

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. 90-321
EFFECTIVE ON DECEMBER 27, 1990)

O R D E R

On June 19, 1991, Kentucky-American Water Company ("Kentucky-American") filed a petition for rehearing of the Commission's May 30, 1991 Order. Kentucky-American requests rehearing on four issues: cost of gasoline; service contract; calculation errors in the rates in Appendix A; and management audit expense.

On July 1, 1991, the Utility and Rate Intervention Division of the Attorney General's office ("AG") filed its response to Kentucky-American's petition for rehearing. The AG claims that Kentucky-American failed to demonstrate that any evidence now exists that could not have been presented at the hearing and, therefore, rehearing should be denied on all issues.

After consideration of Kentucky-American's petition and being otherwise sufficiently advised, the Commission finds that rehearing should be denied on all issues except the calculation of rates.

Cost of Gasoline

Kentucky-American asserts that by not allowing any increase in the cost of gasoline, the Commission is ignoring the increase in the federal gasoline tax of \$.05 per gallon. While the

gasoline tax did increase by \$.05 per gallon in November 1990, there is no evidence that this tax was immediately passed on to the consumers via an increase in the price of gasoline. Kentucky-American's revised adjustment to the proposed gasoline expense, filed April 4, 1991, long after the tax increase went into effect, is based on an amount \$.21 less than the highest price paid during the test period. The price of gasoline is volatile and dependent on several variables, only one of which is the federal gasoline tax. Kentucky-American presented no evidence that the increase in the federal gasoline tax resulted in a concurrent increase at the pump. The Commission remains convinced that the overall methodology of utilizing the price of gasoline on one particular day, as employed by Kentucky-American, to determine a pro forma expense level for this item does not provide a sufficient degree of reliability to warrant its acceptance.

Service Agreement

Kentucky-American contends that the Commission erred in disregarding the terms of Kentucky-American's 1989 Service Agreement ("1989 Agreement") with its affiliate, the American Water Works Service Company ("Service Company"). The Service Company provides numerous services, including accounting, financial, engineering, and human resources, to Kentucky-American and other affiliated water companies. The 1989 Agreement bases all indirect cost allocations upon the number of customers served by Kentucky-American and its affiliated water companies.

Kentucky-American argues that there is no evidence in the record to substantiate the Commission's concerns set forth in the

May 30, 1991 Order regarding: Kentucky-American's failure to consider the impact that the 1989 Agreement would have on its operations; Kentucky-American's failure to consider the underlying characteristics of each cost set forth in the service agreement; and the process used to develop and ratify the 1989 Agreement.

Kentucky-American claims that it presented evidence that showed that it determined which individual costs increased due to the 1989 Agreement, analyzed each increase to determine the underlying cause, and concluded that the increased costs were reasonable.

Kentucky-American further contends: that the 1989 Agreement was approved by its board of directors; that the president, vice president, and treasurer of Kentucky-American were involved in negotiating the 1989 Agreement; that the fact that none of these individuals are employed in Lexington, Kentucky has no bearing on whether its 1989 contract is reasonable; that the existence of a corporate relationship between Kentucky-American and the Service Company is in and of itself insufficient to set aside the contract; that the Commission's Order would require the Service Company to maintain and apply a costly system of allocators just for Kentucky-American; and that the 1989 Agreement was previously reviewed in Case No. 89-348.¹

The Commission finds no merit in Kentucky-American's claim that the May 30, 1991 Order does not clearly set forth the

¹ Case No. 89-348, Notice of Adjustment of the Rates of Kentucky-American Water Company Effective on January 28, 1990.

reasoning to support the rejection of the 1989 Agreement. Rather, that Order plainly stated that the 1989 Agreement was a less-than-arms-length transaction, there was no evidence to demonstrate that Kentucky-American considered the financial impact of the 1989 Agreement before approving it, and all indirect costs are to be allocated on the same basis irrespective of the underlying cost causative factors.

