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September 9, 2016

PARTIES OF RECORD

Re: Case No. 2016-00163

Attached is a copy of a memorandum which is being filed in the record of the above-referenced case. If you have any comments you would like to make regarding the contents of the memorandum please do so within five days of receipt of this letter.

If you have any questions, please contact Jennifer Fell, Commission Staff Attorney, at 502-782-2585.

Sincerely,

Aaron D. Greenwell for

Talina R. Mathews
Executive Director

JLF/ph

Attachment

INTRA-AGENCY MEMORANDUM

KENTUCKY PUBLIC SERVICE COMMISSION

TO: Case File No. 2016-00163

FROM: Jack Scott Lawless, Team Leader
Jennifer Fell
John Park
Eddie Beavers

DATE: September 9, 2016

RE: Informal Conference of September 1, 2016

Pursuant to Commission Staff's August 26, 2016 notice, an informal telephonic conference ("IC") was held in this matter on September 1, 2016. A list of attendees is attached hereto. The purpose of the IC was to discuss Marion County Water District's ("Marion District") comments to certain findings made in Commission Staff's Report dated August 11, 2016. In its comments, Marion District disputed Staff's proposal to depreciate transmission and distribution mains over 62.5 years. Marion District also disputed Staff's accounting and ratemaking treatment of pension costs that Marion District reported pursuant to Governmental Accounting Standards Board ("GASB") Statement No. 68 ("GASB 68"). Marion District has not requested that a hearing be held in this matter.

Depreciation

During the test year, Marion District depreciated water main that was installed during the years 1970, through 2007, using a 50-year depreciable life. It deprecated main that was installed from 2008, through 2015, using a 40-year life. In its report, Staff adjusted the depreciable life assigned to all main to 62.5 years, the midpoint of the 50 to 75 year life range for mains found appropriate by the National Association of Regulatory Utility Commissioners ("NARUC") in its 1979 publication entitled Deprecation Practices for Small Water Utilities ("NARUC Study").

In its comments to Staff's report, Marion District questioned the reasonableness of Staff's application of the NARUC Study noting that it is much larger than the water utilities for which the study was designed. Marion District noted that the study was designed to assist in the development of the depreciation practices of small utilities that have less than: 1) 200 customers; 2) $50,000 in annual revenue; and 3) $1,000,000 in plant investment.

At the IC, Staff explained that, the NARUC Study clearly states that the average service lives of a small water utility would be similar to those of an average water utility if the small utility uses the same construction techniques and has similar equipment, maintenance standards, and accounting practices as the average utility. Staff further explained that since the depreciable lives in the NARUC Study are similar to those of an average utility, the Commission has historically relied on the NARUC Study to develop the depreciation rates of all regulated water districts and water associations without regard to the number of customers they serve or the amount of their annual revenues and plant investment. Staff noted that the Commission used the NARUC Study as the basis for the depreciable lives authorized for Northern Kentucky Water District, the state's largest regulated water district serving over 100,000 customers and reporting over $50 million for annual revenues and over $468 million for utility plant.

After Staff's explanation, Marion District stated at the IC that its primary objection to the NARUC Study is that the study was performed in 1979, and could not have adequately taken into account the effects of mains constructed of polyvinyl chloride ("PVC"), which Marion District asserted became prevalent in the mid 1970's. Marion District stated that PVC has been used to complete many of its water main extension projects and represents a significant portion of the main in its distribution system.

Staff explained that, although significant time has elapsed since the issuance of the NARUC Study, the results of the NARUC Study represents a conservative estimate of the anticipated useful lives of Marion District's assets when compared to the results of the formal depreciation studies that have been approved by the Commission for Kentucky American Water Company ("KAWC"), the only water utility that has filed a formal deprecation study with the Commission. Staff noted that, in KAWC's most recent depreciation study approved by the Commission in Case No. 2015-00418,[1] the average service life assigned to mains was 85 years, significantly longer than the 62.5 years used by Staff in this proceeding. Staff noted that KAWC's mains are constructed of iron, PVC, galvanized steel, and concrete[2] and that KAWC supported the 85-year life, in part, by stating that the 85-year life is "within the typical service life range of 75 to 100 years for water mains"[3] of all types.

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[1] Case No. 2016-00163, *Application of Kentucky-American Water Company for an Adjustment of Rates* (Ky. PSC Aug. 23, 2016).

