COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

NOTICE OF ADJUSTMENT OF THE RATES OF KENTUCKY-AMERICAN WATER COMPANY) CASE NO. 10069

O R D E R

On December 1, 1987, Kentucky-American Water Company ("Kentucky-American") filed its notice with the Commission seeking to increase its rates and charges effective January 1, 1988 to produce an annual increase in revenue of $1,732,386, an increase of approximately 8.45 percent. On January 21, 1988, Kentucky-American amended its application by proposing various adjustments to both rate base and operating expenses to arrive at a revised annual increase of $1,649,350. On February 19, 1988, Kentucky-American further revised its application to reflect an annual increase of $1,603,465. In its rebuttal testimony, Kentucky-American reduced its requested return on equity from 14 to 13.5 percent resulting in a final requested annual increase of $1,432,475.

In order to determine the reasonableness of the request, the Commission suspended the rates and charges for 5 months after the proposed effective date. Kentucky-American requested that a settlement conference be scheduled in an attempt to settle issues prior to the scheduling of a hearing.

The settlement conference was held on March 30, 1988 in the Commission's offices in Frankfort, Kentucky. The Utility and Rate

Intervention Division of the Attorney General's office ("AG"), and the Lexington-Fayette Urban County Government ("LFUCG"), intervened in this matter and participated in both the settlement conference and public hearing.

Brown Sprinkler, Inc. ("Brown"), also intervened in this matter. However, on April 5, 1988, Brown filed a Motion to withdraw. By its Order dated April 11, 1988, the Commission granted Brown's Motion.

At the settlement conference, the Commission Staff ("Staff") and Kentucky-American formulated a proposed settlement agreement ("Proposal") to be submitted to the Commission for approval. It was made part of the record and is attached to this Order as "Appendix B". The AG/LFUCG objected to the terms of the Proposal and was not a signatory to it.

In order to determine the reasonableness of the Proposal, a public hearing was scheduled and held on May 5, 1988 in the Commission's offices in Frankfort, Kentucky, following notice given pursuant to the Commission's regulations.

Witnesses for Kentucky-American prefiling testimony and appearing at the hearing were Charles F. Phillips, Jr., Professor of Economics at Washington and Lee University; Robert A. Edens, Vice President and General Manager of Kentucky-American; Chris E. Jarrett, Vice President and Treasurer of Kentucky-American; and Edward J. Grubb, Revenue Requirements Specialist, American Water Works Service Company. Appearing on behalf of the AG/LFUCG was Thomas C. DeWard, a Certified Public Accountant and Senior Regulatory Analyst for Larkin and Associates.

This Order addresses the Commission's findings and determination on the Proposal and issues raised at the hearing, issues raised in subsequent Motions by the AG/LFUCG concerning the appropriateness of the Proposal, and issues raised by the AG/LFUCG not addressed in the Proposal.

The discussion on adjustments and return in this Order are directed to those proposed by the AG/LFUCG which were not included in the Proposal. The Order is drafted in this manner because these particular issues raised by the AG/LFUCG are the only additional factors to be considered in determining the reasonableness of the Proposal and were offered by the AG/LFUCG as grounds that the Proposal should not be found reasonable.

The Commission's overall finding is that the Proposal and the rates produced by the Proposal are fair, just, and reasonable. Thus, the Commission has granted rates and charges to produce an annual increase of $842,610 herein.

MOTION

At the hearing, the AG/LFUCG filed a Motion seeking rejection of the Proposal. The grounds for the Motion are that the Commission lacks authority to accept a proposed settlement if a party objects; the procedure used violates due process because it shifts the burden of proof, and denies intervenors the opportunity to cross-examine the Staff; the Commission engaged in ex parte contact with its Staff; and the rates are unreasonable. After considering the arguments presented, the Commission denied the Motion from the bench.[1]

NET INVESTMENT RATE BASE

Kentucky-American originally proposed a net investment rate base as of September 30, 1987, of $58,306,349, which it later reduced to $58,068,556. Kentucky-American and the Staff agreed to a compromise net investment rate base of $57,981,203 as determined in the Proposal.

The AG/LFUCG proposed the following additional adjustments to Kentucky-American's proposed rate base. None of these adjustments were accepted in the Proposal.

Construction Work in Progress ("CWIP")

The AG/LFUCG proposed to reduce rate base by $3,130,410 to eliminate CWIP not completed as of September 30, 1987.[2] Allowance for funds used during construction ("AFUDC") applies only to construction projects exceeding 1 year. Approximately one-half of the end-of-period CWIP is composed of projects of less than 1 year. The AG/LFUCG stated that the inclusion of CWIP creates a mismatch between rate base and earnings since the company has made no projection of associated revenues. The AG/LFUCG further stated that since the majority of CWIP has a construction period of less than 1 year, then AFUDC does not offset the apparent mismatch.

In the Proposal the only expense associated with CWIP included in operations was property taxes on one-half of the

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1 Transcript of Evidence ("T.E."), page 39.

2 Direct Testimony of Thomas C. DeWard, Schedule 6.

end-of-period CWIP, which was included in accordance with current practice. When CWIP is placed in service, the plant or investment will generate increased operating revenue. However, depreciation expense will accrue at that time as well as maintenance expenses, additional customer accounts expenses, and the full level of property taxes.

The AG/LFUCG did not propose any adjustments to take into consideration the increased expenses associated with CWIP placed in service. Thus, the AG/LFUCG's adjustment represents a further mismatch. Therefore, the Commission finds that there is no appropriate justification to deviate from its normal rate-making practice regarding CWIP.

Customer Advances for Construction

The AG/LFUCG proposed to increase customer advances by $330,179 to the average test period level of customer advances.[3] Staff and Kentucky-American, in the Proposal, reduced customer advances by the advances on which construction had not yet begun. It is the AG/LFUCG's opinion that regardless of whether the construction was included in either CWIP or plant in service, cost-free funds were available to Kentucky-American, and therefore, the average level of customer advances should be used as a reduction to rate base.

Customer advances is one of the few accounts on the "right side" or liabilities side of the balance sheet that can be directly traced to specific assets. Hence, a mismatch occurs if

3 Ibid., Schedule 8.

customer advances are deducted from rate base and the associated construction project is not included in either CWIP or plant in service. The AG's adjustment creates said mismatch and, it is the Commission's opinion, this adjustment should, therefore, be denied.

Working Capital

The AG/LFUCG proposed to reduce working capital by $755,223 to reflect the elimination of non-cash items from Kentucky-American's proposed lead/lag study. The AG/LFUCG considers Kentucky-American's lead/lag study flawed because it includes depreciation, amortization, uncollectibles, the current portion of deferred tax expense, and net earnings.

