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 an application to increase its rates and charges effective January 1, 1988 to produce additional revenue of $1,732,386 annually, an increase of approximately 8.45 percent. Pursuant to KRS 278.190(2), the Commission suspended for five months the rates proposed by Kentucky-American while an investigation was conducted to determine the reasonableness of the request. During the course of the investigation, Kentucky-American filed three downward revisions to its application, eventually requesting an increase in revenue of $1,432,475 annually.

On June 3, 1988, the Commission issued an Order accepting a proposed settlement and authorizing Kentucky-American to increase its rates and charges by $842,610 annually. The Commission's Order was appealed by the Attorney General's Office and the Lexington-Fayette Urban County Government ("AG/LFUCG") on the grounds that the Commission lacked the authority to accept a nonunanimous settlement. The Kentucky Supreme Court held that the Commission lacked such authority and remanded the rate case to the Commission for further proceedings. Kentucky-American Water Co. v. Commonwealth of Kentucky, ex rel. Cowan, Ky., 847 S.W.2d 737 (1993). Upon remand to the Commission, the parties unanimously agreed to hold this case in abeyance and they subsequently agreed to submit the case to the Commission for a decision based on the existing evidence of record without an evidentiary hearing.

ANALYSIS AND DETERMINATION

Test Period

Kentucky-American proposed and the Commission has accepted the 12-month period ending September 30, 1987 as the test period in this proceeding.

Valuation Method

Kentucky-American proposed a net investment rate base at September 30, 1987 of $58,306,349.[1] The Commission has accepted Kentucky-American's proposed rate base with the following exceptions:

Preliminary Survey & Investigation Charges. Kentucky-American included in its rate base preliminary survey and investigation charges ("preliminary survey charges") of $126,742. Since these charges are supported by retained earnings and debt included in the test-period capital structure, Kentucky-American claims that without rate base treatment, it would be unable to earn its allowed rate of return.

The AG/LFUCG proposed to eliminate these charges because Kentucky-American failed to recognize any offsetting revenues or to guarantee that the preliminary survey charges would result in construction. According to the AG/LFUCG, Kentucky-American has historically undertaken similar investigations that were eventually abandoned and written off as a cost of operation. Based on this uncertainty, the AG/LFUCG proposed to remove the preliminary survey charges from rate base.

Kentucky-American argues that the preliminary survey charges represent the cost of its Comprehensive Planning Study. Without rate base recognition of these charges,

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[1] Exhibit No. 3, Schedule 2.

Kentucky-American claims that it, "will not be compensated for prudently planning to assure continuity and adequacy of its service to current and future customers."[2]

The Commission finds that it is highly uncertain whether any construction will ultimately result from the preliminary survey charges. This uncertainty is the reason the Uniform System of Accounts for Class A Water Utilities requires these costs to be recorded in a deferred debit account, Account 183 - Preliminary Survey and Investigation Charges. This account defers the cost of preliminary investigations until actual construction begins. At that point the charges are transferred to the appropriate utility or CWIP accounts and included in rate base.

Since the ratepayers receive no current benefit from the preliminary survey, the financing or carrying costs should be borne by Kentucky-American's stockholders until construction begins. When compared to total rate base, the preliminary survey charges are minimal and their elimination from rate base will not significantly affect Kentucky-American's ability to earn its allowed rate of return or its capability to plan for the continuity and adequacy of service.

Based on the uncertainty of the construction, the lack of benefit currently being derived by the rate payers, and the de minimis effect these costs will have on Kentucky-American's ability to earn its allowed return, the Commission finds that rate base should be reduced by $126,742 to eliminate the preliminary survey charges.

CWIP. Kentucky-American reported CWIP of $6,551,800 in its rate base. Included in that amount is $3,130,410 of construction projects that were not completed by the end of the test period. To properly match return requirements with revenue, the AG/LFUCG

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2 Rebuttal Testimony of Chris E. Jarrett, page 8.

has proposed to reduce rate base by $3,130,410. The AG/LFUCG does not question the reasonableness or necessity of the construction projects Kentucky-American included in test period CWIP. All completed projects will eventually be included in rate base, but the timing of that inclusion is challenged by the AG/LFUCG.