Kentucky-American admitted that a majority of the individuals involved in negotiating and approving the 1989 Agreement on behalf of Kentucky-American had ties with its parent organization and/or the Service Company and/or other affiliated water companies. For example, the president of Kentucky-American who is also a member of Kentucky-American's Board of Directors, voted on behalf of Kentucky-American to accept the 1989 Service Agreement. However, this same individual is also a regional vice president for the service company.² In this latter role, he was responsible for developing the 1989 Service Contract for the Service Company. Given this substantially less-than-arms-length transaction, it is essential that the underlying cost causative factors be fully examined by Kentucky-American to ensure that these costs are being properly allocated.

The first step in developing an allocation methodology should be to analyze each indirect cost to determine the cost causative characteristics, and then choose the best allocation factors for

² Transcript of Evidence ("T.E."), page 34.

each cost category. This procedure was not followed by the Service Company in the development of the 1989 Agreement. Rather, the Service Company looked at the philosophy that all the services it provides to the water companies are to assist in providing customer service and, therefore, the appropriate allocation factor for all indirect costs is the number of customers. During the hearing, Kentucky-American admitted that particular areas could be challenged but maintained that overall, a decision was made to allocate based on the number of customers.³

Kentucky-American makes a number of references to the relationship that exists between the number of customers and the data processing function. Based on this relationship, Kentucky-American concluded that the best allocator for data processing costs would be the number of customers. Yet Kentucky-American failed to present any analysis or study to substantiate either the relationship between the two, or that the number of customers is the best allocator for data processing expenses.

The only alternative methods of allocating indirect cost considered by the Service Company were the ones contained in the 1971 Agreement. Failure to consider the individual cost causative characteristics of each indirect cost substantially flaws the 1989 Agreement allocation factor. Kentucky-American failed to meet the burden of proof to show the reasonableness of the 1989 Agreement.

³ T.E., page 112.

While the 1989 Agreement was filed in response to an AG request for information in Case No. 89-348, none of the expenses in that case arose from the 1989 Agreement. The reasonableness of the 1989 Agreement was not an issue in that case and, accordingly, the Commission made no findings at that time on this issue. Further, Kentucky-American's evidence shows that its test-year expenses for services provided by the Service Company increased by \$132,707, which is directly attributable to the use of the 1989 Agreement, rather than the 1971 Agreement.⁴ In its petition for rehearing, Kentucky-American has attempted to submit new evidence to compare its costs for the 1986-1989 period under the 1989 Agreement versus the 1971 Agreement. This financial information was not part of the record of this case and, accordingly, not considered by the Commission. In all future rate cases, Kentucky-American will be expected to submit an analysis, similar to Jarrett Exhibit CJ-3 to ensure that for rate-making purposes, only the cost allocation methodologies under the 1971 Agreement are reflected.

Management Audit Expense

Kentucky-American complained that the Commission's disallowance of the unamortized costs of the management audit in rate base was contrary to the November 12, 1990 Letter of Agreement between Schumaker & Company, Kentucky-American, and the Commission. Kentucky-American also questioned the Commission's

⁴ Jarrett Direct Testimony, page 17.

assessment that the disallowance should be made to provide for a sharing of the benefits between the ratepayers and the shareholders since, according to Kentucky-American, the majority of the benefits will accrue to the ratepayers.

While Kentucky-American may have assumed that it could recoup the carrying cost associated with the unamortized portion of the management audit expense, such treatment has not been afforded any other utility seeking recovery of management audit expenses. The agreement between the parties to the management audit states that, "The cost of the audit shall be an allowable expense of operations for rate-making purposes." Further, KRS 278.255 (3) states "the Commission shall include the cost of conducting any audits required in this section in the cost of service of the utility for rate-making purposes." The carrying cost is not a cost recognized in the statute or the Letter of Agreement. Moreover, the Commission in its original decision allowed Kentucky-American to recover the costs of a pre-management audit as well as the total cost of the audit itself.

