COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

WEST MCCRACKEN WATER DISTRICT APPLICATION FOR (1) GENERAL RATE DECREASE (2) REFUND TO CUSTOMERS	) CASE NO. 95-588

O R D E R

On December 27, 1995, West McCracken County Water District ("West McCracken") submitted an application requesting approval of a rate decrease. The application was deficient until West McCracken cured the deficiencies on January 31, 1996. In its application, West McCracken requests a decrease in its rates for water service of approximately $91,353 and proposes to refund to its customers, with interest, the difference between its existing approved customer charges[1] and the lower customer charges it proposes in this case. A public hearing was held on August 6, 1996.

After consideration of the evidence of record and being otherwise sufficiently advised, the Commission finds that West McCracken should be granted a decrease of $96,265, or 20.4 percent, from its annual revenue from water sales. West McCracken's proposed rates are, however, denied, as is its request to issue refunds to its customers

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1 The existing rates were set by the Commission in Case No. 94-450, Application of West McCracken County Water District for (1) General Rate Increase, (2) Revision of Tariffs, (3) Approval of Surcharge, and (4) Request for Approval of Variance on Financial Data, Order dated July 21, 1995. Rehearing denied September 1, 1995.

with the exception of those refunds created by overbillings as addressed elsewhere in this Order.

REFUNDS

West McCracken states in its application that the purpose of this filing is to permit the district to decrease its rates and refund to its customers "excessive revenues" resulting from rates established by the Commission in Case No. 94-450.[2]

West McCracken obviously had certain legal remedies available to it to challenge the rates set by the Commission in the last case. Although West McCracken did request rehearing, it chose not to pursue its other legal remedies when its rehearing was denied. Refunds of rates set by the Commission in Case No. 94-450 are not a lawful option for West McCracken and its proposal amounts to nothing more than an impermissible collateral attack on the Commission's final Order in Case No. 94-450. Kentucky law is well settled on this point. See, Ward v. Commonwealth of Kentucky, Natural Resources and Environmental Protection Cabinet, Ky.App., 814 S.W.2d 589 (1991) and Bd. of Adjustments of City of Richmond v. Flood, Ky., 581 S.W.2d 1 (1978). The Commission's Order became final when West McCracken failed to appeal our determination of its fair, just, and reasonable rates.

The filed rate doctrine prohibits refunds of the sort proposed by West McCracken in this case. West McCracken charged its customers the rates lawfully established by the Commission and the rates contained in its tariff. Those rates were established for prospective application using different test year data and those rates remain lawful and

[2] Application, Exhibit A, at 1.

in effect until new rates are authorized. West McCracken has cited no statutory provision and no case law to support a retroactive rate decrease for service previously rendered to customers under its effective tariff. As rates are exclusively prospective in application, future rates may not be designed to recoup over- or under-recoveries from past periods. Prohibitions against retroactive rate-making prevent the Commission from granting the relief sought by West McCracken.[3] Thus, the rate decrease granted in this case can be applied prospectively only. West McCracken's request to refund to its customers the difference between the customer charges authorized in Case No. 94-450 and the customer charges approved in this case should, therefore, be denied.

TEST PERIOD

West McCracken proposed the 12-month period ending September 30, 1995 as the test period for determining the reasonableness of the proposed rates. The Commission has accepted this test period as reasonable and has given full consideration to appropriate known and measurable changes.

REVENUES AND EXPENSES

West McCracken reported test year operating revenues and expenses of $356,995 and $324,413, respectively, and proposed several adjustments to its test period operations to reflect normalized operating conditions. The Commission has reviewed the proposed adjustments and determined that the following adjustments should be made for rate-making purposes.

