

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ELECTRONIC PROPOSED ADJUSTMENT OF)	
THE WHOLESALE WATER SERVICE RATES)	CASE NO.
OF LEBANON WATER WORKS)	2017-00417

ORDER

Lebanon Water Works (Lebanon Water) proposes to increase the wholesale water rates it charges to Marion County Water District (Marion District). Lebanon Water's proposal is to increase its monthly meter charge from \$6.75 to \$7.35, or 8.89 percent and to increase the volumetric rate from \$2.50 per 100 cubic feet to \$3.35 per 100 cubic feet, or 34.00 percent. Lebanon Water further proposes to assess a monthly surcharge to Marion District over 36 months to recover any rate case expenses it incurs participating in and defending its proposed rates in this current proceeding.¹ The Commission has jurisdiction over Lebanon Water's rates for wholesale water service to Marion District pursuant to KRS 278.200 and the Supreme Court's decision in *Simpson County Water District v. City of Franklin*, 872 S.W.2d 460, 463 (Ky. 1994), where the Court specifically stated that "where contracts have been executed between a utility and a city . . . KRS 278.200 is applicable and requires that by so contracting the City relinquishes the exemption and is rendered subject to the PSC rates and service regulation."² Following

¹ TFS 2017-00512, *Lebanon Water Works Proposed Water Rate Increase* (filed Sept.13, 2017).

² *Simpson County Water District v. City of Franklin*, 872 S.W.2d 460, 463 (Ky. 1994).

the Court's decision in *Simpson County*, the Commission has allowed city-owned utilities to file rate adjustments by a tariff filing, and if a hearing is requested and the Commission suspends the proposed rate, the requirements, and procedures set forth in KRS Chapter 278, and the Commission's regulations apply equally to filings by a city-owned utility or a jurisdictional utility.³ Therefore, the parties in this case present two issues to the Commission. The first issue is whether Lebanon Water's proposed rate increase is fair, just, and reasonable based upon the evidentiary record and the second issue is whether Lebanon Water's rate case expense and the proposed 36-month surcharge to recover that expense is fair, just, and reasonable based upon the evidentiary record.

BACKGROUND

Lebanon Water is a nonprofit corporation created by an act of the Kentucky General Assembly in 1884 and its sole shareholder is the city of Lebanon. Lebanon Water owns and operates raw water storage, water treatment, finished water storage, transmission, and distribution facilities that provide retail water service to 2,644 customers located in and near Lebanon, Kentucky. It also provides wholesale water service to Marion District.⁴

Marion District is a water district organized pursuant to KRS Chapter 74 that owns and operates a water distribution system through which it provides water service to

³ *Id.*; *City of Danville v. Public Service Comm'n, et al.*, Civil Action No. 15-CI-00989, *Opinion and Order* (Franklin Circuit Court Division II, June 14, 2016).

⁴ Testimony of Daren Thompson, at 2–3 (94 pp), Memorandum in Support of Motion to Assign Burden of Proof (19 pp.) (filed January 31, 2018).

approximately 5,971 retail customers in Marion County and Nelson County, Kentucky.⁵ Marion District's last general rate adjustment occurred in 2016.⁶

PROCEDURAL

On September 13, 2017, pursuant to 807 KAR 5:011, Lebanon Water filed a revised tariff proposing to increase its existing rate for wholesale water service to Marion District.⁷ On September 25, 2017, Marion District filed an objection to Lebanon Water's proposed wholesale rate and requested further proceedings to determine the reasonableness of the proposed wholesale water rate. In the protest letter, Marion District listed nine points of specific concern regarding Lebanon Water's proposed water service rate increase, including questions about the "use of budgeted expense in its calculations, as opposed to audited figures from the current test year," and the percentage of the proposed increase borne by Marion District.⁸ By Order dated November 13, 2017, pursuant to KRS 278.190(2), the Commission determined that further proceedings were necessary and suspended the rates for five months, up to and including April 14, 2018. The Commission further granted Marion District leave to intervene in this current proceeding.

⁵ *Annual Report of Marion County Water District to the Public Service Commission for the Calendar Year Ended December 31, 2017* at 12 and 48.

⁶ Case No. 2016-00163, *Alternative Rate Adjustment Filing of Marion County Water District* (Ky. PSC Nov. 10, 2016).

⁷ KRS 278.190(3) requires that the Commission render a final decision on Lebanon Water's proposed rate no later than ten months after the filing of the schedule. This ten-month period ends on July 12, 2018.

⁸ Protest Letter from Marion District (filed Sept. 25, 2017).

On January 31, 2018, Lebanon Water submitted its motion requesting the Commission establish a procedural schedule, assign the burden of proof to Marion District and filed the testimony of Daren Thompson, operations and management superintendent of Lebanon Water.⁹ Lebanon Water submitted a 19-page memorandum and 94 pages of testimony to support its position that Marion District should be assigned the burden of proof because, by filing a protest to the rate adjustment, Marion District was essentially requesting to rewrite an agreement first made between Lebanon Water and Marion District in 1988 (Master Agreement).¹⁰ Mr. Thompson testified that the Master Agreement provides the method for adjusting the rates to Marion District, going on to quote the Master Agreement, and he explained that the process to increase rates to Marion District is the same as the process to increase rates to retail customers of Lebanon Water. Mr. Thompson also claimed that Marion District was protected from unreasonable rate increases because the Master Agreement requires the use of a “single, uniform rate.”¹¹

⁹ Testimony of Daren Thompson, (94 pp.) Memorandum in Support of Motion to Assign Burden of Proof (19 pp.) (filed January 31, 2018).

¹⁰ Lebanon Water’s Memorandum in Support of Motion for an Order Establishing a Procedural Schedule and Assigning Burden of Proof (filed Jan. 31, 2018). This was essentially, the first attempt in the record of Lebanon to respond to Marion District’s specific questions about the calculations used or the method of determining the proposed rate increase, but definitely not the last attempt to claim that the Master Agreement somehow contained the method by which Lebanon Water determined a fair and reasonable proposed rate increase.

