

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of

RATE ADJUSTMENT OF KENTON) CASE NO.
COUNTY WATER DISTRICT) 8572

Order on Rehearing

On April 27, 1983, the Commission granted Kenton County Water District ("Kenton County") a rehearing on two issues adjudicated in the Commission's Order entered March 22, 1983, in Kenton County's general rate request. The rehearing, held on June 16, 1983, afforded Kenton County the opportunity to present additional evidence in support of its position with respect to interest income and depreciation expense on contributed property. Intervenors of record participated in the rehearing. Based on the information presented on rehearing the Commission has determined that the following issues require further commentary:

Depreciation Expense on Contributed Property

The Commission determined in the original Order that contributions in aid of construction at test year end represented 7.1 percent of the total cost of utility plant in service. Depreciation expense was reduced by \$38,417 to exclude depreciation on assets purchased with contributions in aid of construction. In the application for rehearing, Kenton County objected to this adjustment on the grounds that

depreciation expense on contributed property was allowed in its prior rate case, Case No. 7794, that the Commission had demonstrated a lack of a consistent policy on this issue, that recognized accounting practice requires provision for depreciation expense on all property, and that the disallowance of this expense results in insufficient rates.

The Commission is aware of isolated instances in which depreciation on contributed property was inadvertently allowed for rate-making purposes since the practice of disallowing said depreciation expense was implemented in Case No. 7901, Marion County Water District, Application for General Adjustment of Rates, in 1980. The Commission is likewise aware that generally accepted accounting principles provide for the recording of full depreciation on capitalized assets regardless of the source of the funds used to purchase those assets. The Uniform System of Accounts for Water Utilities is silent on the issue of recording depreciation on contributed property. However, the Commission is of the opinion that neither of the arguments presented by Kenton County addresses the heart of the issue which is whether the revenue requirements of a utility should include depreciation expense which provides recovery of the cost of assets when such assets were provided at no cost to the utility.

The issue of depreciation in the rate-making process is complex. Depreciation, from an accounting standpoint, is simply the amortization of the cost of an asset over a designated time period. The simplest method of depreciation

is termed straight line ("SL") and recognizes the same amount of depreciation expense in each year of an asset's estimated useful life ("service life"). Many other depreciation methods are used for financial reporting and tax purposes; however, for utility accounting and rate-making purposes the SL method of depreciation is required. The primary reason for this requirement is to provide an accurate matching of costs and revenues of the utility for the financial reporting period. From the rate-making perspective, the matching of costs and revenues provides some degree of assurance that the customers of a utility are paying only their fair cost of receiving utility service. For instance, if a method of accelerated depreciation were used, the cost of service, and rates to the customers, would be greater in the initial years of an asset's service life and the customers would be paying higher rates than will be required of future customers when the level of depreciation expense is lower. Likewise, if an asset is depreciated over a period less than the service life, future customers would receive the benefit of that asset but would not be required to pay their proportionate share of the cost. The theory is that when a depreciable asset is placed into service, all customers are benefited equally over the entire service life. Therefore, when the SL depreciation method is used to determine revenue requirements, the customers will pay only for the amount of benefit they received from that asset.

Another way to view depreciation expense is as the recovery of invested capital. When a utility purchases facilities that have extended service lives it has to pay for those facilities through one or a combination of its sources of capital. The primary sources of capital include long-term and short-term debt, various forms of equity and contributions in aid of construction. Obviously, a utility with contributions in aid of construction on its books has some amount of assets on its books which were purchased with those contributions. In the rate-making process, if all assets are depreciated over their useful lives based on SL depreciation, the cost of service of the utility will include a component of depreciation expense each year which relates to contributed property. If the component of depreciation expense relating to customer contributions is included in the determination of revenue requirements, the ratepayers are returning to the utility capital in the form of general funds to pay for plant which was purchased with customer contributions or some other form of contributions. Thus, the customer is paying for assets which were provided at no cost to the utility. In some instances, such as contributions in the form of tap-on-fees, the customers are actually paying for the same asset twice. Kenton County offered no evidence which would refute the possibility of double recovery of costs through depreciation on contributed property.

In its petition for rehearing, Kenton County suggested that a certain component of plant purchased with contributions in aid of construction may no longer be on the books of the utility. The Commission agrees; however, when given the opportunity to provide evidence on this point on rehearing, Kenton County offered no additional proof which would make it possible for the Commission to adjust depreciation expense in any other manner.