[2] Case No. 2015-00418, *Application of Kentucky-American Water Company for an Adjustment of Rates* Application, Exhibit 10, Volume 1 of 2, Direct Testimony of Brent E. O'Neill, P.E., Exhibit BEO-1 at A-3.

[3] *Id.* Volume 2 of 2, Direct Testimony of John J. Spanos, Exhibit JJS-1 at III4.

In response to Staff's report, Marion District supported the 50-year life it assigned to main by comparing its operations to those of South Water and Sewer District ("Southern District"). Marion District noted that the Commission, in Case No. 2009-00309,[4] allowed Southern District to depreciate mains over 50 years and that, since Marion District's operating characteristics are similar to those of Southern District, it should also be allowed a 50-year life. Staff explained that, while some of Marion District's operating characteristics may be similar to those of Southern District, Marion District has not provided evidence demonstrating that its mains have suffered the same level of decay as those of Southern District. Staff further explained that without this evidence, a 50-year life appears to be unreasonable. Marion District countered by arguing that some of the PVC main it installed during the 1970's has become extremely brittle and, as a result, a five mile section of this main was replaced in 2014 after being in service for only 40 years. Staff explained that the 62.5 year life represents the average life of all main and that not all main is expected to be in service for 62.5 years. Some main will experience a shorter life while others will experience a longer life.

In its response to Staff's report, Marion District argued that the Commission has previously approved the 50-year depreciable life for its mains and that this life should not be changed in this proceeding. At the IC, Marion District stated that it was referring to the Commission's Order in Case No. 7901.[5] Staff explained that the Commission is not bound by the Order in Case No. 7901 and that the Commission may adjust depreciable lives that were previously approved by the Commission when there is evidence to support an adjustment to those lives.

After the IC, Staff reviewed the Commission's file for Case No. 7901. Staff found that, while Marion District did not submit a depreciation schedule or plant ledger in Case No. 7901 to show the depreciable lives that had been assigned to Marion District's assets, Charles M. White, CPA, testified that "the majority of lines are on a 2% depreciation" but that he did not develop the depreciation rates, he "inherited them."[6] The Commission did not adjust this rate in its final Order; effectively allowing Marion District to depreciate mains using a 50-year life.[7] There is no evidence in the record of

[4] Case No. 2009-00309, *Application of Southern Water and Sewer District for an Adjustment in Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC Sept. 5, 2012).

[5] Case No. 7901,*General Adjustment of Rates of Marion County Water District, Effective July 21, 1980* (Ky. PSC Nov. 21, 1980).

[6] Case No. 7091, Oct. 28, 1980 Hearing Transcript at 28 - 29.

[7] A 2 percent depreciation rate that does not include salvage represents a 50-year depreciable life (1 / .02 = 50).

Case No. 7901 documenting the method used by Marion District to select the 50-year life or the methods used by the Commission to determine its reasonableness.

In its response to Staff's report, Marion District supported the 40-year life assigned by it to some main by explaining that this life resulted in a write-off of $249,500 in additional depreciation, an amount that is significantly less than the $550,087 undepreciated cost of the 4,800 mechanical meters that Marion District has removed from service but has not written off of its plant ledger and recorded as a loss. The cost of these meters remains on Marion District's plant ledger and were depreciated during the test year using a 50-year life. Marion District stated that the "collective impact" of its decisions to switch from a 50-year life to a 40-year life for mains installed after 2007 and to not write off the retired meters represents a "net conservative approach to depreciation expense for the District."

At the IC, Staff explained that the depreciation of mains should be independent of the accounting treatment applied to the undepreciated cost of the retired mechanical meters. Staff further explained that Marion District should not "write-off" as a loss the undepreciated cost of the retired meters. Staff stated that Marion District may charge the undepreciated cost to Accumulated Depreciation following the accounting requirements of the Uniform Systems of Accounts.[8] This method of accounting would increase Marion District's depreciable basis in the new replacement meters by the amount of the undepreciated cost of the retired meters. Staff explained that in lieu of this method, Marion District may continue to report the cost of the retired meters on its plant ledger and depreciate them in future reporting periods as was done by Marion District during the test year.

At the IC, Staff also explained that Marion District overstated, by a material amount, the undepreciated cost of the retired mechanical meters in its response to Staff's report. The $550,087 referenced by Marion District includes the cost of the mechanical meters as well as the cost to install those meters. Staff did not attempt to separate the meters' actual cost from their installation cost using Marion District's property records; however, based on information provided by Marion District in Case

[8] USoA for Class A/B Water Districts and Associations at 42, 108.1, B.

