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May 14, 2007

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Re: Case No. 2006-00444
Frankfort Electric and Water Plant Board

Gentlemen:

The enclosed memorandum has been filed in the record of the above-referenced case. Any comments regarding this memorandum's contents should be submitted to the Commission within ten days of the date of this letter. Any questions regarding this memorandum should be directed to Gerald Wuetcher, Assistant General Counsel, at (502) 564-3940, Extension 259.

Sincerely,

Beth O'Donnell
Executive Director

gw
Enclosure
cc: Parties of Record

INTRA-AGENCY MEMORANDUM

KENTUCKY PUBLIC SERVICE COMMISSION

TO: Case File No. 2006-00444

FROM: Gerald Wuetcher
Assistant General Counsel

DATE: May 14, 2007

RE: Conference of January 31, 2007

On January 31, 2007, Commission Staff held a conference in this case in the Commission's offices in Frankfort, Kentucky. Present were:

Herbbie Bannister	-	Frankfort Electric and Water Plant Board
Warner Caines	-	Frankfort Electric and Water Plant Board
Michael Dudgeon	-	Frankfort Electric and Water Plant Board
John Hughes	-	Frankfort Electric and Water Plant Board
Michael Lane	-	Frankfort Electric and Water Plant Board
Hance Price	-	Frankfort Electric and Water Plant Board
Shannon Taylor	-	Frankfort Electric and Water Plant Board
Warner Broughman	-	U.S. 60 Water District/North Shelby Water Co.
Don Prather	-	U.S. 60 Water District/North Shelby Water Co.
Thomas Marshall	-	Peaks Mill Water District/Elkhorn Water District
Eddie Beavers	-	Commission Staff
Mark Frost	-	Commission Staff
Jason Green	-	Commission Staff
Sam Reid	-	Commission Staff
Gerald Wuetcher	-	Commission Staff

On January 23, 2007, the Commission ordered that the conference be convened after findings that certain of Frankfort Electric and Water Plant Board's ("FEWPB") responses were inadequate and reflected a possible misunderstanding of the methodology that the Commission uses to establish utility rates.

Beginning the conference, Mr. Wuetcher stated that Commission Staff would prepare minutes of the conference for the case record, that a copy of these minutes would be provided to all parties, and that all parties would be given an opportunity to submit written comments upon those minutes.

Mr. Frost noted several problems with FEWPB's application. He noted that the Commission establishes rates based upon either a historical test period or a future test period. When establishing rates based upon a historical test period, the Commission

uses the actual operations for a historical period adjusted for known and measurable changes. When a future test period is used, the Commission establishes rates based upon budgeted expenses but examines closely the reliability and accuracy of the budgets or projections. FEWPB used neither method to develop its rates. Its revenue requirements are based upon Calendar Year 2005 trial balances with adjustments based upon its Fiscal Year 2006 budget projections. Many of the adjustments were not based upon known and measurable changes (e.g., an increase in insurance premiums, increase in employee wages and salaries), but budget projections.

Mr. Frost further noted that the records submitted are not consolidated but represent a mixture of two different time periods. To support its historical test period, FEWPB has used financial information from two different fiscal years – FY 2005 and FY 2006. This practice prevents any comparison of a utility's test period expenses to the utility's audited financial statements. He also noted that the utility's reliance on trial balances undermines the reliability of the reported test period revenues and expenses. Audit financial statements are generally regarded as more reliable because an auditor has reviewed the statements and corrected any misstatements or eliminated the effects of any inappropriate accounting entries. Mr. Frost further noted that because the test period spans two fiscal years and thus two audited statements, matching auditor adjustments to the trial balances is very difficult and time-consuming.

Mr. Frost also noted the significance of FEWPB's general ledger to the review process. Generally, post-audited balances can be directly traced to line items on a utility's financial statement. This ensures that the reviewer can verify all amounts that are included in a specific expense account for the test period. Because the test period straddles two fiscal years, this tracing cannot be performed.

Mr. Frost further noted that, if FEWPB intends to base its proposed rates upon budget projections, it should submit the information that is normally required when a future test period is used. A list of this information is found in the Commission's Rules of Procedure. See 807 KAR 5:001, §10. Because the accuracy and reliability of these projections becomes a critical issue in the Commission's determination, Mr. Frost noted, FEWPB should expect discovery requests regarding its budgeting process and that process's past accuracy.

FEWPB officials questioned whether it would be preferable to use FEWPB's Fiscal Year 2006 audited records and substitute Fiscal Year 2006 as the current proposed test period. They noted that the audit was nearly complete. Mr. Lane stated that use of the FY 2006 records would require a new cost-of-service study.

Mr. Wuetcher stated that FEWPB had complete discretion in the choice of a test period upon which to base its proposed rates. In rendering its final decision upon the

proposed rates, Mr. Wuetcher stated, the Commission could determine that the proposed test period was inappropriate or unreasonable and use a different period. He noted that a key point for the utility to consider was the discovery requests generated by its proposed test period. The use of the current test period, which spanned two fiscal years and required significant adjustments, was likely to produce a larger number of discovery requests from Commission Staff.

FEWPB questioned the Commission's response if the use of FY 2006 records required a larger rate adjustment than proposed. Mr. Wuetcher responded that the Commission's response would depend upon FEWPB's action. If FEWPB did not revise its proposed rates and the record demonstrated that the higher rate was reasonable, then the Commission had the discretion of awarding either the requested rates or the higher rates. Mr. Wuetcher noted that the Commission in prior cases had established rates that did not produce revenues equal to the utility's total expenses plus a reasonable rate of return when the utility expressly requested the lower rate. He further noted that the Commission had in prior cases established rates at a level higher than requested when the proposed rates would not generate revenues sufficient to meet all reasonable expenses plus provide a reasonable rate of return.

Mr. Wuetcher also noted that, if FEWPB revised its proposed rates, the statutory clock for reviewing the proposed rate would be reset. KRS 278.190 requires the Commission to render a decision on the proposed rate within 10 months of its filing. If FEWPB filed revised tariff sheets with a higher rate, then the 10-month review period would begin on the date of such filing.

Mr. Hughes stated that FEWPB would review whether to change its proposed test year to FY 2006 and to restate its responses to reflect FY 2006 actual operations. Such action, Mr. Hughes stated, would also require FEWPB to revise its cost-of-service study. FEWPB will advise Commission Staff within the next 14 days of its decision.

The conference then adjourned.

Postscript: The following week Mr. Hughes placed a message on my office voice mail indicating that FEWPB intended to revise its responses to reflect FY 2006 operations and submit these revised responses and a revised cost-of-service study after its FY 2006 audit is completed and reviewed.

cc: Parties of Record

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