The AG/LFUCG's position is that since there is no absolute payment or outlay of cash required on these non-cash items, these items should not be a part of Kentucky-American's working capital investment. Kentucky-American's position is that these non-cash items are legitimate expenses (considering earnings as an expense of stockholders) that do require consideration and inclusion in cash working capital because they are current assignments of amounts owed by Kentucky-American.

Both positions have been adopted by various Commissions in past cases. This Commission is of the opinion that the inclusion of all expenses, including earnings and non-cash items, is a theoretically sound approach.

Therefore, the Commission finds that Kentucky-American's calculation is reasonable and, thus, accepts the level of cash working capital in the Proposal.

REVENUES AND EXPENSES

Kentucky-American had net operating income of $5,660,659 for the 12-month period ending September 30, 1987. In order to normalize current operating conditions Kentucky-American proposed several adjustments to its test period revenues and expenses which resulted in an adjusted net operating income of $5,459,627. The Staff and Kentucky-American, in the Proposal, reached a compromise net operating income of $5,712,105, based on the adjustments agreed to therein. The following are revenue and expense adjustments proposed by the AG/LFUCG, which were not accepted in the Proposal.

Year-End Customers

The AG/LFUCG proposed to increase operating revenues by $334,490 to reflect Kentucky-American's end-of-period customers. The AG/LFUCG's adjustment was calculated using the number of Kentucky-American's residential customers at the end of the test year of 63,619.

Kentucky-American's witness, Mr. Grubb, in his rebuttal testimony, argued that the AG/LFUCG's adjustment ignored the fact that customers leave the system and are not immediately replaced. In its Supplemental to Memorandum of the AG filed May 23, 1988, the AG argued that the adjustment was, in fact, conservative since 2,318 "potential customers," on an average, left the system during the 47 "average replacement days" prior to the end of the test period. Therefore, the use of 63,619 year-end customers as opposed to 65,937 potential year-end customers constituted a conservative revenue estimate.

Kentucky-American's adjusted billing analysis is complex in its calculations of customers' billings throughout the year but is, in the Commission's opinion, representative of the end-of-period revenue level. The adjusted billing analysis and, thus, the Proposal reflect Kentucky-American's adjustments to revenues which include an adjustment to reflect end-of-period residential customers of 63,619. Therefore, the Commission is of the opinion the AG's adjustment should be denied.

Matching Revenues to Pumpage

The AG/LFUCG proposed to increase operating revenues by $190,568 in order to match revenues with pumpage.[4] The AG/LFUCG states that Kentucky-American records its expenses as they are incurred and that there is a lag between recording revenues and recording the expenses associated with the water pumped.

In order to properly match revenues and pumpage, the Commission is of the opinion that a complete analysis of all recording lags for expenses and revenues would be necessary. As it stands now, the AG/LFUCG's adjustment equates revenues recorded with volumes of water pumped during a particular time frame. Notably, revenue would be recorded later than the metered volumes pumped are recorded. However, the same holds true for the expenses that associated with the metered volumes of water pumped.

Therefore, the AG/LFUCG's adjustment does not properly match all revenues and expenses associated with the full pumping and delivery cycles. Based on the apparent mismatch that would result

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4 Ibid., pages 17 and 18.

from the adjustment, the Commission is of the opinion that the AG/LFUCG's adjustment is incorrect, and finds that it should be denied.

Lab Testing

The AG/LFUCG proposed to decrease lab testing expense by $38,061, based on the assumption that the testing equipment[5] rented by Kentucky-American has enabled it to perform tests that were previously performed by the Belleville unit of the service company.[6] The AG/LFUCG stated that the failure to make such an adjustment would result in a duplication of services, and would not recognize any possible savings from the equipment rental.

Kentucky-American stated that due to the requirements of the Safe Drinking Act of 1986 ("Safe Drinking Act") and its following amendments, the testing requirements have increased. Therefore, the testing performed by the Belleville Lab Facilities will not be reduced as the AG/LFUCG states,[7] and, thus, it would be inappropriate to consider the AG/LFUCG's adjustment at this time.

The information requested by the AG/LFUCG at the hearing, reveals that the Belleville Lab Facilities testing cost for comparable periods during and after the test period has increased rather than decreased. Based on the increased testing required by the Safe Drinking Act, the evidence requested by the AG/LFUCG at the hearing, and the absence of supporting evidence for the

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5 Atomic Absorption and Gas Chromatograph units.

6 Direct Testimony of Thomas C. DeWard, page 23.

7 Rebuttal Testimony of Robert A. Edens, pages 5 and 6.

AG/LFUCG's adjustment, the Commission finds that the AG/LFUCG's proposed adjustment is incorrect and should be denied.

Service Company Allocation

The AG/LFUCG proposed to decrease the service company allocation by $68,181, to reflect the allocation of costs to non-operating companies.[8] The service company's general charges or overheads are allocated to the separate operating companies by a formula approach. The AG/LFUCG contended that the non-operating companies are charged for work specifically performed on their behalf but are not allocated their fair share of the overhead costs. Therefore, the AG/LFUCG concluded that these companies receive an undeserved subsidization, and for the purposes of setting rates the non-operating companies should be allocated their fair share of the overhead or general costs.

With regard to the AG/LFUCG's adjustment to service company charges, Mr. Jarrett made the following statement, "As Manager of Finance for the Southern Region, I can state for the record that none of the employees within the Southern Region are involved, either directly or indirectly, with the functions of the non-operating companies."[9]

Based on this statement, the Commission is of the opinion that the AG/LFUCG's proposed adjustment contradicts the actual operations of the service company and should be denied.

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8 Direct Testimony of Thomas C. DeWard, page 24.

9 Rebuttal Testimony of Chris E. Jarrett, page 6. Emphasis added.

Cost of Serving New Customers

The AG/LFUCG proposed to decrease Kentucky-American's cost of serving new customers adjustment by $43,158.[10] The AG/LFUCG stated that the methodology used by Kentucky-American assumes that costs other than the cost of producing water will increase proportionately with the increased customers. The AG/LFUCG claimed that many of the costs are fixed and do not vary directly with sales, and, thus Kentucky-American's adjustment is incorrect.

Kentucky-American stated that the AG/LFUCG's adjustment is erroneous because the majority of its operation and maintenance expenses (including labor) vary with the number of customers served and the resulting sales level. Kentucky-American also pointed to the following customer accounting costs as examples of variable costs ignored in the AG/LFUCG's adjustment: computer services, postage, bill forms, and uncollectibles.

The Commission agrees with the AG/LFUCG that there are costs which do not vary proportionately with either the number of customers served or the sales volume. However, the AG/LFUCG's adjustment did not recognize all of the costs that would vary proportionately and, therefore, the Commission is of the opinion that the AG/LFUCG's adjustment should be denied.

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[10] Direct Testimony of Thomas C. DeWard, pages 25 and 26.