The AG/LFUCG claims that construction projects completed at or near the end of the test period will not be fully matched with revenues until all potential customers are served. If a water main was designed to serve 54 customers but only 5 customers were receiving service at the end of the test period, there would be a mismatch between return requirements, depreciation expense, property taxes, and revenues. According to the AG/LFUCG, this alleged mismatch would be compounded if Kentucky-American is also allowed to earn a return on CWIP not completed by the end of the test period.

Kentucky-American's Comprehensive Planning Study concluded that in the 5 year period between 1986 and 1991, its system will require approximately $59,157,000 in capital improvements. To phase-in the rate increases resulting from its capital investments over the same 5 year period, Kentucky-American relied on prior Commission decisions of allowing rate base recovery of CWIP. Kentucky-American asserts that eliminating the return on its investment in CWIP would impair its plan of gradual rate increases, resulting in the possibility of both rate shock and higher embedded long-term interest rates.

Kentucky-American is currently operating in a construction mode, which will require large additions to capital. In these circumstances rate base recovery of the actual end-of-period CWIP results in a series of smaller rate increases rather than awaiting completion of the projects to impose one large rate increase. This is one of the reasons the

Commission has historically allowed Kentucky-American to earn a return on its CWIP investment.[3]

The AG/LFUCG's adjustment would result in lower rate increases during high levels of construction activity, followed by higher rate increases upon the completion of the construction projects. This would increase the possibility of rate-shock which is detrimental to the ratepayers and the utility. Therefore, the Commission finds that this adjustment should not be accepted.

Accumulated Depreciation. Kentucky-American increased its accumulated depreciation reserve and depreciation expense by $132,793 to reflect depreciation on $5,717,165 of CWIP, which included $3,215,075 of construction projects completed, but not yet transferred to Utility Plant In Service ("UPIS").

Depreciation is included as a rate-making expense in recognition that physical assets are consumed in the process of providing a service or product.[4] However, if the asset is not yet in service it is not being consumed and ratepayers should not be charged depreciation. Kentucky-American's depreciation reserve and expense adjustment should be reduced by 54.755 percent,[5] the ratio of construction projects not completed at the end of the test period to Kentucky-American's claimed depreciable CWIP. Using this ratio, the Commission has reduced accumulated depreciation and depreciation expense by $72,710.

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3 See e.g. Case No. 9482, Notice of Adjustment of the Rates of Kentucky-American Water Company Effective On and After February 7, 1986, Order dated July 8,1986; Case No. 9283, Notice of Adjustment of the Rates of Kentucky-American Water Company, Order dated October 1, 1985; and Case No. 8571, Notice of Adjustment of the Rates of Kentucky-American Water Company Effective On and After September 17, 1982, Order dated February 17, 1983.

4 Accounting for Public Utilities, 6.03 page 5.

5 $3,130,410 ÷ $5,717,165 = 54.75%.

The reduction to depreciation expense will result in an increase in net operating income of $44,509.

Customer Advances for Construction. Kentucky-American reduced its customer advances account by the amount of advances collected prior to construction projects being undertaken. This has the effect of increasing Kentucky-American's rate base by that amount. The AG/LFUCG claims that all customer advances, even those collected prior to construction, represent cost-free funds and no return should be allowed on those funds. Therefore, the AG/LFUCG has proposed to increase customer advances by $330,179 to Kentucky-American's average test period level.

The Commission finds that customer advances received prior to construction represent a source of cost free capital and the timing of the advance receipt should not affect the rate-making treatment. If all customer advances are not deducted from rate base, stockholders would be able to earn a return on capital they did not supply. Therefore, the Commission will increase customer advances by $330,179.

Working Capital. Kentucky-American proposed a cash working capital allowance of $1,350,000 based on 1/7 of its pro forma operations and maintenance expense. To support its requested 1/7 cash working capital formula, Kentucky-American performed a lead/lag study.

Kentucky-American also preformed a lead/lag study to determine its cash working capital requirements in Case No. 8314.[6] In that proceeding, while the Commission expressed concern with specific lead/lag days, the effect was found to be immaterial and Kentucky-American's methodology was accepted. Based on the findings of that study, the

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[6] Case No. 8314, Notice of Adjustment of Rates of Kentucky-American Water Company, Order dated February 8, 1982.

Commission found that a 1/6 cash working capital formula was more appropriate for Kentucky-American to determine its cash working capital requirements than the standard 1/8 formula used for other utilities.

