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October 8, 2010

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OCT 08 2010
PUBLIC SERVICE
COMMISSION

HAND DELIVERED

Hon. Jeff Derouen
Executive Director
Public Service Commission
211 Sower Boulevard
P.O. Box 615
Frankfort, KY 40601

Re: Delta Natural Gas Company, Inc.
Case No. 2010-00116

Dear Mr. Derouen:

Please find enclosed for filing an original and ten copies of the Post-Hearing Brief of Delta Natural Gas Company, Inc. in the above-captioned case. Please place it with the other papers in the case and bring it to the attention of the Commissioners. Thanks in advance for your assistance.

Sincerely,

Robert Watt

Robert M. Watt, III

rmw:
Enclosures
cc: Parties of Record (w/ encl.)

RECEIVED

OCT 08 2010

PUBLIC SERVICE
COMMISSION

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF DELTA NATURAL GAS COMPANY, INC. FOR AN ADJUSTMENT OF RATES	)))	**CASE NO. 2010-00116**

POST-HEARING BRIEF OF DELTA NATURAL GAS COMPANY, INC.

Filed: October 8, 2010

INTRODUCTION

On April 23, 2010, Delta Natural Gas Company, Inc. ("Delta" or "Company"), requested the Kentucky Public Service Commission's ("Commission") approval of an increase in its base rates in the amount of $5,315,428 on an annual basis.[1] During the course of the proceeding, as a result of information developed during discovery and the revision of schedules accompanying its application, Delta revised its requested increase to $5,357,875 on an annual basis.[2] Included in the Application was Delta's request that the Commission approve new depreciation rates in accordance with Delta's depreciation study submitted with its request for a rate increase. Additionally, Delta is seeking approval of a Pipeline Replacement Program tariff, as well approval to recover uncollectible gas costs and storage gas losses through its Gas Cost Recovery ("GCR") mechanism.

Despite Delta's efforts to contain its costs, the need for an increase in base rates can no longer be forestalled. The effects of the challenging economic climate, along with declining consumption and continued decreases in its number of customers, have resulted in the need for financial relief through increased rates. The financial difficulties affecting Delta are evident in the Company's earned return on equity in the test year, which was only 5.1%.[3] The relief requested herein is fair, just and reasonable.

I. PROCEDURAL BACKGROUND

On March 16, 2010, Delta gave its notice of intent, pursuant to 807 KAR 5:001, Section 10(2) and 807 KAR 5:011, Section 8(1), to file an application for a general adjustment in base rates. On April 23, 2010, Delta filed its Notice and Application, together with the Filing Requirements set forth in the Commission's regulations. The Application included the direct

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[1] Application at paragraph 3.
[2] *See* Delta's updated Filing Requirement 10(6)(h) filed August 24, 2010 at Tab 27, Summary.
[3] Direct Testimony of Glenn R. Jennings of April 23, 1010 (Case No. 2010-00116) ("Jennings Direct") at 6.

testimony of Glenn R. Jennings, John B. Brown, Matthew D. Wesolosky, Martin J. Blake and William Steven Seelye.

On May 4, 2010, the Attorney General of the Commonwealth of Kentucky ("AG") filed his motion to intervene, which was granted on May 13, 2010. The AG is the only intervenor herein.

On May 7, 2010, the Commission entered an order suspending the proposed rates up to and including October 22, 2010. The order established a procedural schedule that included two rounds of discovery to Delta, intervenor testimony, a round of discovery to intervenors, and rebuttal testimony. The schedule was followed throughout the pendency of the case without modification. Because the AG elected not to file testimony, the Company neither issued data requests to the AG nor filed rebuttal testimony.

On March 31, 2010, the Commission issued its first data requests to Delta, to which responses were filed on May 7, 2010. On May 24, 2010, the Commission issued its second data requests to Delta. The AG's first data requests were also issued on May 24, 2010. Delta responded to the AG's and Commission's requests on June 8, 2010. On June 21, 2010, the Commission issued its third data requests and the AG filed his supplemental data requests to Delta. Responses were filed on July 2, 2010.

This matter proceeded to evidentiary hearing on August 31, 2010, and concluded on September 1, 2010. At the outset of the hearing, the Commission inquired as to whether public notice of the hearing had been given in accordance with the governing regulations.[4] Delta's counsel explained that the Company had filed a Motion to Deviate from the publication rule due to the failure of two newspapers to publish timely notice and the failure of one newspaper, the

[4] VR: 8/31/10; 10:07:03-10:07:05.

Clay City Times, to publish the notice at all.[5] The Commission granted the Motion to Deviate with respect to the two newspapers that failed to publish timely notice.[6] The Commission, however, did not grant the Motion to Deviate for the *Clay City Times*, requiring Delta to have the notice published in the newspaper and reconvene the hearing following publication to afford customers in the *Clay City Times*' service area the opportunity for public comment.[7] The Commission scheduled the public comment hearing for September 30, 2010. Notice was timely published in the *Clay City Times* on September 16, 2010, and the public comment hearing occurred as scheduled. No one appeared at the public comment hearing and it was adjourned by the hearing officer.

The Commission, Delta, and the AG were represented by counsel at the evidentiary hearing and all of Delta's witnesses appeared and were subject to cross-examination. During the course of the hearing, the Commission and the AG issued several hearing data requests to Delta, to which Delta filed responses on September 14, 2010.

II. STANDARD OF REVIEW

Throughout this proceeding, Delta has provided the Commission and the AG with substantial and extensive information in support of its requested increase in rates. This information was provided in the Filing Requirements and testimony accompanying Delta's Application, in addition to the Company's responses to numerous data requests. This information demonstrates the reasonableness of Delta's requested revenue increase in this proceeding.

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[5] VR: 8/31/10; 10:07:08-10:10:42.
[6] VR: 8/31/10; 10:11:50-10:12:55.
[7] VR: 8/31/10; 10:11:50-10:12:55.

While Delta submitted significant information supporting its proposed rate increase, no contradictory evidence has been offered. As mentioned, the AG, who is the only intervenor, elected not to file testimony in this proceeding. As such, Delta's evidence is uncontradicted. While Delta understands that as an applicant it has the burden of proof in this proceeding,[8] it is mindful of the Supreme Court of Kentucky's acknowledgement that when an applicant's evidence is "virtually uncontradicted," it often has "probative value sufficient to compel a finding consistent with it," rendering a contrary ruling arbitrary.[9]

Thus, while the Commission is not bound to accept "every figure and every rate proposed," the Supreme Court has held that when an applicant's evidence is uncontradicted and probative, the Commission may be required to accept some or all of the utility's methods and findings.[10] Cumulatively, these precedents demonstrate that Delta retained the burden of proof in this proceeding, but once Delta satisfied the burden by providing credible evidence that remains uncontradicted, the Commission should accept the utility's position.

Delta respectfully submits that it has sufficiently satisfied its burden of proof in this proceeding, as it has demonstrated the reasonableness of its requested increased through its Application, Filing Requirements and direct testimony, responses to data requests, and through thorough cross-examination by the Commission Staff and the AG. As such, the Company believes that its evidence is sufficiently probative to compel findings consistent with its stated positions.

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[8] *Lee v. International Harvester Co.*, 373 S.W.2d 418 (Ky. 1963).
[9] *Kentucky Power Company v. Energy Regulatory Commission of Kentucky*, 623 S.W.2d 904, 908 (Ky. 1981).
[10] *Id.*

III. RATE BASE

Delta initially proposed a rate base as of the end of the test year, December 31, 2009, of $110,358,397 in this proceeding.[11] This was later revised to $109,855,579.[12] This amount is the investment attributable to Delta's regulated operations, as Delta's subsidiary companies have been excluded from the calculation.[13] Delta's calculation of its rate base was performed in accordance with prior precedent and consistent with Commission orders in prior rate cases. Each item involved in the calculation is discussed below.

