COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ELECTRONIC APPLICATION OF KENTUCKY-AMERICAN WATER COMPANY FOR AN ADJUSTMENT OF RATES, A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY FOR INSTALLATION OF ADVANCED METERING INFRASTRUCTURE, APPROVAL OF REGULATORY AND ACCOUNTING TREATMENTS, AND TARIFF REVISIONS	))))))))	CASE NO. 2023-00191

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

On July 7, 2023,[1] Kentucky-American Water Company (Kentucky-American), pursuant to KRS 278.180, KRS 278.190, and 807 KAR 5:001, Section 16(1)(b)(1), filed an application requesting (1) an increase to its rates; (2) approval of a Certificate of Public Convenience and Necessity (CPCN) for Advanced Metering Infrastructure (AMI) meters pursuant to KRS 278.020(1) and 807 KAR 5:001, Section 15(2); (3) approval of a proposed modification to its Qualified Infrastructure Program (QIP); (4) approval to establish regulatory assets or liabilities; (5) establishment of an alternative level of unaccounted for water loss; (6) approval of a universal affordability tariff; (7) and approval of its revised tariffs.

[1] Kentucky-American tendered its application on June 30, 2023. By letter dated July 7, 2023, the Commission rejected the application for filing deficiencies. The deficiencies were subsequently cured, and the application is deemed filed on July 7, 2023. On July 14, 2023, Kentucky-American filed a motion for a ruling from the Commission regarding sufficiency of the June 30, 2023 application. On July 25, 2023, the Commission entered an order denying Kentucky-American's motion and finding the application deemed filed on July 7, 2023.

BACKGROUND

Kentucky-American, a wholly owned subsidiary of American Water Works Company, Inc. (American Water), is a jurisdictional utility that distributes and sells water across three divisions, including its Central Division, which consists of Bourbon, Clark, Fayette, Harrison, Jessamine, Nicholas, Scott, and Woodford counties; its Northern Division, which consists of Gallatin, Owen, Grant, and Franklin counties; and its Southern Division, which consists of Rockcastle and Jackson counties.[2] Kentucky-American provides water service to more than 138,000 customers throughout its three divisions.[3] Kentucky-American last applied for a general rate adjustment in 2018.[4]

In its application, Kentucky-American requested an increase in water revenues of $26,051,990 for the forecasted test period,[5] compared to the operating revenues for the forecasted test period under existing water rates. This would result in a 22.7% increase in water service revenues, net of QIP revenues.[6] On November 8, 2023, Kentucky-American filed a base period update (Base Period Update) that the requested annual increase was revised to $25,563,294.[7]

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[2] Application at 2; Application.

[3] Direct Testimony of Jeffrey Newcomb (Newcomb Direct Testimony) at 4.

[4] Case No. 2018-00358, *Electronic Application of Kentucky-American Water Company for an Adjustment of Rates*.

[5] Application, Exhibit 37, Schedule A at 2.

[6] Application at 3; Application Item 9.

[7] Base Period Update (filed Nov. 8, 2023), unnumbered page 1.

PROCEDURE

By Order entered July 21, 2023, the Commission suspended the proposed rates up to and including February 5, 2024. Following discovery, the Commission held an evidentiary hearing on December 11, 2023, and December 13, 2023, in Frankfort, Kentucky. All parties filed simultaneous post-hearing briefs on January 5, 2024. Kentucky-American and Lexington-Fayette Urban County Government (LFUCG) filed response briefs on January 12, 2024. On February 5, 2024, Kentucky-American filed a notice of intent to implement proposed rates on or after February 6, 2024.[8] The Commission issued an Order on February 9, 2024, requiring Kentucky-American to maintain its records in such a manner as to allow it, the Commission, or any customer to determine the amounts to be refunded, and to whom, in the event a refund is ordered.[9] The Commission denied Kentucky-American's request for approval of a CPCN for AMI meters in its April 9, 2024 Order. All other matters now stand submitted to the Commission for a decision.

There are two intervenors in this matter: the Attorney General of the Commonwealth of Kentucky, by and through the Office of Rate Intervention (Attorney General), and LFUCG. The Attorney General and LFUCG entered into a joint participation agreement and co-sponsored one witness (jointly Attorney General/LFUCG).

[8] Kentucky-American's Notice of Intent to Implement Proposed Rates (filed Feb. 5, 2024) at 1.

[9] Order (Ky. PSC Feb. 9, 2024) at 3.

LEGAL STANDARD

Kentucky-American filed its application pursuant to KRS 278.180, KRS 278.190, and 807 KAR 5:001, Section 16(1)(b)(1). The Commission's standard of review for a utility's request for a rate increase is whether the proposed rates are "fair, just and reasonable."[10] Kentucky-American bears the burden of proof to show that the proposed rates are just and reasonable under the requirements of KRS 278.190(3).

Kentucky-American additionally requested approval for a new tariff identified as a Universal Affordability Tariff. KRS 278.170(1) provides that no utility shall, as to rates or service, give any unreasonable preference or advantage to any person or subject any person to any unreasonable prejudice or disadvantage, or establish or maintain any unreasonable difference between localities or between classes of service for doing a like and contemporaneous service under the same or substantially the same conditions.

Kentucky-American further requested approval for a deviation from an unaccounted-for water loss level of 15 percent for ratemaking purposes. Commission regulation 807 KAR 5:066, Section 6(3) provides that for ratemaking purposes, a utility's unaccounted-for water loss shall not exceed 15 percent of total water produced and purchased, excluding water used by a utility in its own operations.

Kentucky-American also requested approval to establish regulatory assets or liabilities for various expenses that have not previously been provided such accounting treatment. KRS 278.220 sets out that the Commission may establish a uniform system of accounts (USoA) for utilities and, in Kentucky-American's case, that system of accounts shall conform as nearly as practicable to the system adopted or approved by

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[10] KRS 278.300; *Pub. Serv. Comm'n v. Com. Ex rel. Conway*, 324 S.W.3d 373, 377 (Ky.2010).

the National Association of Regulatory Utility Commissioners (NARUC). The NARUC USoA provides for regulatory assets, or the capitalization of costs that would otherwise be expensed but for the actions of a rate regulator. It must be probable that the utility will recover approximately equal revenue through the inclusion of these costs for ratemaking purposes, with the intent to recover the previously incurred cost not a similar future cost.[11] The Commission has historically approved regulatory assets where a utility has incurred: (1) an extraordinary, nonrecurring expense, which could not have reasonably been anticipated or included in the utility's planning; (2) an expense resulting from a statutory or administrative directive; (3) an expense in relation to an industry sponsored initiative;

[11] The Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 71, Accounting for the Effects of Certain Types of Regulation, which was codified as Accounting Standards Codification (ASC) 980, Regulated Operations, provides the criteria for recognition of a regulatory asset. ASC 980-340-25-1 provides, in full, as follows:

> **25-1** Rate actions of a regulator can provide reasonable assurance of the existence of an asset. An entity shall capitalize all or part of an incurred cost that would otherwise be charged to expense if both of the following criteria are met:
>
> > a. It is probable (as defined in Topic 450) that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.
> >
> > b. Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost.
>
> A cost that does not meet these asset recognition criteria at the date the cost is incurred shall be recognized as a regulatory asset when it does meet those criteria at a later date.

or (4) an extraordinary or nonrecurring expense that over time will result in a saving that fully offsets the cost.[12]

TEST PERIOD

Kentucky-American used as its forecasted test period the 12-month period ending January 31, 2025.[13] Its base period is the 12-month period ending September 30, 2023.[14] The base period and test year period meet the requirements in KRS 278.192 and KAR 5:001, Sections 16(6), (7), and (8) and the Commission finds that it is reasonable to use the 12-month period ending January 31, 2025, as the test period in this case.

VALUATION

Pursuant to KRS 278.290(1), the Commission is empowered to "ascertain and fix the value of the whole or any part of the property of any utility," and in doing so is given guidance by the legislature "in establishing value of utility property in connection with rates," and the Commission must "give due consideration" to a number of factors, including capital structure, original cost and "other elements of value recognized by law" in order to ascertain the value of any property under KRS 278.290 "for rate-making purposes."[15]

Rate Base

[12] Case No. 2008-00436, *The Application of East Kentucky Power Cooperative, Inc. for an Order Approving Accounting Practices to Establish a Regulatory Asset Related to Certain Replacement Power Costs Resulting from Generation Forced Outages* (Ky. PSC Dec. 23, 2008), Order at 4.

[13] Application at 2-3, paragraph 5.

[14] Application at 3, paragraph 6.

[15] *National Southwire Aluminum Co. v. Big Rivers Elec*., 785 S.W.2d 503, 512 (Ky. App. 1990).

In its application, Kentucky-American proposed to use the rate base method to calculate its revenue requirement and required increase rather than the capitalization method.[16] Kentucky-American proposed a rate base of $588,397,566.[17] However, on November 9, Kentucky-American filed a Base Period update of a proposed rate base of $588,437,566.[18] The Attorney General/LFUCG proposed an appropriate rate base of $580,294,681.[19] As explained below, the Commission has weighed the evidence filed in the case and finds that Kentucky-American's base rates should be based on a rate base of $489,426,491.

REVENUE REQUIREMENT

Rate Base Adjustments

Cash Working Capital – Cash Working Capital recognizes that cash supplied by shareholders, on behalf of the utility's customers, may be needed to finance operating costs incurred between when a utility disburses cash to vendors in its accounts payable and when revenues are collected from customers for accounts receivable. If shareholders supply that capital, they should be compensated for their investment. A positive Cash Working Capital amount indicates shareholders supplied the working capital, whereas a negative Cash Working Capital amount means that the utility has excess cash available to pay bills. Assuming a higher Cash Working Capital than actually exists results in rates that overstate a utility's costs.

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[16] Application, Exhibit 37, Schedule A at 2.

[17] Application, Exhibit 37, Schedule A at 2.

[18] Base Period Update, Exhibit 37, Schedule B-1 at 2.

[19] As discussed below, the Attorney General/LFUGC proposed one adjustment to rate base, a revised cash working capital amount. $588,397,566 – 8,102,885 = $580,294,681.

Kentucky-American based its cash working capital on a lead/lag study and included $3,141,000 in rate base.[20] This lead/lag study was based on historical data from the 12-month period ending September 30, 2023.[21] Kentucky-American provided updated cash working capital in the base period update of $3,181,000.[22] The Attorney General/LFUCG argued two items were inappropriate in the calculation of working capital. First, that Kentucky-American included non-cash items in the lead/lag study and recommended removing regulatory expense, amortization, uncollectibles, depreciation and amortization, deferred income taxes, and net income.[23] The Attorney General/LFUCG also argued that Kentucky-American is proposing that its service company charges be treated as a prepayment and recommended that the service company charges receive the same expense lead as the contracted services charges.[24] The Attorney General/LFUCG recommended a final cash working capital of ($4,961,885).[25]

Kentucky-American argued that its methodology for calculating the cash working capital has been approved since its 1992 rate case and while the expenses are non-cash items, they are still expenses to Kentucky-American.[26] Additionally, Kentucky-American argued that the service company lead days are based on the actual payment schedule

[20] Application, Exhibit 37, Schedule B-1 at 2.

[21] Application, Exhibit 37, Schedule B-5, 2 at 4.

[22] Base Period Update, Exhibit 37, Schedule B-5, 2 at 4.

[23] Direct Testimony of Greg Meyer (Meyer Direct Testimony) (filed Sept. 29, 2023) at 32.

[24] Meyer Direct Testimony at 35–36.

[25] Meyer Direct Testimony, Exhibit GRM-2.

[26] Kentucky-American's Post-Hearing Brief at 22–25.

and should not be adjusted because the charges are made at cost and do not include a mark-up.[27]

The Commission finds no reason to depart from recent precedent to remove non-cash items from cash working capital.[28] Although the Commission recognizes that Kentucky-American used a methodology that had been previously approved in their rate cases, the Commission has given weight in other rate applications to removing the items that are not cash expenditures to the utility, and agrees that the non-cash items should be removed.

Additionally, the Commission finds that Kentucky-American has not provided any reasoning for service company expenses to be collected in revenues from customers and paid before the actual service is performed. The Commission finds that the Attorney General/LFUCG's adjustment to cash working capital included in rate base is reasonable and should be accepted. This adjustment will reduce the rate base amount by $8,102,885. This adjustment, at Kentucky-American's proposed weighted average cost of capital of 7.87 percent, will reduce the revenue requirement by $637,697.[29]

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[27] Kentucky-American's Post-Hearing Brief at 21.

[28] Case No. 2021-00183, *Electronic Application of Columbia Gas of Kentucky, Inc. for an Adjustment of Rates; Approval of Depreciation Study; Approval of Tariff Revisions; Issuance of a Certificate of Public Convenience and Necessity; and Other Relief* (Ky. PSC Dec. 28, 2021), Order at 14; Case No. 2021-00214, *Electronic Application of Atmos Energy Corporation for an Adjustment of Rates* (Ky. PSC May 19, 2022), Order at 20; Case No. 2022-00372, *Electronic Application of Duke Energy Kentucky, Inc. for (1) An Adjustment of Electric Rates; (2) Approval of New Tariffs; (3) Approval of Accounting Practices to Establish Regulatory Assets and Liabilities; and (4) All Other Required Approvals and Relief* (filed Oct. 12, 2023), Direct Testimony of Paul Norman at 6 and Attachment PMN-1 at 1; Case No. 2023-00159, *Electronic Application of Kentucky Power Company for (1) a General Adjustment of ITS Rates for Electric Service; (2) Approval of Tariffs and Riders; (3) Approval of Accounting Practices to Establish Regulatory Assets and Liabilities; (4) a Securitization Financing Order; and (5) All Other Required Approvals and Relief* (filed June 29, 2023), Application, Section V, Exhibit 1 at 89.

[29] $3,141,000 – ($4,961,885) = ($8,102,885). ($8,102,885) x 7.87% = ($637,697).

Slippage – Beginning with Kentucky-American's first forecasted test year in 1992, the Commission has applied a "slippage" factor to Kentucky-American's construction expenditures based on a ten-year average of actual to budget expenditures. The purpose of the slippage factor "is to produce a more accurate, reasonable, and reliable level of forecasted construction."[30] As early as 2012, Kentucky-American included a "reverse slippage" in its calculations with slippage factors for recurring projects above 100 percent. The Commission notes that in this case, Kentucky-American calculated a slippage factor of 119.48 percent[31], while consistently underestimating construction spending in all of the last ten years. The Commission is concerned that the applied slippage factor has not produced a more accurate, reasonable, and reliable level of forecasted construction for Kentucky-American and it is appropriate in this case to eliminate the slippage factor. The Commission puts Kentucky-American on notice that producing accurate, reasonable and reliable levels of forecasted construction is necessary.

CWIP/AFUDC – Construction work in progress (CWIP) is a plant account for capital projects that have not yet been completed and cleared to utility plant in service. While a construction project is classified as CWIP, it accrues an allowance for funds used during construction (AFUDC) to account for the use of cash for construction expenditures rather than for other purposes during the construction phase. Once the project is completed and placed in service, the AFUDC is included in the total account balance of the project. When CWIP is included in rate base, the utility earns a return on the CWIP balance that compensates the utility for financing costs during the construction period.