Excess Deferred Taxes

The AG/LFUCG proposed to reduce deferred taxes to flow back the deferred taxes at 34 percent over a 5-year period by $16,031.[11]

Kentucky-American stated that the flow back of these taxes was at 40 to 46 percent, and that if the AG/LFUCG's adjustment was accepted, the result would be double counting of the deferred tax amortization.

The Commission has reviewed the aforementioned exhibit and is of the opinion that the AG/LFUCG's adjustment would result in a double counting of the amortization of deferred taxes. Thus, the Commission finds that the AG/LFUCG's adjustment should be denied.

State Deficiency

The AG/LFUCG proposed to decrease federal taxes by $6,856 to reflect the savings that Kentucky-American will incur because of the deficiency in the state deferred taxes.[12] Kentucky-American stated that the deficiency affects deferred federal taxes rather than current federal taxes.[13] Thus, Kentucky-American amortized the tax effect over the remaining life of the assets to coincide with the aforementioned deferred tax effect.

The Commission is, therefore, of the opinion that the AG/LFUCG's adjustment should be denied.

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11 Ibid., pages 27 and 28.

12 Ibid., page 27.

13 T.E., page 128.

Property Taxes

The AG/LFUCG proposed to reduce property taxes by $27,279 to eliminate property taxes associated with CWIP.[14] The AG/LFUCG's adjustment is in conformity with the rate base adjustment which eliminated CWIP. Current practice in taxation is that property taxes should be paid on one-half of the value of CWIP, thus, this is a known and measurable adjustment. Based on this, the Commission is of the opinion and finds that the AG/LFUCG's adjustment should be denied.

Uncollectible Accounts Expense

The AG/LFUCG proposed to reduce uncollectible accounts expense by $14,541.[15] To show that test period uncollectibles were overstated, the AG/LFUCG compared the test period level to the historical amounts.

During the test period Kentucky-American adopted the "Black Motor Formula Method" for determining the level of uncollectible accounts. The Commission has reviewed this new methodology and has found it to be acceptable. The Commission is of the opinion that the test period amount should be the ongoing level for this expense, and that it would be improper to compare the results of the new methodology with historical amounts not adjusted to reflect the new methodology. Therefore, the Commission finds that the AG/LFUCG's adjustment should be denied.

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14 Direct Testimony of Thomas C. DeWard, page 11.

15 Ibid., page 21.

RATE OF RETURN

In its Memorandum to the Commission, the LFUCG contended that Kentucky-American Water Company overstated its required cost of equity. Mr. DeWard proposed a maximum return of 12 percent. Furthermore, the AG/LFUCG memorandum listed several areas of disagreement with Dr. Phillips' calculation of Kentucky-American's rate of return. These included: (1) Dr. Phillips' choice of proxy companies; (2) his choice of market price in calculating dividend yields; (3) using expected dividends versus current dividends; and (4) Dr. Phillips' failure to perform a discounted cash flow ("DCF") analysis of Kentucky-American's parent company, American Water Works Company ("AWW").

The Commission notes that by Mr. DeWard's own statement he is not an expert on rate of return.[16] He presented no methodology in arriving at his recommended 12 percent return on equity in his testimony.

The Commission finds AG/LFUCG's analysis and criticisms of Dr. Phillips and his DCF model to be without merit. First, there are only 14 water companies listed in Dr. Phillips' source, C. A. Turner Utility Reports, available for analysis.[17] Given the limited number of water companies available, the Commission is of the opinion that Dr. Phillips' standard of selecting companies for comparison analysis based on a stock rating of A- or better and at

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16 Ibid., pages 13-14.

17 C. A. Turner Utility Reports, "Common Stocks of Telephone and Water Companies," October 1987.

least 85 percent of its revenues derived from water sales is reasonable.[18] Second, the Commission agrees that using closing prices in October 1987 results in higher dividend yields than using a 52-week high/low average. However, using a 52-week high/low average price still results in a 13.14 percent return on equity.[19] Third, in a DCF analysis, it is a common and standard practice to use future expected dividends in determining the dividend yield component within the DCF model. It is the summation of the investor's expected cash flows (dividends) discounted to the current period that determines a stock's current price. The AG/LFUCG's comments on using an "expected market price" as relating to some future price is without basis within the framework of the DCF model. The theory behind the DCF model is that the expected market price equals the current market price. Finally, the Commission is of the opinion that using next period's dividend, which is estimated as the current dividend times one plus the expected growth rate, is an appropriate application of the DCF model. Thus, the Commission rejects AG/LFUCG's use of a current dividend yield as opposed to an expected dividend yield in its analysis of AWW as a misapplication of the DCF model.

Therefore, based on a full review of all the evidence, the Commission is of the opinion that a 13 percent return on equity, as reflected in the Proposal, is fully supported and is fair, just, and reasonable.

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18 Phillips' Direct Testimony, pages 13-14.

19 Ibid., Schedule 12-B.

AUTHORIZED INCREASE

The net operating income that the Staff and Kentucky-American found reasonable in the Proposal was $6,227,181. Based on the findings regarding the AG/LFUCG's proposed adjustments contained herein, the Commission is of the opinion that the net operating income determined to be reasonable in the Proposal is fair, just, and reasonable. Therefore, the Commission affirms the Proposal.

To achieve this level of operating income, Kentucky-American is entitled to increase its rates and charges to produce additional revenues on an annual basis of $842,610 determined as follows:

Adjusted Net Operating Income	$5,712,105
Net Operating Income Found Reasonable	6,227,181
Operating Income Deficiency[20]	$ 515,076
Deficiency Adjusted for Income Taxes and PSC Fees[21]	$ 842,610

RATE DESIGN

At the hearing in this case, Kentucky-American filed proposed rates that generate the additional revenues reflected in the attached Proposal and granted in this Order. These rates are attached to this Order as Appendix A.

Although the rates are not based on a cost-of-service study which has been the past practice, the Commission will accept them as fair, just, and reasonable, effective for service rendered on and after June 1, 1988.

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20 Page 19 of Appendix B.

21 Ibid.

OTHER ISSUES

In its Memorandum filed May 10, 1988, the AG raised questions on the level of insurance expense and service company charges; however, the AG did not propose adjustments for these items.

The AG challenged the level of insurance expense, stating that Kentucky-American had failed to shop around adequately and that the worker's compensation could be obtained at a cheaper cost. American Waterworks obtains all of its insurance in a package deal through Aetna Life and Casualty ("Aetna"). It would stand to reason that the centralized entity could obtain insurance at a lower rate than could be obtained by separate divisions, such as Kentucky-American, and the AG presented no proof to the contrary.

The Commission requested in Case No. 9482, Notice of Adjustment of Rates of Kentucky-American Water Company, that Kentucky-American obtain quotes regarding its insurance expense. Kentucky-American only received two quotes, one from Aetna and the other from St. Paul. Traveler's declined to provide a quote stating that it was too costly to prepare and that Kentucky-American expressed no serious dissatisfaction with Aetna. When comparing the two quotes received by Kentucky-American, Aetna's was somewhat cheaper.