A. Materials and Supplies

Included in the Company's rate base is the dollar amount of materials and supplies. In order to calculate the appropriate amount for inclusion in rate base, Delta, in accordance with past practice, utilized a thirteen month average. This calculation has resulted in the inclusion of $596,121 in rate base.[14]

B. Prepayments

Delta has utilized the customary thirteen month average for calculation of its prepayments. In keeping with the Commission's decision in Case No. 2004-00067, the Company has deducted from the prepayments balance the amount of the Commission's assessment, which is $47,027.[15] After deducting this amount, the balance of prepayments originally included in Delta's rate base was $1,678,738, which was later revised to $1,678,137.[16]

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[11] Tab 27 of the Filing Requirements, Schedule 6.

[12] Delta's updated Filing Requirement 10(6)(h) filed August 24, 2010 at Tab 27, Schedule 6.

[13] Direct Testimony of John B. Brown of April 23, 2010 (Case No. 2010-00116) ("Brown Direct") at 6.

[14] Tab 27 of the Filing Requirements, Schedule 6.

[15] *Id.*; *In the Matter of: Application of Delta Natural Gas Company, Inc. for an Adjustment of Rates* (Case No. 2004-00067) Order, November 10, 2004 at 5. The Commission held that the "PSC Assessment should be excluded from the balance for Prepayments included in the determination of Delta's rate base."

[16] Tab 27 of the Filing Requirements, Schedule 6; Delta's updated Filing Requirement 10(6)(h) filed August 24, 2010 at Tab 27, Schedule 6.

C. Gas in Storage

Consistent with the Commission's prior methodology in the calculation of Delta's rate base, the Company utilized a thirteen month average for calculation of its gas in storage.[17] This resulted in the amount of $3,777,901 in Delta's rate base.[18]

D. Unamortized Debt Expense per Books

Delta calculated its unamortized debt expense based upon the balance of the expense at the end of the test year, which was December 31, 2009. The balance at the end of the test year that has been included in Delta's rate base is $4,542,382.[19]

E. Cash Working Capital

Delta calculated cash working capital in accordance with the methodology utilized pursuant to the Commission's order in Case No. 9331.[20] The Company thus calculated its cash working capital allowance based upon the 1/8 formula, under which the Company is permitted to include 1/8 of its proposed total operation and maintenance expense for the test period as cash working capital that is included in rate base.[21] Based upon this formula, Delta initially included $1,694,219 in its rate base for its cash working capital allowance.[22] Due to updated information regarding operation and maintenance expenses, this amount was later revised to $1,650,365.[23]

F. Accumulated Depreciation

In addition to the items discussed above that increase Delta's rate base, the Company has also included the effect of several items that decrease the Company's rate base. The first such

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[17] Tab 27 of the Filing Requirements, Schedule 6; *In the Matter of: Application of Delta Natural Gas Company, Inc. for an Adjustment of Rates* (Case No. 2004-00067) Order, November 10, 2004 at 6.
[18] Tab 27 of the Filing Requirements, Schedule 6.
[19] *Id.*
[20] *In the Matter of: An Adjustment of Rates of Delta Natural Gas Company, Inc.* (Case No. 9331) Order, November 15, 1985.
[21] *Id.* at 3.
[22] Tab 27 of the Filing Requirements, Schedule 6.
[23] Delta's updated Filing Requirement 10(6)(h) filed August 24, 2010 at Tab 27, Schedule 6.

deduction to rate base is the accumulated depreciation balance at the end of the test year, which was $70,042,570.[24]

Comprised within this amount is the Company's proposed depreciation adjustment and cost of removal.[25] Delta is seeking the Commission's approval of its proposed depreciation expense, which is based upon a depreciation study that recommends new rates calculated in conjunction with this proceeding. The Company's calculation of its depreciation expense for the test year, itemized by account, is found at Filing Requirement 10(6)(h), Tab 27, Schedule 4. The initial proposed depreciation expense adjustment was a $1,311,714 reduction to rate base;[26] this expense adjustment was later revised to $1,770,077 due to calculation of a revised Schedule 4 pursuant to Item 12 of Staff's Third Data Requests. Also, the elimination of the proposed cost of removal reduces rate base by $75,264.[27]

G. <u>Customer Advances for Construction</u>

The Company has also deducted from rate base the balance of customer advances for construction,[28] which are contributions supplied from developers, businesses, or government agencies. This item reduced Delta's rate base by $54,605.[29]

H. <u>Accumulated Deferred Income Taxes</u>

The final item reducing Delta's rate base is the Company's balance of accumulated deferred income taxes as of the end of the test year.[30] This balance, which is always an offset to rate base, reduced Delta's rate base by $29,427,209.[31] This reduction is greater than in prior proceedings due to Delta's effectuation of a tax method change pertaining to Internal Revenue

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[24] Tab 27 of the Filing Requirements, Schedule 6.
[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] *Id.*
[29] *Id.*
[30] *Id.*
[31] *Id.*

Code § 162. By receiving approval of this method change, Delta accelerated tax deductions which reduced rate base in this proceeding by approximately $3,200,000.[32]

IV. CAPITAL STRUCTURE

Delta's capital structure is set forth at Schedule 8 of Filing Requirement 10(6)(h) at Tab 27. As illustrated in that schedule, at the end of the test year, the equity component of Delta's capital structure was 44.49%.[33] This percentage corresponds to equity of $56,492,338 at December 31, 2009.[34]

As for debt, the Company had 46.04% in long-term debt and 9.46% in short-term debt.[35] At the end of the test year, these percentages corresponded to $58,459,000 in long-term debt and $12,015,728 in short-term debt.[36]

V. OPERATING INCOME AND EXPENSES

Delta has approached the determination of operating income and expenses for ratemaking purposes with primary attention to the actual test year experience with adjustments for known and measurable changes in accordance with 807 KAR 5:001, Section 10(a). The information relating to the Company's operating income is set forth in the schedules at Tab 42 of the Filing Requirements and adopted by Mr. Brown in his direct testimony.[37] The calculation of Delta's operating income was made utilizing the schedules set forth at Tab 27 of the Filing Requirements. During the course of this proceeding, Delta updated information contained at Tab

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[32] Delta's Response to AG 2-2.
[33] Tab 27 of the Filing Requirements, Schedule 8.
[34] *Id.*
[35] *Id.*
[36] *Id.*
[37] Brown Direct at 3.

27, where applicable.[38] Delta has determined that its test year adjusted net operating income is $1,910,618.[39]

As mentioned, the Company's calculation of its net operating income relied upon Delta's actual operation and maintenance expenses with adjustments for known and measurable changes. While the AG has not specifically contested any of Delta's operating income determinations, each of the Company's proposed adjustments are discussed below.

A. <u>Elimination of Asset Retirement Obligations</u>

Delta has eliminated asset retirement obligations (ARO) from its reported property, plant and equipment.[40] An ARO is a legal obligation associated with the retirement of long-lived tangible assets. Pursuant to the adoption of FASB Accounting Standards Codification Topic 410-20-05, Delta made the appropriate initial entries for GAAP financial reporting.[41] Adoption of the Codification did not impact regulatory accounting or consequently the manner in which Delta's costs for property, plant and equipment are recovered.[42] As such, the initial entries adopting the standard, along with ongoing ARO accounting has been recorded as a regulatory asset, as opposed to an expense.[43] Further, all related balances have been removed from test year financial statements to ensure there is no impact on the revenue requirement.[44]

B. <u>Removal of Unbilled Revenues</u>

This adjustment removes unbilled revenues for the test period from the calculation of the revenue requirement. Consistent with prior practice, Delta has presented its operating revenues,

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[38] Delta's updated Filing Requirement 10(6)(h) filed August 24, 2010 at Tab 27, Schedule 6.
[39] This amount was calculated by subtracting from Delta's pro forma net income, which is $5,293,435, the net increase from the revenue deficiency which is $3,382,817. The calculation of Delta's pro forma net income can be found at Tab 27, Schedule 7 of the updated filing requirement 10(6)(h), filed August 24, 2010. To complete the calculation of the $3,382,817, the revenue deficiency of $5,357,875 was reduced by Delta's income tax expense, utilizing an effective income tax rate of 36.8627%. The income tax expense included the Commission's assessment.
[40] Tab 42 of the Filing Requirements.
[41] Tab 20 of the Filing Requirements.
[42] *Id.*
[43] *Id.*
[44] *Id.*

purchased gas expense and income taxes on a billed basis.[45] As such, the Company removed unbilled income from the test period to consistently reflect its revenues.[46]

C. <u>Temperature Normalization Adjustment</u>

Delta has proposed a temperature normalization adjustment to better reflect the impact of temperature changes on customer consumption. Currently, Delta has a Weather Normalization Adjustment ("WNA") clause that automatically adjusts the commodity charge to reflect normal temperatures.[47] The WNA clause normalizes billings for residential and small non-residential customers from December through April.[48] Delta has not proposed a temperature normalization adjustment for these customer classes during the period in which the WNA applies.

