COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

NOTICE OF ADJUSTMENT OF RATES OF KENTUCKY-AMERICAN WATER COMPANY	))	CASE NO. 9482

ORDER FOR REHEARING

On July 8, 1986, the Commission entered an Order granting Kentucky-American Water Company ("Kentucky-American") an increase in revenues of $1,510,714 annually. On July 28, 1986, the Consumer Protection Division of the Attorney General's Office ("AG") filed a petition for rehearing of the following issues:

(a) Stock (Inventory) Shortages and Service Awards

(b) Corporate Secretarial and Water Quality Charges By the Service Company

(c) Accrued Utility Revenues

(d) Fire Protection Revenues

(e) Wage Increases

(f) Treatment of Revenues From the Versailles Project

(g) Insurance Expense

(h) Operating Revenues

(i) Embedded Cost of Debt

DISCUSSION

The AG contended in its petition that the Commission had not addressed in its Order several issues identified in its brief. The AG complained that the stock shortages were non-recurring and should be capitalized because the materials would be used in construction activity.[1] It is the Commission's judgment that inventory or stock shortages of this nature are in the normal course of business and require no special treatment. In addition, the AG stated in its brief that the service awards were somewhat non-recurring because the test-period level represented a "catch-up" since Kentucky-American only recently initiated the program.[2] The Commission concurs that the expense may not be at the same dollar amount every year; however, it is the Commission's judgment that the amount of $3,021 involved is not unreasonable. For the reasons stated herein the Commission denies rehearing of the stock shortage and service award issues.

The AG's petition stated that the issues of corporate secretary and water quality charges were not addressed in the Commission's Order. While these specific issues were not addressed, the Commission considered at length the entire issue of overall charges billed by American Water Works Service Company ("American") and disallowed approximately $56,000, thereby allowing an approximate 2.6 percent increase over the level that the Commission found reasonable in Case 9283.[3] The Commission therefore denies rehearing on these issues.

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1 Brief of the AG, page 19.

2 Ibid.

3 Notice of Adjustment of the Rates of Kentucky-American Water Company.

The AG submitted in its brief that Kentucky-American's rate base should be reduced by $888,122 to reflect deferred income tax expense on income taxes attributable to $1,930,701 of accrued revenues. The AG stated that for tax purposes Kentucky-American records its revenues on a billed basis and that for book purposes Kentucky-American records revenues on an unbilled basis causing a timing difference. But as reflected on Exhibit No. 4, Schedule 2, unbilled or accrued revenues are deducted from Kentucky-American's test period revenues for rate-making purposes and thus taxes for both tax purposes and rate-making purposes are the same. The Commission, therefore, denies rehearing of the issue of accrued utility revenues.

The AG argues that Kentucky-American's operation and maintenance expenses are overstated by $18,284 due to Kentucky-American computing additional expenses based on public and private fire protection revenue increases resulting from rates instead of revenue figures based on an increase in the number of customers. The Commission grants rehearing of this issue.

The AG states in its brief that it is improper to allow Kentucky-American annual wage increases in excess of the Consumer Price Index ("CPI") and asserts the same in his petition for rehearing. The Commission's Order in this case granted Kentucky-American wage increases of approximately 4 percent for union and 5 percent for non-union personnel. While the Commission uses the CPI as one of its guidelines for examining the reasonableness of a company's requested wages, it does not attempt to hold a company's wages strictly to the CPI. The Commission found Kentucky-American's request to be reasonable in this case. The Commission therefore denies rehearing on this issue. The Commission will continue to closely scrutinize Kentucky-American's wage requests in future rate proceedings. Any future wage increases should reflect the moderating trend that is evident throughout the national and state economy.

The AG submits in its brief that Kentucky-American did not support its proposed increase in insurance expense and that the Commission should disallow the entire increase of $230,177.[4] The AG challenged the increase for three basic reasons: (1) Kentucky-American relies soley on American to negotiate its premiums, (2) Kentucky-American proposes to capitalize an insufficient amount of its workers compensation premiums and (3) Kentucky-American inappropriately changed its booking procedure for insurance expense during the test period.

The Commission, in its Order, addressed at length issues of Kentucky-American's insurance expense. The Commission found that due to rapid increases in insurance premiums Kentucky-American's proposed level of insurance expense is acceptable in this case, but advised that the Commission will not allow such increases in the future unless Kentucky-American provides sufficient proof that it has exhausted all efforts to acquire insurance coverage at the least cost possible to its ratepayers.[5]

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4 Brief of the AG, page 30.