In Case No. 9482, the Commission determined that the 1/6 cash working capital formula was still reasonable. However, for several years prior to the test period in that case, Kentucky-American's capital fluctuated in comparison to rate base, and in some instances substantially exceeded rate base. For this reason the Commission directed Kentucky-America to present a new lead/lag study or explore alternative methods of calculating cash working capital in its next rate proceeding. In response, Kentucky-American performed a new lead/lag study using a methodology identical to the one approved in Case No. 8314.

The AG/LFUCG states that Kentucky-American's lead/lag study is flawed because it includes the following non-cash items: depreciation; amortization; uncollectibles; the current portion of deferred tax expense; and net earnings. According to the AG/LFUCG, since non-cash items do not require an absolute payment or outlay of cash, they should be eliminated from any lead/lag study. By eliminating the non-cash items, Kentucky-American's cash working capital allowance would be reduced by $594,777.

Kentucky-American claims that the AG/LFUCG failed to recognize that non-cash items are a direct result of cash outlays that occurred some time in the past and that there is a delay in recovering these expenses from the ratepayers. Therefore, non-cash items are legitimate expenses that should be included in a lead/lag study.[7]

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[7] Rebuttal Testimony, Edward J. Grubb, page 2.

The Commission finds that recording depreciation does not require the outlay of cash at the time it is recorded and charged to the ratepayer. However, capital was expended when the property was acquired. Depreciation reduces plant investment in the month recorded, even though there is a delay, or lag, before the revenue related to depreciation is collected from the customers through rates.[8] This also applies to amortization expense, uncollectible expense, and the current portion of deferred tax expense.

Theoretically, operating income becomes the property of the stockholder when service is provided to the customer. However, there is lag between the time service is rendered, the customer is billed for the service, and the company collects its payment. This lag in receipt of operating income would result in a cash working capital requirement.[9]

Given the similarity between the lead/lag studies performed by Kentucky-American in this proceeding and Case No. 8314, the Commission will accept the use of the 1/7 cash working capital formula for this proceeding. However, the cash working capital allowance has been reduced by $30,521 to reflect the Commission's adjustments to Kentucky-American's proposed operations and maintenance expenses.

The Commission has determined Kentucky-American's rate base to be as follows:

Utility Plant In Service	$ 84,406,347
CWIP	6,345,485
Deferred Maintenance	613,434
Deferred Debits	165,055
Prepayments	87,085
Materials and Supplies	311,479
Other Working Capital Allowance	1,319,479
Subtotal	$ 93,248,364

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8 Accounting for Public Utilities, 5.08[2], page 5-20.

9 Id., page 5-22.

Less:	
Accumulated Depreciation Reserve	$ 11,826,400
Accumulated Amortization Reserve	5,422
Utility Plant Acquisition Adjustment	1,511,936
Contributions In Aid Of Construction	5,364,371
Customer Advances For Construction	9,611,296
Deferred Income Taxes	7,026,787
Unamortized Investment Tax Credit	248,328
Subtotal	$ 35,594,540
Net Investment Rate Base	$ 57,653,824

Operating Revenues

In its application, Kentucky-American reported actual and pro forma operating revenues of $18,617,966 and $18,564,418, respectively. Kentucky-American amended its application to show pro forma operating revenues of $18,588,961. Kentucky-American's proposed adjustments to operating revenues are reasonable and acceptable for rate-making purposes with the following exceptions:

Year-End Customers. The AG/LFUCG proposed to increase operating revenues by $334,490 to reflect Kentucky-American's year-end customer level. The AG/LFUCG maintains that Kentucky-American's pro forma adjustment to increase test year billings and sales to year-end customers does not match revenues and expenses. Kentucky-American's year-end customer level is 61,466 and actual year-end customers are 63,619. The AG/LFUCG proposes to adjust the revenues for customer charges and estimated consumption for the additional 2,153 customers.

Kentucky-American maintains that the AG/LFUCG fails to recognize that there is a gap between the time a customer receives a final bill and a new customer starts receiving service. In his rebuttal testimony, Mr. Grubb states that during the test year approximately 18,000 final bills were issued. Mr. Grubb performed an analysis wherein it was determined

that the number of days between the time a customer is final billed and when that customer is replaced ranges from 0 to 290 days with the average being 47.15 days.