¹¹ Direct Testimony of Daren Thompson (460 pp.) at 4–6 (filed March 21, 2018). In fact, after repeated information requests from Commission Staff and Marion District to provide a method used to determine their proposed rate increase, and an extended discovery process requested by Lebanon Water, including voluminous filings in response to information requests that were non-responsive, Lebanon Water testified for the first time at the hearing held on June 20, 2018, that the numbers used to calculate the proposed rate increase were budgeted or forecasted numbers and explained the exact test year Lebanon Water used. June 20, 2018 H.V.T. Nicholas, 3:11:44; H.V.T. Thompson, 18:42. Additionally, Thompson addressed his claim that it was “mathematically impossible” for Marion District to be paying more because of the “single, uniform rate” of the Master Agreement and explained that he did not present the fact that applying a single uniform rate scheme would disproportionately impact Marion District as a wholesale customer to the Lebanon City Council. H.V.T. 1:49:15.

On February 7, 2018, Marion District filed its response objecting to Lebanon's motion to assign the burden of proof and requesting the Commission to establish a procedural schedule. Lebanon Water filed a reply February 12, 2018, and also raised new issues, prompting Marion District to file a motion for leave to file a sur-reply and the requested sur-reply on February 16, 2018, to which Lebanon Water filed a response on February 19, 2018.

Despite the voluminous filings, throughout discovery Lebanon Water failed to supply documents or identify the method used to support its proposed rate increase. Additionally, aside from pointing to the Master Agreement, Lebanon Water did not respond to Marion District's basic inquiries regarding, among other items, the use of budgeted numbers in its calculations and the disproportionate percentage of the proposed increase to be allocated to Marion District as opposed to Lebanon Water's retail customers.

In its February 28, 2018 Order, the Commission found that pursuant to KRS 278.200, KRS 278.190(3), and the Kentucky Supreme Court's decision in *Simpson County Water District v. City of Franklin*, 827 S.W.2d 460 (Ky.1 994), Lebanon Water has the burden of proof to show that its proposed wholesale rate adjustment is fair, just, and reasonable. The Commission also established a procedural schedule to ensure a complete record and an orderly review of Lebanon Water's proposal. The Commission directed Lebanon Water to file certain information, to respond to Marion District's protest

letter, and to provide the specific formula from the referenced Master Agreement and the calculations used to determine the proposed rates.¹²

In response to Lebanon Water's request for an extension of time and over Marion District's objection, the Commission granted Lebanon Water's motion to modify the procedural schedule to permit each party the opportunity to file written testimony in this matter in Commission's March 19, 2018 Order. On April 13, 2018, Lebanon filed a notice of its intent to put the proposed rates into effect subject to refund pending the final order in this matter pursuant to KRS 278.190(2).

Throughout discovery, Lebanon Water filed 473 pages of direct testimony and hundreds additional pages in responses to information requests that failed to provide both responses to key issues regarding the test year and documents required to analyze the calculations used to determine the proposed rates until days prior to the public hearing which was held on June 20, 2018.¹³ Testifying at this hearing on behalf of Lebanon Water were Mr. Thompson and Holly L. Nicholas, Funding and Project Administration Specialist with Kentucky Engineering Group, PLLC. At the hearing, Mr. Thompson and Ms. Nicholas confirmed the use of budgeted numbers in their calculations and identified the test year as the fiscal year ending on June 30, 2016.¹⁴ Charles White, CPA testified on behalf of Marion District.

¹² February 28, 2018 Order, Appendix B.

¹³ See fn. 11 and Direct Testimony of Holly Nicholas (filed March 21, 2018), Lebanon Responses to Requests for Information (48 pp to Staff) (filed March 7, 2018); (295 pp to Marion District) (filed April 12, 2018); (19 pp to Marion District) (filed May 3, 2018); (161pp to Staff) (filed May 3, 2018); and (287pp to Staff) (filed June 3, 2018).

¹⁴ June 20, 2018 H.V.T., Nicholas, 3:11:44; H.V.T. Thompson, 18:42.

In its post-hearing brief filed June 29, 2018, Lebanon Water proposed using a new test year to evaluate the reasonableness of the rate increase.¹⁵ Marion District objected to the use of a new test year in its post-hearing brief, which was filed July 3, 2018. In its post-hearing brief, Marion District also addressed Lebanon Water's argument that it was not necessary to use any test year for revenue determination, pointed to the many documents and figures that Lebanon failed to provide, and noted that Lebanon Water failed to use the historic test year or forecasted test year for its proposed revenue increase.¹⁶ Lebanon Water filed its reply brief on July 6, 2018, and argued for the use of a new test year, the 12 months ending June 30, 2017, rejecting its original rate proposal.

TEST PERIOD

The Commission accepts the 12-month period ending June 30, 2016 (Fiscal Year 2016) as initially proposed by Lebanon Water as the test period for determining the reasonableness of the proposed wholesale rate. Lebanon Water filed its proposed rate increase based on that test year, and this entire investigation was conducted to determine the reasonableness of the results, as adjusted, of that test year. In using this historic test year, the Commission has given full consideration to appropriate known and measurable changes.¹⁷

¹⁵ Lebanon Post-Hearing Brief at 1 (June 29, 2018).

¹⁶ Marion District Post-Hearing Brief, p. 5, fn. 22.

¹⁷ In Lebanon's Post-Hearing Brief it requested to use a different test year, however, the Commission denies this request as untimely. This case has been pending since September 9, 2017 and despite Commission Staff's three sets of information requests, Lebanon did not provide a direct answer to Staff's request as to how they determined the amount of the requested increase in rates until the hearing on June 20, 2018, when Daren Thompson testified they were using budgeted numbers and then Lebanon requested to use a new test year in their post-hearing brief. The waste of time, resources and abuse of process contributed the unreasonably high amount of legal fees incurred by Lebanon Water.