[30] Case No. 2010-00036, *Application of Kentucky-American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year* (Ky. PSC Dec. 14, 2010), Order at 7.

[31] Kentucky-American's Response to Staff's First Request for Information, Item 14(b), Attachment.

Kentucky-American has previously used a hybrid approach to CWIP in its rates and included that approach in its application. Kentucky-American included $21,980,639 of CWIP in rate base, which included projected AFUDC.[32] In this hybrid approach, Kentucky-American made an adjustment to increase revenues by $1,672,091 to account for AFUDC included in CWIP during the forecasted period.[33] However, the adjustment does not include AFUDC from before the forecasted test period. Kentucky-American stated that it has used this approach for over a decade and the Commission has expressly approved it in Kentucky-American's 2010 rate case.[34]

Solely from its 2018 rate case, Kentucky-American's AFUDC for projects previously recovered in CWIP is $840,908, which is included in rate base for this proceeding.[35] Kentucky-American did not provide the amount of AFUDC from previous rate cases and stated it does not have the information to do so.[36] Kentucky-American argued that AFUDC for plant previously included in CWIP is an appropriate component of rate base because the AFUDC is rolled into plant in service. Kentucky-American also argued that the previously capitalized AFUDC is not included in the "return on" component of its revenue requirement, and rather only the "return of" component through depreciation.[37]

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[32] Application, Exhibit 37, Schedule B-1 at 2.

[33] Application, Exhibit 37, Schedule C-2, unnumbered page 59.

[34] Kentucky-American's Response to Commission Staff's Third Request for Information (Staff's Third Request) (filed Sept. 21, 2023), Item 3(a).

[35] Kentucky-American's Response to Staff's Third Request, Item 2(a), Attachment.

[36] Kentucky-American's Response to Commission Staff's Post-Hearing Request for Information (Staff's Post-Hearing Request) (filed Dec. 22, 2023), Item 6(d).

[37] Kentucky-American's Post-Hearing Brief at 55.

The Commission finds that CWIP should be removed from Kentucky-American's rate base. The benefit of including CWIP in rate base is that financing costs are concurrently recovered, negating the need to recognize AFUDC for ratemaking purposes, which reduces financing costs and rate base. Kentucky-American is not removing the previous AFUDC amounts for projects included in rate base as CWIP. This means that customers are prepaying for the construction financing through including CWIP in rate base and then Kentucky-American is including those same financing costs through AFUDC in rate base in subsequent rate cases. Kentucky-American's adjustment to revenues only serves to not include the financing costs in both the CWIP balance and the "return on" component on base rates for the forecasted period. The "return on" component of base rates, i.e., the full rate base multiplied by the weighted average cost of capital, includes the previously removed AFUDC in subsequent rate cases. In other words, although Kentucky-American removes the AFUDC in the current rate case, it includes that same AFUDC in rate base in later rate cases. The Commission notes that Kentucky-American's proposed treatment of AFUDC and CWIP is inequitable. Removing CWIP from rate base will reduce the revenue requirement by $1,729,876[38] to account for the reduction in rate base and increase the revenue requirement by $1,672,091 to remove the AFUDC offset revenues, for a net revenue requirement reduction of $57,785.

<u>AMI Meters</u> – The Commission denied Kentucky-American's request for a CPCN for AMI meters in the April 9, 2024 Order. Removing the differential between the AMI meters and Kentucky-American's current meters will result in revenue requirement

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[38] $21,980,639 x 7.87% = $1,729,876.

reductions of $113,196[39] to account for the reduced rate base and $375,051 to account for decreased depreciation expenses.[40] .

QIP Roll-In – As discussed below, the Commission denies the roll-in of the QIP into base rates. Removing the roll-in of QIP results in revenue requirement reductions of $5,308,254 to account for the reduction in rate base and $3,053,037 to account for the reduction in operating expenses.[41]

The total adjustments to rate base are as follows:

Total Rate Base as Filed	588,397,566
Adjustments:	
Reduce Cash Working Capital	(8,102,885)
Remove CWIP	(21,980,639)
Remove AMI Meters	(1,438,321)
Reject QIP Roll-In	(67,449,230)
Final Rate Base	489,426,491

Operating Income Adjustments

For the base period, Kentucky-American reported operating revenues and expenses of $112,476,773 and $78,174,006, respectively.[42] Kentucky-American proposed several adjustments to revenues and expenses to reflect the anticipated operating conditions during the forecasted period, resulting in forecasted operating revenues and expenses of $116,213,137 and $89,310,982, respectively.[43] The Attorney General/LFUCG proposed adjustments to Kentucky-American's revenue requirement

[39] $1,438,321 x 7.87% = $113,196.

[40] Kentucky-American’s Response to Staff’s Third Request, Item 6.

[41] Kentucky-American’s Response to Staff’s Third Request, Item 1, Attachment.

[42] Application, Exhibit 37, Schedule C-1.

[43] Application, Exhibit 37, Schedule C-1.

totaling $12,856,999. After weighing the evidence submitted in the case, the Commission accepts Kentucky-American's forecasted operating revenues and expenses, with several additional adjustments as discussed in further detail below.

Water Revenues – The Attorney General/LFUCG argued that, while Kentucky-American's forecasted customer count is reasonable, it's forecasted usage per customer is lower than the last five years and is unreasonably low.[44] The Attorney General/LFUCG recommended an adjustment to increase the forecasted usage to use a three-year average, net of variable expenses related to increased water sales. The Attorney General/LFUCG's net adjustment is a revenue requirement reduction of $1,875,547.[45]

Kentucky-American argued that the Attorney General/LFUCG's average usage assumption created unreasonable results compared to the actual usage from 2013 to 2022, which it used to populate a linear regression model that accounted for weather normalization, declining usage trends, and the impact of COVID-19.[46]

The Commission is not persuaded by the Attorney General/LFUCG's proposed reduction, which does not appear to address declining usage trends. However, the Commission finds that Kentucky-American's regression model slightly understates the residential customer usage and that the appropriate residential usage should be based on the linear trend line from 2013 to 2022, or approximately 5,810,000 thousand gallons,

[44] Meyer Direct Testimony at 20–22.

[45] Meyer Direct Testimony at 22.

[46] Rebuttal Testimony of Charles Rea at 5.

which is 61,551 thousand gallons above Kentucky-American's proposed residential customer usage. The resulting revenue requirement impact is a reduction of $308,297.[47]

Labor Adjustments – The Attorney General/LFUCG recommended not including the labor cost of unfilled positions in the revenue requirement, for a revenue requirement reduction of $347,956.[48] The Attorney General/LFUCG also recommended adopting a three-year average of the expensed/capitalized payroll ratio from 2020-2022 which decreases payroll expense by $1,830,785.[49] The Attorney General/LFUCG's capitalization ratio adjustment was based on an incomplete subset of capitalization ratios and the Attorney General/LFUCG rescinded the proposed adjustment. The Attorney General/LFUCG proposed an adjustment related to payroll taxes and other labor related overhead expenses related to the proposed reduction in payroll expenses but was unable to provide the amount of the adjustment.[50] Kentucky-American stated that it could not provide a general overhead factor for a reduction to payroll expense because it "forecasted each employee in the rate case based on their employee benefits and payroll information."[51]

The Commission finds both portions of the adjustment are unreasonable and should be denied. Precedent suggests that unfilled positions be included as Kentucky-American is actively seeking to fill those positions, the vacancies are not an unreasonable amount, and the Attorney General/LFUCG's adjustment does not account for an increase

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[47] 61,551 x 5.0088 = 308,297.

[48] Meyer Direct Testimony at 13, Table GRM-5.

[49] Meyer Direct Testimony at 13, Table GRM-5.

[50] Meyer Direct Testimony at 16.

[51] Kentucky-American's Response to Staff's Post-Hearing Request, Item 7.

in overtime or contractor labor to offset unfilled positions.[52] The capitalization adjustment was based on incomplete data. The actual capitalization ratios have been fairly consistent since 2018, although they have been trending upwards for the last decade. The Commission puts Kentucky-American on notice that the Commission will monitor Kentucky-American's capitalization ratios going forward because increased capitalization ratios primarily benefit shareholders through lower expenses and higher rate base amounts. The significant increases of capitalization ratios between rate cases is a cause for concern when they are not reviewed over a longer trend and supported with specific reasoning for the increases.

Incentive Compensation – Kentucky-American included $712,961 in incentive compensation in the test year.[53] The Attorney General/LFUCG recommended removing 50 percent of Kentucky-American's Annual Performance Plan (APP) that is driven by earnings per share and proposes to remove the entirety of Kentucky-American's Long-Term Performance Plan (LTPP).[54] The Attorney General/LFUCG proposed that shareholders, who are the beneficiaries of the incentive compensation, bear the responsibility, resulting in a revenue requirement reduction of $373,598.

Kentucky-American argued that the APP and LTPP benefit customers because it allows Kentucky-American to lower other forms of compensation and still provide market

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[52] See Case No. 95-554, *Application of Kentucky-American Water Company to Increase Its Rates* (Ky. PSC Sept. 11, 1996); Case No. 2004-00103, *Adjustment of the Rates of Kentucky-American Water Company* (Ky. PSC Feb. 28, 2005); Case No. 2010-00036, Dec. 14, 2010 Order; and Case No. 2018-00358, Aug. 8, 2019 Order.

[53] Kentucky-American's Response to Commission Staff's First Request, Item 33.

[54] Meyer Direct Testimony at 16.

competitive compensation and attract competent employees.[55] Kentucky-American also argued that the APP and LTPP encourage employees to perform more efficiently.[56] Kentucky-American also argued that the Attorney General/LFUCG proposed to remove an arbitrary amount of the APP.[57] Finally, Kentucky-American asked that the Commission revisit the precedent to remove incentive compensation tied to financial performance metrics.[58]

While Kentucky-American contended that the total compensation is market competitive, the Commission finds that the adjustment to remove incentive compensation based on financial performance metrics should be approved, consistent with precedent. The Commission disallowed recovery of the cost of employee incentive compensation plans tied to fiscal measurements in Case No. 2018-00358 and explained that the decision is based on the performance measures that result in incentive compensation payouts.[59] Incentive compensation tied to financial performance measures overwhelmingly benefit shareholders over customers, and customers should not bear the expense of those plans. The resulting revenue requirement impact is a reduction of $373,598.

<u>Inflation Factors</u> – Kentucky-American applied an inflation adjustment to 10 of its expenses based on the Consumer Price Index (CPI) from the Bureau of Labor Statistics

[55] Kentucky-American's Post-Hearing Brief at 14.

[56] Kentucky-American's Post-Hearing Brief at 14.

[57] Kentucky-American's Post-Hearing Brief at 14.

[58] Kentucky-American's Post-Hearing Brief at 16.

[59] Case No. 2018-00358, June 27, 2019 Order.

(BLS).[60] The inflation indexes are granular to each cost component for seven expenses and a broad general CPI for three expenses. Kentucky-American stated that it incorporated an inflation factor in its prior rate case but used more specific inflation factors in the instant case.[61]

The Commission finds that the inflation factors should be removed from the forecasted test year. Kentucky-American stated in its application that its expenses have increased below inflation.[62] Kentucky-American stated that removing the inflation factors would reduce the revenue requirement by $970,674 but did not provide a calculation.[63] The Commission has previously held a general CPI inflation factor is not an appropriate forecasting method and even the granular inflation factors are not specific to Kentucky-American's experience.[64] Use of general inflation factors fails to satisfy Kentucky-American's burden that its proposed rates are just and reasonable, as they are not, in and of themselves, reflective of Kentucky-American's costs. The Commission expects a utility such as Kentucky-American, with the shared resources of American Water, to develop and implement more robust forecasting methodologies for expenses than general CPI inflation factors with a review of specific factors impacting costs. For example, Kentucky-American applied an inflation factor to its fuel and power costs

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[60] Kentucky-American's Response to Staff's Post-Hearing Request, Item 10, Attachment.

[61] Kentucky-American's Response to Staff's Third Request, Item 25.

[62] Application, Direct Testimony of William Lewis (Lewis Direct Testimony) at 21, Direct Testimony of Kathryn Nash (Nash Direct Testimony) at 7, and Direct Testimony of John Watkins (Watkins Direct Testimony) at 2.

[63] Kentucky-American's Response to Staff's Post-Hearing Request, Item 11.

[64] Case No. 2013-00148, *Application of Atmos Energy Corp. for an Adjustment of Rates & Tariff Modifications*, (Ky. PSC Apr. 22, 2014), Order at 16-17.

through the end of the test period, although its largest power provider, Kentucky Utilities Company, has a commitment for a base-rate "stay-out" for any base rate increases to not take effect until after July 1, 2025, beyond the end of the test period.[65] Removing the inflation factors from the individual worksheets in which they were applied provided an overall revenue requirement reduction of $1,009,889.[66]

Water Loss – As discussed below, the Commission denies Kentucky-American's request to increase the allowable water loss percentage. Kentucky-American proposed an allowable water loss percentage of 20 percent,[67] but did not make any adjustments in the forecasted test period for expenses even when projected non-revenue water was 20.96 percent[68]. Kentucky-American did not meet its burden of proof in requesting a

[65] Case No. 2020-00349, *Electronic Application of Kentucky Utilities Company for an Adjustment of Its Electric Rates, a Certificate of Public Convenience and Necessity to Deploy Advanced Metering Infrastructure, Approval of Certain Regulatory and Accounting Treatments, and Establishment of a One-Year Surcredit* (Ky. PSC June 30, 2021).

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Expense	As filed	Inflation Removed	Difference
Fuel & Power	5,664,614	5,166,090	498,524
Support Services	12,519,428	12,394,857	124,572
Contract Services	1,437,684	1,394,512	43,172
Building Maintenance & Services	911,837	844,101	67,736
Office Supplies & Services	239,411	209,321	30,090
Employee Related Expense	176,764	156,988	19,777
Miscellaneous Expense	807,314	719,101	88,213
Rents	47,180	37,581	9,598
Other Customer Accounting	478,972	474,727	4,245
Maintenance Supplies & Services	2,725,221	2,601,260	123,962
Total	25,008,425	23,998,536	1,009,889

[67] Direct Testimony of William A. Lewis (Lewis Direct Testimony) at 39.

[68] KYAW Revenue tab, KAWC 2023 Rate Case – Exhibits (25, 26, 37) Revenue WP Support.xls. 3,163,096 gallons non-revenue/15,089,470 gallons system delivery = 20.96%,

deviation and did not offer an alternative water loss amount to the proposed non-revenue water amount. However, as described in the testimony of Kentucky-American witness, William A. Lewis, Kentucky-American has not achieved water loss levels of less than 20 percent in the last four years.[69] The total impact of reducing the unaccounted-for water percentage from 20.96 percent to 15 percent is an expense reduction of $660,193. The impact of these reductions will be addressed in each expense component.

Fuel & Power – In addition to removing the inflation factor, the Commission has reduced Fuel & Power expenses due to water loss. Fuel & Power expenses once the inflation factor is removed is $5,166,090 or a reduction of $498,524. The Commission increased the forecasted residential water sales as described above, which will increase Fuel & Power expenses. Assuming a per thousand gallon Fuel & Power expense of $0.3424,[70] Fuel & Power would increase by $21,075.[71] Removing 5.96 percent of expense for water loss reduces the Fuel & Power expense another $309,155.[72] The total net adjustment to Kentucky-American's Fuel & Power expense is a reduction of $786,604.