Kentucky-American's adjusted billing analysis methodology properly considers the time interval between final bills and replacement customers and includes an adjustment to reflect the 63,619 residential year-end customers. The Commission finds that this approach is reasonable and should be accepted.

Matching Revenues to Pumpage. The AG/LFUCG proposed to increase operating revenue by $190,568 to match revenue with water pumpage. The AG/LFUCG states that there is a lag between recording revenues and actual water delivery and that water delivered prior to the test year may be billed during the test year, while water delivered near the end of the test year may not be billed until after the test year.

The Commission finds that an analysis of all recording lags for expenses and revenues would be necessary to accurately match revenues and pumpage. While revenues are recorded later than the metered volumes pumped are recorded, the expenses that are associated with the metered volumes pumped would also be recorded after the fact. Since the AG/LFUCG's adjustment does not properly match all revenues and expenses associated with pumping, the adjustment is incorrect and should not be accepted.

AFUDC. Kentucky-American's original application included AFUDC of $124,134 in test-period operating revenue. This proposal was based on the 13-month average of CWIP available for AFUDC. However, Kentucky-American revised its AFUDC upward to $147,677 to recognize CWIP that should be completed by the anticipated date of the final Order in this proceeding.

The AG/LFUCG proposed to eliminate any AFUDC attributable to projects not placed in service as of the end of the test period. The AG/LFUCG's position is that Kentucky-American can continue to accrue AFUDC on these projects and these additional costs (AFUDC) would be recovered from the ratepayers when the projects are placed in service. This adjustment is consistent with the AG/LFUCG's proposed elimination of CWIP from rate base.

As discussed in the prior section on CWIP, when construction activity is high and large capital additions are necessary, rate base recovery of the actual end-of-period CWIP allows a utility to phase in smaller rate increases rather than larger increases when each construction project is completed. While including AFUDC as an operating revenue does not offset the total rate impact of CWIP, it does facilitate gradual rate increases and reduce the possibility of rate shock.

Therefore, the Commission finds that the AG/LFUCG's adjustment should not be accepted. However, the evidence of record does not support Kentucky-American's proposal to base AFUDC on its estimates of completed CWIP.

The Commission has calculated AFUDC of $286,123 based on Kentucky-American's end-of-period CWIP available for AFUDC of $2,664,083 and the rate of return found reasonable herein. This results in an increase to operating revenue of $138,446 and an increase to operating income of $84,749.

Operating Expenses

In its application, Kentucky-American reported actual and pro forma operating expenses of $12,957,307 and $13,157,228, respectively. Kentucky-American amended its application to show pro forma operating expenses of $13,129,334. The amended application also included net operating income of $5,459,627. Kentucky-American's

proposed adjustments to operating expenses are reasonable and acceptable for rate-making purposes with the following exceptions:

Temporary Services. Kentucky-American's pro forma operation and maintenance labor of $3,304,860 includes temporary service costs of $26,647. Since pro forma labor expense reflects Kentucky-American's full staffing requirements, the AG/LFUCG claims that a duplication of cost would result if the temporary services were not removed. Therefore, the AG/LFUCG proposed to reduce maintenance and operation labor expense by $26,647.

Kentucky-American acknowledges that the AG/LFUCG's adjustment is partially correct, but notes that $9,160 of the temporary services was due to regular employees taking sick leave and vacation. Since these costs will be incurred on a recurring basis, Kentucky-American proposed to reduce the AG/LFUCG's adjustment by $9,160.

The Commission finds that the AG/LFUCG's adjustment, as reduced by the $9,160 recurring portion, should be accepted. Therefore, operating expenses have been decreased $17,487, resulting in an increase to net operating income of $10,705.

Rate Case Expense. Kentucky-American claims that the magnitude of its 1987 and 1988 investment budgets will necessitate the filing of a rate case using a test period ending September 30, 1988. Thus, it requested to include the total cost of this current proceeding as an expense, rather than amortizing the cost over time. This would increase rate case expense by $91,633.

The AG/LFUCG claims that during the test period Kentucky-American incurred rate case expenses that were reflected in outside service expenses. Because Kentucky-American has proposed to include the actual cost of this proceeding, the AG/LFUCG

proposed to reduce rate case expense by $59,921 to eliminate the double recovery of the cost of this rate case.