Despite the presence of the WNA clause, further temperature normalization is required with regard to rate classes to which the WNA does not apply, as well as for heating months not covered by the WNA. The most significant customer classes currently not covered by the WNA are the large non-residential and interruptible rate classes.[49]

For the customer classes not covered by the WNA clause, Mr. Seelye performed a standard temperature normalization adjustment.[50] Mr. Seelye found that Delta's actual revenues for customer classes not covered by the WNA clause were somewhat understated due to slightly warmer than normal temperatures during the test period.[51] Mr. Seelye made this determination by examining the number of heating degree days during the test period that were below the

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[45] *Id.*
[46] *Id.*
[47] Direct Testimony of William Steven Seelye of April 23, 2010 (Case No. 2010-00116) ("Seelye Direct") at 27.
[48] *Id.* at 27.
[49] *Id.*
[50] *Id.* at 28.
[51] *Id.*

thirty-year average Weather Bureau heating degree days as of December 31, 2009.[52] Mr. Seelye utilized degree-day data obtained from the Lexington, Kentucky weather station.[53]

Mr. Seelye's methodology first required determination of the annual non-temperature sensitive and temperature sensitive volumes for each rate class.[54] Mr. Seelye utilized gas deliveries occurring in July and August for non-temperature sensitive volumes as those months have had no heating degree days.[55] Those volumes were then multiplied by six to calculate an annual non-temperature sensitive load that was subsequently deducted from total gas deliveries during the test year to determine the annual amount of temperature sensitive volumes.[56]

Once non-temperature sensitive and temperature sensitive volumes were determined, Mr. Seelye ascertained the volumetric adjustment necessary to normalize gas deliveries to reflect normal temperatures.[57] To accomplish this, Mr. Seelye divided annual temperature sensitive volumes by the number of actual heating degree days in the test period, and the resulting Mcf per degree day was multiplied by the degree departure from normal to ascertain the appropriate volumetric adjustment for each rate class.[58] Finally, Mr. Seelye applied the volumetric adjustment for each rate class to the applicable distribution component for each rate class not currently billed under the WNA clause.[59]

Mr. Seelye has also determined the appropriate gas temperature normalization adjustment for the residential and small non-residential rate classes which are billed under the WNA clause.[60] Mr. Seelye utilized the same methodology as for large non-residential and interruptible

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52 *Id.*
53 *Id.*
54 *Id.*
55 *Id.*
56 *Id.*
57 *Id.*
58 *Id.*
59 *Id.* at 29.
60 *Id.*

rate classes, except that degree days were determined only for the months in which the WNA clause does not apply.[61] The temperature normalized adjustment Delta has proposed adjusts customer volumes during the months of May through November.[62] Mr. Seelye's analysis determined that actual heating degree days related to cycle-billed customer deliveries were above the thirty-year average Weather Bureau heating degree days for those months.[63] The difference was used in the calculation for the residential and non-residential rate classes.[64]

Cumulatively, the temperature normalization adjustment Delta has proposed results in a net decrease of $63,111 in Delta's operating revenue.[65] Calculation of this amount is summarized at Exhibit 9 of Mr. Seelye's testimony. Further, the decrease, enumerated by rate class and in total, can be found in Mr. Seelye's Exhibit 3 at Column 5.

D. Purchased Gas Adjustment

In keeping with prior practice, Delta has proposed to adjust its purchased gas expense to reflect the current GCR rate.[66] In Case No. 2009-00534, Delta filed its quarterly report, which serves as the basis for adjustments to the GCR.[67] The Commission's order approving the rates noted that in Delta's last rate proceeding, Case No. 2007-00089, the Commission approved the Company's rates and provided for further adjustment in accordance with Delta's GCR.[68] The Commission found that Delta's proposed GCR adjustments were "fair, just, and reasonable" and permitted their use on and after January 25, 2010.[69]

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[61] *Id.*
[62] *Id.*
[63] *Id.*
[64] *Id.*
[65] *Id.*
[66] Tab 20 of the Filing Requirements.
[67] *In the Matter of: Purchased Gas Adjustment Filing of Delta Natural Gas Company, Inc.* (Case No. 2009-00534).
[68] *In the Matter of: Purchased Gas Adjustment Filing of Delta Natural Gas Company, Inc.* (Case No. 2009-00534) Order, January 15, 2010.
[69] *Id.*

The Company's proposed adjustment in this proceeding incorporates these Commission-approved rates into Delta's purchased gas expense to ensure that the most current GCR adjustments are reflected in base rates.

E. Gas Inventory

In its initial filing, Delta sought recovery of $867,900 due to gas lost from its Canada Mountain storage facility occurring from approximately October 2006 to October 2007.[70] The reason for the lost gas was a failure in the cement associated with a well approximately 2,800 feet below the surface. The amount of the loss became known and measurable in January 2009. For Securities and Exchange Commission reporting purposes, however, because Delta's Form 10-Q for the quarter ended December 31, 2008 had not yet been filed when the loss became known and measurable, the loss was accrued on Delta's books in December 2008 as an entry in Miscellaneous Non-Operating Expenses, a "below the line" account.[71] In April 2009, during the test year, the entry was corrected and properly booked "above the line" in the Gas Storage Losses account.[72] Delta did not intend to include the expense for ratemaking purposes until it became apparent, through protracted communications with its insurance carrier that the carrier would not reimburse the Company for the losses.[73] The insurance carrier's position regarding Delta's ability to recover insurance proceeds for the lost gas was not fully understood until the beginning of 2010.[74] In its application, Delta originally sought recovery of the entire $867,900 as an expense.

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[70] Delta's Response to Staff 2-46. The total amount of the loss, and consequent insurance claim, is $1,300,000. The $867,000 for which Delta is seeking recovery in this proceeding represents the portion of the loss allocable to Delta's regulated operations. VR: 8/31/09; 11:24:21-11:25:01.

[71] Delta's Response to Staff 2-46.

[72] *Id.*

[73] *Id.*

[74] Delta's Response to Staff 3-15(d).

As the proceeding developed, Delta realized that the more preferable method of recovery for this expense is the establishment and amortization of a regulatory asset for the precise amount of the loss, rather than including the full annualized amount in base rates.[75] As the Commission Staff correctly noted that Delta has not had any expenses in this account in the last five years,[76] the stored gas loss at issue in this proceeding is of adequate infrequency and sufficient magnitude to warrant regulatory asset treatment.[77] The loss is comparable to the costs that electric utilities incur for uncommonly severe storms, which are often approved for regulatory asset treatment.[78]

Delta thus has proposed to recover the $867,900 loss over an amortization period of three years.[79] In an updated filing pertaining to adjustments to its revenue deficiency, Delta reflected its new position, by decreasing its test year gas inventory expense by $578,600, which corresponds to two-thirds of the expense.[80] If the Commission accepts Delta's proposed amortization period, $289,300 will be collected annually over three years. Delta is still negotiating with its insurance carrier and, if any funds are recovered, they will be reflected in the Company's GCR to avoid double recovery.[81] Any insurance proceeds received will be allocated between Delta's regulated and non-regulated operations proportionate to their respective share of the loss.[82]

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[75] *Id.*
[76] Staff 2-46.
[77] Delta's Response to Staff 3-15(d).
[78] *Id.* See, e.g., *In the Matter of: Application of Kentucky Utilities Company for an Order Approving the Establishment of a Regulatory Asset*, Case No. 2008-00457, Order dated December 22, 2008 (Hurricane Ike); *In the Matter of: Application of Kentucky Utilities Company for an Order Approving the Establishment of a Regulatory Asset*, Case No. 2009-00174, Order dated September 30, 2009 (2009 Winter Storm).
[79] Delta's Response to Staff 3-15(d).
[80] *See* Delta's updated Filing Requirement 10(6)(h) filed August 24, 2010 at Tab 27, Summary.
[81] VR: 8/31/10; 11:46:52-11:48:59.
[82] VR: 8/31/10; 11:47:01-11:47:21.

