue requirement. He has, however, stated that he does not object to the increase. Second Stipulation at 2.

scheduled hearing in this matter be cancelled and that the Commission approve and implement the Second Stipulation no later than January 1, 2014.

Having reviewed the Second Stipulation and being otherwise sufficiently advised, the Commission finds that:

1. The parties have addressed the concerns that led to our rejection of the First Stipulation.

2. The stipulated revenue requirement will provide sufficient revenues to Fern Lake Company to meet its reasonable operating expenses and provide a reasonable rate of return on its investment.

3. Fern Lake Company's originally proposed rates will produce revenues in excess of that found reasonable and should be denied.

4. The rates set forth in the Appendix to this Order will produce the stipulated revenue requirement and are fair, just, and reasonable.

IT IS THEREFORE ORDERED that:

1. The Joint Motion to accept the Second Stipulation and to cancel the scheduled hearing is approved.

2. The terms of the Second Stipulation are approved.

3. Fern Lake Company's proposed rates are denied.

4. The rates set forth in the Appendix to this Order are approved for water service that Fern Lake Company renders on and after the date of this Order.

5. The hearing scheduled in this matter for December 16, 2013, is canceled.

6. Within 20 days of the date of this Order and using the Commission's Electronic Filing System, Fern Lake Company shall with the Commission a revised tariff sheet that contains the rates set forth in the Appendix.

By the Commission

ENTERED
DEC 12 2013
KENTUCKY PUBLIC
SERVICE COMMISSION

ATTEST:

Executive Director

APPENDIX

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2013-00172 DATED DEC 12 2013

The following rates and charges are prescribed for the customers in the area served by Fern Lake Company for service rendered on and after the date of this Order. 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

First 41,667,000 gallons	$	10,267	Minimum bill
Additional 1,000 gallons		0.26	Per 1,000 gallons

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