The Commission is of the opinion that Kentucky-American could possibly obtain its Worker's Compensation Insurance at a lower cost; however, taking away one piece of the insurance package may cause the cost of the remaining insurance to increase. Based on this analysis, the Commission finds that no adjustment to insurance expense is warranted at this time. However, acceptance in this instance does not constitute future Commission acceptance or preclude future Commission investigation into the reasonableness of this expense.

Regarding the service company charges, the AG pointed to what it deemed to be significant percentage increase in Treasury Department and Employee Relations Department expenses. The Commission has determined that the Treasury Department charges have increased for legitimate reasons. These reasons relate to internal changes from the operating companies and the heavier work load caused by the requirements of the Tax Reform Act of 1986, including complications arising from the taxation of Contributions in Aid of Construction.

It was determined that the Employee Relations Department expense increased because this is a new department, started January 1, 1986, which was not fully staffed in the year the comparison was made.

SUMMARY

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

1. The rates proposed by Kentucky-American produce annual revenues in excess of those found reasonable herein and should be denied upon application of KRS 278.030.

2. The Proposal presented to the Commission by Kentucky-American and the Commission's Staff on April 25, 1988 is reasonable and should be approved.

3. The rates approved herein will permit Kentucky-American to cover its operating expenses, pay its interest, and provide a reasonable dividend and surplus for equity growth.

4. The rates in Appendix A are the fair, just, and reasonable rates to be charged for water service by Kentucky-American.

IT IS THEREFORE ORDERED that:

1. The proposed rates sought by Kentucky-American be and they hereby are denied upon application of KRS 278.030.

2. The rates in Appendix A be and they hereby are approved as the fair, just, and reasonable rate for water service rendered by Kentucky-American on and after June 1, 1988.

3. Within 30 days from the date of this Order, Kentucky-American shall file with this Commission its revised tariff sheets setting out the rates for water service approved herein.

Done at Frankfort, Kentucky, this 3rd day of June, 1988.

PUBLIC SERVICE COMMISSION

Richard D. Heman, Jr. respectfully dissents from majority opinion.

Chairman

Robert M. Davis

Vice Chairman

[signature]

Commissioner

ATTEST:

Executive Director

DISSENTING OPINION OF RICHARD D. HEMAN, JR.

Case No. 10069 - Kentucky-American Water Company

At the hearing held May 5, 1988, to consider the reasonableness of the proposed settlement between Kentucky-American and Staff, the Attorney General and the Lexington-Fayette Urban County Government filed a Motion to Reject "Proposed Settlement". Among other things, the Motion stated that the Order (Settlement) is unlawful in that it does not permit Intervenors to confront and examine Staff. The Commission overruled the Motion. My concern goes to the refusal to allow Intervenors to question Staff, and I believe the Commission should reconsider its ruling.

I believe the Commission may approve contested settlements provided a party not signing the settlement agreement is afforded an opportunity to present evidence and cross examine witnesses at the settlement hearing. This includes examination of Staff. Staff did not prefile testimony. However, I believe the settlement procedure used here is valid provided we allow direct examination and cross examination of Staff (and discovery, if necessary).

The Motion also referred to the burden of proof. The utility clearly has the burden of proof with respect to the reasonableness of its proposed rates (KRS 278.190). I do not believe the burden has shifted.

At the hearing there was discussion as to the "burden of going forward" on the party (or parties) who have not agreed to the settlement (Transcript at page 21 and following). The burden of going forward is not a shifting of the statutory burden of proof. However, I think the Attorney General makes a good point at page 22 - "Well, I don't think we should have to have the burden of going forward either, because we have not had the opportunity to cross examine the staff, we have not had the opportunity to do any discovery".

In my judgment the "burden of going forward" is not fairly assigned without the opportunity to question the Staff.

I do not agree with the position set forth in the Motion that Staff can only participate in a settlement conference on an informal basis, and that the Staff cannot take a formal position with respect to the reasonableness of the settlement. Staff is a necessary participant. The procedures followed by many Commissions of which I am aware do not require that Staff be formally designated a party in order to fully and formally participate in a settlement proceeding or to file testimony, submit briefs and the like. The regulations of our Commission do not preclude active, formal participation by Staff in the negotiations. But if these regulations need to be clarified, let us do so.

The settlement process is a viable alternative to litigation in balancing the interests of the parties and arriving at a result which is in the public interest. As stated, the Staff must participate. Staff represents the public interest, that is, the statutory obligation of the Commission to establish rates which (1) allow the regulated utility to remain viable in order to provide safe and adequate service, and (2) allow consumers to receive service at rates which are fair, just and reasonable.

The Staff perspective, although coinciding on some issues, differs from that of the other participants. The Staff represents no particular constituency. It has no ax to grind. In negotiations the Staff cannot be merely an observer, an advisor, a mediator, a conciliator, an arbitrator, or a referee. Rather, it must independently and vigorously negotiate for the public interest.

In this instance ground rules were not established at the beginning of the settlement conference. Staff was not informed by the Commission that it should be prepared for direct examination, cross examination and possible discovery at the settlement hearing should an agreement be reached which did not include all participants. This was an error. However, a subsequent proceeding could be scheduled for this purpose.

Questions have been raised concerning due process - and fairness. The Commission and Staff are implementing Staff testimony in cases. We must press forward. This is the practice of virtually every Commission in the land. It will facilitate settlements. It will provide accountability. It will enable the Commission to more fully assess Staff positions. It will result in a better and more complete public record on which a decision can be based.

I doubt whether any regulator would deny the extremely important role of the Staff and its significant and necessary input into Commission decisions. In a recent Commission case [Case No. 9310, Sanitation District No. 1 of Campbell and Kenton Counties, November 13, 1985 Transcript, Pages 34 and 35] the question was asked from the bench whether, by the same reasoning being applied by Applicant's counsel to the Commission Staff, due process rights would be violated if a clerk to a Judge had expressed strong opinions about a case after analyzing it and communicated those to a Judge in a conference room and yet was not subject to cross examination on the witness stand. William Robinson, counsel for Applicant, responded, in part:

> "I would not begin to speak as President of the Kentucky Bar Association without the authority of our Board on this or any other issue. But if I might just speak as counsel for the Sanitation District in this hearing, I can only say in comment with very quick reflection obviously, that in our dealings with the staff, and for me this is a new experience, we did not understand ourselves to be dealing with a clerk to a Judge, but we understood ourselves to be dealing with someone who purports to be in an adversary situation, who purports to, and I say that professionally not anything other than professional adversary, it is the nature of the system as I have seen it so far, and it is in any context professionally for someone like myself. We can prepare our side of the case, but to point out the obvious, Commissioner, we cannot rebut an argument that we cannot hear. We cannot rebut proof that we do not see. We can only come before you and argue the proof that we do see, that we did develop at some considerable expense and that we did present conscientiously and in good faith..." (Emphasis supplied.)