Calculation of Rates

The rates for service charges set forth in Appendix A to the Commission's May 30, 1991 Order were calculated by multiplying the then effective rates by the overall percentage increase in revenue authorized by the Commission. Due to mathematical rounding utilized in this process, many of the annual (or quarterly) service charges are one cent more or less than 12 times (or 3 times) the monthly charges.

This rate-calculation process was not utilized in prior Kentucky-American rate cases and is erroneous. The overall percentage revenue increase should have been multiplied by the monthly rates only with this product then multiplied by 12 or 3 to determine the annual or quarterly rates respectively. The service charge should be uniform for each size water meter and the amount of the charge should not vary with the billing period utilized. Accordingly, the Commission has recalculated the service charges so that the annual and quarterly rates are 12 and 3 times respectively the monthly rates. This being a calculation error that appears on the face of the Order, it should be corrected nunc pro tunc. The rates set forth in Appendix A, attached hereto and incorporated herein, reflect the correction of this error.

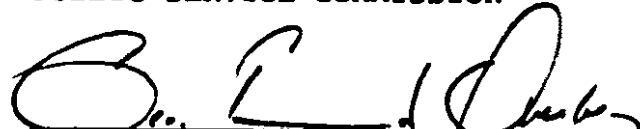
IT IS THEREFORE ORDERED that:


1. Rehearing shall be denied on all issues raised with the exception of the calculation of rates.
2. Appendix A to the May 30, 1991 Order be and it hereby is modified nunc pro tunc to correct the calculation errors set forth in the service charges contained therein.
3. The rates set forth in Appendix A are fair, just, and reasonable and shall be charged for service rendered on and after May 30, 1991.

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

Done at Frankfort, Kentucky, this 9th day of July, 1991.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman

Commissioner

ATTEST:


Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 90-321 DATED 7/09/91

The following rates and charges are prescribed for the customers 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 charge provided for herein:

	<u>1000 Gallons Per Month</u>	<u>Rate Per 1000 Gallons</u>	<u>100 Cubic Feet Per Month</u>	<u>Rate Per 100 Cubic Feet</u>
For the First	600	\$1.739	800	\$1.304
For all Over	600	1.360	800	1.020

	<u>1000 Gallons Per Quarter</u>	<u>Rate Per 1000 Gallons</u>	<u>100 Cubic Feet Per Quarter</u>	<u>Rate Per 100 Cubic Feet</u>
For the First	1,800	\$1.739	2,400	\$1.304
For all Over	1,800	1.360	2,400	1.020

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.

<u>Size of Meter</u>	<u>Service Charge</u>	
	<u>Per Month</u>	<u>Per Quarter</u>
5/8 inch	\$ 5.19	\$ 15.57
3/4 inch	7.77	23.31
1 inch	12.95	38.85
1-1/2 inch	25.89	77.67
2 inch	41.42	124.26
3 inch	77.66	232.98
4 inch	129.44	388.32
6 inch	258.89	776.67
8 inch	414.23	1,242.69

CLASSIFICATION OF SERVICE
SERVICE CLASSIFICATION NO. 3

RATES

<u>Size of Service</u>	<u>Rate Per Month</u>	<u>Rate Per Annum</u>
2 inch diameter	\$ 3.23	\$ 38.76
4 inch diameter	12.91	154.92
6 inch diameter	29.04	348.48
8 inch diameter	51.63	619.56
12 inch diameter	116.18	1,394.16
14 inch diameter	158.12	1,897.44

CLASSIFICATION OF SERVICE
SERVICE CLASSIFICATION NO. 4

RATES FOR PUBLIC FIRE SERVICE

	<u>Rate Per Month</u>	<u>Rate Per Annum</u>
For each public fire hydrant contracted for or ordered by Urban County, County, State or Federal Governmental Agencies or Institutions	\$20.21	\$242.52

RATES FOR PRIVATE FIRE SERVICE

For each private fire hydrant contracted for by Industries or Private Institutions	29.04	348.48
--	-------	--------