Chemical Expense – Kentucky-American proposed a forecasted Chemical expense of $5,624,592. The Commission increased the forecasted residential water sales as described above, which will increase Chemical expenses. Assuming a per thousand gallon Chemical expense of $0.3727,[73] Chemical expenses would increase by

[69] Lewis Direct Testimony at 38-39.

[70] Fuel & Power expense: $5,166,090/15,089,470 thousand gallons = $0.3424/thousand gallons.

[71] Fuel & Power expense: $0.3424 x 61,551 = $21,075.

[72] Fuel & Power expense: ($5,166,090 + $21,075) x 5.96% = $309,155.

[73] Chemical expense: $5,624,592/15,089,470 thousand gallons = $0.3727/thousand gallons.

$22,940.[74] The Commission further finds that a reduction for water loss of 5.96 percent above the 15 percent allowed for ratemaking purposes reduces the expense by $335,226.[75] The total net adjustment to Kentucky-American's Chemical expense is a reduction of $312,286.

Purchased Water – Kentucky-American proposed a forecasted test year expense of [redacted]. The Commission increased the forecasted residential water sales as described above, which will increase Purchased Water expenses. Assuming a per thousand gallon Purchased Water expense of [redacted],[76] Purchased Water expenses would increase by [redacted][77] The Commission finds that a reduction for water loss of 5.96 percent above the 15 percent allowed for ratemaking purposes reduces the expense by [redacted].[78] The total net adjustment to Kentucky-American's Purchased Water expense is a reduction of [redacted].

Waste Disposal – Kentucky-American proposed in the forecasted test year an expense of $679,404. The Commission increased the forecasted residential water sales as described above, which will increase Waste Disposal expenses. Assuming a per thousand gallon Waste Disposal expense of $0.0450[79], Waste Disposal expenses would increase by $2,770.[80] The Commission further finds that a reduction for water loss of

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[74] Chemical expense: $0.3727 x 61,551 = $22,940.

[75] Chemical expense: ($5,624,592 + $22,940) x 5.96% = $313,653.

[76] Purchased Water expense: $[redacted]/15,089,470 thousand gallons = $[redacted]/thousand gallons.

[77] Purchased Water expense: $[redacted] x 61,551 = $[redacted].

[78] Purchased Water expense: ($[redacted] + $[redacted]) x 5.96% = $[redacted]

[79] Waste Disposal expense: $679,404/15,089,470 thousand gallons = $0.0450/thousand gallons.

[80] Waste Disposal expense: $0.0450 x 61,551 = $$2,770.

5.96 percent above the 15 percent allowed for ratemaking purposes reduces the expense by $40,658.[81] The total net adjustment to Kentucky-American's proposed Waste Disposal expense is a reduction of $37,888.

Miscellaneous Expenses – The Attorney General/LFUCG recommended removing miscellaneous expenses of $121,116, which includes food, gifts, charitable donations, and membership dues.[82] The bulk of the adjustment, $106,069, is shared services business development expenses that were not specifically justified.

Kentucky-American argued that only $9,348 should be removed, for $6,799 of promotional gifts and $2,549 of membership dues.[83] Kentucky-American argued that the $5,699 of food expenses are de minimis and similar expenses have been allowed recovery for electric cooperatives' annual meetings.[84] Kentucky-American also argued that allocated business development expenses benefit customers.[85]

The Commission finds that the Attorney General/LFUCG's adjustment is reasonable and should be approved. Providing employees with food is not analogous to an electric cooperative annual meeting and allocated business development expenses are not specific to Kentucky-American's development efforts.

Rate Case Expense – Kentucky-American proposed a two-year amortization period for rate case expense of $1,321,037, for a test-year expense of $660,519.[86]

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[81] Waste Disposal expense: ($679,404 + $2,770) x 5.96% = $40,658.

[82] Meyer Direct Testimony at 27–29.

[83] Rebuttal Testimony of Jeffrey Newcomb (Newcomb Rebuttal Testimony) at 4.

[84] Kentucky-American's Post-Hearing Brief at 31.

[85] Kentucky-American's Post-Hearing Brief at 33.

[86] Application, Exhibit 37, Schedule D-2 at 5.

The Commission finds that rate case expenses should be based on the actual expenses of $1,059,527, less witness preparation expenses of $62,787, and amortized over three years.[87] The Commission has found that witness preparation expenses should not be recovered from ratepayers as they receive no benefit from these expenses.[88] Additionally, a three-year amortization period is standard and Kentucky-American has stated that the QIP will delay rate cases, such that a two-year amortization period is unreasonable. The net impact of these adjustments is a revenue requirement reduction of $328,272.[89]

Credit Card Fees – Kentucky-American proposed to remove payment processing fees as a separate charge that is paid directly by the customer and include those costs in base rates.[90] Kentucky-American stated that it proposed to include these fees in base rates to make it more convenient for customers to pay their bills.[91]

The Attorney General/LFUCG recommended removing credit card fees from base rates, which results in a revenue requirement reduction of $348,284.[92] The Attorney

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[87] Kentucky-American's Supplemental Response to Staff's Post-Hearing Request, Item 12 (filed Jan. 12, 2024).

[88] Case No. 2020-00174, *Electronic Application of Kentucky Power Company for (1) A General Adjustment of Its Rates for Electric Service; (2) Approval of Tariffs and Riders; (3) Approval of Accounting Practices to Establish Regulatory Assets and Liabilities; (4) Approval of a Certificate of Public Convenience and Necessity; and (5) All Other Required Approvals and Relief* (Ky. PSC Jan. 13, 2021), Order at 19–20.

[89] 1,059,527 - 62,787 = 996,740 / 3 = 332,247. 660,519 – 332,247 = 328,272.

[90] Newcomb Direct Testimony at 13.

[91] Newcomb Direct Testimony at 13.

[92] Meyer Direct Testimony at 10.

General/LFUCG argued that including these fees in base rates would require all customers to subsidize the cost of these transactions.[93]

The Commission agrees that the credit card fees should be removed from base rates. Neither the Attorney General/LFUCG nor Kentucky American provided persuasive evidence regarding their position. In light of that, the Commission denies the inclusion of credit card fees in base rates because Kentucky-American did not propose any offsetting adjustments to late payments or uncollectible accounts. Additionally, Kentucky-American did not provide evidence that there would be a decrease in transaction costs, an overall benefit to customers, or increased revenues if Kentucky-American pays the processing fee and there is no convenience fee.

Legal Fees for Investigation – Kentucky-American forecasted its contracted services legal fees based on 2022 expenses and an inflation factor. As discussed above, the Commission will remove the inflation factor. Included in the 2022 expenses are also $28,928 of legal expenses incurred for the Commission investigation in Case No. 2022-00299.[94] The Commission finds that these expenses should be removed from the legal fees included in the forecasted period, resulting in a revenue requirement reduction of $28,928.

Employee Stock Purchase Program – Kentucky-American employees can participate in the American Water Employee Stock Purchase Program (ESPP), in which they are able to purchase American Water stock at 85 percent of the market value of the

[93] Meyer Direct Testimony at 10.

[94] Case No. 2022-00299, *Electronic Investigation of Kentucky-American Water Company's Alleged Violation of a Tariff and Commission Regulations Regarding Meters and Monitoring Customer Usage* (Ky. PSC Sept. 27, 2022). Kentucky-American's Response to Commission Staff's Post-Hearing Request (filed July 10, 2023), Item 15, Attachment 1.

share on the purchase date with certain limits on timing and contributions to the plan. The differential between the market price and the price paid by the employee through the ESPP is included in the proposed revenue requirement in this case in the amount of $30,039.[95]

The Commission finds that Kentucky-American's ESPP discounts should be removed from the test year because it is not reasonable to recover from ratepayers as they do not benefit from the program.

Depreciation – Kentucky-American proposed new depreciation rates in this proceeding, supported by a depreciation study based on Kentucky-American's water plant in service as of December 31, 2022.[96] Kentucky-American proposed to increase the composite depreciation rate from 2.61 percent to 3.29 percent.[97]

LFUCG recommended that meter depreciation expense be reduced from $2,243,128 to $326,595, a reduction of $1,916,533 to reflect a more reasonable approach to Kentucky-American's routine meter replacement schedule.[98] Additionally, the Attorney General stated that Kentucky-American proposed to "drastically increase and accelerate the depreciation rates for the existing meters" in order to reduce the stranded assets associated with the proposed AMI meter project.[99]

LFUCG appears to interchange the meter testing period, replacement cycle, and depreciation rates. Kentucky-American's proposed depreciation rates are based on

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[95] Kentucky-American's Response to Staff's Post-Hearing Request, Item 5.

[96] Application, Direct Testimony of Larry Kennedy (Kennedy Direct Testimony) at 2–3.

[97] Kennedy Direct Testimony at 6.

[98] LFUCG's Post-Hearing Brief (filed Jan. 5, 2024) at 5.

[99] Attorney General's Post-Hearing Brief at 27.

actual retirements and additions as of December 31, 2022, and the proposed depreciation rate for meters do not include the proposed AMI meters. The depreciation rates for Kentucky-American's meters are increasing because the last depreciation rates were set significantly lower than the actual useful life of the current meters.[100] The Commission finds that Kentucky-American's proposed depreciation rates are reasonable and should be approved.

RATE OF RETURN

Capital Structure

Kentucky-American's proposed capital structure, based on the projected 13-month average balances for the forecasted test period and the costs assigned to each capital component, is shown in the table below:[101]

Class of Capital	13-Month Average Net Carrying Amount	Ratio	JDITC	Adjusted Capital	Cost Rate	13-Month Average Weighted Cost
Short-Term Debt	$5,752,848	0.96%	-	$5,752,848	3.818%	0.040%
Long-Term Debt	$275,967,192	46.21%	$0.30	$275,967,193	4.681%	2.160%
Preferred Stock	$2,245,236	0.38%	-	$2,245,236	8.510%	0.030%
Common Equity	$313,228,976	52.45%	$0.34	$313,228,976	10.75%	5.640%
Total	$597,194,252		$0.64	$597,194,252		7.870%

When submitting its Base Period Updates, Kentucky-American proposed the following revisions to its forecasted capital structure to reflect (1) an updated projected long-term debt of $28 million in May of 2024 divided evenly between 10-year and 30-year taxable bonds with coupons of 5.904 percent and 6.201 percent; (2) an increase in projected retained earnings from $12,912,433 to $15,155,445; and (3) an increase in

[100] Case No. 2015-00418, *Application of Kentucky-American Water Company for an Adjustment of Rates* (Ky. PSC Aug. 23, 2016), Application, Direct Testimony of John Spanos, Exhibit JJS-1 at unnumbered page 310. Meter accounts had an average composite remaining life of 35.9 years.

[101] Application, Exhibit 37, Schedule J-1.

projected short-term debt balance of $4,263,202 due to the timing shift of the long-term debt issuance.[102] Kentucky-American's revised forecasted capital structure and assigned cost rates are shown in the table below.[103]

Class of Capital	13-Month Average Net Carrying Amount	Ratio	JDITC	Adjusted Capital	Cost Rate	13-Month Average Weighted Cost
Short-Term Debt	$9,168,090	1.54%	-	$9,168,090	5.354%	0.080%
Long-Term Debt	$273,581,929	45.87%	$0.29	$273,581,929	4.544%	2.080%
Preferred Stock	$2,245,236	0.38%	-	$2,245,236	8.510%	0.030%
Common Equity	$311,462,178	52.22%	$0.33	$311,462,178	10.75%	5.610%
Total	$596,457,432		$0.64	$596,457,432		7.800%

The Attorney General agreed with Kentucky-American regarding its proposed costs of short-term debt, long-term debt, and preferred stock.[104] However, the Attorney General argued that Kentucky-American's proposed common equity ratio of 52.45 percent is excessively high when compared to recent historical equity percentages and recommended a common equity ratio of 50.00 percent and rebalance the long-term debt ratio to 48.66 percent.[105] Additionally, the Attorney General accepted the proposed short-term debt and preferred stock ratios.[106]

The Attorney General argued that Kentucky-American's average common equity ratios ranged from 46.90 percent in 2019 to 49.30 percent in 2022 and that its proposed common equity ratio of 52.45 percent represents a sharp increase from its historical

[102] Rebuttal Testimony of Nicholas Furia (Furia Rebuttal Testimony) at 4-5.

[103] Base Period Update, Exhibit 37, Schedule J-1.

[104] Direct Testimony of Richard A. Baudino (Baudino Direct Testimony) at 33.

[105] Baudino Direct Testimony at 34.

[106] Baudino Direct Testimony at 34.

capitalization ratios and a significant increase over 2022.[107] The Attorney General noted that a common equity ratio of 52.45 percent would inflate the revenue requirement for Kentucky-American's ratepayers and should therefore be reduced.[108]

Kentucky-American argued that the Attorney General only cited to historical information and provided no credible basis for utilizing a common equity ratio of 50.00 percent for the forecasted test-year ending January 31, 2025.[109] Kentucky-American also argued that the Attorney General did not consider how it has been financed in recent periods or how it is projected to be financed for the forecasted test year.[110]

Upon review of the record and being otherwise sufficiently advised, the Commission finds that Kentucky-American's revised capital structure accurately projects the test-year capitalization requirements. However, the Commission has an expectation that utilities in Kentucky should have a capital structure that is reasonably balanced between equity and debt such that it does not over burden its ratepayers to the benefit of shareholders.[111] Also, the Commission notes that Kentucky-American has control over its capital structure and financing such that it chooses the amounts of debt and equity to be issued. The Commission agrees with the Attorney General that Kentucky-American's common equity ratio has increased almost every year since 2019.[112] The Commission

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[107] Baudino Direct Testimony at 34.

[108] Baudino Direct Testimony at 34.

[109] Furia Rebuttal Testimony at 8.

[110] Furia Rebuttal Testimony at 8.

[111] *See* Case No. 2022-00372, *Electronic Application of Duke Energy Kentucky, Inc. For (1) an Adjustment of Electric Rates; (2) Approval of New Tariffs; (3) Approval of Accounting Practices to Establish Regulatory Assets and Liabilities; and (4) All Other Required Approvals and Relief* (Ky. PSC Oct. 12, 2023), Order at 35. *See also* Baudino Direct Testimony at 34.

[112] Baudino Direct Testimony at 34.

puts Kentucky-American on notice that Kentucky-American is expected to exercise prudent control over the amount of equity that is issued so that it maintains a more balanced capital structure and places less of a burden on its ratepayers.

Return on Equity

In its application, Kentucky-American proposed an ROE using the discounted cash flow model (DCF), the capital asset pricing model (CAPM), and the empirical CAPM (ECAPM). The modeling utilized a Combined Utility Proxy Group, which included water, natural gas distribution utilities, and combination electric and gas utilities. Kentucky-American noted that both proxy group model results exclude American Water.[113] Kentucky-American is requesting an ROE of 10.75 percent based upon a range from 10.00 percent to 11.00 percent.[114]

Kentucky-American stated that it based its decision upon multiple factors including its capital expenditure program relative to proxy groups, flotation costs associated with American Water, environmental risks, regulatory risks, and its proposed capital structure as compared to the proxy groups.[115] Additionally, Kentucky-American noted that the analyses rely on forward-looking inputs and assumptions.[116] The table below summarizes the range of Kentucky-American's ROE estimates:[117]

Method	Low Growth Rate	Average Growth Rate	High Growth Rate

[113] Application, Direct Testimony of Ann E. Bulkley (Bulkley Direct Testimony) at 27.