Rate cases are viewed as non-recurring costs that should be amortized over an appropriate period rather than expensed. Because utilities generally seek rate relief every 3 years, this has been the standard amortization period for these costs. However, given the frequency of Kentucky-American's rate filings, the Commission finds that a 2-year amortization period is reasonable. This results in a $58,800 reduction in operating expenses and a $35,993 increase in net operating income.

Lab Testing. Kentucky-American adjusted its test period operations to reflect renting a Atomic Absorption unit and a Gas Chromatograph unit. The AG/LFUCG claims this equipment will allow Kentucky-American to perform tests previously performed by a contractor. Therefore, to eliminate the claimed duplication of services, the AG/LFUCG reduced lab testing expense by $38,061.

Kentucky-American cited the requirements of the Safe Drinking Water Act of 1986 ("Safe Drinking Water Act"), as amended, to demonstrate that water testing requirements are continually increasing. Consequently, Kentucky-American stated that its use of contractor testing will not decrease and there will be no duplication of services.

The Commission finds that the requirements of the Safe Drinking Water Act have been continually increasing and the costs to perform the required tests have also increased. Despite Kentucky-American's ability to now perform some tests previously done by a contractor, the adjusted test year level for lab testing is reasonable considering the additional testing required and the higher costs per test. Therefore, the Commission will accept the adjusted test year level for this expense.

Service Company Allocation. Kentucky-American has a contract with the American Waterworks Service Company ("Service Company") listing the services to be provided to Kentucky-American and the costs for those services. Those costs include overheads which are costs not directly attributable to the work performed for a particular utility. Under the service company contract, the overhead costs are allocated by the use of a formula.

The AG/LFUCG's position is that the Service Company performs work for both utility and non-regulated companies. According to the AG/LFUCG, the non-regulated companies are only charged for the specific work done on their behalf and are not allocated any overhead costs; therefore, they are receiving an undeserved subsidy from the utility companies. To eliminate this alleged subsidy, the AG/LFUCG has proposed to reduce Kentucky-American's service company allocations by $68,181.

The evidence clearly demonstrates that Kentucky-American is part of the Southern Region of the service company and none of the employees in that region perform any work for non-regulated companies.[10] Thus, there is no potential for Kentucky-American to be charged any subsidy. Therefore, Kentucky-American's proposed service company charges are reasonable and should be accepted.

Cost of Serving New Customers. Kentucky-American adjusted its test period operating revenues to reflect a full 12 months of revenue to be collected from the end-of-period customer level. To be consistent, Kentucky-American increased operating expenses by $86,451 based on a ratio of per book operation and maintenance expenses, less payroll costs, to present rate revenues applied to the pro forma revenue adjustment.

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[10] Rebuttal Testimony of Chris E. Jarrett, page 6.

The AG/LFUCG claims that Kentucky-American's methodology is flawed because it assumes that all operation and maintenance costs, except those that are payroll related, vary proportionately with the number of customers served. Since the AG/LFUCG claims that many of Kentucky-American's operation and maintenance costs are fixed, rather than variable, they propose to reduce the cost of serving new customers by $43,158 to reflect the fixed costs.

The Commission finds that although some operation and maintenance costs do not vary proportionately with either the number of customers served or the volume of sales, the AG/LFUCG's adjustment assumed all costs except for power, chemical, and sludge removal to be fixed costs. There are numerous other costs, such as customer accounting, that are not fixed but vary proportionately with the number of customers.

Absent an in-depth analysis to identify all costs that can be separated into variable and fixed, the amount of the adjustment, if any, is unknown. Therefore, the Commission finds that Kentucky-American's adjustment to serve new customers should be accepted.

Uncollectible Accounts Expense. Based on a comparison of test-period uncollectibles to the historical amounts, the AG/LFUCG concluded that the test-period level was overstated. Therefore, the AG/LFUCG proposed to reduce the uncollectible accounts expense by $14,541.

During the test period, Kentucky-American adopted the "Black Motor Formula Method" to calculate its uncollectible accounts. Due to this change in methodology to calculate uncollectibles, the Commission finds that there is no basis to compare the test-period level to historical amounts. Furthermore, there is no evidence to demonstrate that the historical amounts of uncollectibles are a better indicator of the ongoing level than the

test-period actual expense. Therefore, the Commission finds that Kentucky-American's test-period level of uncollectibles should be accepted.