It is the nature of the system I have observed.

I believe the Commission should reconsider its ruling with respect to the Motion of the Attorney General and Lexington-Fayette Urban County Government. We should either (1) schedule a hearing for the purpose of direct examination and cross examination of Staff on the proposed settlement or (2) reject the settlement agreement and proceed to a hearing on the merits of the case.

Richard D. Heman, Jr.
Chairman
Kentucky Public Service Commission

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 10069 DATED JUNE 3, 1988.

The following rates and charges are prescribed for the customers in the area served by Kentucky-American Water Company. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the effective date of this Order.

CLASSIFICATION OF SERVICE
SERVICE CLASSIFICATION NO.1

METER RATES

The following shall be the rates for consumption, in addition to the service charges provided for herein:

	1000 Gallons Per Month	Rates Per 1000 Gallons	100 Cubic Feet Per Month	Rate Per 100 Cubic Feet
For the first	12	1.31733	16	.988
For the next	588	1.03333	784	.775
For all over	600	.93333	800	.700

	1000 Gallons Per Quarter	Rate Per 1000 Gallons	100 Cubic Feet Per Quarter	Rate Per 100 Cubic Feet
For the first	36	1.31733	48	.988
For the next	1,764	1.03333	2,352	.775
For all over	1,800	.93333	2,400	.700

SERVICE CHARGES

All metered general water service customers shall pay a service charge based on the size of meter installed. The service charge will not entitle the customer to any water.

Size of Meter	Service Charge Per Month	Service Charge Per Quarter
5/8 inch	$ 4.73	$ 14.19
3/4 inch	7.09	21.27
1 inch	11.82	35.46
1 1/2 inch	23.64	70.92
2 inch	37.82	113.46
3 inch	70.92	212.76
4 inch	118.20	354.60
6 inch	236.39	709.17
8 inch	378.23	1,134.69

CLASSIFICATION OF SERVICE
SERVICE CLASSIFICATION NO. 3

RATES

Size of Service	Rate Per Month	Rate Per Annum
2 inch diameter	$ 2.21	$ 26.52
4 inch diameter	8.83	105.96
6 inch diameter	19.86	238.32
8 inch diameter	35.32	423.84
12 inch diameter	79.45	953.40
14 inch diameter	108.14	1,297.68

CLASSIFICATION OF SERVICE
SERVICE CLASSIFICATION NO. 4

RATES FOR PUBLIC FIRE SERVICE

	Rate Per Month	Rate Per Annum
For each public fire hydrant contracted for or ordered by Urban County, County, State or Federal Governmental Agencies or Institutions	$19.86	$238.32

CLASSIFICATION OF SERVICE
SERVICE CLASSIFICATION NO. 4

RATES FOR PRIVATE FIRE SERVICE

	Rate Per Month	Rate Per Annum
For each private fire hydrant contracted for by Industries or Private Institutions	$19.86	$238.32

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 10069 DATED JUNE 3, 1988.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

NOTICE OF ADJUSTMENT OF THE RATES OF KENTUCKY-AMERICAN WATER COMPANY	)))	CASE NO. 10069

PROPOSED SETTLEMENT

On December 1, 1987, Kentucky-American Water Company ("Kentucky-American") filed its notice with the Commission seeking to increase its rates and charges effective January 1, 1988, to produce an annual increase in revenue of $1,732,386, an increase of approximately 9.45 percent. On January 21, 1988, Kentucky-American amended its application by proposing various adjustments to both rate base and operating expenses to arrive at a revised annual increase of $1,649,350.[1] Kentucky-American, on February 19, 1988, revised its pro forma level of property taxes resulting in a further revised annual increase of $1,603,456.[2] In its rebuttal testimony Kentucky-American reduced its requested return on equity from 14.00 to 13.50 percent[3] resulting in a final requested annual increase of $1,432,475.

In order to determine the reasonableness of the request, the Commission suspended the rates and charges for 5 months after the

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1 Updated Exhibit 3, Schedule 1.

2 Updated Exhibit 3, dated February 18, 1988, Schedule 1.

3 Rebuttal Testimony of Dr. Charles F. Phillips, Jr., page 6.

proposed effective date. Kentucky-American requested that a settlement conference be scheduled in an attempt to settle issues prior to the scheduled hearing.

807 KAR 5:001 Section 4(6) provides that parties to any proceeding or investigation may agree upon the facts involved in the proceeding, and such written stipulations shall be regarded and used as evidence at hearing. 807 KAR 5:001 Section 4(4) further contemplates that the issues in any Commission proceeding may be settled by the mutual agreement of the parties.

A settlement conference was held on March 30, 1988, in the Commission's offices in Frankfort, Kentucky. The Utility and Rate Intervention Division of the Attorney General's office ("AG") and the Lexington-Fayette Urban County Government ("LFUCG") intervened in this matter and participated in the settlement conference.

Brown Sprinkler, Inc. ("Brown"), also intervened in this matter. However, on April 5, 1988, Brown filed a Motion to withdraw. By its Order dated April 11, 1988, the Commission granted Brown's Motion.

The AG and LFUCG did not agree with the settlement reached by Commission Staff and Kentucky-American. The agreed upon annual increase is $842,610 as determined herein.

VALUATION METHODS

Net Investment

Kentucky-American originally proposed a net investment rate base as of September 30, 1987, of $58,306,349.[4] Amendments to the

4 Exhibit 3, Schedule 2.

original application proposed by Kentucky-American reflected the following: (1) the deduction of 1 year's amortization expense of both the Least Cost Planning Study and the waste cost disposal expense; (2) revision of deferred taxes to recognize the deduction of the 1 year's amortization expense; (3) the reduction to Construction Work in Progress ("CWIP") to eliminate contract retentions and reimbursements from third parties; and (4) the reduction to cash working capital to reflect revised pro forma expenses.[5] The aforementioned amendments reduced the proposed rate base to $58,068,556.[6] The following are adjustments to the amended rate base that were agreed upon by Staff and Kentucky-American at the settlement conference:

Kentucky-American proposed to include the cost of the preliminary survey and investigation charges of $126,742 in its amended rate base. Kentucky-American stated that if these costs were not included in rate base they would be unable to attain the allowed rate of return since these costs would be in its capital structure but not rate base.[7] The AG contended in its prefiled testimony that the cost of the preliminary survey and investigation should be excluded from rate base for the following reasons: (1) these costs have not been previously included in rate base; (2) no offsetting revenues are included; and (3)

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5 Supplemental Testimony of Edward J. Grubb, filed January 21, 1988, page 3.

