

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

PROPOSED ADJUSTMENT OF THE)
WHOLESALE WATER SERVICE RATES OF) CASE NO. 98-283
THE CITY OF OWENTON, KENTUCKY)

ORDER

The city of Owenton, Kentucky (Owenton) proposes to adjust the rate of wholesale water service to Tri-Village Water District (Tri-Village) from \$1.28 per 1,000 gallons to \$2.22 per 1,000 gallons, or 73.4 percent. Based upon its water sales to Tri-Village during the test period, this proposed adjustment would generate additional annual revenue of \$97,546. By this Order, the Commission denies the proposed adjustment and authorizes Owenton to increase its wholesale water service rate to \$2.11 per 1,000 gallons and to assess a temporary surcharge of \$.04 per 1,000 gallons to recover rate case expenses.

COMMENTARY

Owenton is a city of the fifth class that, through its Water and Sewer Department, operates facilities providing water and sanitary sewer service. Owenton provides retail water service to 1,022 customers and wholesale water service to Tri-Village. On January 5, 1993, Owenton and Tri-Village executed a water purchase contract that requires Owenton to provide Tri-Village with a daily maximum of 500,000 gallons of water. The parties entered the contract as part of a financing agreement with the

Farmers Home Administration (FmHA) for the construction of an addition to Owenton s water treatment plant. The water purchase contract has a term of 50 years.

PROCEDURE

On April 29, 1998, Owenton filed a proposed revision to its existing rate for wholesale water service to Tri-Village. Upon Tri-Village s objection to the proposed rate and after finding that further proceedings were necessary to determine the reasonableness of the proposed rate, the Commission suspended the proposed rate until October 31, 1998 and established a procedural schedule. The Commission further granted Tri-Village leave to intervene in this proceeding.

Following discovery in this proceeding, the Commission held a public hearing on the proposed rate on January 11, 1999. Testifying at this hearing were William Gill, chairman of Owenton s Water and Sewer Department; D. Scott Taylor, professional engineer; and William C. Babington, consultant. This case stood submitted for decision on February 5, 1999 when both parties submitted written briefs.

TEST PERIOD

Owenton proposes and the Commission accepts the 12-month period ending June 30, 1997 (Fiscal Year 1997) as the test-period for determining the reasonableness of the proposed rate. In using this historic test period, the Commission has given full consideration to appropriate known and measurable changes.

REVENUES AND EXPENSES

Operating Expenses

During Fiscal Year 1997, Owenton incurred expenses of \$459,997 to operate its water treatment and distribution facilities. Tri-Village has disputed neither the accuracy

nor reasonableness of the expenses. Accordingly, the Commission finds that \$459,997 should be used to determine Owenton's wholesale water service rate.¹

Debt Service Requirements

During the test period, Owenton had 3 outstanding long-term debt obligations. It reports that the debt service requirements associated with these obligations were \$71,260.² The Commission accepts these requirements for rate-making purposes.

COST ALLOCATION

Owenton proposes to allocate to Tri-Village approximately \$213,805 of its total operating expenses of \$459,997 and \$17,591 of its \$71,260 debt service costs. Of the allocated operating expenses, approximately \$164,248 is attributable to water treatment functions and \$48,837 is attributable to distribution functions. These allocations produce a wholesale water service rate of \$2.22 per 1,000 gallons of water.

In support of its proposed allocation, Owenton has presented a detailed cost-of-service study. Based upon this study, Owenton allocated water treatment costs based upon the ratio of total gallons of water sold to Tri-Village to total gallons sold.

¹ Owenton's total operating expenses, as reported in Owenton's Audit Report for Fiscal Year 1997, are \$458,394. In its cost-of-service study, Owenton reported total operating expenses of \$459,997. The cost-of-service study reported additional salaries and wages of \$1,170 and purchase power expense of \$433. Because Owenton provided detailed information in support of these latter figures, the Commission has chosen to rely upon the amounts stated in its cost-of-service study. See Owenton's Response to the Commission's Order of November 5, 1998, Item 5; Owenton's Response to the Commission's Order of December 18, 1998, at 8.

² The debt service payments with this debt were as follows:

Waterworks Revenue Bonds of 1988		\$17,350
Waterworks Revenue Bonds of 1994	Series A	42,750
Waterworks Revenue Bonds of 1994	Series B	<u>11,160</u>
Total:		<u>\$71,260</u>

Owenton's allocation of distribution expenses was based upon the following factors: water use; inch-mile ratio of jointly used lines; distribution share; and adjustments.