[114] Bulkley Direct Testimony at 7.

[115] Bulkley Direct Testimony at 3.

[116] Bulkley Direct Testimony at 5. Kentucky-American noted specifically that the forward-looking analyses are the projected analyst growth rates in the DCF model, forecasted risk-free rate, and market risk premium in the CAPM analysis.

[117] Bulkley Direct Testimony at 5.

DCF			
Mean Results			
30-Day Average	8.13%	9.31%	10.66%
60-Day Average	8.10%	9.28%	10.63%
180-Day Average	8.13%	9.31%	10.65%
Average	8.12%	9.30%	10.65%
Median Results			
30-Day Average	8.36%	9.95%	10.52%
60-Day Average	8.38%	9.93%	10.51%
180-Day Average	8.41%	9.97%	10.55%
Average	8.39%	9.95%	10.52%

	Current 30-day Average 30-Year Treasury Bond Yield	Near-Term Forecast 30-Year Treasury Yield	Longer-Term Forecast 30-Year Treasury Yield
CAPM			
Current Value Line Beta	10.49%	10.50%	10.53%
Current Bloomberg Beta	10.07%	10.09%	10.12%
Long-Term Average Beta	9.76%	9.78%	9.82%
ECAPM			
Current Value Line Beta	10.87%	10.88%	10.90%
Current Bloomberg Beta	10.55%	10.56%	10.59%
Long-Term Average Beta	10.32%	10.34%	10.37%

The Attorney General provided an ROE analysis that employed the DCF and the CAPM while utilizing Kentucky-American's proposed proxy group.[118] The Attorney General's DCF analyses are based on the standard constant growth form that employs four different growth rate forecasts from the Value Line Investment Survey, Yahoo! Finance, and Zacks.[119] Additionally, the Attorney General employed the CAPM analyses

[118] Baudino Direct Testimony at 15.

[119] Baudino Direct Testimony, at 15.

using both historical and forward-looking data.[120] The Attorney General recommended an ROE of 9.40 percent and the range of reasonableness of 8.70 percent to 10.00 with giving more emphasis to the DCF results but still supported by the CAPM analysis.

For the DCF model, the Attorney General employed the average dividend yield and earnings growth rates, and calculated DCF estimates using two methods.[121] The first applied average growth rates and the second, median growth rates.[122] Average growth rates ROE estimates range from 8.67 to 9.94 percent and median growth rates ROE estimates range from 8.41 to 9.52 percent, with the average of the two methods being 9.04 percent.[123] The Attorney General noted that given the persistently high rate of inflation and the increasing long-term bond yields so far this year, that the 8.41 percent for the median growth rate is too conservative and that the lower DCF result should be 8.70 percent and the highest DCF result should be 10.00 percent.[124]

For the CAPM model, the Attorney General employed three approaches. The first approach used the forward-looking expected return on the market, the second approach used historical market risk premiums (MRP) based on actual stock and bond returns, and the third approach used public sources that estimate current investor required MRP.[125] When determining the risk-free rate, the Attorney General utilized two different rates. The first measure was a six-month average of the 30-year Treasury bond yields from March

[120] Baudino Direct Testimony at 15.

[121] Baudino Direct Testimony at 21.

[122] Baudino Direct Testimony at 21-22.

[123] Baudino Direct Testimony at 21.

[124] Baudino Direct Testimony at 22.

[125] Baudino Direct Testimony at 25.

through August 2023 resulting in a 3.90 percent bond yield.[126] The second measure was a three-month average from July to August 2023. The 31-basis point increase in the 30-Year Treasury yield resulted in a 4.30 percent risk-free rate.[127] The following table summarizes the Attorney General's results:[128]

Method	Average
DCF	
Average Growth Rates	
High	9.94%
Low	8.67%
Average	9.07%
Median Growth Rates	
High	9.52%
Low	8.41%
Average	9.04%
CAPM	
Forward-looking Market Return	12.77%
Historical Risk Premium	
Arithmetic Mean	10.04%
Supply side MRP	9.44%
Supply side less WWII Bias[129]	8.64%
Kroll MRP	8.75%
Damodaran MRP	8.20%

The Attorney General argued that the Commission should adopt an ROE range of 8.70 percent to 10.00 percent for Kentucky-American considering the range is formed mainly by the DCF results but supported by the CAPM analyses.[130] Additionally, the Attorney General took issue with multiple assumptions used in the ROE calculations by Kentucky-American and still concluded that based on the DCF analysis, excluding the

[126] Baudino Direct Testimony at 30.

[127] Baudino Direct Testimony at 30.

[128] Baudino Direct Testimony at 32.

[129] *See* Baudino Direct Testimony at 31.

[130] Baudino Direct Testimony at 32.

12.77 percent CAPM ROE as a viable ROE result, and consideration of current financial market conditions, an ROE for Kentucky-American of 9.40 percent is appropriate and near the midpoint of the recommended range.[131]

Regarding Kentucky-American's DCF calculation, the Attorney General argued that both approaches were very similar in that the same proxy group was used, six-month or 180-day averages of stock prices were used, the same three sources for the growth rates were utilized, and the same method to calculate the expected dividend yield were used.[132] However, the Attorney General's witness, Baudino, noted that the reason why his DCF calculation was lower was due to the decline in Yahoo! Finance earnings growth rates.[133]

Regarding the CAPM and ECAPM calculations, the Attorney General argued that Kentucky-American used only one source to estimate the recommended MRP and that the MRP range is overstated, which leads to an overestimation of the CAPM ROE.[134] Also, the Attorney General argued that the main issue with Kentucky-American's CAPM analysis is the sole reliance on a forward-looking market return for the S&P 500.[135] The Attorney General noted that the projected market return of 12.00 percent is overstated due to Kentucky-American's reliance on an average Value Line long-term projected growth rate of 10.19 percent, which is simply unsustainable in the long run.[136] The

[131] Baudino Direct Testimony at 32-33.

[132] Baudino Direct Testimony at 37.

[133] Baudino Direct Testimony at 38.

[134] Baudino Direct Testimony at 39.

[135] Baudino Direct Testimony at 39.

[136] Baudino Direct Testimony at 39.

Attorney General argued that Kentucky-American's unsustainable earnings growth forecast is not supportable when further consideration is given to both historical and forecasted Gross Domestic Product (GDP) growth for the United States.[137] The Attorney General argued that the ECAPM is designed to account for the possibility that the CAPM understates the ROE for companies with betas less than 1.0 and that the argument that an adjustment factor is needed to "correct" the CAPM results for companies with betas less than 1.0 is further evidence of the lack of accuracy inherent in the CAPM itself and with beta measures in particular.[138] Therefore, the Attorney General recommended that due to the constant growth DCF requiring a sustainable long-run growth rate, Kentucky-American's projected market return and MRP estimate are overstated and should be rejected.[139]

The Attorney General noted that Kentucky-American presented risks and other considerations when setting the ROE such as floatation costs, its capital expenditure program, environmental risks, and regulatory risks. The Attorney General argued that the Commission should reject the use of floatation costs based on past precedent[140] and that Kentucky-American did not provide any new evidence to warrant the Commission changing its historical stance on this issue.[141] In addition, the Attorney General argued that it is up to Kentucky-American to prudently manage the timing and amount of its capital

[137] Baudino Direct Testimony at 39.

[138] Baudino Direct Testimony at 42.

[139] Baudino Direct Testimony at 41.

[140] Baudino Direct Testimony at 43. *See* Case No. 2021-00214, *Electronic Application of Atmos Energy Corporation for an Adjustment of Rates* (Ky. PSC May 19, 2022), Order at 48.

[141] Baudino Direct Testimony at 43.

expenditures in conjunction with the timing of its rate cases to ensure that it collects its prudent costs of providing service to its ratepayers while maintaining a competitive return on its investments. Therefore, the Attorney General argued, the Commission should not consider Kentucky-American's capital expenditure program.[142] Lastly, the Attorney General argued that it did not believe the additional risks articulated by Kentucky-American significantly affected its risk as compared to the proxy group and is not a basis for the Commission to give it a higher return.[143]

In rebuttal testimony, Kentucky-American disputed the Attorney General's analyses for the following reasons: (1) the use of dividend growth rates in the constant growth DCF model; (2) the application of the constant growth DCF model to the proxy group; (3) reliance on the constant growth DCF results without consideration of how current market conditions are affecting the constant growth DCF model; (4) the market risk premium relied upon to estimate the CAPM analysis; (5) the relevance of the ECAPM analysis; (6) the effect of company-specific risks on the cost of equity for KAWC; and (7) the appropriate equity ratio for Kentucky-American.[144]

Kentucky-American noted overall that even with updating the cost of equity estimation models, the results continue to support the recommended ROE of 10.75 percent and that capital market conditions that have contributed to an increase in the cost

[142] Baudino Direct Testimony at 44.

[143] Baudino Direct Testimony at 44.

[144] Rebuttal Testimony of Ann E. Bulkley (Bulkley Rebuttal Testimony) at 16.

of equity are expected to remain during the period in which Kentucky-American's rates will be in effect.[145]

In its post-hearing brief, Kentucky-American argued that its proposed 10.75 percent ROE creates a reasonable opportunity for capital investors to earn a risk-comparable return, allows Kentucky-American to maintain its financial integrity, and enables it to attract necessary capital investment for the benefit of its customers.[146] Additionally, Kentucky-American noted that its proposed ROE recognizes the increase in interest rates that has occurred since its previous rate case and reflects the changes in modeling results as the utility sector underperformed the market and the dividend yields increased throughout this case.[147]

In its post-hearing reply brief, the Attorney General argued that if the Commission were to approve Kentucky American's inflated ROE proposal of 10.75 percent, it would cause rates to increase to an unreasonable level and harm ratepayers.[148] Therefore, the Attorney General requested that the Commission adopt its recommendation of a 9.40 percent ROE for Kentucky-American and, if the Commission accepts its proposed ROE, it would reduce Kentucky-American's requested rate increase by approximately $5,608,705 million.[149]

In evaluating the ROE for Kentucky-American, the Commission must evaluate and review each model and all parties' positions and balance the financial integrity of the utility

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[145] Bulkley Rebuttal Testimony at 4.

[146] Kentucky-American's Post-Hearing Brief at 53.

[147] Kentucky-American's Post-Hearing Brief at 53.

[148] Attorney General's Post-Hearing Brief at 24.

[149] Attorney General's Post-Hearing Brief at 24.

with the interests of the consumer and the statutory obligation that rates be fair, just and reasonable. The Commission notes that in recent cases including Case Nos. 2020-00349/2020-00350,[150] 2022-00147,[151] 2022-00222,[152] and 2022-00372,[153] the Commission has discussed that it is appropriate for utilities to present, and for the Commission to evaluate, multiple methodologies to estimate ROEs, and each approach has its own strengths. As demonstrated in the respective ROE testimonies in this proceeding, there is considerable variation in both data and application within each modeling approach, which can lead to different results. The Commission's role is to conduct a balanced analysis of all presented models, while giving weight to current economic conditions and trends.

The Commission notes that Kentucky-American supported a forward-looking model with relatively high forecasted interest rates and bond yields.[154] Whereas, the

[150] *See generally* Case No. 2020-00349, *Electronic Application of Kentucky Utilities Company for an Adjustment of its Electric Rates, A Certificate of Public Convenience and Necessity to Deploy Advanced Metering Infrastructure, Approval of Certain Regulatory and Accounting Treatments, and Establishment of a One-Year Surcredit* (Ky. PSC June 30, 2021); Case No. 2020-00350 *Electronic Application of Louisville Gas and Electric Company for an Adjustment of its Electric and Gas Rates, A Certificate of Public Convenience and Necessity to Deploy Advanced Metering Infrastructure, Approval of Certain Regulatory and Accounting Treatments, and Establishment of a One-Year Surcredit*, (Ky. PSC June 30, 2021).

[151] *See generally* Case No. 2022-00147, *Electronic Application of Water Service Corporation of Kentucky for A General Adjustment in Existing Rates and A Certificate of Public Convenience and Necessity to Deploy Advanced Metering Infrastructure* (Ky. PSC June 13, 2022).

[152] *See generally* Case No. 2022-00222, *Electronic Application of Atmos Energy Corporation to Establish PRP Rider Rates for The Twelve Month Period Beginning October 1, 2022,* (Ky. PSC May 25, 2023), Order.

[153] *See generally* Case No. 2022-00372, *Electronic Application of Duke Energy Kentucky, Inc. For (1) an Adjustment of Electric Rates; (2) Approval of New Tariffs; (3) Approval of Accounting Practices to Establish Regulatory Assets and Liabilities; and (4) All Other Required Approvals and Relief* (Ky. PSC Dec. 14, 2022).

[154] Bulkley Rebuttal Testimony at 5-6.

Attorney General argued that the forecasted rates are projected to decline.[155] The Commission found in Case No. 2018-00281, that forecasted interest rates were not reliable and that the most current interest rates which embody investors' expectations of the future are the best estimate when discussing capital markets.[156] Additionally, in Kentucky-American's previous rate case, the Commission found that it continues to view forecasted interest rates as unreliable and frequently inaccurate.[157] While the Commission acknowledges the arguments that Kentucky-American raised in regard to expected capital market conditions, the Commission agrees with the Attorney General's arguments regarding interest rates and still agrees with its previous findings and will support models that utilize current interest rates and data.

The Commission is not persuaded by Kentucky-American's argument that a 10.75 percent ROE is reasonable. The Commission notes that Kentucky-American's argument regarding its capital expenditure program, environmental risks, and regulatory risks are factors that should be considered when determining a fair ROE is not persuasive. Kentucky-American has control over the amount and timing of its capital expenditures program and many of the other factors are mitigated through the use of a forecasted test year and Kentucky-American's QIP rider program, which is approved in this Order with modifications. Both mechanisms lower regulatory lag and allow for a timelier recovery of capital investments. Additionally, the Commission further reiterates that it continues to reject the use of flotation cost adjustments, financial risk adjustments, and explicit size

155 Baudino Direct Testimony at 10-11.

156 Case No. 2018-00281, *Electronic Application of Atmos Energy Corporation for an Adjustment of Rates* (Ky. PSC May 7, 2019), Order at 43-44.

157 Case No. 2018-00358, June 27, 2019 Order at 64.

adjustments in the ROE analyses considering a business risk or size adjustment has not been approved previously.