6 Updated Exhibit 3, Schedule 2.

7 Direct Testimony of Edward J. Grubb, pages 5 and 6.

Kentucky-American has provided no assurances that these projects will be included in any future rate base.[8]

Staff agreed that the costs of the preliminary survey and investigation should be excluded because Kentucky-American's ratepayers are not receiving a current benefit from the preliminary survey. Therefore, the stockholders should pay for the financing or carrying cost until the projects are actually constructed and included in rate base as either CWIP or Utility Plant in Service. Kentucky-American has accepted the Staff's position that these costs should be excluded and, therefore, rate base has been reduced by $126,742.

Kentucky-American included in both the pro forma depreciation expense and the accumulated depreciation account depreciation on CWIP in the amount of $132,793.[9] Included in both Kentucky-American's end-of-period CWIP of $6,345,485 and in its calculation of depreciation on CWIP is plant that has been completed, but not yet transferred to Plant in Service in the amount of $3,215,075.[10]

Staff asserted that since CWIP is not actually used or useful at the end-of-period, then Kentucky-American should not be allowed to claim depreciation on that portion of CWIP. Staff has calculated depreciation on uncompleted CWIP in the amount of

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8 Direct Testimony of Thomas C. DeWard, filed March 4, 1988, page 11.

9 Updated Exhibit 4, Schedule 4, page 2 of 5.

10 Supplemental Testimony of Edward D. Grubb, Exhibit EJG-1.

$72,710.[11] Kentucky-American has accepted Staff's position on the elimination of depreciation on CWIP and, therefore, the accumulated depreciation account has been reduced by $72,710. The adjustment to depreciation expense will be discussed in a later section.

Kentucky-American proposed a cash working capital allowance of 1/7 of its pro forma operation and maintenance expense or $1,350,000,[12] based on its proposed lead lag study which the Commission advised Kentucky-American to perform in Case No. 9482, Notice of Adjustment of the Rates of Kentucky-American Water Company, Order entered July 8, 1986. The AG stated that the lead lag study presented by Kentucky-American was flawed since it included non-cash items, net earnings, and an overstated rate case expense.[13] The AG determined cash working capital to be $755,223 which excluded non-cash items and adjusted rate case expense.[14]

Staff reviewed both proposals and compared them to the lead lag study Kentucky-American presented in Case No. 8314, Notice of Adjustment of Rates of Kentucky-American Water Company, Order

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Uncompleted CWIP - Supplemental Testimony of Edward J. Grubb, Exhibit EJG-1	$3,336,725
Less: Contract Retentions and Reimbursements Projects - Updated Ex. 4, Shc. 4, pg. 4 of 5	- 206,315
Net End-of-Period CWIP	$3,130,410
Divided: Depreciable CWIP Updated Ex.4, Sch. 4, page 4 of 5	+5,717,165
% of CWIP Included in Accumulated Dep.	54.755%
Times: CWIP Depreciation	X $132,793
Depreciation Uncompleted CWIP	$ 72,710

12 Updated Exhibit 3, Schedule 2.

13 Prefiled Testimony of Thomas C. DeWard, page 12.

entered February 8, 1982. Staff consulted the resource material at its disposal and contacted other state commissions and concluded that Kentucky-American's proposed lead lag study was correct. Therefore, Kentucky-American and Staff have agreed to a cash working capital based on 1/7 of adjusted operation and maintenance expenses determined at the settlement conference, to arrive at a reduction of $33,321 to Kentucky-American's pro forma level.

Kentucky-American and Staff have agreed that the net investment rate base as of September 30, 1987, to be as follows:

Utility Plant in Service	$84,406,347
Construction Work in Progress	6,345,485
Deferred Tank Painting	613,434
Deferred Debits	165,055
Preliminary Survey & Investigation	-0-
Prepayments	87,085
Materials and Supplies	311,479
Cash Working Capital	1,316,679
Subtotal	$93,245,564
Less:	
Reserve for Depreciation	$11,826,400
Reserve for Amortization	5,422
Contributions In Aid of Construction	5,364,371
Customer Advances for Construction	9,281,117
Deferred Federal and State Taxes	7,026,787
Unamortized Investment Tax Credit	248,328
Subtotal	$33,752,425
Net Original Cost Rate Base	$59,493,139
Less:	
Plant Acquisition Adjustment	1,511,936
Net Investment Rate Base	$57,981,203

Capital

Kentucky-American proposed end-of-period capitalization of $58,411,662[15] inclusive of Job Development Investment Tax Credits,

[14] Ibid., Schedule 9.

in compliance with past Commission decisions. Neither the AG nor Staff questioned Kentucky-American's level of capitalization. Therefore, Staff has agreed with Kentucky-American's level of capitalization of $58,411,662.

REVENUES AND EXPENSES

Kentucky-American had net operating income of $5,660,659 for the 12-month period ending September 30, 1987.[16] In order to normalize current operating conditions Kentucky-American proposed several adjustments to its test period revenues and expenses which resulted in an adjusted net operating income of $5,459,627.[17] The following are adjustments to the pro forma revenues and expenses agreed to by Staff and Kentucky-American:

Operating Revenues

Staff and Kentucky-American have agreed to use the company's billing analysis without any adjustment for year-end residential customers and water produced but not billed.

Unaccounted for Water

The AG proposed to decrease Kentucky-American's pro forma operating expenses by $40,981[18] due to what it described as a significant increase in the level of lost and unaccounted for water over Kentucky-American's 5-year historical average.[19] Upon reviewing Kentucky-American's response to Item 18 of the

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15 Exhibit 5, Schedule 1.
16 Updated Exhibit 4, Schedule 1.

17 Updated Exhibit 4, dated February 18, Schedule 1.

18 Direct Testimony of Thomas C. DeWard, Schedule 24.

AG/LFUCG's first request filed January 26, 1988, Staff determined that Kentucky-American's unaccounted for water loss for the test period was 16.3418 percent.[20]

It has been the past practice of this Commission to allow an unaccounted for water loss of 15 percent and, thus, Staff proposed to decrease Kentucky-American's pro forma operating expenses by $35,946.[21] Kentucky-American will accept the Staff's position regarding the reduction of pro forma operating expenses by $35,946 to reflect the allowable 15 percent unaccounted for water loss. This adjustment results in a increase to net operating income of $22,004.

Rate Case Expense

Kentucky-American proposed to increase the test year rate case expense by $91,633[22] to reflect the expensing of the estimated cost of this case. Kentucky-American explained that it chose to expense these rate case costs rather than amortizing them

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19 Ibid., page 24.