This incident has made apparent the need for an established regulatory mechanism to recover losses that may occur in the future. Delta has suggested that its GCR is an appropriate method to address subsequent storage inventory adjustments.[83] This proposed revision to the GCR is discussed at length in a later section of this brief.

F. <u>Payroll Expense</u>

Delta has proposed an adjustment to its payroll expense that incorporates several known and measurable changes. The Company has adjusted its payroll expense to reflect wage increases given on July 1, 2009.[84] To fully recognize the going-forward impact of these increases, Delta annualized its salaries and wages so that a full year of the current salaries and wages is reflected in rates.[85]

Delta also adjusted its payroll expense to include the appropriate amount of seasonal labor. The Company employs individuals on a part-time and/or seasonal basis to complete work that is most easily executed during the summer months.[86] These employees are terminated well in advance of December 31, which is the end of the test year in this proceeding.[87] Thus, the Company's salary and wage expense as of December 31, 2009, is not representative of Delta's annual payroll expense as its seasonal employees were not included in the calculation.[88] The Company has thus pro formed its payroll expense to accurately reflect the amount of seasonal labor expense it annually incurs.

The net effect of these pro forma adjustments resulted in a payroll expense decrease of $41,046.[89]

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[83] Delta's Response to Staff 3-15(d).
[84] Brown Direct at 6.
[85] Tab 27 of the Filing Requirements, Schedule 3.1.
[86] Delta's Response to Staff 3-2.
[87] *Id.*
[88] *Id.*
[89] Tab 27 of the Filing Requirements, Schedule 3.1.

G. Rate Case Expenses

Consistent with the Commission's prior treatment of rate case expenses, Delta is seeking to recover its expenses incurred in this proceeding through an amortization period of three years.[90] In addition to seeking recovery of the expenses incurred in this proceeding, the Company is still amortizing its rate case expenses incurred in Case No. 2007-00089.[91]

The Company estimated its rate case expenses in this proceeding by relying upon the actual amount incurred in Case No. 2007-00089.[92] Pursuant to Staff 1-52, Delta has provided updated actual rate case expenses each month. As mentioned, Delta is still amortizing its costs from Case No. 2007-00089, as pursuant to the Commission-approved settlement agreement the Company was permitted to amortize its rate case expenses over a period of three years.[93] There remains $12,177 that still needs to be amortized.[94] As the annual projected expenses from this proceeding, assuming a three-year amortization period, and the amount remaining from the prior proceeding is less than the annual amount of amortization during the test year, this adjustment actually decreases the Company's test year expenses.[95]

H. Bad Debt Expense

Delta has proposed an adjustment to adjust its bad debt expense to reflect the reversal of a booked reserve.[96] During 2008, Delta booked a reserve in its uncollectible account to cover uncollectible risks regarding certain non-regulated customers.[97] During the test year in 2009, the uncollectible reserve was reversed in order to transfer the reserve to the books of the appropriate

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[90] Brown Direct at 6.
[91] Tab 27 of the Filing Requirements, Schedule 3.2.
[92] *Id.*
[93] *In the Matter of: Application of Delta Natural Gas Company, Inc. for an Adjustment of Rates* (Case No. 2007-00089) Order, October 19, 2007.
[94] Tab 27 of the Filing Requirements, Schedule 3.2.
[95] *Id.*
[96] Brown Direct at 6.
[97] *Id.*

subsidiary.[98] Delta's proposed adjustment is necessary to accurately state regulated bad debt expense for the test year.[99]

The Company has also adjusted its bad debt expense by deducting the portion of the expense attributable to the Gas Cost Collection Charge, which Delta has proposed to collect separately through its GCR mechanism.[100] The proposed modification to the GCR is discussed at length in a later section of the brief. If the proposed modification to the GCR is not approved and Delta is not permitted to collect the charge as proposed through the GCR, the bad debt expense will need to be increased by $237,709.[101]

Cumulatively, this adjustment increases the Company's operating expense by $331,291.[102] During discovery, this adjustment was increased by $298, due to an error Delta detected in responding to Staff 2-4(c)(1). This is the only operation and maintenance adjustment Delta has proposed that increases its expenses.[103]

I. <u>Legal and Insurance Expenses</u>

During the course of discovery, Delta learned of certain legal and insurance expenses that should not have been included in the test year.[104] In an updated filing delineating its adjustments to the revenue deficiency, Delta eliminated $69,889 of legal expenses, along with $7,633 in insurance expenses from calculation of its revenue deficiency.[105] Delta also made a corresponding adjustment to prepayments, an element of rate base, to ensure that all affected schedules were revised.

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[98] *Id.*
[99] *Id.*
[100] *Id.*
[101] Tab 27 of the Filing Requirements, Schedule 3.3. This amount was calculated by subtracting the $145,879 base revenue portion of bad debt expense from the test year regulated bad debt expense, which was $383,588.
[102] Tab 27 of the Filing Requirements, Schedule 3.
[103] Brown Direct at 6.
[104] Delta's updated Filing Requirement 10(6)(h) filed August 24, 2010 at Tab 27, Summary.
[105] *Id.*

J. Pension Expense

During the course of the proceeding, Delta obtained a more recent pension plan and post-retirement actuarial study than the plan available when the Company's application was filed. In July 2010, Harbridge Consulting Group, LLC provided Delta with year-end disclosures for the fiscal year ending June 30, 2010, as well as the net periodic cost for the fiscal year ending June 30, 2011.[106]

The most recent calculation of the net periodic cost of Delta's defined benefit retirement plan is $304,632 greater than the last projection provided by Harbridge, which was $824,000 as provided in the Company's initial response to AG 1-60.[107] Pursuant to this most recent report, Delta's test year pension expense was initially understated by $304,632. The Company included this increase in pension expense in its updated Filing Requirement 10(6)(h), Tab 27.[108] The total expense should be $1,128,632.

K. Previously Disallowed Miscellaneous Expenses

In Case No. 2004-00067, the Commission disallowed certain expenditures for ratemaking purposes.[109] These items related to lobbying expenses,[110] public and community relations expenses,[111] marketing and conservation expenses,[112] and promotional advertising.[113] Pursuant to the Commission's finding in that proceeding, Delta has decreased its test year expenses by removing all costs associated with these expenses.[114] The amount reduced for each item was as

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[106] Delta's Updated Response to AG 1-60, Filed August 19, 2010.
[107] *Id.*
[108] Delta's updated Filing Requirement 10(6)(h) filed August 24, 2010 at Tab 27, Summary.
[109] *In the Matter of: Application of Delta Natural Gas Company, Inc. for an Adjustment of Rates* (Case No. 2004-00067) Order, November 10, 2004.
[110] *Id.* at 21-23.
[111] *Id.* at 23-24.
[112] *Id.* at 24-26.
[113] *Id.* at 25, 45.
[114] Tab 20 of the Filing Requirements.

follows: advertising expense of $1,438,[115] $16,952 in lobbying expense,[116] lobbying benefits and taxes of $2,242,[117] public and community relations expense of $26,450,[118] marketing expense of $1,944,[119] and $600 in conservation expense.[120] Cumulatively, these adjustments reduced Delta's test year expense by $49,626.