The Commission notes that while it has previously allowed Kentucky-American's proxy group to utilize different types of utilities, including natural gas and electric, in previous rate cases, the argument that when determining the proxy group, the utilities possess similar operating and financial risk to that of Kentucky-American is flawed. The Commission acknowledges Kentucky-American's argument that the sample size for water utilities is relatively small, however, the Commission notes that gas and electric utilities assume and absorb far more financial, environmental, and regulatory risk than a water utility. While the distribution and operational characteristics of the natural gas utilities may be similar to that of a water, the market volatility and procurement process for energy resources of electric and gas utilities are far more unpredictable and pronounced. For example, when calculating the DCF and CAPM in this case, the dividend yields, betas, and CAPM ROE for electric and gas utilities are drastically higher when compared to the dividend yields, betas, and CAPM ROE for water utilities.[158] The Commission notes that the inclusion of gas and electric utilities in the proxy group tends to inflate the resulting ROE analyses over the results from a water utility only proxy group. In addition, gas and electric capital structure equity ratios are drastically higher than water utilities. The Commission finds that Kentucky-American should provide sufficient justification for continuing to include gas and electric utilities in its proxy group in its next base rate case. Kentucky-American's proposed 10.75 percent ROE is far above the industry average, the proxy group average of 9.51 percent, and is far greater than recent

[158] Bulkley Direct Testimony, Exhibit AEB-3 at 1 and Exhibit AEB-4 at 1-2.

returns awarded by this Commission and not in line with the Commission's objective to balance the needs of the utility and the customer.

For the reasons set forth above, the Commission finds that a ROE of 9.70 percent, which appropriately balances the needs of Kentucky-American and its customers and addresses the current economic state of the capital markets. Furthermore, this ROE is within the mean and median results of Kentucky-American's DCF models, is supported by Kentucky-American's revised DCF and CAPM models and is within the range of the DCF models presented by the Attorney General.

Total Revenue Requirement

The effect of the Commission's adjustments is a total revenue requirement increase of $10,606,517, as shown in Appendix A, which includes the return on equity (ROE) discussed above. This reflects a $15,445,482 decrease of Kentucky-American's requested revenue increase of $26,051,999.

Operating Revenues at Present Rates	114,849,344
Less Total Expenses	81,064,878
Present Rate Operating Income	33,784,465
Net Rate Base	489,426,491
Rate of Return	9.07%
Operating Income Required	44,390,983
Less: Present Rate Operating Income	33,784,465
Required Revenue Increase	10,606,517

COST-OF-SERVICE STUDY

Kentucky-American filed a cost-of-service study (COSS) using the base-extra capacity method as outlined in the American Water Works Association (AWWA), “Principles of Water Rates, Fees and Charges,” (AWWA M1 Manual). The methodology discussed in the AWWA M1 Manual is widely recognized within the water industry as an acceptable methodology for allocating costs.[159] The Commission notes that it previously accepted the use of this methodology for cost allocation and development of water service rates in Kentucky-American's previous rate case.[160] Therefore, the Commission finds the COSS to be acceptable for use as a guide in allocating the revenue increase granted herein.

However, the Commission notes that it has some concern in regard to the allocation of the Public Fire service. With Kentucky-American's proposed revenue increase, it reduced the Public Fire service revenue increase by $8,695,502 and allocated that amount between the other classes. The majority of the increase was allocated mostly between residential with an additional allocation amount of $6,669,926 and commercial with $1,668,650, overall increasing the residential and commercial's overall increase and the amount allocated to each class.[161] The COSS supported an approximate 200 percent increase to the Public Fire service.[162] Therefore, due to the changed allocation of the Public Fire service, the total revenue allocation of residential class is now 53.51 percent with a proposed 19.1 percent increase.[163]

In Case No. 2010-00036, the Commission found that allocating public fire hydrant service costs to general service rates also increases the likelihood that pricing signals will

[159] Application, Direct Testimony of Wesley E. Selinger (Selinger Direct Testimony) at 11-12.

[160] Case No. 2018-00358, June 27, 2019 Order at 67-68.

[161] Application, Exhibit 36 at 4. From the COSS the initial residential allocation was 48.68% and commercial allocation was 24.17%. However, the updated allocation with subsidizing the Public Fire service is 53.51% for residential and 25.38% for commercial.

[162] Application, Exhibit 36 at 4.

[163] Application, Exhibit 36 at 4. $73,793,458 / $137,898,823 = $53.51%.

be distorted, and public accountability will be lessened.[164] Additionally, the Commission also found that allocating public fire hydrant service costs to general service users effectively hides these costs from the public view and discussion and renders informed public decisions on the availability and appropriateness of such service more difficult.[165] Finally, the Commission determined in Case No. 2010-00036 that with a unified rate structure serves areas outside of Fayette County for which no fire protection service is provided, the potential exists that Kentucky-American customers who reside outside of Fayette County will be subsidizing through their rates fire protection services for Fayette County residents.[166] Kentucky-American provided no evidence to refute these previous findings.

While the Commission acknowledges that the COSS is used as a guide, it notes that Kentucky-American only stated that it has proposed a revenue increase to public fire consistent with the overall revenue increase requested in this case and that any additional revenue requirement for fire hydrants that is over and above the requested increase has been allocated back to other customer classes on the same basis as the revenue requirement for the metering cost category.[167] The Commission acknowledges that an approximate 200 percentage increase to one class is extremely high and unreasonable and would potentially create rate shock. However, the Commission disagrees with subsidizing the Public Fire service by such a substantial amount and allocating a large

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[164] Case No. 2010-00036, Dec. 14, 2010 Order at 79.

[165] Case No. 2010-00036, Dec. 14, 2010 Order at 79.

[166] Case No. 2010-00036, Dec. 14, 2010 Order at 78.

[167] Selinger Direct Testimony at 23.

amount of the revenue to the residential class without sufficient evidence as to why it is reasonable to do so. Lack of any evidence otherwise, the Commission also still agrees with its concerns and findings in Kentucky-American's 2010 rate case regarding free/reduced public hydrant fees as discussed above. Therefore, the Commission will address the allocation of its approved revenue below.

RATE DESIGN

For all general water service, Kentucky-American separates customers by classification. Kentucky-American currently charges a monthly service charge and a flat volumetric fee that is varies only by meter size. Kentucky-American distinguishes the amount of the service charges only between residential users, and all other customers. The monthly meter charge is intended to recover the cost of customer facilities such as meters and services, and the cost of customer accounting, including billing and collecting and meter reading.[168] Each customer class then has a different volumetric charge for water per 100 gallons. The volumetric fee is intended to recover the cost of producing, transporting, and distributing the water.[169]

In developing its proposed rates, Kentucky-American used the COSS as the basis to propose an increase in the customer charge.[170] As seen in the table below, the COSS is less in most meter customer charges than those being proposed by Kentucky-American.

[168] Selinger Direct Testimony at 15.

[169] Selinger Direct Testimony at 15.

[170] Selinger Direct Testimony at 17.

Monthly Service Charge

Meter Size	Current Rate	COSS Rate	Proposed Rate
5/8”	$15.00	$18.00	$20.00
3/4”	$22.40	$23.46	$29.80
1”	$37.30	$37.27	$49.60
1 1/2”	$74.70	$65.14	$99.40
2”	$119.50	$100.79	$158.90
3”	$224.00	$188.12	$297.90
4”	$373.00	$287.24	$496.60
6”	$746.70	$561.61	$993.10
8”	$1,194.70	$892.29	$1,589.00
10”		$1,285.38	
12”		$2,378.79	

LFUCG raised the objection to the higher customer charges and argued that Kentucky-American has compounded the customer charges for the residential customers but also for the customers that use a meter larger than 1” meter.[171] As illustrated above, for meters 1” and larger the differences between the COSS and the proposed rates are even more pronounced. Additionally, LFUCG argues that the calculated monthly service charge is based upon the expenses allocated to the service charge from meter expenses, service expenses and customer service expenses.[172]

The Attorney General raised an objection to the increase being proposed by Kentucky-American to the residential monthly customer charge.[173] The Attorney General believes the increase will be a financial hardship to customers who are finding it difficult to pay their current utility bills.[174] Additionally, the Attorney General discussed the

[171] LFUCG Post-Hearing Brief at 2.

[172] LFUCG Post-Hearing Brief at 3.

[173] Attorney General’s Post-Hearing Brief at 37.

[174] Attorney General’s Post-Hearing Brief at 37-38.

Commission's previous acceptance of gradualism, and this is a prime example where an increase of 33 percent should be such a time for the Commission to limit the increase to the COSS rate of $18.00.[175]

In its reply brief, Kentucky-American, argued that its forecasted revenue deficiencies indicate that an increase in both the volumetric charge and its monthly service charge is necessary so that it can gradually move its rate design towards a Straight Fixed Variable design.[176] Additionally, Kentucky-American noted that a change to one of the components will necessitate that the other component would need to be adjusted to offset the change.[177]

The Commission acknowledges LFUCG's argument that the proposed rates are out of line with the COSS. The Commission also acknowledges that the inherent fallacy in Kentucky-American's argument, that if one component is increased at a lower level than proposed, then the other component would need to be increased at a higher level than proposed.[178] Additionally, the Commission agrees with the Attorney General that the increase to the residential customer service charge is high for an increase to this customer classification. The Commission notes that while Kentucky-American argues that the proposed rates are within the range of reasonableness, the effect of the percentage increase over current charges are remarkably higher than the rates compared to the COSS rates, as illustrated above.

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[175] Attorney General's Post-Hearing Brief at 38.

[176] Kentucky-American's Reply Brief at 14.

[177] Kentucky-American's Reply Brief at 14.

[178] Kentucky-American's Post-Hearing Brief at 14.

The Commission acknowledges that any alterations in the amount of the customer charge rates would necessitate a change in the volumetric rates and therefore the delicacy this represents to Kentucky-American and its customer's monthly bill. The Commission finds that the argument raised by LFUCG, and the Attorney General has some merit and should be considered. The Commission notes that the residential water sales from the test year should be increased from 5,748,449 to 5,810,000. Additionally, the Commission finds that with the reduction in the revenue requirement and the decrease to the water sales revenues from the base period to the test year, Kentucky-American's proposed allocation is reasonable with certain modifications.

With the Commission's approved revenue increase of $10,606,517 or 9.44 percent, the Commission will allocate an across-the-board percentage of its approved increase to all customer/service charges with the exception of the Fire service class. The Commission will then apply an approximate 10.75 percent to all volumetric charges including the Fire service class to offset the remaining revenue increase. Additionally, the Commission expects Kentucky-American in its next base rate case to provide sufficient evidence for subsidizing the Public Fire service by a substantial amount. The Commission also expects Kentucky-American to utilize the COSS as intended and attempt to move each class to its cost-to-serve in a reasonable and cost-effective manner.

The changes in the rates and in the revenue requirement found to be reasonable in this case results in the average bill for a residential customer using 3,800 gallons per month increasing by $4.45, from $40.77 to $45.08, or 10.94 percent with the inclusion of the QIP rate.

MODIFICATIONS TO QIP

In Case No. 2018-00358, the Commission approved the QIP and found that Kentucky-American established the need for an infrastructure replacement tariff due to its infrastructure deteriorating at a faster rate than the replacement rate.[179] In that proceeding, Kentucky-American stated that it would prioritize the replacement of cast iron and galvanized steel mains, which represented 15 percent of the distribution system but accounted for 64.2 percent of annual main breaks.[180]

In its application, Kentucky-American requested to expand the QIP from the current annual replacement of 10-13 miles of cast iron main to 27-34 miles of any type of main.[181] Kentucky-American asserted that while the existing scope of the QIP has allowed it to accelerate some replacement of its aging infrastructure, it is not sufficient to address the pace at which the aging infrastructure should be replaced to best serve the long-term interest of its customers.[182] Additionally, Kentucky-American explained that it currently replaces approximately 0.5 percent of its system annually through the QIP, which at that accelerated replacement rate would take nearly 204.5 years to replace the entire distribution system.[183] Kentucky-American explained that in order to replace the entirety of the system while keeping up with the pipe's life expectancy, the recommended rate is to replace 29 miles of main annually would be a replacement rate of 1.1 percent to 1.4 percent annually.[184]

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[179] Case No. 2018-00358, June 27, 2019 Order at 83-84.

[180] Case No. 2018-00358, June 27, 2019 Order at 76.

[181] Application, Direct Testimony of Krista E. Citron (Citron Direct Testimony) at 2.

[182] Citron Direct Testimony at 5.

[183] Citron Direct Testimony at 9.

[184] Citron Direct Testimony at 7.

Kentucky-American explained that it utilizes a pipeline prioritization model (PPM) to help determine which mains should be replaced each year and that the criteria for consideration is low pressure, number of breaks/leaks, fire flow, age, material type, size of main, water quality, and customer impact.[185] Kentucky-American stated that it has continued grouping projects in geographical proximity to control the cost-per-foot and to assist with design and construction efficiency.[186]

In addition, Kentucky-American proposed that the first post-case QIP test period be the full eleven months following the forecasted test year, February 2025 to December 2025.[187] Kentucky-American also proposed to make its first Annual Filing at least 120 days prior to the commencement of this first QIP Period, by October 4, 2024, and that subsequent filings would be the first full 12 months.[188]

Kentucky-American explained that currently the return on net QIP-eligible plant in-service, at the overall rate of return on capital authorized in its previous base water rate case, is only grossed up for federal and state income taxes, and is therefore proposing that the return on net-QIP eligible plant in-service, at the overall rate of return on capital, be grossed up by applying the gross revenue conversion factor based on the previous rate case.[189] Kentucky-American asserted that by applying the gross revenue conversion factor to the return on component of the QIP revenue requirement is appropriate because

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[185] Citron Direct Testimony at 10.

[186] Citron Direct Testimony, at 18.

[187] Newcomb Direct Testimony at 20.

[188] Newcomb Direct Testimony at 20.

[189] Newcomb Direct Testimony at 21.

it accounts for the additional uncollectible and PSC fee expense it can expect to experience as a result of incremental QIP revenues.[190]

Kentucky-American proposed that the QIP percentage be calculated by dividing the QIP revenue requirement by the total authorized water revenue, then multiplied by number of days the QIP percentage will be in effect, and then divided by 365 days.[191] Kentucky-American explained that the total authorized water would continue to include meter fees, volumetric water sales, fire service fees, and public/private fire hydrants. Kentucky-American stated that this percentage calculation will yield a rate that is designed to recover from customers the QIP revenue requirement over the rate effective period but that the QIP Rider Surcharge would continue to be cumulative and remain in place until reset to zero on the effective date of new base rates.[192]

Kentucky-American explained that currently the Balancing Adjustment filings are made annually within 90 days after the conclusion of each completed QIP Period and is therefore proposing that the Balancing Adjustment Filings be filed contemporaneously with the annual filing for each completed QIP period with the intention of establishing a Balancing Adjustment after each QIP period.[193] Kentucky-American stated that it would continue to include a detailed listing of each qualifying QIP project completed and placed in service during the immediately preceding QIP period, including any project modifications resulting from changing priorities.[194]

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[190] Newcomb Direct Testimony at 21.

[191] Newcomb Direct Testimony at 21.

[192] Newcomb Direct Testimony at 22.

[193] Newcomb Direct Testimony at 22.

[194] Newcomb Direct Testimony at 22.