REVENUES AND EXPENSES

During Fiscal Year 2016, Lebanon Water reported operating revenues and operating expenses of \$2,674,904 and \$2,291,499, respectively.¹⁸ The Commission's review of Lebanon Water's test-year operating revenues and expenses are set forth below.

Forecasted Expenses

Ms. Nicholas testified that the Fiscal Year 2016 was selected as the test year because the financial statement for that period was the most recent audited financial statement available.¹⁹ Ms. Nicholas explained that after several adjustments were made to reduce or eliminate the effects of unusual occurrences, the Fiscal Year 2016 generally was reflective of normal operations.²⁰

Ms. Nicholas's rate study contained several scenarios showing how pro forma expenses would be impacted by the amount of water purchased from the city of Campbellsville. The scenario ultimately selected by Lebanon Water's Board reported pro forma operating expenses of \$2,905,217, an increase of \$613,718 over the audited operating expenses.²¹ Contrary to Ms. Nicholas claim that all of the pro forma adjustments were explained²² in Mr. Thompson's testimony, the Commission believes

¹⁸ Responses to Marion District's First Request for Information Request, (Marion District's First Request) Item 11, Exhibit 11-2, Financial Statements June 30, 2016, and 2015 (2016 Audit) at 5.

¹⁹ Direct Testimony of Holly Nicholas (Nicholas Testimony) at 3 (Mar. 21, 2018).

²⁰ *Id.* at 4.

²¹ \$2,905,217 (Pro Forma Operating Expenses) - \$2,291,499 (Audited Test Year Operating Expenses) = \$613,718.

²² Nicholas Testimony at 5.

that Lebanon Water did not provide detailed descriptions, supporting documentation nor adjustment calculations. Further, Ms. Nicholas described Lebanon Water's adjustments as being known and measurable which is in contradiction of Mr. Thompson's testimony that Lebanon Water's pro forma operating revenues and expenses were based on budgets.²³

In Case No. 2001-00211,²⁴ Hardin County Water District failed to provide documentary evidence to support its proposed adjustments that were based upon budgetary projections. In that proceeding the Commission made the following finding:

While such projections may be acceptable when an applicant bases its application upon a forecasted test period, they are not when the basis for the proposed rate adjustment is a historical test period. Assuming arguendo that the projections were permissible support for Hardin District's application, the utility's failure to produce the calculations and assumptions used to develop these projections makes it impossible for the Commission to assess the validity and reasonableness of such projections.²⁵

Lebanon Water has not presented any evidence in this proceeding that would persuade the Commission to reverse its prior finding that pro forma adjustments based on budgetary projections in a historical test period should be disallowed as unsupported

²³ June 20, 2018 H.V.T., Thompson, 18:42.

²⁴ Case No. 2001-00211, *The Application of Hardin County Water District No. 1 for (1) Issuance of Certificate of Public Convenience and Necessity, (2) Authorization to Borrow Funds and to Issue Its Evidence of Indebtedness, therefore, (3) Authority to Adjust Rates, and (4) Approval to Revise and Adjust Tariff* (Ky. PSC March 2, 2002).

²⁵ *Id.* at 8.

and neither known nor measurable. Accordingly, we find that Lebanon Water's proposed pro forma adjustments of \$613,710 should be denied.

Marion District objected to Lebanon Water's proposed revenue requirement increase of \$798,208 and proposed several revisions to Lebanon Water's budgetary adjustments. The Commission has rejected the use of Lebanon Water's budgetary adjustments and it is making known and measurable adjustments to Fiscal Year 2016 income statement. In calculating its adjustments, the Commission has taken into consideration the adjustments proposed by Marion District.

Operating Revenues

Applying the current rates to the test year billing analysis produces a normalized test-year operating revenue of \$2,629,444, an increase of \$3,928 over test-year revenues from water sales of \$2,625,516. The Commission has imputed additional revenues of \$92,500 to reflect eliminating the free water service provided to the city of Lebanon. Lebanon Water has the discretion to provide free water service to any of its retail customers, revenue must be imputed for that free service in determining the wholesale rates for sales to Commission regulated utilities to ensure that the wholesale customers are not paying for that free service. The overall increase in Lebanon Water's operating revenue is \$96,428.

Purchased Water

Campbellsville Water Transmission Main was placed into service on March 5, 2018. On December 29, 2015, Lebanon Water entered into a Water Purchase Contract with the city of Campbellsville whereby Lebanon Water agreed to a minimum daily water

purchase of 300,000 Gallons. Lebanon Water has not provided any evidence into the record to support purchasing a larger amount than the 300,000-gallon minimum. The Commission is increasing test-year operating expenses by \$348,920²⁶ to reflect the minimum daily purchases.

Employee Salaries

Lebanon Water reported test-year employee salaries and wages expense of \$528,862.²⁷ In the period from 2016 through 2018, Lebanon Water experienced changes in its staffing. Several long-term employees either have retired or remained on staff to train the replacements. To avoid including the wages and fringe benefits of duplicate employees, the Commission is adjusting test-year salaries and wages expense to reflect the current staff level and 2018 wages,²⁸ which results in an increase of \$18,752 as calculated in the table below.

²⁶ 300,000 Gallons (Daily Purchases) x 365 Days = 109,500,000 Gallons (Annual Minimum Purchases) x \$0.00346 (Cost per Gallon) = \$378,870 (Annual Water Cost) - \$29,950 (Plant Cost Reduction) = \$348,920.

²⁷ Responses to Marion District's First Request, Item 11, Exhibit 11-2, 2016 Audit at 5.

²⁸ Lebanon Water anticipates that two of its licensed plant operators will retire in the near future. Two new operators have been hired in the interim so that they can be trained. The salaries and fringe benefits of the new plant operator's has been removed from test year operating expenses to eliminate the double recovery of the cost.