5 Order, July 8, 1986, page 20.

The AG further states in its petition that the Commission should rehear the issue of insurance expense for the same reasons stated in its brief. It is the Commission's judgment that the AG has presented additional evidence to support rehearing on the proposed capitalization of workers compensation premiums, but has not presented any new evidence on other aspects of the insurance expense. The Commission, therefore, grants rehearing on the capitalization of workers compensation premiums but denies rehearing of all other arguments by the AG concerning Kentucky-American's insurance expense. It is the Commission's opinion that Kentucky-American should respond to the AG's petition for rehearing regarding Item 18(a) page 30 of 50 of the response to the Commission's Order of January 17, 1986.

At the hearing of May 14, 1986, the AG and Kentucky-American reached an agreement in which Kentucky-American would reduce its "revenue request by $143,553".[6] The agreement was the result of a meeting between the parties during a break in the hearing to expedite a line of questioning by the AG. It should be noted that no member of the Commission staff was present during the meeting. In the Commission's Order the agreement of the parties was set aside.[7] It is evident that a misunderstanding exists among the Commission, the AG and Kentucky-American as to what the agreement entailed. A meeting on July 15, 1986, between members of the Commission staff, representatives of the AG's office and

6 Transcript of Evidence, pages 103-104.

7 Order, July 8, 1986, page 11.

representatives of Kentucky-American failed to resolve the misunderstanding. It is the Commission's judgment that additional information is needed from both the AG and Kentucky-American before a proper reconsideration of the issue can be attained. The information required by the Commission from the AG and Kentucky-American is:

(1) The agreement in writing from both parties stating:

(a) the reason(s) for the agreement

(b) the details of the agreement

(c) the impact of the agreement upon Kentucky-American's revenue request, revenue requirement, and billing analysis

(2) All exhibits, as filed by Kentucky-American, that are affected by the agreement.

(3) All adjustments to the appropriate components of the schedules referred to in item (2) above with a complete narrative description of all adjustments.

(4) All of the exhibits in item (2) above, with revisions showing the pro forma effect of all adjustments resulting from the terms of the agreement.

The Commission grants rehearing of the issues involved in the aforementioned agreement between Kentucky-American and the AG, subject to the condition that the AG and Kentucky-American file the information ordered herein. If differences arise from these responses, replies may be permitted at a later date.

In its petition for rehearing, the AG stated that the embedded cost of debt found reasonable by the Commission was incorrect.[8] Kentucky-American computed a 9.97 percent embedded cost of long-term debt based on a capitalization of $46,901,988. However, the Commission used an adjusted capitalization of $49,668,983. The AG argued that since the Commission used a greater capitalization figure, the embedded cost of long-term debt should decrease because interest costs were being divided by a larger amount.[9]

The Commission uses a specific methodology to compute the embedded cost of long-term debt. This methodology is set out in item 2a, schedule 2, of the staff request dated January 17, 1986. When $1,700,000 of Series E bonds (which matured May 1, 1986) are removed, the embedded cost of long-term debt is 9.97 percent for the test year ended October 31, 1985. The Commission uses this 9.97 percent embedded cost of long-term debt in its computation of the weighted average cost of capital.

The Commission frequently makes adjustments to the total dollars of capitalization (such as adding back end-of-period JDIC). However, these dollar adjustments do not affect the actual costs of the various capital components. The 9.97 percent cost of long-term debt found reasonable by the Commission is correct. Therefore, the AG's petition for rehearing on the issue of the appropriate cost of long-term debt is denied.

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8 AG's petition for rehearing, page 15.

9 Ibid.

IT IS THEREFORE ORDERED that:

1. The AG's petition for rehearing is denied in part and granted in part as discussed in this Order.

2. Within 2 weeks from the date of this Order Kentucky-American and the AG shall file the information requested with regard to the agreement on operating revenues.

3. Within 2 weeks from the date of this Order Kentucky-American shall respond to the AG's petition for rehearing and the AG's brief concerning the capitalization of workers compensation premiums.

Done at Frankfort, Kentucky, this 18th day of August, 1986.

PUBLIC SERVICE COMMISSION

Richard D. Heman Jr.

Chairman

Vice Chairman

Susan N. Williams J.

Commissioner

ATTEST:

Executive Director