The Attorney General/LFUCG does not support the continuation of the QIP.[195] The Attorney General/LFUCG argued that: Kentucky-American did not give thought to rate affordability; there is not a provision for the decline of the previous QIP investments rolled into rate based on what is established as base rates in the previous rate case; there is no consumer-protection mechanism; and Kentucky-American profits are enhanced.[196] The Attorney General/LFUCG noted that in the alternative, if the Commission does continue the QIP, it recommends including a depreciation offset to capture the decline in value associated with QIP rolled into rate base.[197]

Kentucky-American disagreed with the Attorney General/LFUCG stating the need for pipeline replacement is significant and the QIP is a well-suited mechanism for the cost recovery of that replacement.[198] Additionally, Kentucky-American argued that it has the advantages of faster but more gradual cost recovery which smooths out rate impacts for customers and the approval of the QIP in its 2018 rate case is one of the reasons it was able to avoid filing a rate case for over five years.[199]

In its post-hearing brief, Kentucky-American reiterated that while the existing scope of the QIP has allowed it to accelerate some replacement of its aging infrastructure, it is not sufficient to address the pace at which the aging infrastructure should be replaced to best serve the long-term interest of its customers.[200] Kentucky-American explained that

[195] Meyer Direct Testimony at 41.

[196] Meyer Direct Testimony at 43.

[197] Meyer Direct Testimony at 44.

[198] Rebuttal Testimony of Krista E. Citron (Citron Rebuttal Testimony) at 2.

[199] Citron Rebuttal Testimony at 2.

[200] Kentucky-American’s Post-Hearing Brief at 66.

expanding the QIP will smooth out rate impacts for customers and avoid rate shock, allow for a faster but more gradual cost recovery, enable Kentucky-American to avoid rate cases frequently, and allow the Commission a greater opportunity to examine pipeline replacement projects with more detail than would typically occur in a general rate case.[201]

In its post-hearing brief, the Attorney General argued that the Commission should deny Kentucky-American's request to expand the QIP because the proposed expansion will cost approximately $177 million from 2025 to 2028 which would be over-bearing to customers and that the cost per mile to replace the infrastructure flowing through the QIP has drastically increased.[202] The Attorney General reiterated that if the Commission allows for the continuation of the QIP, the Attorney General recommends implementing a depreciation offset to capture the decline in value of those QIP investments rolled into base rates, rather than only recognizing the effect of the accumulated depreciation for investments currently being recovered through the QIP.[203]

In its post-hearing brief, LFUCG stated that Kentucky-American has not demonstrated that the implementation of the QIP has improved Kentucky-American's non-revenue water percentages and questions if the QIP is necessary in order to continue to replace, maintain, and upgrade its infrastructure to ensure that Kentucky-American continues to provide safe and reliable service.[204] LFUCG asserted that if the QIP is necessary for Kentucky-American to replace the mains in order to maintain safe and

[201] Kentucky-American's Post-Hearing Brief at 70-71.

[202] Attorney General's Post-Hearing Brief at 29-30.

[203] Attorney General's Post-Hearing Brief at 32.

[204] LFUCG's Post-Hearing Brief at 8.

reliable service, it should have been annually replacing more than 2.5 miles of main from 2013 to 2017 even without the QIP. Rather, Kentucky-American did not accelerate main replacement under "traditional" ratemaking mechanisms and only did so upon implementation of the QIP.[205] Therefore, LFUCG recommended that the Commission deny the expansion of the QIP.[206]

It is well established that KRS 278.030 and KRS 278.040 expressly grant the Commission plenary ratemaking authority to regulate and investigate utilities and to establish fair, just and reasonable rates.[207] In the absence of any statute that requires a particular procedure to determine whether rates are fair, just and reasonable, the Commission has the authority to consider and decide ratemaking issues such as the QIP and any expansions or modifications proposed by Kentucky-American and that the same statutory authority that permits the Commission to authorize a QIP also grants the authority to terminate or limit the QIP.[208]

The Commission acknowledges Kentucky-American's argument that aging water system infrastructure is an issue with utilities, customers, and regulators across the nation. Specifically, as noted in the case record, the Kentucky Section of the American Society of Civil Engineers issued a 2019 Report Card for Kentucky's Infrastructure that explains that Kentucky has an estimated funding need of $8.2 billion to address drinking

[205] LFUCG's Post-Hearing Brief at 9.

[206] LFUCG's Post-Hearing Brief at 10.

[207] *Public Serv. Comm'n v. Commonwealth ex. Rel. Jack Conway*, 324 S.W .3d 373, 383 (Ky. 2010).

[208] *Public Serv. Comm'n v. Commonwealth ex. Rel. Jack Conway*, 324 S.W .3d 373, 383 (Ky. 2010). *See* Case No. 2018-00358, June 27, 2019 Order at 80.

water infrastructure.[209] This Commission is cognizant of the need to prudently and timely replace aging infrastructure to provide adequate, efficient, and reasonable water service to customers. The Commission notes that it also has a statutory duty to protect ratepayers from excessive rates.

Therefore, based upon the case record and being otherwise sufficiently advised, the Commission is not persuaded by Kentucky-American's arguments regarding expanding the QIP and finds that it should be denied. In Case No. 2021-00090 the Commission stated, "[a]ny future deviations from the QIP approved by the Commission, such as an accelerated replacement cycle, accelerated spending totals, or including standalone non-main plant replacement projects, will be looked upon with extreme disfavor".[210] Additionally, in that same case, the Commission stated that, "[a]ny future requests to include replacement of non-main plant other than plant replaced incidental to the replacement of aging main will be looked upon with extreme disfavor."[211] The Commission expressed its concern and skepticism about the QIP in Case No 2021-00090 and Kentucky-American failed to recognize the import of the Commission's language. The Commission is concerned that Kentucky-American's disregarded previous Commission findings and therefore questions Kentucky-Americans long-term plans and intentions for the QIP. The QIP has appeared to compound Kentucky-American's lack of ability to accurately forecast construction expenditures year-over-year. The Commission

[209] Citron Direct Testimony at 2.

[210] Case No. 2021-00090, *Electronic Application of Kentucky-American Water Company to Amend Tariff to Revise Qualified Infrastructure Program Charge* (Ky. PSC June 21, 2021), Order at 12.

[211] Case No. 2021-00090, *Electronic Application of Kentucky-American Water Company to Amend Tariff to Revise Qualified Infrastructure Program Charge* (Ky. PSC June 21, 2021), Order at 14.

is concerned that the QIP has not produced a reduction in water loss in the first four years of implementation. To the extent that the pipeline eligible for recovery poses a safety risk to the utility's customers, service areas, and employees, the Commission has allowed accelerated replacement and would carefully consider any proposals by Kentucky-American. Additionally, the Commission notes that Kentucky-American has the burden to provide sufficient evidence and testimony that pipeline acceleration is reasonable. Kentucky-American failed to provide sufficient evidence that expanding the QIP is reasonable, and the potential future costs associated with the expansion are fair, just and reasonable and would not cause rate shock to its customers.

The Commission notes that the QIP was designed to address high-failure pipes within the system, not to replace the traditional approach of replacing infrastructure through the normal course of business. The Commission reiterates that the QIP is designed to operate within specific parameters as described above and the Commission has no interest, at this time, for any deviation from the QIPs parameters established in the 2018 rate case and subsequent QIP proceedings. The Commission cautions Kentucky-American that proposing multiple modifications to the QIP causes unnecessary changes and potential confusion to the mechanism and is not consistent with the Commission’s intentions in approving the QIP. The QIP is an infrastructure program which allows the Commission to balance Kentucky-American’s need to make prudent infrastructure replacement investments and to ensure that ratepayers receive adequate, efficient, and reasonable water service, and the mandate that rates be fair, just and reasonable. The Commission has an expectation for Kentucky-American to operate the QIP within the parameters that were set in the 2018 rate case and that should any future modifications arise, Kentucky-American should defer those proposals to its QIP Rider Surcharge true-ups rather than the rate case. The Commission reiterates that any future deviations from the QIP will be looked upon with extreme disfavor.

The Commission acknowledges that there are some modifications that could make the QIP easier to calculate and allow for a more thorough Commission review. The Commission agrees with Kentucky-American's proposal that the return on net-QIP eligible plant in-service, at the overall rate of return on capital be grossed up by applying the gross revenue conversion factor based on the previous rate case and should be approved. The Commission notes that the return on net-QIP eligible plant in-service should be utilizing the gross WACC rather than the ROE component for the overall rate of return. The Commission also agrees with Kentucky-American's proposal that the QIP percentage be calculated by dividing the QIP revenue requirement by the total authorized water revenue then multiplied by number of days the QIP percentage will be in effect and then divided by 365 days (366 days in a leap year) and should be approved. Lastly, the Commission agrees that the Balancing Adjustment Filings be filed contemporaneously with the annual filing for each completed QIP period with the intention of establishing a Balancing Adjustment after each QIP period and should be approved. The Commission notes that Kentucky-American's proposal that the first post-case QIP test period be the full eleven months following the forecasted test year in this case, and the subsequent annual filings would follow a similar schedule, is moot considering the Commission is denying rolling the QIP in rate base.

<u>ALTERNATIVE LEVEL OF UNACCOUNTED FOR WATER LOSS</u>

Kentucky-American requested that the Commission establish an alternative level of reasonable unaccounted-for water loss of 20 percent for rate-making purposes. Kentucky-American stated that its current extensive water loss control interventions and limited ability to manage and influence Special Connections' water loss provide a justifiable showing as to why an alternate level should be approved pursuant to 807 KAR 5:066, Section 6(3).[212]

Kentucky-American argued that a deviation of 20 percent is reasonable because it would satisfy the regulatory policy goal of incentivizing Kentucky-American to continue promoting efficient management as demonstrated by Kentucky-American's robust water loss control programs and it is more appropriately tailored to the system specific challenges.[213] Kentucky-American also stated that it has taken the following steps to mitigate and reduce water loss: pressure management; accelerated infrastructure replacement; active leak detection; rapid response to breaks; fire service and water loss audits; large metering testing; and profiling.[214] Kentucky-American further argued that other water utilities across the state utilize a water loss surcharge mechanism as an alternative approach to recover water loss expenses in excess of fifteen percent.[215] Additionally, Kentucky-American recently reached an agreement to outsource water line location requests which results in Kentucky-American being able to re-dedicate four employees to specialize in addressing non-revenue water (NRW) loss beginning in

[212] Lewis Direct Testimony at 38-39.

[213] Kentucky-American's Post-Hearing Brief at 37.

[214] Lewis Direct Testimony 31-34.

[215] Kentucky-American's Response Brief at 13.

January 2024.[216] Kentucky-American's primary reason for the requested deviation is because many of special connections, which make up 4 percent of the distribution system, have multiple valve connections with Kentucky-American mains.[217] Kentucky-American further argued that it is unable to repair or replace mains if leaks occur in Special Connections as it does not have legal access to the property and argued that it is unable to accurately track and prevent unauthorized use of privately owned fire hydrants and unauthorized connections to be metered between the connection to Kentucky-American's water distribution system and the downstream individual unit meters.[218] Kentucky-American argued that there is no uniform approach to combating water loss, that it should not be held to unrealistic standards for unaccounted-for water loss for rate making purposes, and that it has met its burden of proving the current threshold for unaccounted-for water loss of 15 percent is unreasonable in as applied to their circumstance and that 20 percent is a reasonable deviation.[219] However, Kentucky-American noted that there is no formal plan for addressing water loss for the special connections.[220]

The Attorney General stated that it is unaware of any water utility in the state that has received a deviation for unaccounted-for water loss and Kentucky-American was unable to provide one.[221] Additionally, the Attorney General argued that it would be

[216] Kentucky-American's Post-Hearing Brief at 37.

[217] Lewis Direct Testimony at 39.

[218] Lewis Direct Testimony at 39.

[219] Kentucky-American's Post-Hearing Brief at 41.

[220] Kentucky-American's Response to Attorney General's Second Request for Information, Item 21.

[221] Attorney General's Post-Hearing Brief at 13.

unreasonable for a large, sophisticated, investor-owned company to be allowed a 20 percent unaccounted-for water loss while smaller, less sophisticated water districts and water associations are held to the established 15 percent unaccounted-for water loss standard.[222] The Attorney General argued that Kentucky-American performed limited surveys on the special connections water loss issue and that Kentucky-American admitted to not having implemented any formal plan to address this issue.[223] The Attorney General further asserted that it would be unfair to require the customer base to pay increased water rates when Kentucky-American alone has the ability to rectify the significant unaccounted-for water loss associated with the special connection customers.[224]

LFUCG argued that Kentucky-American has not produced sufficient evidence to support a special exemption for Kentucky-American that would separate Kentucky-American from other water utilities, many of which provide service in mountainous territory that presents unique challenges.[225] LFUCG further argued that, regardless of the source of its water loss, it is prudent for Kentucky-American to investigate water loss while still considering the cost benefit analysis in its decision making.

Pursuant to 807 KAR 5:066, Section 6(3), Kentucky-American has the burden of proof to establish that an alternative threshold for unaccounted-for water loss is more reasonable than the regulatory standard of 15 percent. Kentucky-American has not

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[222] Attorney General's Post-Hearing Brief at 13.

[223] Attorney General's Post-Hearing Brief at 14.

[224] Attorney General's Post-Hearing Brief at 14.

[225] LFUCG's Post-Hearing Brief at 10.

shown good cause to explain why their water loss has continually increased, nor has it shown strong evidence that the special connections are as significant of a contributor to the water loss issue as it has claimed. Despite continuous increases in water loss percentages in the last seven years, the Commission notes that Kentucky-American has not developed a formal plan for identifying the source of increasing water loss or reducing water loss. Kentucky-American brought no request for additional resources into this case either through additional personnel or equipment. This signals to the Commission that Kentucky-American does not appear to take the increasing water loss as a serious matter. This is a cause for serious concern. In 2019, the Commission established Case No. 2019-00041 to investigate jurisdictional water utilities that recorded water loss of more than 35% in their most recent annual reports. The Commission found in 2019 that "[a] water utilities inability to reduce excessive water loss over time is a symptom of other significant problems plaguing the utility, such as poor financial management and operational practices."[226] The Commission previously denied a similar request in Kentucky-American's last general rate case, Case No. 2018-00358.[227] Additionally, the Commission notes that Kentucky-American's unaccounted-for water loss has been nearly 20 percent since 2018. Specifically, the unaccounted-for water loss percentage historically has been as follows:[228]

**<u>Kentucky-American's Water Loss
Percentage</u>**

[226] Case No. 2019-00041, *Electronic Investigation into Excessive Water Loss by Kentucky's Jurisdictional Water Utilities* (Ky. PSC Nov. 22, 2019), final Order, Appendix L, An Investigative Report by the Kentucky Public Service Commission, November 2019, at ii.

[227] Case No. 2018-00358, June 27, 2019 Order.

[228] Lewis Direct Testimony at 36-37.

Year	Unaccounted-for-Water Loss Percentage
2018	19.95%
2019	21.10%
2020	20.47%
2021	21.09%
2022	21.59%

The Commission further notes that the last time Kentucky-American was in compliance with 807 KAR 5:066, Section 6(3) was in 2015, when Kentucky-American had unaccounted for water loss of 14.4283 percent.[229]

While Kentucky-American is now dedicating four employees to address NRW loss as of January 2024, the Commission notes that there does not appear to have been any prior effort to address water loss issues until the beginning of 2024, after this case was established.[230] The Commission agrees with the Attorney General that it would be unreasonable for a large, sophisticated, investor-owned company to be allowed a 20 percent unaccounted-for water loss while smaller, less sophisticated water districts and water associations are held to the established 15 percent unaccounted-for water loss standard and is dismayed that Kentucky-American requested this deviation in consecutive cases without any effort to address water loss. While Kentucky-American pointed out that the Commission has authorized water loss surcharge mechanisms, the purpose of those mechanisms is to provide water utilities adequate financial resources to address excessive water loss. Those surcharge mechanisms require specific plans to address water loss and all expenditures from those revenues must be individually

[229] *Annual Report of Kentucky-American to the Public Service Commission for the Calendar Year Ended December 31, 2015* (2015 Annual Report) at 61.