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[3] See, Borough of Ellwood City v. Fed. Energy Reg. Com'n, 583 F.2d 642 (1978) and Towns of Concord, Norwood & Wellesley v. FERC, 955 F.2d 67 (D.C.Cir. 1992)

Operating Revenues from Water Sales

West McCracken filed a billing analysis in its application using the 12-month test period usage amounts with its current rates.[4] The revenue amount generated by the billing analysis was then adjusted by the estimated dollar amounts of known usage changes from the test period. The application shows test year revenue from the sale of water as $471,009.[5] The Commission performed a billing analysis with the current rates using the 12-month test period usage amounts filed by West McCracken. The usage amounts generated by the billing analysis was then adjusted by the estimated usage amounts for the adjustments filed in the application.[6] The rate charged to the commercial mobile home parks served by West McCracken was adjusted to reflect a one inch meter customer charge of $20.93.[7] The adjusted billing analysis produced normalized test year revenue from water sales of $472,204. The difference of $1,195 or 0.25 percent is within the limits necessary for rate-making purposes. Normalized test year revenue from water sales is determined to be $472,204.

Purchased Water Expense

West McCracken reported test year purchased water expense of $126,110, which it proposed to increase by $2,854, based on normalized test year usage of 106,581,946

4 Application, Exhibit B, Table 3.

5 Application, Exhibit B, Table 1.

6 Application, Exhibit B, Table 1 Notes.

7 This adjustment was necessary to reflect overbilling discussed elsewhere in this Order.

gallons. The Commission has calculated normalized test year usage to be 99,376,724 gallons.

West McCracken determined that its line loss for the test year ended September 30, 1995 was 8 percent. However, line loss reported in its 1995 annual report was 5.3 percent. Accordingly, the Commission has calculated normalized test year purchased water expense to be $129,604,[8] resulting in an increase to test year expense of $3,494.

Electric Pumping Expense

An adjustment was proposed by West McCracken to eliminate test year electric pumping expense to reflect the elimination of booster pumps. The Commission eliminated this expense for rate-making purposes in the last case based upon West McCracken's representation that the booster pumps would be eliminated. However, that representation now appears unfounded as the expense is still being incurred by the district some sixteen months after the initial representation was made.[9] Therefore, the Commission has included electric pumping expense since it continues to be an operating expense of the District.

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Normalized Test Year Usage	99,376,724
Adjustment for 5.3% Line Loss*	÷ 0.947
Allowable Purchased Water for Resale	104,938,463
Water Used by Company*	2,172,000
Allowed Purchased Water	107,110,463
Current Purchased Water Rate	$ 0.00121
Adjusted Test Year Purchased Water Exp.	$ 129,604

*Per West McCracken County Water District's 1995 Annual Report

9 July 31, 1996 Filing entitled "Notice of Additional Witnesses and Exhibits," Exhibit 5, Profit/(Loss) Statement, at 2.

Salary Expense

West McCracken proposed to increase salary expense by 5 percent for a total adjustment of $4,353. Since salary expense is allocated to several different accounts, this resulted in proposed increases to Maintenance Expense - Pumping & Tower; Maintenance Expense - Mains; Maintenance Expense - Meters, Services, Hydrants; Office and Accounting Salary Expense; Meter Reading Expense; and Administrative Salary Expense. The Commission has calculated the total increase to be $8,661, based on the actual salaries in effect as of January 1, 1996.[10]

Billing Supplies and Office Supplies & Expense

In its application West McCracken proposed to increase billing supplies expense and office supplies and expense by 3.5 percent, based on a 3.5 percent increase in number of bills during the test year. The Commission concurs that there would be a direct correlation between number of bills and billing supplies expense so an adjustment has been included to increase billing supplies expense by 3.5 percent, or $145. However, office supplies and expense would not necessarily increase as a direct result of an increase in the number of bills. Therefore, the proposed increase to this account has been disallowed for rate-making purposes.

Taxes and Employee Benefits

West McCracken proposed a 5 percent increase to taxes and employee benefits expense based on the 5 percent proposed increase to salary expense. The Commission

[10] Response to the Commission's February 20, 1996 Order, Attachment 11.

has increased test year expense by $1,759[11] based on the $8,661 increase to salary expense and the annualization of health insurance expense. The Commission has disallowed the employee Christmas party expense in the amount of $367 that was apparently charged to this account during the test year.[12]

Insurance Expense

An adjustment was proposed by West McCracken to reflect an increase in Workers' Compensation insurance as a result of the proposed increase to salary expense. Based on the invoices provided by West McCracken during this proceeding, there was no known and measurable increase to Workers' Compensation insurance. It has therefore been disallowed. The Commission has increased this account by $598 to reflect the annualization of the most recent property insurance premiums in effect for West McCracken.[13]