<u>Employee Number</u>	<u>Position Title</u>	<u>Current Wages - Hr</u>	<u>Pro Forma 2080 Hrs.</u>
000000003	Ofc Mgr	\$ 24.66	\$ 51,293
000000006	Trmt Plant Oper	\$ 21.43	44,574
000000007	Dist Mgr	\$ 27.24	56,659
000000008	Dist Oper	\$ 19.01	39,541
000000009	Trmt Plant Oper-PT	\$ 24.52	12,855
000000011	Trmt Plant Oper	\$ 18.59	38,667
000000015	Trmt Plant Mgr	\$ 27.24	56,659
000000017	Cust Srv Rep	\$ 15.66	32,573
000000018	Bd Member		4,150
000000019	Trmt Plant Oper	\$ 17.50	36,400
000000020	Oper & Maint Supt	\$ 47.04	97,843
000000021	Dist Oper	\$ 16.94	35,235
000000022	Dist Oper	\$ 16.94	35,235
000000023	Trmt Plant Oper	\$ 16.42	0
000000024	Trmt Plant Oper	\$ 16.42	0
000000025	Laborer	\$ 10.00	3,535
000000026	Admin Asst/CSR 1	\$ 10.00	2,395
Total Monthly			547,614
Less: Actual			<u>(528,862)</u>
Pro Forma Adjustment			<u>\$ 18,752</u>

Employee Fringe Benefits

Lebanon Water reported a test-year total employee fringe benefits expense of \$411,141. The Commission finds \$248,862 to be the reasonable level for Lebanon Water's test-year employee fringe benefits expense and decreases its reported level by \$161,955,²⁹ as explained below:

County Employee Retirement System (CERS).

Lebanon Water provides pension benefits and post-retirement health care benefits to its employees by participating in the CERS. As a participating member, Lebanon Water is required to contribute a percentage of its employee wages to CERS. In the fiscal year,

²⁹ \$112,701 (CERS) + \$113,069 (Health and Dental) + \$1,515 (AD&D, Vision, Life) + \$21,900 (Reported Miscellaneous) = \$249,185 - \$411,140 (Test Year Employee Fringe Benefits) = \$(161,955).

beginning July 1, 2016, the CERS contribution rate was 17.06 percent and in the fiscal year ending July 1, 2018, the rate increased to 21.48 percent. The CERS pension expense Lebanon Water reported in the test year conformed to the requirements of the General Accounting Standards Board Pronouncement No. 68 (GASB 68).

In Case No. 2016-00163,³⁰ the Commission discussed in great detail the reporting requirements of GASB 68 and how those requirements would impact a utility's income statement and balance sheet. In that proceeding, the Commission found that the annual pension expense should be equal to the amount of a district's contributions to CERS, which historically have been "fairly constant." By using the increased CERS rate of 21.48 percent and the pro forma salaries and wages expense determined reasonable herein, the Commission calculates a pro forma CERS expense of \$112,701.³¹

Employee Health and Dental Insurance.

In Fiscal Year 2017, Lebanon Water began requiring its employees receiving family health insurance coverage to contribute towards the premiums but did not require contributions from its employees with single coverage.

The Commission is placing greater emphasis on evaluating employees' total compensation packages, including both salary and benefits programs for market and geographic competitiveness to ensure the development of fair, just, and reasonable rates. The Commission has found that in most cases 100 percent employer-funded healthcare

³⁰ Case No. 2016-00163, *Alternative Rate Adjustment Filing of Marion County Water District* (Ky. PSC Nov. 10, 2016).

³¹ \$524,679 (Full-time Employee Salaries) x 21.48 % (New CERS Rate) = \$112,701.

does not meet those criteria. Absent a utility's requirement of reasonable employee participation in healthcare costs, the Commission has applied a consistent standard by utilizing the Bureau of Labor Statistics report,³² which reflects an average employee contribution to single healthcare coverage of 21 percent of the cost.

Using the 2018 health and dental premiums and a 21 percent employee contribution rate for single coverage,³³ and a 60 percent employee contribution rate for dental, the Commission calculates a pro forma health and dental expense of \$111,777.

Other Employee Fringe Benefits.

Lebanon Water reported test-year other employee fringe benefits of \$1,795.³⁴ The Commission is reducing other employee fringe benefits by \$280³⁵ to eliminate the other fringe benefits provided to the two plant operators. The pro forma other fringe benefits expense is \$1,515.

Miscellaneous Fringe Benefits.

The miscellaneous Employee fringe benefits of \$21,900 include uniform and safety equipment; continuing education expense; and membership dues and fees.

³² Bureau of Labor Statistics, Healthcare Benefits, March 2016, Table 10, private industry workers. (<https://www.bls.gov/ncs/ebs/benefits/2016/ownership/private/table10a.pdf>).

³³ Bureau of Labor Statistics, Healthcare Benefits, March 2016, Table 10, private industry workers. (<https://www.bls.gov/ncs/ebs/benefits/2016/ownership/private/table10a.pdf>).

³⁴ \$948 (Vision) + \$741 (Dental) + \$106 (AD&D) = \$1,795.

³⁵ \$146 (Vision) + \$117 (Dental) + \$17 (AD&D) = \$280.

Payroll Taxes – FICA

Lebanon Water reported test-year payroll tax - FICA expense of \$38,371.³⁶ Applying the FICA tax rate of 7.65 percent to Lebanon Water's pro forma employee salaries and wage expenses result in a pro forma payroll tax – FICA expense of \$41,892. Accordingly, the Commission is increasing test year expenses by \$3,521.

Depreciation

Lebanon Water reported test-year depreciation expense of \$575,320.³⁷ To evaluate the reasonableness of the depreciation practices of small water utilities, the Commission has historically relied upon the report published in 1979 by the National Association of Regulatory Utility Commissioners (NARUC) titled Depreciation Practices for Small Water Utilities (NARUC Study). When no evidence exists to support a specific life that is inside or outside the NARUC ranges, the Commission has historically used the mid-point of the NARUC ranges to depreciate utility plant.