Interest Income

In the Order of March 22, 1983, the Commission decreased operating revenue requirements by \$508,242 to reflect the total interest income earned by Kenton County for the test year. In its petition for rehearing, Kenton County contended that certain items of interest income should not be considered because "they are restricted or no longer available." These items of income include \$191,680 of funds irrevocably placed in a trust to provide for the defeasement of old bonds; \$76,246 associated with the debt service reserve fund; \$14,750 generated from the general revenue fund-customer guarantees; \$13,132 generated from the improvement, repair and replacement fund; and \$27,426 generated from the plant fund. At the rehearing Kenton County presented additional testimony on why the income from these funds should not be included in the determination of revenue requirements.

Defeasement Fund

Mr. James Sparrow, CPA for Kenton County, testified that the debt escrow account for the defeasement of the bonds is considered to be treasury investment and is described as a book entry with the U.S. Department of Treasury and at no time does Kenton County have access to interest income on the funds.¹ Kenton County is currently carrying the defeased bonds as a liability and the present value of future principal and interest payments in an escrow account on its balance sheet and is reflecting the interest income earned on this escrow account in its operating statement. Mr. Sparrow stated that as more information is available on the issue he may remove the investments from the balance sheet.² However, he was uncertain at the rehearing whether any change would be made in the accounting treatment of this issue or what the treatment would be. The Commission finds that the accounting treatment of the defeased bonds by Kenton County was handled improperly according to the Uniform System of Accounts which requires that when bonds are reacquired the difference between the face value, adjusted for unamortized discount, expense or premium, and the amount paid upon requisition shall be debited or credited as appropriate to Account 421, Miscellaneous Non-Operating Income, or Account 426, Miscellaneous Income Deductions. The improper

¹ Transcript of Evidence, June 16, 1983, page 17.

² Ibid., page 57.

accounting for the defeasance has resulted in the inclusion of the interest income on the defeased escrow account on the operating statement.

Projected Interest Income

Kenton County contended that the Commission did not consider the estimated level of investments to be made subsequent to the test year for the plant fund, debt service reserve fund and improvement, repair and replacement fund. Kenton County argued that these funds will no longer be available at the same level as during the test period. Therefore, Kenton County proposed to eliminate the balances in the plant fund and improvement, repair and replacement fund and to reduce the debt service reserve fund by an arbitrary amount. Mr. Victor Fender, witness for Kenton County, testified that the plant fund is used to build capital improvements.³ The plant fund is not a requirement of the bond resolution. The bond resolution states that the improvement, repair and replacement fund is to be utilized for unforeseen major repairs and replacements and to pay the cost of construction of additions, extensions, betterments and improvements which will either increase income and revenues or provide a higher degree of service. The Commission is of the opinion that it is improper to eliminate the balances in the plant fund or the improvement, repair and replacement fund due to the completion of construction

³ Ibid., page 87.

projects unless corresponding adjustments are made to reflect the additional revenues and changes in expenses that will occur as a result of these new facilities. Likewise, while the level of these funds may decrease, the possibility exists for these funds to increase. In order to avoid such an arbitrary result, the Commission has recognized the test year end levels in each fund. Since Kenton County did not propose any adjustments to the actual level experienced, the Commission has included the actual interest income earned during the test year.

Debt Service Reserve Fund

According to the bond resolution, the interest earned on the debt service reserve fund is available to the general revenue fund when the debt service reserve fund is fully funded. Since it is now fully funded, there is no basis for Kenton County's claim that the interest income earned on the debt service reserve fund is restricted. Kenton County also argued that a basis for reducing the debt service reserve fund and thus, interest income, was to reflect the reduction in investments that it felt were no longer available.⁴ However, Mr. Sparrow later agreed upon cross-examination that he had no reason for excluding the interest income of \$76,246.⁵

⁴ Ibid., page 36.

⁵ Ibid., page 38.