L. Depreciation Expense

William Steven Seelye performed a depreciation study for Delta, which is included in his testimony. Mr. Seelye recommended new depreciation rates that were adjusted to ensure that the depreciation expenses recorded by the utility and included in the cost of service represent an accurate and systematic measurement of the annual levels necessary to distribute plant costs, less salvage and cost of removal, over the estimated useful life of its assets.[121] Mr. Seelye utilized the same methodology in performing his study as he used in Delta's last two rate cases.[122]

In determining appropriate depreciation rates, Mr. Seelye utilized all available plant additions, retirement and transfer data. Much of the information was available beginning in the 1940s.[123] Where the requisite data was available, Mr. Seelye calculated the average service life of Delta's assets by identifying the survivor curve that most closely corresponded to the pattern of requirements gathered from the historical data the Company provided.[124] When sufficient information was not available, the average service lives and depreciation accrual rates of

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[115] Tab 27 of the Filing Requirements, Schedule 3.
[116] *Id.*
[117] *Id.*
[118] *Id.*
[119] *Id.*
[120] *Id.*
[121] Seelye Direct at Exhibit 11, page 1.
[122] Seelye Direct at 32.
[123] Seelye Direct at Exhibit 11, page 1.
[124] *Id.*

geographically comparable utilities were used as a guide in developing the recommended depreciation rates, together with Mr. Seelye's judgment.[125]

Mr. Seelye calculated depreciation rates for each of Delta's accounts, which are listed on Table 27, Schedule 4 of Filing Requirement 10(6)(h). At hearing, Commission Staff inquired as to why certain of the accounts had increased from the Company's proposed depreciation rates in Case No. 2007-00089.[126] Mr. Seelye provided a comprehensive explanation of each increase in the accounts as to which Commission Staff had inquired.[127] As to Account 352, Storage Wells, Mr. Seelye explained that the net balance for that account increased from $252,152 to $2,661,345 since Delta's last rate case.[128] The ten-fold addition to the net balance of this account is the reason Delta's proposed depreciation rate for this account has increased; the methodology has not varied.[129]

As for Account 376, Distribution Mains, Mr. Seelye has utilized the same methodology as in Case No. 2004-00067, in which the Commission approved Delta's recommended rate.[130] The variance between the proposed rate for Account 376 in this proceeding and the Company's last rate case, Case No. 2007-00089, is attributable to the settlement agreement Delta and the AG reached in that case.[131] The settlement agreement applied the depreciation rate for Account 376 proposed by the AG and not the rate proposed by the Company.[132] Mr. Seelye has applied the methodology utilized in Case No. 2004-00067 in this proceeding because the survivor curve selected most closely corresponds to the historical data for this account, which is the proper

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[125] *Id.*
[126] VR: 8/31/10; 13:50:00.
[127] Delta's Response to Hearing Data Request 8-9, Filed September 14, 2010.
[128] Delta's Response to Hearing Data Request 8(c), Filed September 14, 2010.
[129] *Id.*
[130] *Id.*
[131] *Id.*
[132] *Id.*

methodology.[133] As explained at hearing, due to the absence of continuous records for Account 380, the depreciation rate calculated for Account 376 is also used for Account 380.[134]

As for Account 381, Meters, the proposed depreciation rate has increased due to Mr. Seelye's selection of a survivor curve that more precisely corresponds to the curve indicated by the Simulated Plants Records analysis.[135] Delta's selection of a more representative survivor curve is the principal reason for the variance between the proposed depreciation rate for this account in Delta's last rate case and the depreciation rate proposed in this proceeding.

Mr. Seelye's proposed depreciation rates have been utilized to calculate Delta's test year depreciation expense. The net effect on this expense by applying the updated depreciation rates from the study to the year-end balances increases Delta's depreciation expense by $1,770,077.[136] This amount represents a $458,363 increase from the Company's initial filed position.[137] A revised Tab 27, Schedule 4 of Filing Requirement 10(6)(h) was provided pursuant to Staff 3-12, in which the Company set forth a revised calculation of its depreciation expense that incorporated corrections Delta made in response to Staff 2-42.[138]

M. Taxes Other than Income Taxes

Delta has adjusted its payroll tax expense and property tax expense to more accurately reflect its expected, going-forward level of expense. The cumulative impact of these adjustments increases the Company's expense by $67,835.[139] The total proposed expense is

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[133] *Id.*
[134] *Id.*
[135] Delta's Response to Hearing Data Request 8(b), Filed September 14, 2010.
[136] Delta's updated Filing Requirement 10(6)(h) filed August 24, 2010 at Tab 27, Schedule 4.
[137] Delta's updated Filing Requirement 10(6)(h) filed August 24, 2010 at Tab 27, Summary.
[138] *Id.*
[139] Delta's updated Filing Requirement 10(6)(h) filed August 24, 2010 at Tab 27, Schedule 5.

$1,972,714.[140] Delta has provided a detailed accounting of its proposed adjustments as part of Tab 27, Schedule 5 of Filing Requirement 10(6)(h).

N. Accounting Expenses for Tax Method Change

In order to receive approval of the tax method change pertaining to Internal Revenue Code § 162,[141] Delta engaged Deloitte and Touche, LLP to perform the necessary services.[142] The total cost of Deloitte's services for this method change was $132,589.[143] The amount incurred in effectuating this change has been more than offset by the beneficial result to customers because, as mentioned, the Company's rate base has been reduced by $3,200,000 due to this method change.[144]

Delta is seeking recovery of the amount incurred in receiving the requisite Internal Revenue Service approval. Delta has requested recovery because the frequency with which it has sought method changes renders the expense appropriately recurring for ratemaking purposes. As explained in response to Item 16 of Staff's Third Data Requests, Delta has filed a different method change in each of its three most recent tax years.

At hearing, Commission Staff inquired as to the costs incurred by Delta for services provided by Deloitte and Touche, LLP for method changes in prior years.[145] The Company's response demonstrates that the cost incurred for the most recent accounting change was greater than in prior years.[146] The significant benefit to Delta's customers by the marked reduction in rate base demonstrates the reasonableness and prudency of the expense. If, however, the Commission is concerned that the amount is not representative of the going-forward level of

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[140] *Id.*
[141] *See* the discussion in the Accumulated Deferred Income Taxes subsection of the Rate Base section hereinabove.
[142] Delta's Response to Staff 3-16.
[143] *Id.*
[144] Delta's Response to AG 2-2.
[145] VR: 8/31/09; 11:35:14-11:35:37.
[146] Delta's Response to Hearing Request 5.

outside accounting costs, Delta is amenable to a three-year amortization of the $132,589 expense.

O. Income Taxes

Delta has also adjusted its test year income tax expense to reflect known and measurable changes to the various components comprising the expense. The Company has provided an accounting in Tab 27, Schedule 7 of Filing Requirement 10(6)(h). Delta has also provided a comprehensive accounting of the more detailed components of the income tax calculation, including the return, interest deduction and the application of the tax rate to the equity return.[147] The cumulative effect of the adjustments resulted in an expected total income tax liability, including a gross up of the Commission's assessment, of $3,090,573.

VI. COST OF CAPITAL

The Company's capital structure, including ratios and cost of capital at December 31, 2009, is set forth in Tab 27 of the Filing Requirements, Schedule 8. The revised and updated version of this schedule was filed on August 24, 2010, and reflects the most recent cost rates. The annual cost rate for long-term debt is 6.830%.[148] Long-term debt comprises 46.04% of Delta's capital structure.[149] The annual cost rate for short-term debt as of December 31, 2009, was 2.096%.[150] Short-term debt comprises 9.46% of Delta's capital structure.[151] Delta's capital structure included 44.49% in common equity.[152] Delta's expert witness, Dr. Martin J. Blake has recommended an annual cost rate of 12.00% for its common equity.[153] This evidence is

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[147] Delta's updated Filing Requirement 10(6)(h) filed August 24, 2010 at Tab 27, Schedule 7.
[148] Delta's updated Filing Requirement 10(6)(h) filed August 24, 2010 at Tab 27, Schedule 8.
[149] *Id.*
[150] *Id.*
[151] *Id.*
[152] *Id.*
[153] *Id.*

uncontroverted. The AG, the only intervenor to the proceeding, did not file direct testimony and has thus offered no annual cost rate differing from that of the Company.

Dr. Blake performed various analyses to determine the return on common equity Delta must be permitted to earn in order to ensure that the Company is able to attract competitively priced capital. Based upon his Discounted Cash Flow ("DCF") analyses, Capital Asset Pricing Model ("CAPM") analysis, risk premium results and examination of companies of corresponding risk, Dr. Blake determined that a reasonable range for return on equity in this proceeding is between 11.28% and 15.08%.[154] Dr. Blake has recommended that a 12.0% return on equity be approved, which is the average return on equity for 201 companies with risk comparable to Delta's risk as reported by *Value Line*.[155]

Dr. Blake explained that certain of Delta's inherent business operations increase the Company's operating risk, thus indicating the need for a higher return on equity than less risky utilities, in order to ensure Delta has sufficient access to capital markets. The components of Delta's operations that increase its risks include its primarily rural service territory, high percentage of residential customers, small size and relatively highly leveraged capital structure.[156] Pursuant to the parameters established by the United States Supreme Court in *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*[157] and *Federal Power Commission v. Hope Natural Gas Company*,[158] Delta must be allowed to earn a rate of return that is comparable to alternative investment opportunities of corresponding risk, while attracting capital on reasonable terms.