Advocating rejection of the proposed cost allocation, Tri-Village contends that Owenton's cost allocation methodology is not consistent with the Water Purchase Contract or FmHA cost allocation methodology upon which the contract was based. Our review of the contract finds no support for any particular cost methodology. The contract provides no cost allocation methodology nor does it refer to any recognized cost allocation. As to an FmHA endorsed methodology, neither Tri-Village nor its witness Babington has referred to any published methodology that FmHA has endorsed or required.

The Commission acknowledges that the contract contains some cost allocation principles. Paragraph C5 of the contract specifically provides that a 1992 FmHA grant of \$314,900 will accrue only to the Purchaser [Tri-Village] for the purpose of reducing the Purchaser's portion of the debt service associated with the 1992 water supply project. It further provides for a 10 percent debt service reserve or such other reserve as may be required by the bond holders. The absence of additional cost allocation principles in the contract, however, suggests that the parties either failed to consider or were unable to reach agreement upon any comprehensive cost allocation methodology.

Assuming arguendo that the parties had reached some agreement upon cost methodology, such agreement is not binding upon the Commission. The Commission has the right and duty to regulate rates and services, no matter what a contract provided. Board of Ed. of Jefferson County v. William Dohrman, Inc., 620 S.W.2d 328, 329 (Ky.App. 1981). While the Commission should give weight to the intent of the parties, its ultimate obligation is to establish rates that are fair, just and reasonable.

During the proceeding, Tri-Village offered an alternative wholesale rate of \$1.1430 per 1,000 gallons of water. This rate is comprised of a debt service component of \$.1657 per 1,000 gallons and an operation and maintenance expense component of \$.9773. It is based upon a purported cost-of-service study performed by Tri-Village witness Babington.

The Commission finds that Tri-Village's purported cost-of-service study should be given little weight. Based upon our review of his testimony, the Commission finds that the study's author had little understanding of cost allocation concepts and no experience in preparing cost-of-service studies. His cost allocation methodology does not comport with generally accepted rate-making practices or any recognized authority. The study contained no explanation of its proposed cost allocations nor did its author provide such explanation when testifying. Where a party has proposed to exclude all distribution expenses from the calculation of a wholesale rate, the Commission expects, at a minimum, a detailed explanation, supported by some empirical data, of why such exclusion is appropriate. In this case, that explanation is totally lacking.

In contrast, Owenton's cost-of-service study is supported by significant empirical data. Each cost allocation factor is explained. Its author is experienced in preparing cost-of-service studies. Finally, Owenton's cost allocation methodology is consistent with generally accepted rate-making practices and generally recognized within the water utility industry. The Commission finds that Owenton's cost-of-service study, with the exceptions noted below, should be accepted as the basis for establishing the wholesale rate.

Having reviewed Owenton's cost-of-service study, the Commission finds that the total gallons sold factor was incorrectly calculated. Owenton allocates several joint

costs based upon the ratio of total gallons of water sold to Tri-Village. When calculating this factor, Owenton omitted from its calculation 5,475,000 gallons of water that Owenton provided to its Sewer Department at no charge. Owenton witness Taylor, the author of the cost-of-service study, agreed that this water should be considered when calculating this allocation factor.³ Taking into account this water, this allocation factor is reduced from .5933⁴ to .5754.⁵

The Commission further finds that Owenton's cost-of-service study incorrectly allocated the cost of operating expenses. Originally Owenton proposed to allocate all operating supplies expense equally between its water treatment and distribution functions. In post-hearing filings with the Commission, Owenton has indicated that these expenses should be totally allocated to the water treatment function. The Commission concurs with this change.

The Commission also finds that adjustments to the proposed allocation of water treatment costs are necessary. In its cost-of-service study, Owenton allocated water treatment expenses based upon the ratio of total gallons sold to Tri-Village. Use of this allocation is appropriate for those expenses classified as commodity expenses - expenses concerning chemicals, river pumping facilities and water treatment that vary directly with the amount of water sold. An allocation factor of .5348, however, should be

³ Transcript at 52. Taylor suggests that the omission of this water is offset by Owenton's failure to allocate to Tri-Village the cost of office space that the Sewer Department provided to the Water Department at no charge. Since the cost of such office space has not been calculated and no allocation attempted, the Commission has made no provision for it.

⁴ $103,772,000/174,876,100 = .5933$.

⁵ $103,772,000/180,351,100 = .5754$.

used for all other treatment expenses. This factor takes into consideration water loss and plant use and results from the calculation of the ratio of water sales and the water production multiplier. The water production multiplier shows that when line loss, plant use, and the inch mile ratio are considered, Owenton must produce 1.3156 gallons to sell one gallon to its retail customers and must produce 1.2228 gallons to sell one gallon to Tri-Village. These adjustments are reflected in Appendix B.