[230] Kentucky-American's Post-Hearing Brief at 37.

approved by the Commission – the mechanisms are not simply an alternative approach to recover water loss revenues in excess of 15 percent. The Commission also agrees with the Attorney General and LFUCG that Kentucky-American has failed to meet its burden of proof, and therefore finds that Kentucky-American's proposed alternative 20 percent threshold should be denied. Additionally, as discussed above, the Commission will make an adjustment related to the unaccounted-for water loss above 15 percent and remove it from the revenue requirement.

ACCOUNTING DEFERRAL

Kentucky-American is requesting authority to defer the amount above or below base rates for production expenses, pension, and other post-employment benefits (OPEB) expenses, taxes other than income (excluding sales tax), and income taxes.[231] Kentucky-American proposed to recover the regulatory deferrals in its next base rate case and stated that it is not asking for carrying charges.[232]

As the Commission noted in Case No. 2008-00436:

> A regulatory asset is created when a rate-regulated business is authorized by its regulatory authority to capitalize an expenditure that under traditional accounting rules would be recorded as a current expense. The reclassification of an expense to a capital item allows the regulated business the opportunity to request recovery in future rates of the amount capitalized. The authority for establishing regulatory assets arises under the Commission's plenary authority to regulate utilities under KRS 278.040 and the Commission's authority to establish a system of accounts under KRS 278.220. Historically, the Commission has exercised its discretion to approve regulatory assets where a utility has incurred: (1) an extraordinary, nonrecurring expense which could not have reasonably been anticipated or included in the utility's

[231] Newcomb Direct Testimony at 24.

[232] Newcomb Direct Testimony at 24–25.

> planning; (2) an expense resulting from a statutory or administrative directive; (3) an expense in relation to an industry sponsored initiative; or (4) an extraordinary or nonrecurring expense that over time will result in a saving that fully offsets the cost.[233]

By definition, a regulatory liability works in reverse of a regulatory asset, creating a capitalized liability to be returned to customers in future rates in the amount capitalized. Kentucky-American requested authority to establish a regulatory asset/liability for production expenses to defer the difference from base rates for fuel and power, chemicals, waste disposal, and purchased water.[234] Kentucky-American argued that these expenses are volatile and outside of Kentucky-American's control and that water utilities that purchase water are afforded similar protections.[235] For pension and OPEB expenses, Kentucky-American explained that the level of fluctuation in these expenses from year to year can change drastically based on market fluctuations and the factors used to calculate the expenses.[236] Kentucky-American argued that taxes other than income are incurred resulting from statutory or administrative directive.[237] Kentucky-American also explained that it appeals its property tax assessments to lower its property tax bill on a regular basis and that its customers should benefit from appeals that are successful.[238] Finally, Kentucky-American requested preemptive authority to defer any

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[233] Case No. 2008-00436, *The Application of East Kentucky Power Cooperative, Inc. for an Order Approving Accounting Practices to Establish a Regulatory Asset Related to Certain Replacement Power Costs Resulting from Generation Forced Outages* (Ky. PSC Dec. 23, 2008), Order at 3–4.

[234] Newcomb Direct Testimony at 28.

[235] Newcomb Direct Testimony at 27.

[236] Newcomb Direct Testimony at 30.

[237] Newcomb Direct Testimony at 33.

[238] Newcomb Direct Testimony at 33.

changes to income taxes or accumulated deferred income taxes resulting from federal or state tax rate changes, which Kentucky-American classified as from a statutory or administrative directive.[239]

The Attorney General argued that the Commission should deny Kentucky-American's request to grant regulatory accounting treatment for specific expenses, namely, production expenses, pension and OPEB expenses, and expenses related to taxes other than income (excluding sales tax) and income taxes because it would not lead to fair, just and reasonable rates for the customers.[240] The Attorney General argued that the tracking mechanisms that Kentucky-American requests should be denied first, because the production expense, OPEB expense, and various tax expenses are normal and regular expenses that every large water utility company will incur, and therefore should be included in the rates as normal.[241] The Attorney General stated that if Kentucky-American experiences a specific extraordinary level of expenses associated with any of these specific expenses then it has the ability to file a general rate case or file a separate regulatory asset case.[242]

The Attorney General argued that Kentucky-American's request to establish the regulatory assets are not in compliance with Commission precedent.[243] The Attorney

[239] Newcomb Direct Testimony at 35.

[240] Attorney General's Post-Hearing Brief (filed Jan. 5, 2024) at 37.

[241] Attorney General's Post Hearing Brief at 35.

[242] Attorney General's Post Hearing Brief at 36.

[243] Attorney General's Post Hearing Brief at 36; *See* Case No. 2008-00436, *The Application of East Kentucky Power Cooperative, Inc. for an Order Approving Accounting Practices to Establish a Regulatory Asset Related to Certain Replacement Power Costs Resulting from Generation Forced Outages* (Ky. PSC Dec. 23, 2008), Order at 4.

General argued that production expenses, OPEB expenses, and expenses related to taxes other than income (excluding sales tax) and income taxes are recurring, normal expenses, there are no specified new statutory or administrative policies dictating increases to these costs, the request is not the result of industry-sponsored initiatives, and the costs will not eventually be offset by a specific stream of cost savings.[244]

The Attorney General asserted that Kentucky American's request for deferral accounting of production expenses, OPEB expense, and expenses related to taxes other than income (excluding sales tax) and income taxes would be reviewing these expense line items in isolation, and fails to consider that there may be cost offsets in other areas that should be applied, or that there may be offsetting revenues resulting from customer growth, improved efficiencies, etc.[245] The Attorney General also argued that if regulatory asset deferral were allowed for these specific expenses then it could disincentivize cost controls.[246]

Having reviewed the record and being otherwise sufficiently advised, the Commission finds that the proposed deferrals should be denied because the variance in these expenses are immaterial to Kentucky-American's financial position and are outside the categories previously approved for regulatory asset treatment. Specifically, production, pension, and OPEB expenses are recurring expenses that can be included in Kentucky-American's planning. Furthermore, an expense resulting from a statutory or administrative directive is incurred in pursuit of complying with those directives. If a tax

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[244] Attorney General's Post Hearing Brief at 36.

[245] Attorney General's Post-Hearing Brief at 36.

[246] Attorney-General's Post Hearing Brief at 37.

code were a statutory or administrative directive that justified the treatment of that expense as a regulatory asset, then any utility's tax expenses could fit within that standard, which would be unreasonable.

UNIVERSAL AFFORDABILITY TARIFF

Kentucky-American proposed a Universal Affordability Tariff which would provide basic service at two percent or less of annual household income based on the Federal Poverty Level.[247] The Universal Affordability Tariff includes multiple tiers of discounts based on different levels of household income stated as multiples of the Federal Poverty Level (FPL).[248] A 60 percent discount would be available for customers with income up to 50 percent of the FPL and a 20 percent discount would be available for customers with income between 50 percent and 100 percent of the FPL.[249] Discounts would be available on both the 5/8-inch meter charge and the volumetric charges for water service.[250] Kentucky-American anticipated a 10 percent participation level which would result in an approximately $116,000 discount that will be rolled directly into base rates.[251] Residential customers would pay for the cost of the expected discounts, which is approximately $0.02 per thousand gallons.[252]

Kentucky-American argued the Universal Affordability Tariff meets KRS 278.170 because the statue allows for reasonable preferences and advantages and reasonable

[247] Application at 14, paragraph 36.

[248] Application, Direct Testimony of Charles Rea (Rea Direct Testimony) at 20.

[249] Rea Direct Testimony at 20-21.

[250] Rea Direct Testimony at 24.

[251] Rea Direct Testimony at 24.

[252] Kentucky-American's Post-Hearing Brief at 61.

differences between classes.[253] Kentucky-American conducted an analysis under its current rate design and concluded that usage data and customer demographics data show there is a positive correlation between household income and the seasonal use of water i.e., communities with higher household incomes and customers in those communities have more discretionary seasonal use of water than communities with lower household incomes.[254] Kentucky-American also stated that lower income customers generally only use Basic Water Service and do not use water for discretionary purposes in the summertime to the extent that of higher income customers.[255] The analysis concluded that under the current rate design that lower income customers are subsidizing higher income customers.[256] Kentucky-American argued that the affordability assessment, rate design analysis, and cost-of-service analysis provides all factual support necessary to target bills for all residential customers at two percent of household income or less without unduly discriminating against any customer group.[257]

The Attorney General argued that the Universal Affordability Tariff is a violation of law and leads to inequitable results for residential customers.[258] The Attorney General pointed out that Kentucky-American will utilize a third party vendor to conduct income verification and to manage the proposed Universal Affordability Tariff program.[259] This

[253] Kentucky-American's Post-Hearing Brief at 62.

[254] Kentucky-American's Post-Hearing Brief at 62.

[255] Kentucky-American's Post-Hearing Brief at 62.

[256] Kentucky-American's Post-Hearing Brief at 63.

[257] Kentucky-American's Post-Hearing Brief at 63.

[258] Attorney General's Post-Hearing Brief at 32-35.

[259] Attorney General's Post-Hearing Brief at 32.

would include administrative costs of the program in future revenue requirements to be paid for by customers and that neither shareholders nor American Water will be subsidizing the proposed Universal Affordability Tariff.[260] The Attorney General stated this will result in all discounts being exclusively paid for by the rest of Kentucky-American's residential customers through higher water rates.[261] The Attorney General argued that discounted rates should be denied as a matter of law and that KRS 278.030 does not explicitly permit the establishment of a customer classification based upon income level, thus the Commission is not authorized to create a separate rate class for low-income residential customers apart from the general residential customer class.[262] The Attorney General was concerned that the Universal Affordability Tariff will produce an unreasonable preference or advantage for customers who are entitled to the discounted water rates because they make $1 less than another customer.[263]

LFUCG supports Kentucky-American's proposed Universal Affordability Tariff and raised no objections.[264]

The Commission finds that there is insufficient evidence in support of the Universal Affordability Tariff to establish a new customer class based solely on income and doing so would be a violation of KRS 278.170. Kentucky-American argued that discounts based on different levels of household income stated as multiples of the Federal Poverty Level is a reasonable difference which the Commission can permit because the tariff discount

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[260] Attorney General's Post-Hearing Brief at 33.

[261] Attorney General's Post-Hearing Brief at 33.

[262] Attorney General's Post-Hearing Brief at 33-34.

[263] Attorney General's Post-Hearing Brief at 33-34.

[264] LFUCG's Post-Hearing Brief at 10-11.

would be based on federal guidelines that determine eligibility for many federal and other assistance programs and the cost impact of the program is minimal.[265] KRS 278.170(1) does not grant the Commission authority to distinguish between a customer class based on income regardless of whether the Federal Poverty Level is used or some other arbitrary income level. Kentucky-American has provided no authority that would allow for such a distinction.

The Commission acknowledges Kentucky-American's attempt to distinguish residential customers based on usage but the findings from the study are not convincing. The analysis conducted by Kentucky-American involved customer data from an American Water subsidiary in St. Louis.[266] However, none of the information used involved Kentucky-American customers. Additionally, no other factors were considered in the analysis, only the average income level of an area and the usage of that area. Kentucky-American did not consider any additional factors that could influence usage. The study did not provide any significant empirical data to justify creating a new residential customer class.

The Commission notes that while Kentucky-American claimed there would be a minimal cost impact to customers,[267] it failed to provide any shareholder contribution. The Commission has previously held that "if a proposed assistance program is to be more than merely a transfer of income from one customer group to another, the utility must also

[265] Kentucky-American's Response to Staff's Second Request, Item 69.

[266] Hearing Video Transcript of December 11, 2023 Hearing, Testimony of Charles Rea 11:55:56-11:56:44.

[267] Rea Direct Testimony at 24.

make significant contributions."[268] The Commission is not persuaded that Kentucky-American's proposed Universal Affordability Tariff is anything more than a transfer of income from one customer group to another. The Commission also notes that Kentucky-American has the H2O Program that carried a balance of $163,000 as of October 1, 2023, and can be utilized by customers if needed.[269] For the reasons stated above, the Commission finds that Kentucky-American's Universal Affordability Tariff should be denied.[270]

ADDITIONAL TARIFF CHANGES

Cross-Connection Revisions

Kentucky-American proposed to revise the section of its tariff pertaining to cross-connections. Kentucky-American's current tariff prohibits cross-connections unless an acceptable form of protection against contamination by backflow into the water distribution system is provided by a testable backflow prevention assembly.[271] The tariff

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[268] *See*, e.g., Case No. 2001-00323, *Joint Application of Louisville Gas and Electric Company, Metro Human Needs Alliance, People Organized and Workers for Energy Reform, Kentucky Association for Community Action, and Jefferson County Government for the Establishment of a Home Energy Assistance Program* (Ky. PSC Dec. 27, 2001) *and* Case No. 2004-00103*, Adjustment of the Rates of Kentucky-American Water Company* (Ky. PSC Feb. 28, 2005).

[269] Kentucky-American's Response to Commission Staff's Third Request for Information (Staff's Third Request) (filed Sept. 21, 2023), Item 20c.

[270] The PSC has routinely found that it cannot establish different residential rates based upon a customer's income level. *See, e.g.,* 2000 WL 309957, Case No. 1998-00474, *The Application of Kentucky Utilities Company for Approval of an Alternative Method of Regulation of Its Rates and Service*, (Ky. PSC Jan 7, 2000), q*uoting* Case No. 1991-00066, *Application for Adjustment of Electric Rates of Kentucky Power Company*, (Ky. PSC Oct. 31, 1991) at 7. ("If income alone were to be recognized as a reasonable consideration for establishing customer classifications and rates, not only low income, but also middle and high incomes would need to be recognized. If it is appropriate to provide utility service to low income customers at reduced rates, service to high income customers should be at premium rates.") *See also* Case No. 1991-00066, *citing Gainesville Utilities Dept. v. Florida Power Corp.,* 402 U.S. 515, 528 (1971). ("But focus on the willingness or ability of the purchaser to pay for a service is the concern of the monopolist, not of a governmental agency charged both with assuring the industry a fair return and with assuring the public reliable and efficient service, at a reasonable price.").