Unaccounted for Water. During the test period, Kentucky-American experienced an unaccounted for water loss of 16.34 percent. Based on a comparison of the test period water loss with Kentucky-American's 5-year historical average, the AG/LFUCG labeled the test-period level as significantly high and proposed to decrease pro forma operating expenses by $40,981.

The Commission's Purchased Water Adjustment for Privately-Owned Utilities, 807 KAR 5:067, limits line loss to 15 percent if a reasonable percentage was not determined in the utility's last rate case. No such determination was made in Kentucky-American's last general rate case and the record of evidence in this proceeding does not support deviating from the 15 percent water loss limitation.

To reflect the allowable 15 percent water loss limitation, the Commission has determined that operating expenses should be decreased by $35,946, which results in a increase to net operating income of $22,004.

Employee Award Recognition. Included in Kentucky-American's pro forma operations are $16,622 of employee award recognition costs. The AG/LFUCG argues that these costs should be borne by the stockholders and proposes to reduce operating expenses by that amount.

Kentucky-American claims that since non-regulated businesses incur similar employee expenses, ratepayers should bear these costs. According to Kentucky-American, the Commission's past acceptance of wage increases is paramount to finding Kentucky-American's overall employee benefit package including the employee awards to be reasonable, and therefore, this cost should not be eliminated.

The employee benefit package, excluding the costs in question, are at a level that is adequate to ensure that employee satisfaction and morale is maintained at an appropriate level. Furthermore, there is no evidence to show how the ratepayers are directly benefited by these employee relation costs. Therefore, the Commission finds that the expense should be excluded for rate-making purposes. This will decrease operating expenses by $16,724 and increase net operating income by $10,238.

Nonrecurring Expenses. The AG/LFUCG identified the following costs as being nonrecurring:

Paint Chemical Storage Room	$ 6,510
Roof Repair	$ 16,675
Bowel Assembly Replacement	$ 17,549
Intake Pump Repair	$ 12,653
Repair Stair Trends	$ 4,822
Remove Old Paint & Paint Office	$ 7,030

To ensure that Kentucky-American's rates are not distorted, the AG/LFUCG proposed to amortize the nonrecurring costs over 3 years, resulting in a reduction to operating expenses of $43,493.

According to Kentucky-American, during any given year it will perform numerous maintenance tasks that, if viewed on an individual basis, would be labeled as nonrecurring. However, while an individual job may be nonrecurring, the nature of the task is recurring. Therefore, a reasonable level of these costs should be included in its cost of service. To support its position, Kentucky-American provided a 3-year comparison of the maintenance of pumping equipment and structures.

The evidence demonstrates that these costs are nonrecurring and, therefore, they should be amortized rather than expensed. Furthermore, the 3-year comparison provided

by Kentucky-American fully supports this finding. However, the Commission finds that a 2-year amortization period is more appropriate. Based on a 2-year amortization, operating expenses should be reduced by $32,620 for an increase to net operating income of $19,968.

Moving Expense. The AG/LFUCG proposed to reduce test period operating expenses by $25,700 to eliminate the cost of relocating an employee who transferred to Kentucky-American from another American Waterworks company. The AG/LFUCG considers the cost and the level of the cost to be inappropriate for use in setting rates.

According to Kentucky-American, the vacancy occurred when an employee with 25 years of service retired and no other individual on staff qualified for the position. Obtaining an employee, by transfer, with the required level of training and education was a prudent management decision. For these reasons Kentucky-American claims that the employee transfer was reasonable and the cost of the move should be borne by the ratepayers.

The Commission finds that transferring the employee to Kentucky-American was beneficial, but there has been no showing that the transfer hinged on reimbursement of the employee's moving expenses. Furthermore, the moving expense is nonrecurring and its level appears to be excessive. However, invoices provided by Kentucky-American shows that only $9,886 of the moving cost was actually included in the test period operations.

For all these reasons, the Commission finds that the AG/LFUCG's proposal to eliminate the moving cost is reasonable and should be accepted. However, the proposed adjustment must be reduced to reflect the cost included in the test period. Therefore, operating expenses have been reduced by $9,886 and net operating income increased by $6,052.