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[154] Direct Testimony of Dr. Martin J. Blake of April 23, 2010 (Case No. 2010-00116) ("Blake Direct") at 29-30.
[155] *Id.* at 30.
[156] *Id.* at 5-7.
[157] 262 U.S. 679 (1923).
[158] 320 U.S. 591 (1944).

In order to ascertain the return on equity commensurate with investment opportunities of comparable risk, Dr. Blake performed several analyses that are designed to replicate the market process of determining the return on common equity an investor will require. Dr. Blake began by conducting two DCF analyses. Under the DCF methodology, the appropriate return on equity is defined as the discount rate that "equates the current stock price with the stream of expected future dividends."[159] In conducting his DCF analyses, Dr. Blake utilized the *Value Line Investment Survey – Small and Mid-Cap Edition,* March 12, 2010, to determine the high and low stock prices, as well as the most recent annual dividends.[160]

Because the *Value Line Investment Survey* does not provide a forecasted dividend growth rate for companies such as Delta in the small-cap and mid-cap edition, Dr. Blake developed two growth rates for his DCF calculation.[161] The first growth rate Dr. Blake employed was the five-year historical average dividend growth rate for the group of natural gas distribution utilities contained in Exhibit MJB-9.[162] The second growth rate Dr. Blake developed was the average of the forecasted dividend growth rates from 2013 to 2015 for the eight large companies in the *Value Line Investment Survey* that were covered by Edward Jones, as delineated at Exhibit MJB-15.[163]

Dr. Blake then determined the estimated returns on equity utilizing the high and low stock prices multiplied by the market capitalization to obtain the actual amount that shareholders expect to receive annually from their investment.[164] As demonstrated in Exhibit MJB-14, these calculations resulted in returns on equity ranging from 12.08% to 15.08% using the five-year

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[159] Blake Direct at 20.
[160] *Id.* at 22.
[161] *Id.*
[162] *Id.* at 22-23.
[163] *Id.* at 23.
[164] *Id.* at 24.

average dividend growth rate and from 11.28% to 13.79% using the forecasted average dividend growth rate.[165]

Dr. Blake also performed a CAPM analysis to determine the appropriate return on equity for Delta. The CAPM is an equilibrium model of the securities markets in which the expected or required return on a certain security is equal to the risk-free rate of interest, plus the company's equity "beta," multiplied by the market risk premium. The *Value Line Investment Survey –Small and Mid-Cap Edition* of March 12, 2010, estimated Delta's beta coefficient to be 0.65.[166] Dr. Blake utilized the twenty-year United States Treasury bond interest rate as of February 1, 2010, which was 4.48%, as the risk-free rate.[167] The long-horizon expected risk premium for large companies is 6.70%.[168] Dr. Blake testified that Ibbotson's *2010 Valuation Yearbook* recognizes the use of a size premium for small companies, which was calculated to be 4.91%.[169] This percentage represents the calculated difference between the total returns from large company stock minus long-term government bond returns as measured from 1926 through 2009.[170] Using these variables, Dr. Blake's CAPM analysis resulted in an estimated return on equity of 13.745%.[171]

Dr. Blake also conducted a risk premium analysis, which is based on the premise that investors expect to earn a return on equity that reflects a premium above the return the investor expects to earn on an investment portfolio of no-risk long-term bonds. Dr. Blake utilized the ex-post risk premium analysis, utilizing Ibbotson's *2010 Valuation Yearbook* riskless rate of 9.69%

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[165] *Id.* at 29.
[166] *Id.* at 27.
[167] *Id.*; Exhibit MJB-17.
[168] Exhibit MJB-18.
[169] Blake Direct at 27.
[170] *Id.*
[171] *Id.*

and the twenty-year United States Treasury bonds interest rate as of February 1, 2010, which was 4.48%, for his calculation.[172] This analysis produced a return on equity of 14.17%.[173]

Finally, Dr. Blake looked at other entities with corresponding business risk, consistent with the parameters of *Bluefield* and *Hope*.[174] Using the beta coefficient as an objective measure of a stock's risk, Dr. Blake obtained all *Value Line* companies with beta values of 0.65, which is Delta's current beta.[175] Dr. Blake found there were 201 companies with a beta of 0.65.[176] In 2009, when the country was in the midst of a recession, the average return on common equity for these 201 companies was 12.0%.[177] This result should be considered of significant merit, as it is the method most closely conforming to the Supreme Court's belief that utilities should be allowed to earn a return that is commensurate with entities of corresponding risk.

At hearing, Commission Staff introduced a *Value Line* document containing observations and projections for natural gas utilities in 2010 and 2011.[178] The document states that the average allowed return on shareholder equity for 2010 for natural gas utilities is 10.5% and is expected to be 10.0% in 2011.[179] Commission Staff then inquired as to why Dr. Blake had failed to provide the document, as he had relied upon similar documents in prior Delta rate cases.[180] Dr. Blake explained that the document presented composite information for all natural gas utilities, and Delta's operations and financial profile vary significantly from the average natural gas utility so as to render a comparison meaningless.[181] The differences include Delta's small

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[172] *Id.* at 28.
[173] *Id.*
[174] *Id.*
[175] *Id.* at 28-29.
[176] *Id.* at 29.
[177] *Id.*
[178] VR: 9/1/10; 10:19:15-10:20:06.
[179] *See* Staff's Hearing Exhibit 1.
[180] VR: 9/1/10; 10:20:38-10:21:09.
[181] VR: 9/1/10; 10:21:22-10:21:49.

size, substantially rural service territory, and low amount of equity. Dr. Blake rejected the averages referenced in the Staff's questions as appropriate returns for Delta.[182]

The Company's small size and capitalization classifies Delta as a member of the second subdivision of the smallest micro-cap stock decile range as defined in the Ibbotson *SBBI 2010 Valuation Yearbook.*[183] This report observed a strong correlation between the required return on equity and firm size; specifically, that investors required a greater return as the firm size decreased.[184] This report provides strong and credible evidence supporting Delta's award of a return on equity commensurate with its size and not simply an award identical to other natural gas utilities in Kentucky, as the other four major investor-owned natural gas companies are part of corporations that are over thirty times larger than Delta.

Delta operates in eastern Kentucky, which is an area that is primarily rural with low population density, resulting in higher fixed costs per customer than in urban areas.[185] The financial challenge associated with higher costs is exacerbated by low customer usage and a greater proportion of temperature sensitive load.[186] The consequent variable revenue stream and high fixed costs negatively impact Delta's return on equity and further justifies the Company's need for a return on equity higher than the average in the *Value Line* report referenced in the Staff's questions.

Delta's equity percentage is substantially lower than the natural gas companies contained in Edward Jones' *Natural Gas Industry Summary Monthly Financial & Common Stock Information*. Specifically, Delta's equity is 5.2% below the mean of those companies and 4.2%

[182] VR: 9/1/10; 10:21:18-10:21:49.
[183] Blake Direct at 17.
[184] *Id.* at 18.
[185] *Id.* at 16.
[186] *Id.* at 17.

the median for the panel.[187] These values demonstrate that Delta is more heavily leveraged than other natural gas distribution utilities of similar size.[188] When a company is highly leveraged, investors are acutely aware that the company will have required and fixed bond payments, while the firm will have no similar obligation to its common equity holders.[189] When the company's revenue fluctuates, common equity holders will be immediately impacted.[190] A company as highly leveraged as Delta has less flexibility to respond to these fluctuations, due to its high proportion of obligated debt payments.[191]

Based upon the analyses Dr. Blake performed, he has recommended the Commission approve a return on equity of 12.0%, which is well-within the range of results from his cost of equity estimates of 11.28% and 15.08%. As Dr. Blake's recommendation is supported by the credible methodologies he has employed and no contradictory evidence is in the record, Delta submits that the Commission should approve Dr. Blake's recommended return on equity.