Legal Expense

There was no adjustment proposed to test year legal expense. However, the Commission has determined that $1,543 of the reported legal expense was actually

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FICA ($8,661 x 7.65%)	663
Retirement ($8,661 x 8.94%)	774
Annualization of Health Insurance	689
Employee Christmas Dinner	(367)
Total Increase	1,759

12 Transcript of Evidence ("T.E.") at 140.

13 Response to the Commission's February 20, 1996 Order, Attachment 10; Response to the Commission's April 18, 1996 Order, Attachment 5.

incurred as rate case expense.[14] As a result, legal expense has been decreased and the $1,543 will be treated as rate case expense for the determination of West McCracken's revenue requirement.

Rate Case Expense

Based on the responses filed by West McCracken,[15] the Commission has determined that it incurred rate case expenses of $6,682 as a result of this proceeding. This amount includes the $1,543 that was incorrectly reported as legal expense. The Commission has amortized this expense over a period of three years resulting in annual rate case expense of $2,227.

Depreciation Expense

West McCracken proposed to increase depreciation expense by $4,850 to include new water distribution lines that were not yet completed when the depreciation schedule was prepared. The Commission concurs with this adjustment but increased the expense by an additional $2,503[16] based on the depreciation schedule filed in Exhibit B of the Petition, adjusted for known and measurable additions and retirements.

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[14] Response to the Commission's April 18, 1996 Order, Item 16.

[15] Response to the Commission's April 18, 1996 Order, Attachment 4.

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1995 Depreciation Expense per Petition, Exhibit B	52,878
Less: Items Fully Depreciated in 1995	45
Add: Annualized Expense for 1995 Additions	626
Pro forma Adjustment	4,850
Total Test Year Depreciation - Adjusted	58,309
Less: Test Year Depreciation	50,956
Allowed Increase	7,353

Miscellaneous Expense

During the test year West McCracken incurred miscellaneous expenses in the amount of $161 for floral arrangements.[17] Expenses of this nature are not allowed in the determination of a district's revenue requirement, and, accordingly, the Commission has decreased miscellaneous expenses by $161.

Interest Income

West McCracken reported test year interest income of $1,601. Information filed by the District reflects that actual interest earned was $2,039.[18] Of this amount, $343[19] represented interest earned on customer meter deposits. Therefore, the Commission has increased interest income by $95[20] to reflect the appropriate level of interest income available to offset West McCracken's operating expenses.

Summary

Based on the foregoing adjustments to its revenues and expenses, West McCracken's test year operations appear as follows:

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17 Response to the Commission's February 20, 1996 Order, Attachment 16.

18 Response to the Commission's February 20, 1996 Order, Attachment 8.

19 Response to the Commission's April 18, 1996 Order, Item 13.

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Test Year Interest Income	2,039
Less: Interest Earned on Customer Deposits	343
Allowable Interest Income	1,696
Less: Test Year Interest Income	1,601
Increase	95

	Test Year	Commission Adjustments	Commission Adjusted Test Year
Operating Revenues	$ 356,995	$ 127,912	$ 484,907
Operating Expenses	324,413	22,533	346,946
Operating Income	$ 32,582	$ 105,379	$ 137,961
Interest Income	$ 1,601	$ 95	$ 1,696
Income Available for Debt Service	$ 34,183	$ 105,474	$ 139,657

DEBT SERVICE

The Commission has calculated West McCracken's average annual debt service requirement to be $35,160, exclusive of the debt service which is currently in arrears. The Commission is concerned that West McCracken is proposing to decrease rates to its customers when it is in violation of its bond ordinance in failing to meet its debt service requirements as they come due.[21] West McCracken's current debt service arrearage is approximately $62,000.[22] As discussed elsewhere in this Order, refunds of rates previously approved by the Commission are not a lawful option for West McCracken; thus, the amounts held in escrow for this purpose should be used by West

21 West McCracken County Water District, Audited Financial Statements for the Years Ended December 31, 1995 and 1994, Notes to Financial Statements, Note E.