Excess Deferred Taxes. The AG/LFUCG claims that Kentucky-American first established the deferred taxes associated with the least cost planning study, waste disposal, and deferred tank painting using the 40 and 46 percent federal tax rates. However, the federal tax rate was reduced in 1986, and these deferred taxes are being amortized and returned to the ratepayers at the 34 percent tax rate. According to the AG/LFUCG, this creates excess deferred taxes that should be amortized over a 5-year period, resulting in a reduction to deferred taxes of $16,031.

Kentucky-American pointed to Exhibit No. 4, Schedule 6, page 1 of 2, to show that the deferred taxes in question are being returned to the ratepayers at the correct federal rates of 40 and 46 percent. If the AG/LFUCG's adjustment is accepted, Kentucky-American claims the amortization of the deferred taxes would be double counted.

Upon review of the aforementioned exhibit, the Commission has determined that there are no excess deferred taxes and no further adjustment is necessary or appropriate.

State Tax Deficiency. The AG/LFUCG claims that due to the past increase in the Kentucky income tax rates, there is now a deficiency in state deferred taxes that will result in a federal income tax savings. To reflect that tax savings, the AG/LFUCG has proposed to reduce federal income tax expense by $6,856.

Kentucky-American argues that the Tax Reform Act of 1986 mandates that the federal tax savings be amortized over the remaining life of the assets and, therefore, the AG/LFUCG's proposal is incorrect.

The Commission finds that the Tax Reform Act of 1986 dictates the length of the amortization period, and there is no federal tax savings to be reflected in rates. Thus, no adjustment is appropriate.

Property Taxes. As previously discussed, the AG/LFUCG proposed to eliminate CWIP from rate base. To be consistent, they also proposed to reduce property taxes by $27,279, the amount associated with CWIP.

Kentucky requires utilities to pay property taxes on one-half of the value of end-of-period CWIP. Based on this obligation, the Commission finds that no adjustment should be made.

Miscellaneous Adjustments. The AG/LFUCG proposed the following miscellaneous adjustments:

(1) Bank Credits - A decrease to operating expenses of $10,218 to move bank credits "above-the-line" to offset bank processing fees.

(2) Account 930.21 - An increase to operating expenses of $8,246 to remove nonrecurring charges from test-period operations.

(3) Public Education Program - A decrease to operating expenses of $10,000 to reflect Kentucky-American's elimination of this program from its budget.

Kentucky-American presented no evidence to rebut these adjustments. Based on a review of the evidence of record, the Commission finds that these three adjustments are reasonable and should be accepted. Therefore, operating expenses have been decreased by $11,972, which results in an increase to net operating income of $7,329.

Other Expenses

The AG questioned the level of expenses for insurance and service company charges but proposed no adjustments. The AG claimed that Kentucky-American has failed to seek bids to ensure that it obtains the lowest insurance premiums and specifically questioned the workers' compensation premium.

All of the insurance for Kentucky-American and its affiliates is procured by the American Waterworks through a comprehensive package with Aetna Life and Casualty

("Aetna"). Kentucky-American argues that centralized procurement results in a lower premium than could be obtained by any affiliate individually and there is no evidence to the contrary.

In Case No. 9482, Kentucky-American was requested to obtain bids for its insurance coverage. Only two insurance companies responded to Kentucky-American's request, St. Paul and Aetna. A third company, Traveler's, declined to bid citing the high cost to prepare a bid and Kentucky-American's lack of serious dissatisfaction with Aetna. The Aetna quote was the lowest of the two received.

Kentucky-American could possibly obtain a lower Workers' Compensation rate; however, removing one piece of the insurance package could result in higher costs for the remaining coverage. Therefore, the Commission finds that no adjustment to insurance expense is warranted at this time.

The AG also questioned the level of increases in the Service Company allocations of Treasury Department and Employee Relations Department costs.

The evidence demonstrates that the Treasury Department allocations increased due to internal changes in the operating companies and the increased work load resulting from the Tax Reform Act of 1986. The Employee Relations Department was started on January 1, 1986 and was not fully staffed for the year the comparison was made. Thus, the level of increase identified by the AG was abnormal.

For these reasons, the Commission finds no basis to make any adjustment to the Service Company allocations.