VII. COST OF SERVICE, REVENUE ALLOCATION AND RATE DESIGN

Delta had performed a fully allocated, embedded cost of service study based upon Delta's per-books accounting costs and adjustments for known and measurable changes to operating results for the twelve months ended December 31, 2009.[192] The study was performed in accordance with the methodology accepted by the Commission in prior rate case proceedings.[193] The purpose of the cost of service study is to determine for each customer class the rate of return on rate base Delta is earning, which indicates whether Delta's rates reflect the actual cost of

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[187] *Id.* at 12-13.
[188] *Id.* at 13.
[189] *Id.*
[190] *Id.*
[191] *Id.*
[192] *Id.* at 17.
[193] *Id.*

providing service to each customer class.[194] Delta's proposed rates more closely match the unit costs per customer class indicated by the cost of service study performed for this case.[195]

Mr. Seelye analyzed the customer-related costs for each class by calculating the customer-related cost of service and dividing this amount by the number of customers.[196] The Company's cost of service includes the following components: return on investment; income taxes; operation and maintenance expenses; depreciation expenses; and other taxes.[197] Delta's proposed overall rate of return of 8.66% was employed to calculate the unit cost.[198] Mr. Seelye utilized the zero-intercept methodology, which has been accepted by the Commission in many prior cases.[199]

Mr. Seelye primarily summarized his results into two categories: the actual adjusted rate of return per customer class and the proposed rate of return per customer class.[200] The actual adjusted rate of return was calculated by dividing the adjusted net operating income by the adjusted net cost rate base for each customer class.[201] The proposed rate of return was calculated by dividing the net operating income adjusted for the proposed rate increase by the adjusted net cost rate base.[202]

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194 *Id.*
195 *Id.* at 15.
196 *Id.*
197 *Id.*
198 *Id.*
199 *In the Matter of: Application of Delta Natural Gas Company, Inc. for an Adjustment of Rates* (Case No. 2004-00067); *In the Matter of: An Adjustment of the Gas Rates of the Louisville Gas and Electric Company* (Case No. 2000-080); *In the Matter of: Adjustment of Gas and Electric Rates of Louisville Gas and Electric Company* (Case No. 90-158); *In the Matter of: Adjustment of Gas and Electric Rates of Louisville Gas and Electric Company* (Case No. 2003-00433); *In the Matter of: Application of Louisville Gas and Electric Company for An Adjustment of Its Electric and Gas Base Rates* (Case No, 2008-00252); *In the Matter of: Application of Louisville Gas and Electric Company for An Adjustment of Its Electric and Gas Base Rates* (Case No. 2009-00549); *In the Matter of: Adjustment of Gas Rates of the Union, Light, Heat and Power Company* (Case No. 2001-00092).
200 Seelye Direct at 26.
201 *Id.*
202 *Id.*

From these results, the most significant area of concern was the actual rate of return for the residential class, as it is only 3.44%, well below Delta's overall adjusted rate of return of 4.79%.[203] Delta has addressed the existing 135 basis point difference in its proposed rates, which brings the residential class within 47 basis points of the proposed overall rate of return.[204] As Delta is currently under-earning from its residential customers, Delta has proposed to allocate 67% of its proposed base rate increase to the residential class.[205] This allocation is supported by the current under-earning from this class, as well as Delta's large proportion of residential customers.[206]

Delta has proposed to collect the increased revenues in large part by increasing the residential customer charge.[207] Traditionally, Delta's residential rate design has consisted of a customer charge and volumetric charge, under which a portion of Delta's non-gas costs are collected through a monthly fixed customer charge that does not vary with usage.[208] The other costs are collected through a volumetric charge applied to each unit of natural gas the customer uses.[209] Gas costs are recovered through a volumetric charge known as the GCR.[210]

Delta's proposed rate design, which increases the portion of non-gas costs that are recovered through a fixed monthly customer charge, furthers Delta's move toward a "Straight Fixed Variable" rate design.[211] In a true Straight Fixed Variable rate design, all non-gas costs are recovered through a fixed monthly customer charge.[212] The theory that led to development of this design is that because non-gas costs are fixed for the gas distributor regardless of the amount

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[203] *Id.*
[204] *Id.*
[205] *Id.* at 1.
[206] *Id.*
[207] *Id.*
[208] *Id.* at 4.
[209] *Id.*
[210] *Id.*
[211] *Id.*
[212] *Id.*

of gas consumed by the customer, all non-gas costs should also be fixed.[213] The effect of this design is to eliminate the correlation between a natural gas utility's delivery revenue and its gas sales.[214] Many benefits inure to a utility's customers through the Straight Fixed Variable rate design. These benefits include removal of all incentives for a utility to encourage heightened use by customers; sending appropriate price signals to customers; and removal of the subsidy that low income customers, who typically consume more gas than the average customer, are providing to other residential customers.

This latter benefit was clearly elucidated at the hearing by Mr. Seelye, who estimated the current amount that low income customers subsidize other residential customers each year.[215] In a data response filed after the hearing, Mr. Seelye further explained the reason for the subsidy and how the proposed customer charge significantly remedies the situation.[216] On average, a low income customer, who is defined as a customer participating in the Low Income Home Energy Assistance Program, uses 8.21 Mcf of gas per month, which is 3.72 Mcf greater than the average use of a residential customer at 4.49 Mcf.[217] If the customer charge does not change, the annual subsidy paid by the average low income customer is $123.48.[218] This is attributable to the average low income customer paying a higher proportionate share of fixed costs recovered through the volumetric charge due to increased usage. If the customer charge is increased as proposed, the annual subsidy significantly declines to $36.48.[219] Importantly, although low income customers will see an increase in their customer charge, the corresponding decrease in

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[213] *Id.*
[214] *Id.*
[215] VR: 8/31/10; 14:23:17-14:29:01.
[216] Delta's Response to Hearing Data Request 10, Filed September 14, 2010.
[217] *Id.*
[218] *Id.*
[219] *Id.*

the volumetric charge will more than offset the increase in the customer charge.[220] In fact, annual customer billing under the proposed rates, excluding gas costs, will decrease *ceteris paribus* by $86.50 each year for low income customers if Delta's proposed revenue increase is recovered through the customer charge than if through the volumetric charge.[221] This demonstrates that the proposed increase in the residential customer charge benefits low income customers by substantially reducing the inequitable subsidy currently provided to other residential customers.

Delta is not proposing adoption of a Straight Fixed Variable rate design in this proceeding, although the Company is continuing the move towards such a rate design that began in its last rate case.[222] Adoption of a Straight Fixed Variable rate design would result in a residential customer charge of $43.77 per month, compared to the current customer charge of $15.30.[223] Delta is proposing to further effectuate the trend toward a Straight Fixed Variable rate design by maintaining the volumetric charge close to its current level, while recovering nearly all of its proposed residential revenue increase through its customer charge.[224] Mr. Seelye's cost of service study demonstrates that Delta's monthly customer cost for each residential customer is currently $27.72, which is significantly higher than the Company's current customer charge of $15.30.[225] Delta has proposed a residential customer charge of $24.00, which significantly reconciles the discrepancy, as the proposed customer charge represents 87% of the customer-related costs Mr. Seelye identified in his study.[226] In addition to the $24.00 proposed customer charge, Delta has proposed a flat commodity charge of $0.43344 for all Ccf.[227]

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[220] *Id.*
[221] *Id.*
[222] Seelye Direct at 8.
[223] *Id.* at 9.
[224] *Id.* at 8.
[225] *Id.* at 9.
[226] *Id.*

For its small non-residential rate class, Delta is proposing a customer charge of $35.00 per customer per month, an increase from $25.00 per month.[228] A flat commodity charge of $0.43344 is proposed.[229] For the large non-residential rate class, Delta is proposing a customer charge of $150.00 per customer per month.[230] The proposed commodity charge is $0.43344 for the first 2,000 Ccf, $0.26855 for the next 8,000 Ccf, $0.18894 for the next 40,000 Ccf, $0.14894 for the next 50,000 Ccf, and $0.12984 for all usage over 100,000 Ccf.[231]