Lebanon Water has not presented any supporting analysis or study to show that its depreciation lives are appropriate. The Commission finds that Lebanon Water's test-year depreciation expense should be increased by \$62,118³⁸ to reflect depreciating all of Lebanon Water's utility plant, including post-test year plant, over the NARUC depreciation lives.

³⁶ Responses to Marion District's First Request, Item 11, Exhibit 11-2, 2016 Audit at 5.

³⁷ *Id.*

³⁸ Responses to Commission Staff's Third Request for Information, Item 9, Exhibit 9-1, NARUC Depreciation Worksheet.

Summary Impact of Adjustments

After considering the test-year operating revenues and expenses, including appropriate adjustments found reasonable herein, the Commission has determined that the financial results of Lebanon Water's pro forma test-year operations would be as follows:³⁹

	Fiscal Year 06/30/16 Test-Year	Pro Forma Adjustments	Pro Forma Operations
Operating Revenues	\$ 2,667,097	\$ 96,428	\$ 2,763,525
Operating Expenses	2,291,499	271,356	2,562,855
Net Operating Income	<u>\$ 375,598</u>	<u>\$ (174,928)</u>	<u>\$ 200,670</u>

OVERALL REVENUE REQUIREMENT AND REQUIRED REVENUE INCREASE

The Commission has historically applied a DSC method to calculate the Overall Revenue Requirement of water districts, water associations, and municipal-owned water utilities. This method allows for recovery of 1) cash-related pro forma operating expenses; 2) recovery of depreciation expense, a non-cash item, to provide working capital; 3) the average annual principal and interest payments on all long-term debts, and 4) working capital that is in addition to depreciation expense.

A comparison of Lebanon Water's and the Commission's calculation of the Overall Revenue Requirement and Required Revenue Increase using the DSC method is shown

³⁹ See Appendix A for a detailed summary of this table.

below:

	Lebanon Water Works	Commission
Pro Forma Operating Expenses	\$ 2,905,127	\$ 2,562,855
Plus: Average Annual Debt Principal and Interest Payments	532,038	530,030
Debt Coverage Requirement	<u>63,845</u>	<u>132,508</u>
Total Revenue Requirement	3,501,010	3,225,393
Less: Other Operating Revenue	(53,400)	(41,581)
Non- Operating Revenue		(26,271)
Interest Income	<u>(9,400)</u>	<u></u>
Revenue Required from Rates	3,438,210	3,157,541
Less: Normalized Revenues from Water Sales	<u>(2,640,000)</u>	<u>(2,721,944)</u>
Required Revenue Increase/(Decrease)	<u>\$ 798,210</u>	<u>\$ 435,597</u>
Percentage Increase	<u>30.235%</u>	<u>16.003%</u>

Rates

Lebanon Water's rate design is a two-step rate design, consisting of a meter charge, applied to each meter per month, and a volumetric rate applied to monthly customer usage. Lebanon Water proposed to increase its monthly meter charge from \$6.75 per meter to \$7.35 per meter, an 8.89 percent increase, and increase its volumetric charge from \$2.50 per 100 cubic feet to \$3.35 per 100 cubic feet, a 34.00 percent increase. Lebanon Water claimed the proposed increase to be an across-the-board increase to all customers in accordance with past Commission decisions, based on the percentage increase in revenue required from rates.⁴⁰ The Commission finds that Lebanon Water's claims that the Commission has previously found that an across-the-board increase is an appropriate and equitable method of cost allocation in the absence of a cost-of-service study is correct. However, Lebanon Water failed to apply the

⁴⁰ Lebanon Water Response to Commission Staff's Request for Information, Item 2.

Commission across-the-board increase correctly. For an across-the-board increase, the same percentage increase is applied to each step of the rate design by the percentage increase in the revenue required from rates. Lebanon has proposed varying levels of increases to the proposed two step rate design, not the same level as an across-the-board increase implies. Where a party has proposed varying levels of increases to the rate steps in its rate design, the Commission expects, at a minimum, a detailed explanation, supported by some empirical data, of why such varying increases are appropriate or a supporting Cost of Service Study. Ms. Nicholas testified at the June 20, 2018 Hearing that the proposed \$7.35 meter charge was chosen by her to protect customers on a fixed income rather than statistically supported.⁴¹

The rates set forth in Appendix B are based upon the revenue requirement as calculated by Commission Staff, an approximate 16.00 percent increase in the revenue required from rates. Commission finds that an across-the-board increase, increasing each step of the rate design by the percentage increase in the revenue required from rates, is the appropriate means to allocate the increased revenue requirement. The average monthly bill for Marion District will increase from \$124,642.40 to \$144,585.19, an increase of \$19,942.79 or 16.00 percent.

The Commission notes that Lebanon Water and Marion County have invested significant resources litigating the case. Lebanon Water argues they did not choose to perform a cost of service study due to the expense⁴², however, the high cost of legal fees and the number of resources that were spent on supporting their proposed adjustment

⁴¹ June 20, 2018 H.V.T. at 3:04:08

⁴² Post-Hearing Reply Brief, July 6, 2018.

using a test year that Lebanon Water rejected after nine months may have been avoided if Lebanon Water had at least properly researched and supported the proposed adjustment before attempting to apply the increase. The investment in a full cost of service study performed by a reputable independent entity in accordance with Commission previously approved rate-making practices would provide both parties a measure of confidence in the appropriateness of charges that has not been present in this case.

Rate Case Expenses

A utility may properly recover reasonable rate case expenses as a cost of doing business.⁴³ The Commission has generally permitted rate recovery of a reasonable level of rate case expenses but has disallowed such expenses when a utility has failed to provide adequate documentary evidence of the incurrence of the expense.⁴⁴ The Commission has also disallowed such expenses as unreasonable when related to a poorly or improperly prepared rate application⁴⁵ and in cases where the utility failed to justify the high level of expenses for relatively simple alternative rate filings.⁴⁶

⁴³ See *Driscoll v. Edison Light & Power Co.*, 307 U.S. 104, 120 (1939).