No. 2003-00274,[9] Staff estimates that the amount of the meters' cost that is included in the $550,087 referenced by Marion District is approximately $41,475. If Marion District decides to remove the cost of the retired mechanical meters from its plant ledger, it should remove only the cost of the meters. The cost of the meter installations should not be removed because they remain in service as part of the new replacement meters.

Pension Costs

During the test year, Marion District paid $48,953 to the County Employee Retirement System. Marion District's implementation of GASB 68 using the CERS actuarial valuation for the fiscal year ended June 30, 2014 resulted in Marion District reporting the following:

	Contributions	Decrease for GASB 68 Implementation	Account Balance at Test Year End
Test-Year Pension Expense	$ 48,953	$ (16,339)	$ 32,614
Reduction to Beginning Balance of Retained Earnings			(366,435)
Net Pension Liability			376,000
Deferred Outflows			67,904
Deferred Inflows			42,000

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[9] Case No. 2003-00274, *Application of Marion County Water District to Increase Certain Non-Recurring Charges* (Ky. PSC July 31, 2003). The cost information shown below was taken from the Average Meter Connection Expense Cost Justification sheet that was provided to the Commission as part of Marion District's application.

Cost of a 5/8-3/4-Inch Meter	$ 37.80
Divide by: Average Cost of a Meter and Meter Installation	501.34
Percent of Meter Cost to Total Cost	7.5398%
Times: Total Cost Reported by Marion District	550,087
Estimated Cost of Meters Reported by Marion District	$ 41,475

In its Application, Marion District requested to increase the $32,614 test-year pension expense by $126,250 in order to recover $158,864 in total pension expense. The amount requested for recovery was based loosely on the CERS actuarial valuation for the fiscal year ended June 30, 2015.

In its report, Staff found that Marion District's implementation of GASB 68 using the June 30, 2014 CERS actuarial valuation for the reporting period ended December 31, 2015 violated the provision of GASB 68. Staff found that GASB 68 requires the use of the June 30, 2015 CERS actuarial valuation for implementation during the test year, which would result in Marion District reporting the following:

	Contributions	Increase for GASB 68 Implementation	Account Balance at Test Year End
Test-Year Pension Expense	$ 48,953	$ 85,964	$ 134,917
Reduction to Beginning Balance of Retained Earnings			(358,052)
Net Pension Liability			510,592
Deferred Outflows			66,576
Deferred Inflows			-

Staff further found in its report that Marion District should: 1) be allowed rate recovery of its test-year CERS contributions; 2) reclassify as a regulatory asset the initial charge to retained earnings that was recorded to implement GASB 68; and 3) in future reporting periods, record as a regulatory asset the difference between the amount of pension expense calculated pursuant to GASB 68 and the amount of the Marion District's annual contributions to CERS. In its report, Staff explained that, as a result of this accounting and ratemaking treatment, the balance of Marion District's regulatory asset would mirror the balance of its net pension liability. When the CERS pension liability becomes fully funded, the balance of Marion District's net pension liability and regulatory asset will be zero and Marion District will have recovered through rates the contributions it made to CERS to fund the pension liability.

In its response to Staff's report, Marion District asserted that its use of the June 30, 2014 CERS actuarial valuation to implement GASB 68 was proper and that Staff's suggested accounting treatment ignores GASB 68 completely and is not appropriate.

At the conference, Staff explained that its proposal does not ignore GASB 68. Staff stated that its proposed accounting treatment recognizes Marion District's net pension liability and is permitted by GASB 62. After that explanation, Marion District seemingly acquiesced to Staff's findings, agreeing that GASB 68 "would work itself out."

Finding that no party had any further questions, the conference was adjourned.

Attachment

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ALTERNATIVE RATE ADJUSTMENT FILING OF MARION COUNTY WATER DISTRICT	))	CASE NO. 2016-00163

SIGN IN

September 1, 2016

PERSON	REPRESENTING
Jimmy Mudd	Marion County Water District
Charlie White	White + Company, CPA
Holly Nicholas	Kentucky Eng. Group, PLLC
Jennifer Fell	PSC Legal
John Park	PSC Legal
Scott Lawless	PSC Financial Analysis
Eddie Beavers	PSC FA

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