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 July 31, 1996, the Commission issued an Order finding that Kentucky-American Water Company ('Kentucky-American") was entitled to a revenue increase of $884,523 for the 13-month period of June 3, 1988 through July 3, 1989. Because the rates originally approved by the Commission for that period were designed to produce a revenue increase of $912,690, a refund of $28,167 was due to ratepayers. The Attorney General's Office of Rate Intervention ("AG") and the Lexington-Fayette Urban County Government ("LFUCG") jointly petitioned for rehearing on two issues: 1) the cost to serve new customers; and 2) interest on the amount to be refunded. The Commission granted rehearing on both issues and established a procedural schedule providing for the submission of testimony, discovery, and a hearing. Only Kentucky-American submitted testimony and all parties waived their rights to an evidentiary hearing.

Cost to Serve New Customers

For clarity, this issue will be discussed in terms of the events that occurred during the initial phase as distinguished from those that occurred during the rehearing phase. During the initial phase, Kentucky-American had proposed an increase in test period operating revenues to reflect a full 12 months of the revenue to be collected from the end-of-period customer level. To properly match revenues with expenses, Kentucky-American also proposed to increase its operating expenses to reflect the cost to serve the same end-of-period customer level. The proposed expense increase was $86,451 and was based on a ratio of operation and maintenance ("O&M") expenses less payroll costs to revenues at present rates.

During the initial phase, the AG/LFUCG challenged Kentucky-American's expense adjustment as flawed because it assumes all O&M costs, except payroll related costs, are variable. The evidence presented by the AG/LFUCG during the initial phase identified power, chemical, and sludge removal as costs that would vary with the number of customers served. During the initial phase, the AG/LFUCG proposed to reduce Kentucky-American's adjustment by $43,158 to reflect the exclusion of all O&M expenses except the three identified in its evidence.

In the July 31, 1996 Order, at page 15, the Commission found that:

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

(Emphasis in original). The AG/LFUCG requested rehearing on this issue, claiming that it was inconsistent for the Commission to find that all costs are not variable and then accept an adjustment based on the assumption that all costs are variable. In its September 11, 1996 Order, the Commission granted rehearing for the specific purpose of considering whether the O&M costs included in Kentucky-American's adjustment are all variable, which would indicate that the finding to the contrary was erroneous, or whether the O&M costs are not all variable, which would indicate that the expense adjustment accepted was excessive.

In support of its position that all the costs of serving new customers included in its adjustment are variable, Kentucky-American defined fixed cost as, "[T]hose costs that do not vary with output. These costs are fixed for a certain period of time; <u>in the long run they are variable</u>."[1] (Emphasis in original.) Kentucky-American maintained that in the long run, all its costs are variable and at some point in time a fixed cost will increase if one additional customer is added. Kentucky-American's expense adjustment was based on an O&M ratio of 29.52 percent, while for the period of 1982 through 1986, Kentucky-American's average O&M ratio was 30.03 percent. These percentages were cited by Kentucky-American as further support for its position that the use of an operating ratio of O&M expense to revenue is a valid relationship to use in determining the expense adjustment for the cost of serving new customers.

The Commission finds Kentucky-American's evidence to be persuasive. That evidence demonstrates that while fixed costs do not vary proportionately with either the number of customers or the volume of sales, they do become variable costs in the long run. At some point in time the addition of one customer or the sale of one gallon of water will cause a fixed cost to increase. The Commission also finds that it would be time consuming

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1 Rehearing Testimony of Edward J. Grubb, page 2.

and costly to analyze each individual expense item that comprises the cost to serve customers. Given the historical ratios of operating revenues and expenses presented by Kentucky-American, there is no reason to believe that a detailed expense analysis would produce a significant change in Kentucky-American's proposed adjustment. In all likelihood a detailed expense analysis would be cost prohibitive because any reduction in the expense adjustment would be outweighed by the cost of the analysis.

Based on these findings, the Commission concludes that the finding in the July 31, 1996 Order, at page 15, that, "[S]ome operation and maintenance costs do not vary proportionately with either the number of customers served or the volume of sales . . .," is erroneous and should be superseded by the findings herein. Having thus found that all the expenses comprising the cost to serve new customers are in the long run variable, the Commission finds that its original decision to accept Kentucky-American's adjustment to the cost of serving new customers was appropriate and should be affirmed.

Interest On Refunds

The July 31, 1996 Order did not address the issue of interest on the $28,167 to be refunded to ratepayers. Kentucky-American opposes the inclusion of interest, claiming that: 1) it was not responsible for all of the delays experienced in this case; 2) the makeup of its body of ratepayers has changed over the years, thus rendering interests payments less meaningful; and 3) the absence of an interest requirement in the July 31, 1996 Order indicates the Commission's decision to not require interest.

The Commission well recognizes that the delays experienced in this case are not solely attributable to Kentucky-American, but they are a result of the adoption of a nonunanimous settlement agreement which was held to be illegal by the Kentucky Courts.

The Commission notes that in Case No. 90-321,[2] a prior Kentucky-American rate case that ultimately resulted in refunds after judicial review, the refunds were paid with interest. Considering the illegal nature of the original settlement agreement, the Commission finds that the refunds should be paid with interest. The interest should be calculated on the end-of-month balance at a rate equal to the average of the "3-Month Commercial Paper Rate" for the period June 1988 through February 1997.

IT IS THEREFORE ORDERED that:

1. The July 31, 1996 Order is modified to the limited extent that the finding on page 15 that "some O&M costs are not variable" is superseded by the findings set forth herein.

2. All other provisions of the July 31, 1996 Order are affirmed.

3. Kentucky-American shall refund $28,167 to its customers with interest calculated as provided for in this Order.

4. Within 20 days of the date of this Order, Kentucky-American shall file a plan to refund $28,167 with interest to its customers over a three-month period by a one-time, equal credit to the service charge of each current customer.

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[2] Case No. 90-321, Notice of Adjustment of the Rates of Kentucky-American Water Company Effective on December 27, 1990.

Done at Frankfort, Kentucky, this 5th day of March, 1997.

PUBLIC SERVICE COMMISSION

Linda K Breathitt
Chairman

Ed J. Holmes
Vice Chairman

B. J. Helton
Commissioner

ATTEST:

Don Mills
Executive Director