The Company has proposed relatively small increases for its unmetered light schedules.[232] Further, Delta has proposed the same increase in net margins for its on-system transportation rates as for the underlying sales rates, resulting in a 6.3% increase over current rates.[233] The final proposed rate change is to increase the off-system transportation rate from $0.27 to $0.29 per Mcf of gas transported or $0.29 per dekatherm.[234] Delta has not proposed to modify its interruptible schedules.[235]

VIII. TARIFF CHANGES

A. <u>Pipe Replacement Program</u>

Delta has proposed a new Pipe Replacement Program tariff ("PRP") to permit the Company to recover the cost of replacing all of the existing bare steel within Delta's system in a timelier manner.[236] The program would encompass the planning, design, replacement construction, investment and retirement costs.[237] Further, the proposed PRP would also include

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[227] *Id.* at 15.
[228] *Id.* at 16.
[229] *Id.*
[230] *Id.*
[231] *Id.*
[232] *Id.*
[233] *Id.*
[234] *Id.* at 17.
[235] *Id.* at 16.
[236] Brown Direct at 8.
[237] *Id.* at 10.

the replacement and/or retirement of service lines, curb valves, meter loops, and any mandated relocations.[238] Delta anticipates that the cost of the PRP would vary depending on the size and location of the replacements completed in that year.[239]

A confluence of factors have led to the need for the PRP; namely the accelerated corrosion rates, the incremental expense to the Company without incremental revenues, along with the continuing obligation of providing safe service.[240] While Delta's system is safe, due to aging bare steel and continuous corrosion, public safety will be enhanced by a PRP mechanism that facilitates a systematic and accelerated replacement program.[241] At the present time, the Company's only method to recover the expenses incurred in replacing the pipe is through traditional rate case proceedings such as this one, which are costly and result in regulatory lag.[242] The annual PRP filing Delta has proposed would reduce legal and other expenses inherent in rate cases, while preserving the Commission's rigorous review.[243]

Delta has proposed to apply the rate adjustment proportionately to the monthly customer charge for residential, small non-residential, large non-residential, interruptible and on-system transportation customers as proposed in this case.[244] As explained in its response to Staff 3-4, while Delta has proposed to apply the adjustment proportionate to the monthly customer charge, the Company is also amenable to allocating the adjustment based upon each customer class' proportion of base rate revenue contribution at Delta's proposed rates. Delta has recommended submitting its annual adjustment on or about March 1 of each year, to be effective for meter

[238] *Id.* at 8.
[239] *Id.*
[240] *Id.* Excluding excavation damage, Delta estimates that 69% of all leaks repaired on its system in 2009 were caused by corrosion.
[241] *Id.* at 12.
[242] *Id.* at 8.
[243] *Id.* at 10.
[244] *Id.* at 15.

readings on or after its May billing cycle of that year.[245] The Company has proposed to make its first PRP filing on March 1, 2011, covering expenses incurred since the end of the test year in this proceeding.

The PRP is within the Commission's authority to approve, as pursuant to KRS 278.509, the "...commission may allow recovery of costs for investment in natural gas pipeline replacement programs which are not recovered in the existing rates of a regulated utility."[246] The Commission has recently exercised this authority, approving similar programs for Columbia Gas of Kentucky, Inc. and Atmos Energy Corporation.[247]

B. <u>Uncollectible Gas Cost</u>

Delta has proposed to recover its uncollectible gas cost through its GCR. The Company's GCR is intended to provide recovery of one hundred percent of Delta's costs incurred in procuring gas for its customers.[248] Quite simply, the Company fails to recoup all of its costs when customers do not pay their bills.[249] Historically the Company has recovered the gas cost component of uncollectible accounts in base rates.[250] This method has proven inadequate due to volatile fluctuations in gas costs.[251]

Delta has proposed to modify its GCR to allow the expected gas cost component to include an estimate of uncollectible gas costs, which will become a quarterly line item on Schedule II of the GCR filing.[252] At the end of each month, when the appropriate balance for Delta's reserve for bad debts is determined, the Company will calculate the percentage of gas

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[245] *Id.* at 16.
[246] *Id.* at 13.
[247] *In the Matter of: Application of Columbia Gas of Kentucky, Inc. for an Adjustment in Rates* (Case No. 2009-00141) Order, October 26, 2009; *In the Matter of: Application of Atmos Energy Corporation for an Adjustment of Rates* (Case No. 2010-00354) Order, May 28, 2010.
[248] Brown Direct at 16.
[249] *Id.*
[250] *Id.*
[251] *Id.*
[252] *Id.* at 17.

costs booked to total revenue billed in the month and apply that percentage to the total portion needed to adjust the reserve for the uncollectible amounts.[253] The uncollectible base rate portion will be charged to uncollectible expense as it always has, while the uncollectible gas cost portion will be charged to the unrecovered gas cost account on the balance sheet.[254] The uncollectible gas cost portion will be relieved from that account as the expected gas cost is billed through the GCR.[255]

Permitting the Company to recover this expense through the GCR is beneficial to customers, as there will be substantially less risk to customers that the level of the expense set in base rates is either too high or too low in future periods.[256] In order to ensure that the Company is not discouraged from aggressively pursuing collection of past-due amounts, the Company has proposed to continue to include $145,581 in base rates related to uncollectible accounts. If collection efforts became lax and more write-offs occur, the Company would be exposed to incremental margin losses above those included in base rates.[257]

The Commission has recently been receptive to a similar mechanism for other gas utilities, as analogous programs were recently approved for Columbia Gas of Kentucky, Inc. and Atmos Energy Corporation.[258]

C. Gas Storage Losses

Delta's recent gas storage loss alerted the Company to its current inability to efficiently recover gas storage losses. The Company has proposed to modify its GCR to permit Delta to

[253] *Id.* at 17-18.
[254] *Id.* at 18.
[255] *Id.*
[256] *Id.* at 17.
[257] *Id.*
[258] *In the Matter of: Application of Columbia Gas of Kentucky, Inc. for an Adjustment in Rates* (Case No. 2009-00141) Order, October 26, 2009; *In the Matter of: Application of Atmos Energy Corporation for an Adjustment of Rates* (Case No. 2010-00354) Order, May 28, 2010.

include the recovery of similar losses.[259] The GCR currently permits recovery of comparable storage inventory adjustments, rendering the mechanism the most efficient way to address losses such as the one that recently occurred.[260]

While the Company seeks to recover the $867,900 loss at issue in this proceeding through establishment of a regulatory asset, Delta believes the prudent approach for any future losses is through the GCR, which is beneficial to customers and the Company. As explained with regard to the current loss, because gas storage losses have been infrequent, including the total loss as an ongoing expense during rate case proceedings unfairly "locks in" a level of gas storage loss that is atypical. Further, the Company's proposed method of recovery for the loss at issue in this proceeding, which is through a regulatory asset, delays Delta's recovery of the loss over an extended period. The GCR would permit the Company to recover the loss on a near-real-time basis.[261]

At hearing, the AG inquired as to the effect on customers' bills if a comparable gas loss occurs and is recovered through the GCR.[262] Following the hearing, the Company provided a calculation demonstrating that if a hypothetical $1 million storage loss occurs and is passed through the GCR, the impact on an average residential customer would be $1.36 each month for twelve months.[263] This calculation demonstrates that recovery through the GCR allows the Company to recover its loss in a timely manner, while minimizing the monthly impact on its customers.

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[259] Delta's Response to Staff 3-15(d).
[260] *Id.*
[261] *Id.*
[262] VR: 8/31/10; 11:49:23-11:50:50.
[263] Delta's Response to Hearing Data Request 6, Filed September 14, 2010.

CONCLUSION

Based upon the record of evidence in this proceeding, which remains uncontroverted, Delta respectfully submits that the Commission should approve fair, just and reasonable rates for Delta that will produce an increase in revenues of $5,357,875 on an annual basis. Further, the Commission should also approve Delta's proposed depreciation rates, along with its recommended changes to its tariffs.

Respectfully submitted,

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CERTIFICATE OF SERVICE

This is to certify that the foregoing pleading has been served via U.S. mail, postage prepaid, on this 8th day of October 2010 to the following persons:

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