Interest Synchronization. Kentucky-American proposed interest expense for tax purposes of $3,286,680 based on the proposed rate base and weighted cost of debt. The

Commission has recalculated this expense to be $3,265,384[11] based on the rate base and weighted cost of debt found reasonable herein. This results in a decrease to net operating income of $7,191.

Rate of Return

Return on Equity. Kentucky-American originally proposed a return on common equity of 14 percent but on rebuttal amended its proposal to 13.5 percent.

Kentucky-American's proposed 13.5 percent return on equity is based on a proxy group of five water utilities and includes an adjustment for flotation cost. Kentucky-American believes the recommended return to be necessary given current economic conditions and the increasing expenditures that will be required by the 1986 amendments to the Safe Drinking Water Act.

The AG/LFUCG recommended a return of 12 percent based on no strict financial analysis but, rather, on "logic and information available at the present time." The AG/LFUCG performed no strict financial analysis to determine Kentucky-American's cost of equity. However, based on available information it recommended a 12 percent rate.

The Commission considers Kentucky-American's use of a flotation cost adjustment inappropriate. Removing the flotation cost adjustment, and considering the benefits Kentucky-American derives from its subsidiary relationship with American Waterworks, the Commission finds that a return on equity of 12.75 to 13.25 percent to be fair, just, and reasonable. This range will allow Kentucky-American to attract capital at a reasonable cost and maintain its financial integrity, ensuring continued service. It will provide for necessary

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[11] $57,653,824 Adjusted Rate Base x 58.20942% x 9.73% = $3,265,384.

expansion to meet future requirements, and result in the lowest possible cost to ratepayers. A return of 13 percent will best meet the above objectives.

Authorized Increase

The net operating income found fair, just, and reasonable is $6,192,021.[12] To achieve this level of income Kentucky-American would be entitled to increase its rates and charges to produce additional annual operating revenues of $816,483 determined as follows:

Net Operating Income Found Reasonable	$ 6,192,021
Less: Adjusted Net Operating Income	- 5,692,916
Operating Income Deficiency	$ 499,105
Multiplied by: Gross-up Factor	x1.63589482
Required Revenue Increase, Inclusive of Income Taxes, PSC Fee, and Uncollectibles	$ 816,483

The Commission's Order dated June 3, 1988 authorized Kentucky-American to increase its revenue by $842,483 annually, which is $25,980 more than the amount determined reasonable herein. However, the new rates authorized by the June 3, 1988 Order remained in effect only until July 3, 1989, when they were superseded by rates approved in Kentucky-American's next rate case, Case No. 10481.[13] Consequently, the revenue impact of the rates approved on June 3, 1988 was $912,690, which is thirteen-twelfths of the annual increase. Since the revenue increase should have been only $816,483 annually, it would have been $884,523 for a 13-month period. Thus, Kentucky-American was authorized to collect $28,167 in excess of the revenue found reasonable herein. Considering the relative small amount of the refund due in relation to Kentucky-

[12] $57,653,824 x 10.74% = $6,192,021.

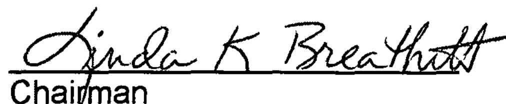
[13] Case No. 10481, Adjustment of Rates of Kentucky-American Water Company.

American's current annual revenues which exceed $34 million, and the desire to have all customers participate, the Commission finds that every customer should receive a one time, equal credit to its service charge over the next complete billing cycle. This shouldresult in a credit of approximately 33 cents for each of Kentucky-American's approximately 85,000 customers.

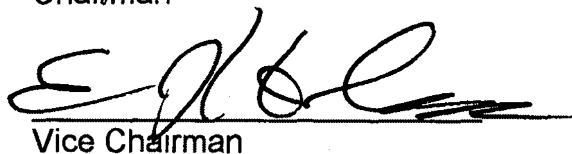
IT IS THEREFORE ORDERED that within 20 days of the date of this order, Kentucky-American shall file a plan to refund $28,167 to its customers over a three month period by a one-time, equal credit to the service charge of each customer.

Done at Frankfort, Kentucky, this 31st day of July, 1996.

PUBLIC SERVICE COMMISSION



Chairman



Vice Chairman

Commissioner

ATTEST:

Executive Director