Debt Service Coverage Requirements

The primary argument presented by Kenton County on the overall issue of interest income is that certain items of income cannot be used by it except for the purposes designated in its bond ordinance. The underlying disagreement between Kenton County and the Commission results from the approach taken in determining the revenue requirements of Kenton County. Kenton County has presented its case for the exclusion of interest income based on requirements of the bond ordinance restricting the use of various cash reserve funds set out in the bond ordinance. The Commission generally agrees with Kenton County's interpretations of the restrictions on the uses of these funds. However, the issue before the Commission is not a matter of whether the bond ordinance restricts the utilization of certain cash funds, but rather how the debt service coverage of Kenton County is to be calculated under the bond ordinance. There is a distinct difference between the restriction of the use of cash funds and the sources of income which may be recognized by Kenton County in meeting the debt service coverage requirements as provided in its bond ordinance. Kenton County and the Commission should be concerned that the earnings requirements of Kenton County's lenders are being recognized and achieved in the rate-making process. Moreover, both parties should be concerned that the earnings requirements of the lenders are not exceeded in the

rate-making process in order to provide service to the ratepayers at the lowest possible rates.

Kenton County has presented extensive arguments on the uses of the investments in its defeasement fund, the debt service reserve fund, general revenue fund-customer guarantees, improvement repair and replacement fund and the plant fund. However, no evidence has been presented by Kenton County which would relate its position to the debt service coverage requirements of its lenders, as set out in the bond ordinance. In accordance with the bond ordinance, the basis for the debt service coverage is the net annual income of Kenton County. No evidence has been presented which reflects that the net annual income for purposes of determining the debt service coverage ratio is any different than the net income reported in Kenton County's financial statements. Since the financial statements of Kenton County for the test year in this case contained \$508,242 of interest income which contributed to the reported net income, the Commission has used this interest income in determining the revenue requirements of Kenton County. Therefore, the Commission will not change its previous decision. If, however, Kenton County adjusts its books to eliminate the defeasement fund and corresponding liabilities relating to the old bonds, the Commission will consider a limited reconsideration of this issue in another proceeding in which the propriety of the adjustments and the effect on the ratepayers can be determined.

LATE-FILED MOTION

On August 24, 1983, Kenton County filed a motion to include a letter dated July 22, 1983, in the record. This letter refers to a loan which Kenton County stated it was arranging so as to meet its August 1, 1983, bond payment. In the alternative, Kenton County asked that the Commission take administrative notice of the letter.

This motion was not timely filed and as such, the Commission need not consider the letter in deciding the issues on rehearing.⁶ However, even if the letter had been presented in a timely fashion, it would not have been relevant to the issues upon which rehearing was granted: depreciation on contributed property and interest income. Had the issue of cash flow been properly raised and rehearing been granted on that point, the tendered letter would not, in and of itself, demonstrate a cash flow problem. There are any number of reasons why Kenton County might borrow money, for instance, construction of extensions. In order to determine the actual reason for the borrowing a further hearing would be required and Kenton County would have to perform a cash flow analysis. For all of these additional reasons, the ultimate decision would have been unchanged had the Commission not overruled the motions as untimely. For these reasons this letter does not affect the outcome.

⁶ Bowman Transportation v. Arkansas-Best Freight System, 419 U.S. 281 (1974).

Summary

The Commission, based upon the evidence of record and being advised, is of the opinion and finds that:

1. Kenton County has failed to present sufficient evidence to support its arguments that depreciation expense on contributed property should be included in test year expenses for rate-making purposes and that interest income on the defeasement fund, plant fund, improvement, repair and replacement fund, debt service reserve fund and customer guarantee fund should be excluded in the calculation of revenue requirements.

2. The Commission will give Kenton County the option of revising its financial statements to account for the defeasance of the old bond issue. If Kenton County wishes to make this change to its financial statements, it may file a letter of intent within 30 days of the date of this Order including the revised financial statements along with supporting journal entries. Also, Kenton County should request a proposed period of amortization of the gain on the defeasance with justification for the proposed period.

3. Kenton County's motion of August 24, 1983, is untimely filed.

IT IS THEREFORE ORDERED that Kenton County may file a letter of intent within 30 days of the date of this Order if it wishes to revise its financial statements to account for the defeasance.

IT IS FURTHER ORDERED that Kenton County's motion of August 24, 1983, be and it hereby is overruled.

IT IS FURTHER ORDERED that Kenton County shall file, with its letter of intent, its revised financial statements along with supporting journal entries. Further, Kenton County should request a proposed period to amortize the gain on the defeasance with justification for the proposed period.

IT IS FURTHER ORDERED that Kenton County's petition for rate relief be and it hereby is denied.

Done at Frankfort, Kentucky, this 20th day of September, 1983.

PUBLIC SERVICE COMMISSION


Chairman

Not Participating
Vice Chairman


Commissioner

ATTEST:

Secretary