

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF LEXINGTON-SOUTH ELKHORN)
WATER DISTRICT AND KENTUCKY-AMERICAN)
WATER COMPANY FOR THE APPROVAL OF THE)
PURCHASE BY KENTUCKY-AMERICAN WATER)
COMPANY OF THE ASSETS OF THE LEXINGTON-)
SOUTH ELKHORN WATER DISTRICT, FOR) CASE NO. 9926
APPROVAL OF RATES TO BE CHARGED FOR)
SERVICE WITHIN THE BOUNDARIES OF THE)
LEXINGTON-SOUTH ELKHORN WATER DISTRICT)
AFTER ACQUISITION AND FOR A CERTIFICATE)
OF CONVENIENCE AND NECESSITY AUTHORIZING)
THE CONSTRUCTION OF CERTAIN IMPROVEMENTS)

O R D E R

On April 30, 1987, the Petitioners, Lexington-South Elkhorn Water District ("Lexington-South Elkhorn") and Kentucky-American Water Company ("Kentucky-American"), filed an application for the approval of the purchase by Kentucky-American of the assets of Lexington-South Elkhorn, for approval of rates to be charged for services within the boundaries of the Lexington-South Elkhorn Water District, and for a certificate of convenience and necessity for the construction of certain improvements.

Lexington-South Elkhorn is a water district created pursuant to Chapter 74 of the Kentucky Revised Statutes and is located in Jessamine County, Kentucky. Kentucky-American is a corporation engaged in the distribution and sale of water in Fayette, Woodford, Scott, Harrison, and Bourbon counties and also provides

service to water districts within a portion of Jessamine County. Each is currently subject to the jurisdiction of the Commission.

On February 4, 1987, Lexington-South Elkhorn and Kentucky-American entered into a written agreement providing for Kentucky-American to purchase and Lexington-South Elkhorn to sell to Kentucky-American the entire water distribution system of Lexington-South Elkhorn. Upon the transfer of the assets Kentucky-American agreed to undertake to serve the existing and future customers within the territorial boundaries of Lexington-South Elkhorn and to make certain improvements subject to the approval of the Commission. The specific terms and conditions of the sale are set forth in the contract of February 4, 1987.

Kentucky-American proposes to finance the acquisition of the assets through the use of available cash and short-term borrowings or a combination of both and, upon completion of the installation of facilities proposed in the application, to convert those costs to permanent financing consisting of long-term debt and equity.

After review of the record and evidence presented at the hearing held on July 15, 1987, the Commission finds that because of Kentucky-American's experience in operating its own system and its demonstrated ability to provide service at reasonable rates, it has the managerial, technical, and financial ability to operate Lexington-South Elkhorn. For these reasons, the transfer should be approved with the exceptions explained below.

PROPOSED CONSTRUCTION OF WATER MAIN EXTENSIONS

Section 5 of the Agreement between the Lexington-South Elkhorn Water District and the Kentucky-American Water Company

("Agreement") requires a series of water main extensions to be constructed over the next four years. Kentucky-American estimates that these extensions will provide water service to 259 new customers at a total cost of approximately \$3 million. Kentucky-American proposes to recover the cost of these extensions from its total customer base and not directly from those customers benefited by the extensions. In fact, it is proposed that the benefited customers not be required to make any direct contribution to finance the cost of the extension. This is a substantial departure from the extension procedure contained in Kentucky-American's approved tariffs as well as the general extension procedure outlined in 807 KAR 5:066 (12).

In Case No. 9283, Notice of Adjustment of the Rates of Kentucky-American Water Company Effective On And After April 19, 1985, Kentucky-American discussed its intention to expand its service outside the Lexington-Fayette Urban County area. In its Order in that Case entered October 1, 1985, the Commission took note of Kentucky-American's development as a regional water supplier and commented in part:

The Commission commends Kentucky-American for pursuing the goal of serving as a regional water supplier. The Commission encourages Kentucky-American to pursue supply contracts with the adjacent districts as a way of using its excess treatment capacity and as an efficient method of providing basic water service within the region. But as a leader in Kentucky in the development of a regional water supply system, Kentucky-American must also look at the accompanying issues that this objective raises for the Commission.

The construction required by Section 5 of the Agreement raises two issues which concern this Commission. First is the

question of the apparent inequity of charging all of the company's existing customers for the cost of extending service to a rather small isolated group of applicants. Secondly, the Commission is concerned that the Agreement's requirements provide essentially free extensions to a particular group of applicants, a service not available to other Kentucky-American applicants. Chapter 278.170 of the Kentucky Revised Statutes states in part:

(1) No utility shall, as to rates or service, give any unreasonable preference or advantage to any person or subject any person to any unreasonable prejudice or disadvantage, or establish or maintain any unreasonable difference between localities or between classes of service for doing a like and contemporaneous service under the same or substantially the same conditions.

While some subsidization among customers is inherent in the concept of a public utility, Kentucky-American's proposal to charge existing customers for substantially all of the cost of the extensions is unreasonable. The Commission encourages Kentucky-American in its efforts to extend its water service area. However, the requirements of Section 5 that substantially all of the costs of the extension be paid by Kentucky-American's existing customers, a requirement that contravenes the Company's approved tariffs, constitutes an unreasonable preference in its present form. The Commission will consider reasonable modifications to Section 5 which balance the need for a regional approach to water supply and service and an equitable assignment of costs.

CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY

In the current proceedings Kentucky-American has petitioned the Commission for approval of a series of construction projects

over the next four years with a total cost of approximately \$3 million.

The record indicates that the proposed construction will involve sufficient capital outlay to materially affect the existing condition of the utility and will ultimately result in increased charges to its customers. The proposed construction projects cannot, therefore, be considered extensions in the ordinary course of business and do require certificates of public convenience and necessity.

The record in this case indicates that Kentucky-American has not completed the design of the proposed extension projects, and is not presently prepared to contract for construction of these projects. 807 KAR 5:001 (9) requires the submittal of a full description of the location of the extension, the manner in which it will be constructed, and all other information necessary to afford the Commission a complete understanding of the project. This information has not been supplied. Kentucky-American is in essence requesting the Commission's prior approval for the future construction contained in Section 5 of the Agreement. While the Commission approves the general concept of the proposed construction, it cannot grant a blanket certificate for unspecified future construction. More directly Chapter 278.020 of the Kentucky Revised Statutes voids a certificate of convenience and necessity unless it is exercised within one year from the grant thereof.

In this instance, the Commission is not approving the proposed construction either generally or specifically. In any

future request for a certificate of public convenience and necessity, Kentucky-American must file the requisite information for Commission review within a reasonable proximity of the expected commencement of construction.

ADOPTION OF KENTUCKY-AMERICAN RATES

Section 4 of the Agreement requires Kentucky-American to charge the customers of the Lexington-South Elkhorn service area the same rates charged to the customers within the Lexington-Fayette County service area after the transfer. Testimony provided by Kentucky-American indicates that it can charge the existing customers of Lexington-South Elkhorn at the Kentucky-American rate schedule and still generate a small surplus after the necessary expenses of operation. The Commission is pleased that in this instance the existing customers of Lexington-South Elkhorn in Jessamine County can receive a reduction in their cost of water service without any subsidy. The Commission considers this the ultimate goal for Kentucky-American's regional supplier efforts. However, the Commission is very much aware of the costs of extending water service beyond Kentucky-American's urban service area. This was recognized by the Commission in its October 1, 1983, Order for Case No. 9283:

The Commission is also concerned about the appropriate rate design for customer classes outside the Urban County. Kentucky-American should be aware that the cost allocation and rate design method approved for the Urban County will not automatically be considered appropriate by the Commission for service to other counties.

In the proceedings for Case No. 9283 the Lexington-Fayette Urban County Government raised several objections to Kentucky-

American's determination of fire service charges. The Commission's Order also recognized some concern in that area:

In at least one area, however, the Commission is of the opinion that the Urban County may have a valid point. That area involves the allocation of costs associated with distribution facilities located outside the political boundaries of the Urban County to fire protection service. Therefore, the Commission advises Kentucky-American that it must address the matter of an adjustment to fire protection service for distribution facilities located outside the political boundaries of the Urban County in any future cost-of-service presentation before the Commission.

The Commission will approve the proposed adoption of Kentucky-American's current rate structure at this time. The Commission reiterates the above statement concerning cost allocation and rate design set forth in the Order in Case No. 9283. Stated another way, the Commission will review any future rate structure applicable to those customers outside the Urban County in the context of a cost of service study and the role of Kentucky-American as a regional water supplier as it affects the public interest.

FINDINGS AND ORDERS

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

1. Section 5 of the Agreement between the Board of Commissioners of the Lexington-South Elkhorn Water District and the Kentucky-American Water Company requiring construction of extensions to a particular group of applicants should be disallowed.
2. Kentucky-American's application for a certificate of public convenience and necessity to construct the improvements outlined should be denied.

3. The transfer, sale, and purchase of Lexington-South Elkhorn's water distribution system to Kentucky-American should be approved.

4. The adoption of Kentucky-American's rate structure for the customers of Lexington-South Elkhorn after the transfer, sale, and purchase is reasonable and should be approved.

IT IS THEREFORE ORDERED that:

1. Section 5 of the Agreement be and hereby is disallowed.

2. Kentucky-American's request for a certificate of public convenience and necessity to construct certain improvements required by Section 5 of the Agreement be and hereby is denied.

3. The transfer, sale, and purchase of Lexington-South Elkhorn's distribution system to Kentucky-American be and hereby is approved.


4. The adoption of Kentucky-American's rate structure for the customers of Lexington-South Elkhorn, after the transfer, sale and purchase, be and hereby is approved.

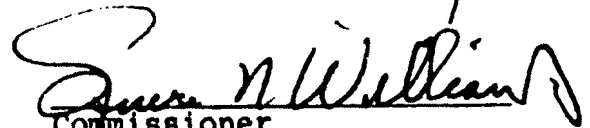
5. Kentucky-American shall within 30 days of the transfer, file the appropriate journal entries reflecting the recording of the assets and liabilities of Lexington-South Elkhorn on its books.

Done at Frankfort, Kentucky, this 23rd day of September, 1987.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Executive Director