⁴⁴ Case No. 2008-00250, *Proposed Adjustment of the Wholesale Water Service Rates of Frankfort Electric and Water Plant Board* (Ky. PSC Apr. 6, 2009).

⁴⁵ Case No. 8783, *Application of Third Street Sanitation, Inc. for an Adjustment of Rates Pursuant to the Alternative Procedural for Small Utilities* (Ky. PSC Nov. 14, 1983).

⁴⁶ Case No. 9127, *Application of Sargent and Sturgeon Builders, Inc., Gardenside Subdivision Sewer Division, for a Rate Adjustment Pursuant to the Alternative Rate Filing for Small Utilities* (Ky. PSC Mar. 25, 1985).

In its September 13, 2016 tariff filing, Lebanon Water proposed a rate case expense surcharge mechanism. The filing proposed to assess a surcharge over 36 months to recover any rate case expenses it may incur to participate in and defend its proposed rates. In the tariff filing, Lebanon Water used rate case expenses totaling \$72,000 as demonstrative of its proposed methodology.

In Case No. 2009-00373, *Proposed Adjustment of the Wholesale Service Rates of Hopkinsville Water Environment Authority*, the Commission analyzed whether the special counsel fees were part of reasonable rate case expenses and capped the rate case expense.⁴⁷ The Commission evaluates the prudence of rate case expense on a case by case basis.⁴⁸ In the Hopkinsville case, the Commission allocated the cost of performing a cost of service study because it related to all the customers and reduced the special counsel fees that were related to the cost of service study because it was performed after the application and not used to develop the proposed rates at issue. The high level of rate case expense compared to the complexity of the issues, and the level of rate case expenses for similar cases, were factors the Commission reviewed in finding that Hopkinsville's expense related to special counsel fees should be capped at \$50,000.⁴⁹

In its post-hearing brief, Lebanon Water stated that it had submitted invoices for all rate case expenses, a total of \$162,695.30. The Commission has required that a utility must justify a high level of expense for a relatively simple alternate rate filing.⁵⁰ Here,

⁴⁷ Case No.2009-00373, *Proposed Adjustment of the Wholesale service Rates of Hopkinsville Water environment Authority* (Ky. PSC July 2, 2010).

⁴⁸ *Id.* at 5–6.

⁴⁹ *Id.* at 9–13.

⁵⁰ Case No. 9127, *Sergent & Sturgeon Builders, Inc.*, at 14.

the rate case expenses represent 20.38 percent of Lebanon Water's intimal proposed revenue increase of \$798,210. Lebanon argues that such a comparison should not be made on an annual basis, but compared to 36 months of revenue, or \$2.4 million.⁵¹ However, the comparison between Marion District's rate case of expense in this matter totaling \$28,914.44⁵² and Lebanon Water's rate case expense of \$162,695.30, is perhaps more demonstrative of Lebanon Water's excessive and unreasonable rate case expense. Lebanon also seeks to blame Marion District for the high rate case expenses as Marion District protested the rate adjustment at issue instead of "negotiating".⁵³ The Commission addressed whether there had been attempts to negotiate at the hearing in this matter as a reasonable means to agree on fair rates. However, to be clear, the argument that rate case expense is higher because Marion District objected to the proposed rate adjustment fails to justify Lebanon's high level of rate case expense when compared to Marion District's rate case expense.⁵⁴ Marion District has a legal right to object to the wholesale rates and Lebanon has submitted itself to the regulatory authority of the Commission by contracting with a regulated utility.⁵⁵

⁵¹ Lebanon Water Post-Hearing Brief at 31 (June 29, 2018).

⁵² Marion County Water District's Responses to Post-Hearing Request for Information from Commission Staff (June 21, 2018).

⁵³ *Id.* at 32.

⁵⁴ *See City of Danville v. Public Service Comm'n*, Civil Action No. 15-CI-00989, *Opinion and Order* (Franklin Circuit Court Division II, June 14, 1016) The Court addressed a similar argument that the extensive rate case expense was due to complaints filed by the utilities involved. The Court held that municipal utilities submit to the regulatory authority of the Commission when they contract with a utility by authority of KRS 278.200.

⁵⁵ *See Id.* at 8.

The submitted invoices for legal services show that three attorneys performed work for Lebanon Water and billing hours related to the engineering study were included as rate case expenses.⁵⁶ While the Commission notes that Lebanon's counsel gave some discounts on their bills, the invoices show that the three attorneys billed several hours for preparing the same responses and briefs and then subsequently billed for meetings with the client.⁵⁷ Additionally, we note that despite the high level of legal expenses and high number of hours expended on preparing responses to requests for information from the Commission, Commission Staff and Marion District, Lebanon Water did not disclose that they had used budgeted numbers in their calculations until the hearing on June 20, 2018,⁵⁸ and in its post-hearing brief filed on June 29, 2018, some nine months after the start of this investigation. Moreover, after extensive hours were dedicated to the instant case by Lebanon Water, it then argued in its post-hearing brief that a new test year should be used to calculate the proposed rate adjustment. Further, Lebanon Water was non-responsive to several requests for information from Commission Staff and did not amend its tariff or discuss whether the documents required to use a new test year were in the record.⁵⁹ In fact, it was not until Commission Staff's Third Request for Information that

⁵⁶ Exhibits 20 and 21 of Direct Testimony of Daren Thompson filed March 21, 2108; Exhibit 5 of the Rebuttal Testimony of Daren Thompson filed on June 8, 2018; and as Exhibit 20-1, 20-2, and 20-3 of the Supplemental Response of Lebanon Water Works Company to Commission Staff's Second Request for Information, Item 20 filed on June 27, 2018.

⁵⁷ See *City of Danville v. Public Service Comm'n* at 9–13.

⁵⁸ June 20, 2018 Hearing H.V.T. Thompson 18:42.

⁵⁹ Lebanon Water Post-Hearing Brief at 1, June 29, 2018.