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Unaccounted for Water	2,234,727 gal.
Divided: Total System Delivery	: 13,674,873 gal.
Line Loss	16.3418 %

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Total Billed Sales: AG/LFUCG Request 1, Item 18	11,174,337 gal.
Non Revenue Usage: AG/LFUCG Request 1, Item 18	+ 265,809 gal.
Subtotal	11,440,146 gal.
Divided: 85%	÷ 85 %
Allowable Water Production	13,458,995 gal.
Less: System Delivery	-13,674,873 gal.
Excess Unaccounted for Water	215,878 gal.
Times: Per Million Gal. Water Cost-Staff Request 2, Item 4	x $166.51
Unaccounted for Water Loss Adjustment	$ 35,946

because of its pending plans to file another rate application. It is expected that this pending application will use the 12 months ended September 30, 1988, as the test year. The pending application is due to the magnitude of the 1987 and 1988 investment budgets.[23]

The AG proposed to decrease the pro forma rate case expense by $59,921[24] to eliminate the rate case expense incurred by Kentucky-American during the test period and charged to outside services.[25] In the past, the Commission has amortized rate case expense over a 3-year period. As pointed out by Kentucky-American, the pro forma rate case expense includes the amortization of expenses associated with Case No. 9283, Notice of Adjustment of Rates of Kentucky-American Water Company, Order entered October 1, 1985, and Case No. 9482. To be consistent with past Commission practices and due to the inclusion of amortization of past rate case expenses, Staff proposed to amortize the actual test period and estimated rate case expense over a 3-year period. Kentucky-American will accept Staff's proposal and, therefore, the

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22 Updated Exhibit 4, Schedule 3.

23 Direct Testimony of Edwin L. Oxley, page 3.

24 Direct Testimony of Thomas C. DeWard, Schedule 17.

25 <u>Ibid</u>., page 21.

pro forma operating expenses were reduced by $78,400,[26] which results in an increase of $47,992 in net operating income.

Employee Award Recognition

The AG proposed to reduce Kentucky-American's pro forma operating expenses by $16,622[27] to remove the costs of various employee award recognition provided by Kentucky-American. The AG stated that this cost should be borne by the stockholders rather than the ratepayers.[28] Kentucky-American stated that the AG's position suggests that these employee expenses are not representative of sound employee relation policies.[29] Kentucky-American further stated that expenses of this type are part of the budget process, and thus, the expenses in question are

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TRA '86 & CIAC Account No. 923.1 AG/LFUCG Request 2, Item 21	$ 10,618
Stoll, Keenon & Park: TRA '86 & Update to Regs AG/LFUCG Request 2, Item 6-76	4,968
Stoll, Keenon & Park: Hearing TRA '86 Same as Above Item 67c	3,983
Stoll, Keenon & Park: TRA '86 Same as Above Item 67d	1,431
Current Estimated Rate Case Expense Staff Request 1, Item 16	96,600
Total Pro Forma Rate Case Expense	$117,600
Times: 2/3	x 66.667 %
Rate Case Expense Adjustment	$ 78,400

27 Direct Testimony of Thomas C. DeWard, Schedule 14.

28 Ibid., page 20.

29 Rebuttal Testimony of Robert A. Edens, page 2.

under tight control and review.[30] Kentucky-American also pointed to the Commission's past approval of wage levels as an acknowledge-ment that Kentucky-American's employee benefit package is appropriate.[31]

Staff is of the opinion that the level of Kentucky-American's employee compensation is adequate to maintain employee satisfaction and, thus, the ratepayers would receive no direct benefit from the employee parties. Kentucky-American will accept Staff's adjustment and, therefore, the pro forma operating expenses have been decreased by $16,724 resulting in an increase in net operating income of $10,238.

Non-recurring Expense

The AG determined that $65,239[32] of test period maintenance expense was considered non-recurring in nature and so as not to disturb rates should be amortized over a 3-year period.[33] Kentucky-American stated that although the individual jobs pointed out by the AG may be non-recurring, the nature of the maintenance is recurring and that a reasonable level should properly be included in the cost of service.[34] Furthermore, Kentucky-American presented the maintenance performed on pumping equipment and

30 Ibid.

31 Ibid.

32 Direct Testimony of Thomas C. DeWard, Schedule 20.

33 Ibid., page 22.

34 Rebuttal Testimony of Edwin L. Oxley, page 4.

company structures for the prior 3-year period to show that the test period level is not excessive.[35]

Staff is of the opinion that the 3-year comparison provided by Kentucky-American gave credence to the AG's position rather than disputing it. Staff and Kentucky-American have reached a compromise by amortizing the expenses over a 2-year period rather than the 3-year period proposed by the AG. The result is an over-all reduction to the operating expenses of $32,620,[36] which results in an increase in net operating income of $19,968.

Temporary Services

The AG proposed to decrease test year operating expenses by $26,647[37] to remove the cost of temporary services. The AG contends that Kentucky-American's pro forma wage adjustment reflects the end of test year level of employees and a duplication of costs would occur if the temporary service costs were to remain in the test year.[38] Kentucky-American proposed to modify the AG's adjustment by $9,160 due to the cost of some temporary services,

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35 Ibid., pages 4 and 5.

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Non-recurring Expenses	$65,239
Times: 1/2	x .5
Amount to be Removed	$32,620

37 Direct Testimony of Thomas C. DeWard, Schedule 13.

38 Ibid., page 19.

which are recurring in nature.[39] Staff has agreed with Kentucky-American's adjustment and, therefore, the pro forma operating expenses have been decreased by $17,487,[40] thus, increasing net operating income by $10,705.

Moving Expense

The AG proposed to reduce test year operating expenses by $25,700[41] to remove the cost of moving an employee. The AG stated that they did not consider either the level of the expense or the charge itself to be an appropriate amount upon which to set rates.[42] Kentucky-American stated that the employee in question replaced an employee who had served for 25 years.[43] Kentucky-American further stated that at that time they did not have a qualified individual to replace the retired employee and that transferring someone with the knowledge, training and expertise was a wise management decision.[44]

Staff believes that the moving expense is excessive in addition to being non-recurring in nature. Staff, after reviewing the invoices supporting the level of moving expense, determined that the majority of the expenses occurred prior to the test

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39 Rebuttal Testimony of Edwin L. Oxley, page 2.

40 Ibid.

41 Direct Testimony of Thomas C. DeWard, Schedule 15.

42 Ibid., page 20.

43 Rebuttal Testimony of Robert A Edens, page 3.

44 Ibid.

period. Staff and Kentucky-American have reached a compromise to remove $9,886 of the moving expense occurring during the test year. This resulted in an increase of $6,052 to net operating income.

Depreciation Expense

The AG proposed to reduce test year operating expenses by $65,511[45] to eliminate depreciation on CWIP. The adjustment coincides with the AG's proposal to eliminate from rate base all CWIP not completed by the end of the test period.[46] Staff believes that it would be improper to allow for rate-making and tax purposes depreciation on plant not actually used and useful by test year end. Kentucky-American will accept Staff's position and, therefore, operating expenses have been decreased by $72,710,[47] thus, increasing net operating income by $44,509.

Allowance for Funds Used During Construction ("AFUDC")

Kentucky-American reported $104,908 of Allowance for Funds Used During Construction ("AFUDC") for the test period. To be consistent with prior Commission Orders, Kentucky-American originally included $124,134[48] of AFUDC in net operating income. Kentucky-American based its level of AFUDC on the 13-month average of CWIP available for AFUDC. Kentucky-American proposed to

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45 Direct Testimony of Thomas C. DeWard, Schedule 6.