22 T.E. at 77.

McCracken to pay off the arrearages in its debt service.[23] Only after West McCracken fully complies with its bonded obligations in eliminating the arrearage can any remaining funds be used for other lawful purposes.

DETERMINATION OF REQUIRED REVENUE DECREASE

Based on the Commission adjusted test year operations, West McCracken's required revenue decrease would be $96,265, calculated as follows:

Adjusted Operating Expenses	$ 346,946
Average Annual Debt Service	36,160
20 Percent Debt Service Coverage	7,232
Total Revenue Requirement	$ 390,338
Less:	
Operating Income From Water Sales	$ 472,204
Other Operating Income	12,703
Interest Income	1,696
Required Revenue Decrease	$ 96,265

RATES

West McCracken did not use an acceptable methodology in performing its cost-of-service study, contrary to representations made in its application. West McCracken's chosen methodology bears little resemblance to the methodology employed by Staff and accepted by the Commission in the prior case, nor does the methodology likewise resemble the commodity-demand methodology set forth in the American Water Works

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[23] As of June 30, 1996, the balance in the escrow account was $41,244.06. Assuming West McCracken continued to deposit $4,500 per month into this account, the balance as of November 30,1996 should be $63,744.06 plus interest earned. This amount should be sufficient to retire West McCracken's debt service arrearage. Any funds remaining in this account after the arrearage is paid off may be used for any lawful purpose West McCracken chooses.

Manual M1 ("Manual M1") upon which Staff's cost-of-service study in the last case was based. [24] Although some variations in methodology are acceptable if well reasoned and supportable, that does not appear to be the case here. After advocating this specific rate design in its last case, West McCracken must adhere to it and follow a methodology which fairly and evenly assigns costs to the classifications of customers who cause those costs to be incurred. We find no adequate reasons in this record to support acceptance of West McCracken's cost-of-service study. It is, accordingly, rejected for the following reasons.

The purpose of a cost-of-service study is to fairly allocate costs among a utility's customer classifications.[25] Manual M1 provides that one of the first steps in preparing a cost-of-service study is to allocate expenses to three components: (1) "commodity" which includes expenses that vary with the quantity of water used, such as purchased water costs, electric pumping expense, and chemicals; (2) "demand' which includes expenses associated with providing the facilities necessary to meet the demands customers place on the system such as maintenance of pumps, towers and mains; and (3) "customer" which includes expenses incurred irrespective of the amount of water used such as billing expenses, meter reading and a portion of administrative costs. Expenses which are allocated to the components must then be subdivided for each

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[24] Brief at 4.

[25] In Case No. 94-450, West McCracken proposed a customer charge for a 5/8 inch meter of $4.00 per month. Commission Staff prepared a cost-of-service study that produced a customer charge of $9.57. West McCracken maintained that a rate of $9.57 would place a burden on its residential customers and the Commission ultimately approved a customer charge of $8.53.

component into expenses which can be directly allocated and those for which no direct allocation can be made such as insurance, office supplies and vehicle expense. In order to allocate the expenses that cannot be directly allocated to one of the three components, the ratio of customer and demand expenses to the total expenses (exclusive of commodity costs) must be determined. Once the ratio is determined, that percentage is applied to the total expenses which cannot be directly allocated to determine the portion to be added to the demand and customer components.

West McCracken's cost-of-service study produced a 5/8 inch customer charge of $4.42. However, West McCracken failed to deduct commodity costs from its total costs in determining the ratio of customer and demand expenses to total expenses. This resulted in an inordinately low allocation percentage of 18 percent for those costs which could not be directly allocated to the customer component. When questioned at the hearing regarding its failure to back out the commodity costs from total costs, West McCracken's witness responded

> [W]e can do it two or three different ways and we'll come up with numbers that I think are fairly close. You back out the commodity, the purchased water, out over here but you recover that in the cost per thousand gallons and we end up later on, in my application, the one that I put together, we're recovering that cost of water purchased again through the cost per thousand. It ends up--the end result is you get there the same way.[26]

During further cross-examination, West McCracken's witness was asked to back out the commodity cost from the total and subsequently acknowledged that the percentage of

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[26] T.E. at 115.

allocable costs increased from 18 percent to approximately 70 percent. The Commission does not concur and will not concede that doing this step two or three different ways will yield numbers that are "fairly close."