[271] P.S.C. Ky. No. 9 First Sheet No. 14 (issued Nov. 28, 2018), effective June 29, 2019.

stated that acceptable forms of protection must comply with all applicable state and local requirements and be approved by Kentucky-American, that the protective device be installed and maintained in good working condition at the expense of the customer, and that the protective device be subject to testing and approval of Kentucky-American prior to being placed into service, and at such times thereafter as may be deemed necessary by Kentucky-American.[272] Any cross-connection, which is in violation of the rules, is required to be removed or corrected and failure of a customer to do so could result in termination of water service.[273]

Kentucky-American proposed adding language that "the customer shall be responsible for the entire expense of such testing, including, but not limited to, expenses and fees a third party may charge for performing the testing and submitting the test results in the Company electronically or otherwise."[274] Kentucky-American stated that it has considered using a third-party contractor, Backflow Solutions, Inc. (BSI) to facilitate the administration of cross-connection backflow certification program, including managing tester certification, test kit calibration, and allowing a switch to online portals, which will reduce the mailing of physical letters.[275] Kentucky-American stated that these tasks are currently handled by its cross-connection team, and that hiring a third-party contractor would allow Kentucky-American's employees to focus on other important tasks.[276] Kentucky-American argued that customers are already responsible for expenses

[272] P.S.C. Ky. No. 9 First Sheet No. 14 and No. 15 (issued Nov. 28, 2018), effective June 28, 2019.

[273] P.S.C. Ky. No. 9 First Sheet No. 15 (issued Nov. 28, 2018), effective June 28, 2019.

[274] Application, Exhibit 2 at 16-17.

[275] Kentucky-American's Post-Hearing Brief at 58.

[276] Kentucky-American's Post-Hearing Brief at 59.

associated with "providing, installing, and maintaining BFAs (backflow assemblies)" and that the language is being added to clarify to customers that they are responsible for those expenses, including third party expenses.[277]

Neither the Attorney General nor the LFUCG submitted testimony or made arguments addressing the changes to the cross-connection portion of Kentucky-American's tariff.

Based upon a review of the tariff filing and being otherwise sufficiently advised, the Commission finds that Kentucky-American's proposed revisions are not fair, just or reasonable, and should be denied for the following reasons. The proposed revisions appear to move the testing and approval from Kentucky-American, to a scheme required by Kentucky-American. Customers would then be subject to costs and expenses charged by a third party, with such charges not subject to Commission jurisdiction. Such concern is amplified by the fact that Kentucky-American has indicated that a customer's service would be terminated if they did not follow the proposed procedure. The current tariff language allows customers to choose their own third party for testing. While customers still may be able to do so under the proposed tariff, another layer has been added which could subject customers to additional fees. Additionally, Kentucky-American provided no support for benefit to customers as a result of the change. The Commission has not been persuaded by the evidence in this application and holds its previous position that these changes to Kentucky-American's cross-connection policy should be denied.[278]

<u>Other Tariff Changes</u>

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[277] Kentucky-American's Post-Hearing Brief at 59.

[278] Case No. 2022-00425, *Electronic Tariff Filing of Kentucky-American Water Company to Revise Its Cross-Connection Policy* (Ky. PSC Dec. 22, 2022), Order.

Kentucky-American proposed several textual revisions to its tariff. Neither the Attorney General nor LFUCG submitted testimony or argued against these textual changes. The first text change is within Service Classification No. 6. changing the classification title from Hidden Leak Adjustment Rate to Service Line Adjustment Rate and expanding the availability of service from residential and commercial customers to residential, commercial, and OPA customers.[279] Within the terms and conditions, the first two sentences are changed from "a hidden underground leak is defined as a leak in the customer service line between the meter and the premises. Hidden underground leak adjustments will be granted to residential and commercial customers"[280] to "a service line leak is defined as a leak in the customer service line between the meter and the premises. Service line leak adjustments will be granted to residential, commercial, and OPA customers."[281]

The next change is a text revision to Rule 3.3(c), changing the bills for private fire hydrants from quarterly to monthly.[282] The updated language proposed was "Bills for private fire hydrants shall be payable *monthly* in advance, except for the changes for private fire hydrant service shall be payable as set forth in Rule 11."[283]

[279] Application, Exhibit 2 at 46.

[280] P.S.C. Ky. No. 9 First Sheet No. 44 (issued Nov. 28, 2018), effective June 28, 2019.

[281] Application, Exhibit 2 at 46.

[282] P.S.C. Ky. No. 9 First Sheet No. 8 (issued Nov. 28, 2018), effective June 28, 2019, and Application, Exhibit 2 at 10.

[283] Application, Exhibit 2 at 10.

Kentucky-American also proposed a text change to Rule 6.1(b), adding the wording private detector devices and private service line Meters.[284] The proposed update was:

> All Meters, except *private* detector devices and/or *private* service line Meters, will be installed, maintained, and replaced by; and at the expense of the Company, but in the case of damage to such Meters by reason of any act, neglect, or omission on the part of the Customer (such as damages occasioned by accident or misuse or purposeful actions) the Customer shall pay to the Company the cost of is repair on presentation of bill therefore.[285]

Kentucky American's proposed text revisions and deletions to Rule 10.3(a)(v) for the term "current estimated cost" that the estimated cost of installing each type of appurtenant related facility will be based upon current materials costs, bids received, and other current project data.[286] Specifically, the updated tariff removes the following language:

> During the first quarter of each year, Company will determine from its records its actual average cost per foot, during the preceding calendar year, of construction and installation of all sizes and grades of water mains for which the construction projects have been completed during such calendar year, together with its average cost during such calendar year of installing each type and size of related facility for which construction has been completed during such year. [287]

Kentucky-American proposed the following updated language:

> The term "current estimated cost" as used herein shall mean that sum determined by Company as the estimated cost of installing one foot of water main, together with that sum

[284] Application, Exhibit 2 at 14.

[285] Application, Exhibit 2 at 14.

[286] Application, Exhibit 2 at 14.

[287] P.S.C. Ky. No. 9 First Sheet No. 21 (issued Nov. 28, 2018), effective June 28, 2019.

> determined by Company as the estimated cost of installing each type of appurtenant related facility *based upon current materials costs, bids received, and other current project data*. Such average cost per foot and such average cost per appurtenant facility shall be deemed to be the "current estimated cost" for such mains and facilities during the twelve-month period immediately following such determinations, it being contemplated that the current estimated cost will be revised annually in order to keep same as current as practicable.[288]

Additionally, Kentucky-American proposed to clarify text revisions to Rule 11.1(g) that meter or detector device refers to private fire meter or private detector device.[289] Specifically, Kentucky-American proposed to change the last sentence of Rule 11.1(g) to "The *private* fire meter or *private* detector device will be maintained by the Company, but at the expense of the Customer."[290]

Lastly, Kentucky-American proposed to move Judy Water Association as a standalone customer in its tariff into the general Sale for Resale customer class.[291]

The Commission has reviewed the requested changes and language revisions and finds that they are reasonable and should be approved.

IT IS THEREFORE ORDERED that:

1. The rates and charges proposed by Kentucky-American are denied.

2. The rates and charges, as set forth in Appendix B to this Order, are approved as fair, just and reasonable rates for Kentucky-American, and these rates and charges are approved for service rendered on and after February 6, 2024.

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[288] Application, Exhibit 2 at 14 of 65.

[289] P.S.C. Ky. No. 9 Original Sheet No. 26 (issued June 30, 2023), effective July 30, 2023.

[290] P.S.C. Ky. No. 9 Original Sheet No. 26 (issued June 30, 2023), effective July 30, 2023.

[291] P.S.C. Ky. No. 10 Original Sheet No. 30 (issued June 30, 2023), effective July 30, 2023.

3. Within 60 days of the date of service of this Order, Kentucky-American shall refund to each customer all amounts collected from that customer in excess of the rates approved in this Order for service rendered on or after February 6,2024, through the date of entry of this Order.

4. Kentucky-American shall pay interest on the refunded amounts at the average of the Three-Month Commercial Paper Rate as reported in the Federal Reserve Bulletin and the Federal Reserve Statistical Release on the date of this Order. Refunds shall 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 February 6, 2024.

5. Within 75 days of the date of this Order, Kentucky-American shall submit a written report to the Commission in which it describes its efforts to refund all monies collected in excess of the rates that are set forth in Appendix B to this Order.

6. Any documents filed with the Commission pursuant to Ordering Paragraph 5 shall be filed in the post-case documents in this case.

7. Kentucky-American's proposed depreciation rates are approved.

8. Kentucky-American's proposed deferrals are denied.

9. Kentucky-American's proposed expansion of its QIP is denied.

10. Kentucky-American's proposed reset of the QIP to a zero balance with current QIP expenditures rolled into base rates is denied.

11. Kentucky-American's proposed changes to its QIP calculations are approved.

12. Kentucky-American’s request for an alternative level of unaccounted-for water loss of 20 percent is denied.

13. Kentucky-American’s proposed Universal Affordability Tariff is denied.

14. Kentucky-American’s proposed tariff revisions to its cross-connection policy are denied.

15. Except for the tariffs that have been modified or denied, Kentucky-American’s proposed tariffs are approved as filed.

16. Within 20 days of the date of this Order, Kentucky-American shall, using the Commission's electronic Tariff Filing System, file its revised tariffs setting out the rates authorized in this Order and reflecting that they were approved pursuant to this Order.

17. Absent a request for rehearing, this case will be closed and removed from the Commission’s docket upon expiration of the statutory time period to request rehearing.

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PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ENTERED

MAY 03 2024 rcs

KENTUCKY PUBLIC SERVICE COMMISSION

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2023-00191 DATED MAY 03 2024

	Description		Final
	Original Requested Revenue Requirement Increase	$	26,051,999
	Rate Base Adjustments		
1	Reduce Cash Working Capital	$	(637,697)
2	Remove CWIP	$	(1,729,876)
3	Remove AMI	$	(113,196)
4	Remove QIP Roll-in	$	(5,308,254)
	Operating Income Adjustments		
5	Remove AFUDC Offset	$	1,672,091
6	Remove AMI Depreciation	$	(375,051)
7	Remove QIP Roll-in	$	(3,053,037)
8	Revenue Adjustment	$	(308,297)
9	Incentive Compensation Adjustment	$	(373,598)
10	Inflation Factors	$	(1,009,889)
11	Water Loss Adjustment	$	(660,193)
12	Miscellaneous Expense Adjustment	$	(121,116)
13	Rate Case Expense	$	(328,272)
14	Credit Card Fees	$	(348,284)
15	Legal Fees for Investigation	$	(28,928)
16	Employee Stock Purchase Program	$	(30,039)
	Cost of Capital Adjustments		
17	ROE and Capital Structure		(2,691,846)
	Adjusted Revenue Requirement Increase		10,606,517
	Forecasted Revenues		112,343,951
	Percent Increase		9.4%

	Base Period	Kentucky-American Adjustments	Commission Adjustments	Forecasted Yeat Year at Present Rates	Adjustment for Increased Rates	Forecasted Test Year at Increased Rates
Operating Revenues						
Water Revenues	110,021,445	2,014,209	308,297	112,343,951	10,606,517	122,950,468
Other Revenues	2,455,328	50,065	-	2,505,393		2,505,393
AFUDC	-	1,672,091	(1,672,091)	-		-
Total Revenues	112,476,773	3,736,365	(1,363,794)	114,849,344	10,606,517	125,455,861
Operating Expenses:						
Purchased Water	379,970	(10,996)	(20,573)	348,401		348,401
Fuel and Power	5,363,786	300,828	(786,604)	4,878,010		4,878,010
Chemicals	4,498,283	1,126,309	(313,653)	5,310,939		5,310,939
Waste Disposal	459,292	220,112	(37,888)	641,516		641,516
Salaries and Wages	8,933,356	34,265	(403,637)	8,563,984		8,563,984
Pension	30,661	106,242	-	136,903		136,903
OPEB	(698,945)	98,630	-	(600,315)		(600,315)
Group Insurance	1,412,762	159,912	-	1,572,674		1,572,674
Other Benefits	733,653	42,254	-	775,907		775,907
Support Services	11,996,359	523,069	(245,688)	12,273,740		12,273,740
Contract Services	1,226,754	210,930	(122,602)	1,315,082		1,315,082
Building Maintenance and Services	844,101	67,736	(67,736)	844,101		844,101
Telecommunications	217,280	57,769	-	275,049		275,049
Postage, Printing, and Stationary	14,087	(2,000)	-	12,087		12,087
Office Supplies and Services	283,848	(44,437)	(30,090)	209,321		209,321
Advertising and Marketing	-	-	-	-		-
Employee Related Expense	160,214	16,550	(19,777)	156,987		156,987
Miscellaneous Expense	708,688	98,626	(98,273)	709,041		709,041
Rents	37,581	9,598	(9,598)	37,581		37,581
Transportation	603,279	51,019	-	654,298		654,298
Uncollectible Accounts	488,418	188,276	(40,758)	635,936	64,063	699,999
Other Customer Accounting	126,998	351,974	(352,529)	126,443		126,443
Regulatory Expense	224	660,295	(328,272)	332,247		332,247
Insurance Other Than Group	1,416,883	236,421	-	1,653,304		1,653,304
Maintenance Supplies and Services	2,410,967	314,254	(123,962)	2,601,259		2,601,259
Total Operating Expenses	41,648,499	4,817,636	(3,001,638)	43,464,497	64,063	43,528,560
Other Expenses:						
Depreciation	21,356,111	7,384,226	(1,399,628)	27,340,709		27,340,709
Amortization of UPAA	23,284	(8,561)	-	14,723		14,723
Amortization Expense	63,980	(6,900)	-	57,080		57,080
State Income Taxes	1,417,262	(549,180)	(565,343)	302,739	527,123	829,862
Federal Income Taxes	4,859,514	(2,346,483)	(2,255,717)	257,314	2,103,220	2,360,534
Investment Tax Credits	(11,833)	11,833	-	-		-
General Taxes	8,817,187	1,834,407	(1,023,778)	9,627,816		9,627,816
Total Other Expenses	36,525,505	6,319,342	(5,244,465)	37,600,382	2,630,342	40,230,724
Total Expenses	78,174,004	11,136,978	(8,246,104)	81,064,878	2,694,406	83,759,284
Operating Income	34,302,769	(7,400,613)	6,882,309	33,784,465	7,912,112	41,696,577

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2023-00191 DATED MAY 03 2024

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

Monthly Service Charge

Meter Size		
5/8” – Meter	$16.40	Minimum Bill
3/4" - Meter	24.50	Minimum Bill
1” – Meter	40.80	Minimum Bill
1 1/2” – Meter	81.80	Minimum Bill
2” – Meter	130.80	Minimum Bill
3” – Meter	245.10	Minimum Bill
4” – Meter	408.60	Minimum Bill
6” – Meter	817.20	Minimum Bill
8” – Meter	1,307.50	Minimum Bill

Volumetric Charge

Service Type		
Residential	$0.0063757	Per Gallon
Commercial	0.0057661	Per Gallon
Industrial	0.0047676	Per Gallon
Other Public Authority	0.0053114	Per Gallon
Sales for Resale	0.0046912	Per Gallon

Water Sold to Judy Water Association

First 70,000 Gal/day	$0.0050057	Per Gallon

Over 70,000 Gal/day	0.0051165	Per Gallon

Monthly Public or Private Fire Connections

2" Diameter	$9.60	Per Month
4" Diameter	38.60	Per Month
6" Diameter	86.90	Per Month
8" Diameter	154.40	Per Month
10" Diameter	241.30	Per Month
12" Diameter	361.20	Per Month
14" Diameter	348.00	Per Month
16" Diameter	617.90	Per Month

Hydrant Charge

Public Hydrant	$53.95	Per Month
Private Hydrant	84.80	Per Month

Bulk Sales (Through Loading Stations)

Rate per 50 Gal	$1.85400
Rate per 100 Gal	3.70800

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