46 Ibid., page 10.

47 Adjustment calculation is shown in footnote number 12.

48 Exhibit 4, Schedule 2, page 1 of 2.

increase AFUDC to $147,677[49] to recognize CWIP that should be completed by the issuance date of the Final Order in this matter.

To be consistent with its proposed elimination of CWIP from rate base, the AG proposed to remove AFUDC from Kentucky-American's operating revenues.[50] Staff has calculated AFUDC of $286,123 by using Kentucky-American's end-of-period CWIP available for AFUDC of $2,664,083[51] and the overall rate of return which Kentucky-American and Staff have agreed upon of 10.74 percent. Staff is of the opinion that Kentucky-American's proposed level of AFUDC based on the estimated completed CWIP would be inconsistent with prior Commission rate-making practices. Kentucky-American accepts the Staff's level of AFUDC and, therefore, operating revenues have been increased by $138,446. This results in net operating income being increased by $84,749.

<u>Interest Synchronization</u>

Kentucky-American proposed interest expense for tax purposes of $3,286,680[52] based on the proposed level of debt, the proposed rate base, and the cost of debt. Staff has recalculated the interest expense to be $3,283,926[53] based on the adjusted rate

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49 Updated Exhibit 4, Schedule 2, page 1 of 2.

50 Prefiled Testimony of Thomas C. DeWard, page 11.

51 $3,873,564 (CWIP Available for AFUDC) - $1,209,481 (CWIP Completed) = $2,664,083.

52 Updated Exhibit 4, Schedule 6, page 2 of 2.

53 $57,981,203 (Adjusted Rate Base) x 58.2094% x 9.73% = $3,283,926.

base and in order to be consistent with past Commission Orders. Kentucky-American has agreed with Staff's calculation which results in a decrease to net operating income of $1,068.

Miscellaneous Adjustments

The following are various adjustments proposed by the AG and a brief explanation of each:

(1) Bank credits - the proposed decrease of $10,218 is to bring credits "above-the-line" to offset the associated processing fees;[54]

(2) Non-recurring credit - this $8,246 adjustment removes non-recurring credits and charges to normalize the test period; and[55]

(3) Public education program - this proposed decrease of $10,000 reduces this expense to Kentucky-American's budgeted amount.[56]

Staff and Kentucky-American reviewed these adjustments and have agreed that they should be accepted. The overall effect of the miscellaneous adjustments is a decrease to operating expenses of $11,972, which results in an increase to net operating income of $7,329.

Return on Equity

In his rebuttal testimony for Kentucky-American, Dr. Charles F. Phillips, Jr., recommended a return on common equity of 13.50

54 Direct Testimony of Thomas C. DeWard, pages 20 and 21.

55 Ibid., page 22.

56 Ibid., page 23.

percent. This recommendation is based on a discounted cash flow analysis of five water utilities which were selected as a proxy group for Kentucky-American, a wholly-owned subsidiary of American Water Works Company. According to Dr. Phillips, all five meet two criteria: a bond rating of A- and at least 85 percent of their revenues derived from water sales.[57]

Dr. Phillips explained that the recommended return is necessary given, among other things, current economic conditions and the sizeable expenditures that will be required in coming months under the 1986 ~~extension~~ amendments of the Safe Drinking Water Act.[58] The recommended return of 13.50 percent is near the top of the range of 13.15 to 13.58 percent, assuming no adjustment for flotation costs, and at the bottom of a range of 13.49 to 13.94 percent with a flotation cost adjustment.[59] As has been reflected in the Commission's Orders in past Kentucky-American rate cases, Staff is not convinced that a flotation cost adjustment is appropriate.

57 Prefiled Testimony of Charles F. Phillips, Jr., pages 13-14.

58 Rebuttal Testimony of Charles F. Phillips, Jr., page 5.

59 Ibid., pages 5-6.

The witness for the AG, Mr. DeWard, offered this return on common equity recommendation:

> From a non-expert's point of view, a 12% return is, in my opinion, closer to reality than the Company's recommended level of 14%. I do not base my conclusion on any DCF or other formulas but on logic and information available at the present time.[60]

Staff remains convinced that Kentucky-American derives certain benefits from its subsidiary relationship with American Water Works Company, such as a ready market for its common equity. These factors help to reduce the riskiness of Kentucky-American and, hence, its required return on equity. Staff is of the opinion that a return on common equity of 13.0 percent is fair, just, and reasonable. This rate is only slightly below the lower limit of the range recommended by Dr. Phillips, assuming no flotation cost adjustment, and reflects the reduced riskiness of Kentucky-American.

Kentucky-American will accept a return on common equity of 13.0 percent.

Rate of Return Summary

Applying rates of 13.0 percent for common equity, 7.26 percent for preferred stock and 9.73 percent for long-term debt to the agreed upon capital structure produces an overall cost of capital of 10.74 percent.

60 Direct Testimony of Thomas C. DeWard, pages 13-14.

Revenue Increase

The net operating income which Staff and Kentucky-American found reasonable is approximately $6,227,181. To achieve this level of income, Kentucky-American would require an increase in rates and charges to produce additional revenues on an annual basis of $842,610 as follows:

Adjusted Net Operating Income	$5,712,105
Net Operating Income Found Reasonable[61]	6,227,181
Operating Income Deficiency	$ 515,076
Deficiency Adjusted for Income Taxes and PSC Fees[62]	$ 842,610

This Stipulation and Recommendation is submitted for purposes of this case only and is not deemed binding upon the parties hereto in any other proceeding, nor is it to be offered or relied upon in any other proceeding involving Kentucky-American.

If the Commission adopts this proposal in its entirety, the parties hereto agree that they shall not file an application for rehearing, nor an appeal to the Franklin County Circuit Court from such order.

If this proposal is not adopted in its entirety, each party reserves the right to withdraw from it and require that hearings should go forward upon all or any matters involved, and that in such event the terms of this agreement shall not be deemed binding upon the parties hereto.

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61 $57,981,203 (agreed to rate base) x 10.74% (agreed to overall rate of return = $6,227,181.

62 $515,076 x 1.63589482 = $842,610.

The preceding paragraphs describe all of the major adjustments to Kentucky-American's filings.

All of the parties hereto agree that the foregoing Stipulation and Recommendation is reasonable and in the best interest of all concerned, and urge that the Commission adopt this agreement in its entirety.

AGREED TO BY:

KENTUCKY-AMERICAN WATER COMPANY

DATE 4/25/88

Stoll, Keenon & Park

BY: Lindsey Ingram

TITLE: attorney

PSC STAFF

DATE 4/25/88

BY: John N. Hughes

TITLE: Attorney