Perhaps in an effort to rehabilitate his sworn testimony at the hearing, West McCracken's witness filed the post-hearing brief on behalf of the District.[27] Although the "testimony" contained therein is unsworn, it does illustrate a lack of understanding of the importance of fairly allocating costs to achieve a fair result to all customers. A further examination of the record regarding four other cost-of-service allocation issues is necessary for a complete understanding of the flaws inherent in West McCracken's chosen methodology.[28]

West McCracken maintains that discretion may be used to modify the methodology set out in Manual M1 and states in support that the Commission modified its Staff's study in the last case by not including direct fire protection costs as a component. Fire protection is not a major function of this district. In fact, according to West McCracken, the primary use of its fire hydrants is to provide access to the water distribution system for flushing, sampling, and testing.[29] While the Commission recognizes that cost allocation can be an inexact process and that reasonable modifications can be made to these studies, West McCracken should realize that

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27 West McCracken was represented by counsel throughout this proceeding. Its post-hearing brief was filed by its General Manager.

28 These issues may be categorized as fire protection costs, hydrant maintenance costs, debt service expense and assignment of meter service ratios.

29 Brief at 4.

unsupportable modifications to achieve a desired result for one class of customers at the expense of other customers are not in the public interest and should not be permitted.

West McCracken maintains that hydrant maintenance costs should be allocated to the commodity category since the primary use of its hydrants is for distribution system flushing, sampling and testing. West McCracken pays an annual fee of $3,500 to the Fire Hydrant Repair Company, to test, inspect and repair all fire hydrants.[30] This expense does not vary with the quantity of water purchased. The Commission disagrees that any part of this fee should be allocated to the commodity category and has allocated $1,750 of this expense to the demand category and the other half to the customer category.

West McCracken did not allocate any portion of debt service expense to the customer category nor did it allocate depreciation in the manner set out in the Manual M1. The Commission has determined that depreciation expense in the amount of $9,376 and debt service of $6,840 should be included in the customer charge category.

West McCracken disagrees with the Commission's assignment of meter and service ratios used to set the customer charges. West McCracken quotes the Manual M1 which states, "Customer meter and service costs are sometimes distributed among customer classes based on factors other than investment."[31] West McCracken goes on to state that the Manual M1 shows a ratio for a 2 inch meter as 2.9, meaning the investment for a 2 inch meter is 2.9 times the investment for a 5/8 inch meter. West

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30 Response to the Commission's February 20, 1996 Order, Item 2.

31 Brief at 4.

McCracken states that based on its current connection fees the investment ratio is 6.25 for a 2 inch meter. In the prior and instant cases, the Commission used an equivalent ratio of 8.0 for a 2 inch meter based on the ratio of gallon per minute flow rates for each meter size in accordance with the American Water Works Association's standard for the safe operating capacity of water meters. Since investment ratios were not used in the prior case and have not been used in this case, the Commission fails to see the relevance of West McCracken's argument.

During the test year West McCracken sold 98,686,987 gallons, an increase of 15,246,905 gallons over test year amounts used in the Case No. 94-450. This increase in sales resulted in an increase in revenue from water sales of approximately $51,126. The majority of costs associated with selling an additional 15 million gallons of water should be allocated to the commodity or demand categories. The cost-of-service study performed in the last case was not fully implemented by the Commission which resulted in the larger users subsidizing customers who do not use large quantities of water. This subsidy was allowed to gradually implement cost based rates to all customers. In this case, expenses have been reallocated based on actual costs which results in all customers receiving a decrease in rates while eliminating as nearly as possible any subsidization. The average residential user who uses 5,000 gallons will receive a decrease of 15 percent while the largest user, Tennessee Valley Authority, will receive a decrease of 32 percent.