Lebanon Water provided enough documents that Staff could evaluate the reasonableness of the proposed rate increase.⁶⁰

In their initial tariff filing, Lebanon Water claimed \$72,000.00 as rate case expenses. This was based on an estimate of engineering fees of approximately \$8,000 and legal fees of approximately \$64,000. Based on its estimated expenses, Lebanon Water had the duty to reasonably manage and control its expenditures. Lebanon Water now seeks to recover by surcharge more than double its estimate, \$162,695.30, which the Commission finds is unreasonable. Lebanon provided documentation of the legal services, however, when compared with the voluminous unresponsive filings, a high number of hours and duplication of billings by three attorneys billing for the production of the same responses to information requests, the total bill for legal services is excessive. In addition, after requests for extensions and nine months of discovery on the proposed adjustment to rates, Lebanon Water did not confirm the use of budgeted numbers, nor actuals as required, for the test year and revenue calculations until the June 20, 2018 Hearing. Lebanon discounted its own arguments by proposing to change the test-year used to evaluate the proposed adjustment in the post-hearing brief filed on June 29, 2018. The Commission finds that during discovery, Lebanon Water did not present adequate documentation of the reasonableness of its proposed adjustment and that the excessive hours and volumes of testimony are not supportive of its proposal. Lebanon argues that \$162,695.30 is comparable to other municipal rate proceedings and cites Hopkinsville and the Frankfort Plant Board as comparisons.⁶¹ However, Hopkinsville was capped at

⁶⁰ Staff requested a comparison of pro forma income statement versus pro forma adjusted income statement and the utility provided a 2016 income statement compared to a revised income statement. Response of Lebanon Water Works Company to Commission Staff's Third Request for Information.

⁶¹ Lebanon Water Post-Hearing Brief at 30–34, June 29, 2018.

\$50,000⁶² and Frankfort Plant Board did not exceed \$68,000.⁶³ Additionally, Lebanon cites cases to support its rate case expense, despite it being greater than the amount originally estimated, however, the facts are distinguishable and in the matter herein, the facts do not support Lebanon's rate case expense as reasonable.⁶⁴

For this case, Lebanon Water hired the Kentucky Engineering Group, PLLC, to perform a rate analysis for all of Lebanon Water's customers. Lebanon Water has submitted invoices totaling \$8,178.89 for preparing the study.⁶⁵ The Commission finds

⁶² Case No.2009-00373, *Proposed Adjustment of the Wholesale service Rates of Hopkinsville Water environment Authority* (Ky. PSC July 2, 2010).

⁶³ Case No. 2008-00250, *Frankfort Plant Board* at 13 (Ky. PSC Apr.6, 2009).

⁶⁴ Lebanon Water Post-Hearing Brief at 1, and 31–33, June 29, 2018. Case No. 2017-00371, *Application of Big Sandy Rural Electric Cooperative Corporation for a General Adjustment of Existing Rate Order at 4–5* (April 26, 2018). Big Sandy filed a poorly supported application which they withdrew and then filed a second time, wherein the consultant fee from the first attempt was approved as reasonable to claim in addition to the second case expense based upon the evidence and testimony that the second consultant used the materials from the first case that was withdrawn. Lebanon Water cites Case No. 2017-00070, *Electronic Application of Monroe County Water District for Rate Adjustment Pursuant to 807 KAR 5:076*, (January 12, 2018) at 16, in support for its argument that a surcharge is more transparent than including rate case expense in the base rate. The facts of Monroe, Case No. 2017-00070 did not involve a surcharge and the Commission found submitting invoices in response to Commission Staff's requests for information insufficient to support a level of rate case expense higher than the estimated level. However, the Commission does not agree with Lebanon Water's characterization of the Monroe decision as supporting the argument that estimated rate case would ever be accepted if the expense has not been actually incurred. Lebanon Post-Hearing Brief at 33–34. Additionally, Lebanon cites Case No. 2014-00392 *Proposed Adjustment of the Wholesale Rates of the City of Danville* (Aug. 13, 2015) and *City of Danville v. Public Service Commission of Kentucky, Parksville Water District, Garrard County Water Association, Inc.* Franklin Circuit Court, Civil Action No. 15-CI-00989, June 14, 2016, which address the issue that municipalities must request an estimated rate case expense and surcharge in its initial filing with the Commission in order to provide sufficient notice to its customers. Lebanon Water complied with this, but notes that the suggestion to amend its application to seek recovery of a higher level of actual expenses is "problematic" because an amendment would "effectively reset the statutory review period, require the utility to provide notice of the amendment in accordance with KRS 278.180, and lengthen the time before the issuance of the final decision". The Commission recognizes the procedural implications, however, the facts of this case present a situation where Lebanon Water is requesting a surcharge to recover an amount of legal fees that exceeds the level in its notice to Marion District and that requires an amendment.

⁶⁵ Exhibits 20 and 21 of Direct Testimony of Daren Thompson filed March 21, 2108; Exhibit 5 of the Rebuttal Testimony of Daren Thompson filed on June 8, 2018; and as Exhibit 20-1, 20-2, and 20-3 of the Supplemental Response of Lebanon Water Works Company to Commission Staff's Second Request for Information, Item 20 (filed on June 27, 2018).

that only a portion of the expenses associated with this rate analysis should be allocated to Lebanon Water's wholesale customers, not the entire cost as proposed because Lebanon Water utilized this same study to increase its retail water rates. The record supports the finding that fees incurred for the engineering report will benefit both the wholesale customers and retail customers of Lebanon Water. Therefore, they should be apportioned to all of Lebanon Water's customers.

The Commission notes that in requesting a surcharge to recover rate case expenses, Lebanon Water failed to give notice to Marion County of the actual amount of the surcharge. Rather, Lebanon water only gave Marion County notice of the expected amount of \$72,000. For all of these reasons, the Commission caps the rate case expense, including legal and engineering, at \$72,000.00, amortized over three years as requested in the initial tariff, and denies Lebanon Water's request to recover the total rate case costs of \$162,695.30 filed in the record.

The Commission, after consideration of the evidence of record and being sufficiently advised, finds that:

1. The rates proposed by Lebanon Water would produce revenues in excess of the amount found reasonable herein and should be denied.
2. Lebanon Water should be permitted to recover \$72,000 for rate case expenses related to engineering and legal fees.
3. The rates set forth in the Appendix to this Order are fair, just, and reasonable and should be approved for the provision of wholesale water service to Lebanon Water for services rendered on and after July 12, 2018.

4. Lebanon Water District should be authorized to assess a monthly surcharge of \$2,000 to each Marion District for a period of 36 months to recover \$72,000 for rate case expenses.

5. Within 30 days of the date of this Order, Lebanon Water should file with the Commission a report on the amount of excess revenues collected from April 14, 2018, through the date of this Order and a plan for refunding these revenues. This report shall include interest for the period the excess revenues were collected at the average of the Three-Month Commercial Paper Rate as reported in the Federal Reserve Bulletin and the Federal Reserve Statistical Release. Lebanon Water shall include in its report its plan to refund the excess revenues collected and the associated interest within 60 days of the date of this order, as required by KRS 278.190(4).

6. Lebanon Water should file a revised tariff setting out these rates as approved and remove language pertaining to the possibility of a refund if a lower rate is determined from its tariff.

IT IS THEREFORE ORDERED that:

1. The wholesale rates proposed by Lebanon Water are denied.

2. The rates and charges found reasonable herein and set forth in Appendix B to this Order are approved for the provision of wholesale water service rendered by Lebanon Water on and after July 12, 2018.

3. Within 30 days of the date of this Order, Lebanon Water shall file with the Commission a report on the amount of excess revenues collected from April 14, 2018, through the date of this Order and a plan for refunding these revenues. This report shall include interest for the period the excess revenues were collected at the average of the

Three-Month Commercial Paper Rate as reported in the Federal Reserve Bulletin and the Federal Reserve Statistical Release. Lebanon Water shall include in its report its plan to refund the excess revenues collected and the associated interest within 60 days of the date of this order, as required by KRS 278.190(4).

4. Within 20 days of the date of this Order, Lebanon Water shall file with this Commission, using the Commission's electronic Tariff Filing System, revised tariff sheets setting out the rates approved herein and reflecting that they were approved pursuant to this Order.

5. Any documents filed pursuant to ordering paragraph No. 3 and 4 of this Order shall reference the case number of this matter and shall be retained in the utility's general correspondence files.

By the Commission

ENTERED
JUL 12 2018
KENTUCKY PUBLIC
SERVICE COMMISSION

ATTEST:


Executive Director

APPENDIX

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN
CASE NO. 2017-00417 DATED **JUL 12 2018**

	Fiscal Year 06/30/16 Test-Year	Pro Forma Adjustments	Pro Forma Operations
Operating Revenues:			
Revenues from Water Sales:			
Metered Water Sales:	\$ 2,625,516	\$ 96,428	\$ 2,721,944
Other Water Revenues:			
Forfeited Discounts	34,344		34,344
Miscellaneous Service Revenues	7,237		7,237
	<u>41,581</u>	<u>0</u>	<u>41,581</u>
Total Other Water Revenues	<u>41,581</u>	<u>0</u>	<u>41,581</u>
	<u>2,667,097</u>	<u>96,428</u>	<u>2,763,525</u>
Operating Expenses:			
Operation & Maintenance Expense			
Purchased Water Expense		348,920	348,920
Electricity	221,646		221,646
Pump Station & Filter Plant	68,029		68,029
Chemicals	167,709		167,709
Maintenance & Repairs	120,903		120,903
Salaries - Gross	528,862	18,752	547,614
Fringe Benefits - Employees	411,140	(161,955)	249,185
Payroll Taxes - Employer S.S.	38,371	3,521	41,892
Directors' Fees	12,600		12,600
Insurance	49,117		49,117
Office Supplies & Expenses	31,416		31,416
Outside Services	44,702		44,702
Bad Debts	5,300		5,300
Miscellaneous	16,384		16,384
	<u>1,716,179</u>	<u>209,238</u>	<u>1,925,417</u>
Depreciation	575,320	62,118	637,438
	<u>2,291,499</u>	<u>271,356</u>	<u>2,562,855</u>
Utility Operating Expenses	<u>2,291,499</u>	<u>271,356</u>	<u>2,562,855</u>
Net Utility Operating Income	<u>375,598</u>	<u>(174,928)</u>	<u>200,670</u>
Other Operating Income (net)			
Other Miscellaneous Income			
Interest Income - CD's	2,226		2,226
Interest Income - NOW Account	9,126		9,126
Interest Income - Bond Issues	579		579
Grant Funds	72		72
Refund from KU	2,000		2,000
State Capital Contribution	10,818		10,818
Other Capital Contributions	2,000		2,000
Rental House Expense - Calvary	(550)		(550)
	<u>26,271</u>	<u>0</u>	<u>26,271</u>
Other Operating Income (net):	<u>26,271</u>	<u>0</u>	<u>26,271</u>
Net Available for Debt Service	<u>\$ 401,869</u>	<u>\$ (174,928)</u>	<u>\$ 226,941</u>

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 2017-00417 DATED JUL 12 2018

The following rates and charges are prescribed for the customers in the area served by Lebanon Water Works 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.

Marion County Water District Rates

Meter Charge, per meter per month	\$7.84
Volume Charge per 100 Cubic Feet	\$ 2.90
Rate Case Expense Surcharge for 36 Months	\$2,000.00 Per Month

*L Allyson Honaker
Goss Samford, PLLC
2365 Harrodsburg Road, Suite B325
Lexington, KENTUCKY 40504

*Marion County Water District
1835 Campbellsville Road
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*Honorable Damon R Talley
Attorney at Law
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