Overbilling

West McCracken dramatically changed its rate design in Case No. 94-450. Its rate design prior to that case consisted of a minimum bill with water usage of 2,000 gallons included in the minimum bill. The current rate design consists of a customer charge (which includes no usage) and a two step rate schedule designed to recover the cost per 1,000 gallons of water. West McCracken's current tariff contains language that presumes the prior rate design is still in effect. West McCracken's billing analysis showed that it is inappropriately applying the language and method of billing to its "multi-family dwellings" and "commercial trailer park" customers resulting in overcharges. This method of billing is inappropriate to use with the current rate design.

West McCracken stated that for the mobile home parks it bills 50 percent of the "minimum charge" for a 5/8 inch meter times the number of units to determine the minimum bill for a mobile home park. West McCracken has two commercial mobile home parks, one with 10 lots and the other with 12 lots. Both have one inch meters and should have been charged one customer charge of $20.93, plus usage. However, the parks were charged minimums of $42.65 and $51.18 respectively. West McCracken agrees that the assessed minimum charges for mobile home parks were excessive and that the parks should have been assessed a customer charge based on meter size rather than the number of lots.[32] West McCracken expressed willingness to issue refunds to the mobile home parks, but only if all other customers receive a refund.[33]

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32 Brief at 6.

33 Brief at 7.

The question of refunds has been addressed elsewhere and is totally irrelevant to the overcharges addressed above. KRS 278.160 provides that West McCracken can collect no more from customers other than rates contained in its filed tariff. The mobile home parks were charged "minimums" which no longer exist in its approved rate design using a method which is no longer appropriate. Both mobile home parks are entitled to refunds.

West McCracken has approximately 40 customers which are categorized as "multi-family dwellings." Multi-family dwellings are defined as a permanent structure, housing two or more families, which includes duplex, triplex and apartment buildings. These customers, who are all served by 5/8 inch meters, were charged multiple customer charges and the usage split evenly between the number of families. West McCracken argued at the hearing that customers who share a meter should each pay a customer charge because there are two bills to print, two bills to track on the computer, and two payments to receive.[34] West McCracken further maintained that, "These accounts typically are the most troublesome for the district, resolving who has the leak, only one of the two parties paying their bill, etc."[35]

The Commission is somewhat unfamiliar with this circumstance. The party who contracts for service and has the meter set in their name is legally responsible for payment of the bill. This eliminates the problem associated with one party not paying the bill or a situation involving a line leak. In the future West McCracken should send

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[34] T.E. at 64.

[35] Brief at 8.

one bill to the customer of record, install a second meter for the additional service, or divide the customer charge and water usage in half and send two bills. However, it cannot charge two customer charges. Since the Commission was unaware of this situation in Case No. 94-450, the rates in effect prior to this Order were based on these customers receiving two bills; therefore, no refunds are required at this time. The rates in this case are based on the elimination of 40 customer charges for the 5/8 inch connections. West McCracken should revise its tariff to remove the obsolete language.

IT IS THEREFORE ORDERED that:

1. The rates proposed by West McCracken are hereby denied.

2. The rates set forth in Appendix A are approved for service rendered by West McCracken on and after the date of this Order.

3. West McCracken should retire that portion of its outstanding debt which is currently in arrears, using funds currently being held in an escrow account for the purpose of customer refunds. Any balance remaining in the escrow account after retirement of the arrearage may be used for any lawful purpose West McCracken chooses.

4. Within 30 days of the date of this Order, West McCracken shall refile its tariffs setting forth the rates approved in this Order and deleting the obsolete language relating to billing of commercial mobile home parks and multi-unit dwellings.

Done at Frankfort, Kentucky, this 26th day of November, 1996.

PUBLIC SERVICE COMMISSION

Linda K Breathitt
Chairman

Edward J Holmes
Vice Chairman

B. J. Helton
Commissioner

ATTEST:

Don Mills
Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 95-588 DATED NOVEMBER 26, 1996

The following rates and charges are prescribed for the customers in the area served by West McCracken County Water District. 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.

Water Rates

Customer Charge

5/8" Meter	$ 8.39 per Month
1" Meter	19.63 per Month
2" Meter	28.06 per Month
3" Meter	47.73 per Month
4" Meter	75.83 per Month

All Water Usage

First	100,000 Gallons	2.98 per 1,000 Gallons
Over	100,000 Gallons	2.17 per 1,000 Gallons