The Commission has made adjustments to Owenton's allocation of distribution costs using the ratio of gallons sold to Tri-Village to total sales, multiplied by the inch mile ratio of jointly used lines. The Commission's adjustments result in an increase in the allocation of distribution costs from Owenton's proposed rate of \$.47 to \$.50 per 1,000 gallons. These adjustments are set out in detail in Appendix B.

In establishing Owenton's wholesale rate, the Commission has included depreciation expense. Arguing that the FmHA does not consider depreciation as a cost of producing water,⁶ Tri-Village has opposed such inclusion. The Commission, however, finds that Kentucky law requires such inclusion. See Public Service Commission v. Dewitt Water District, Ky., 720 S.W.2d 725, 731 (1986) (The Commission is required by statute to treat depreciation as an operating expense to provide an adequate fund for renewals, replacement and reserves.) Moreover, it is generally recognized that depreciation is a real part of the cost of operating a utility, whether government or investor owned. American Water Works Association, Manual M1, Water Rates (4th ed. 1991) at 3.

⁶ Transcript at 90.

In establishing Owenton's wholesale rate, the Commission has rejected Tri-Village's contention that Owenton's retail rates must also be considered. The powers of the PSC are purely statutory and it has only such powers as are conferred expressly or by necessity or fair implication. As a statutory agency of limited authority, the PSC cannot add to its enumerated powers. Boone County Water and Sewer District v. Public Service Commission, Ky., 949 S.W.2d 588, 591 (1997). While the Commission has been granted the authority to review a municipal utility's wholesale rates to public utilities, Simpson County Water District v. City of Franklin, Ky., 872 S.W.2d 460 (1994), it has no authority over a municipal utility's retail rates. Owenton's retail rates, therefore, are not properly within the Commission's scope of review. To the extent that the Commission has carefully reviewed the cost components that comprise Owenton's wholesale rate, moreover, there is no need to review Owenton's retail rates.

In summary, the Commission finds that Owenton's wholesale rate should provide for the following components: \$.17 per 1,000 gallons for debt service; \$1.44 per 1,000 gallons for water treatment costs; and, \$.50 per 1,000 gallons for distribution costs. Owenton's rate for wholesale water service to Tri-Village should be \$2.11 per 1,000 gallons.

RATE CASE EXPENSE

Owenton requests recovery of \$15,861.11 for expenses incurred to prosecute its application for rate adjustment. In support of its request, it contends that these expenses are directly related to its sale of water to Tri-Village and, therefore, are most appropriately borne by Tri-Village. It further argues that the expenses were incurred as a direct result of Tri-Village's failure to negotiate in good faith as required by the Water Purchase Contract.

Tri-Village objects to the requested recovery of any rate case expenses. Tri-Village argues that Owenton, having waited until after the hearing on the proposed rate adjustment to make its request, has not brought its request in a timely manner and should be barred from any recovery. Tri-Village further contends that, as a result of Owenton's late request, it has been deprived of any meaningful opportunity to question these expenses. Finally, the water district contends that, Owenton, not Tri-Village, failed to comply with the Water Purchase Contract by applying to the Commission for a rate adjustment.

Rate case expenses have long been considered as appropriate expenses for inclusion in utility rates. In West Ohio Gas Co. v. Public Utilities Commission, 294 U.S. 63, 74 (1935), the United States Supreme Court held that such expenses must be included among the costs of operation in the computation of a fair return. It declared that [t]he charges of engineers and counsel, incurred in defense of its security and perhaps its very life, were as appropriate and even necessary as expenses could well be. Id.

As a general matter, reasonable rate case expenses are usually borne by all customers. The present case, however, is not a usual case. The Commission regulates only a portion of Owenton's operations. It does not regulate Owenton's retail operations nor is Owenton required to obtain Commission approval for those rates. As the costs associated with Commission review are clearly associated only with Owenton's wholesale rate, the Commission finds that these costs should be attributed to Owenton's wholesale operations only.

The Commission agrees with Tri-Village's position that some rate case expenses are affected by the Water Purchase Contract. According to Paragraph C5 of that contract, the parties are to equally bear the cost of a study on the cost of water

production and distribution by the Seller to the Purchaser. Clearly, a portion of Owenton's rate case expenses was incurred in the preparation of such a study. The Commission is of the opinion that equity and fairness require that both parties equally bear those costs. Of the total amount of rate case expense claimed, approximately \$5,032 is related to the cost-of-service study. The cost of this study should be allocated equally among the parties and only \$2,516 considered recoverable rate case expenses.

The Commission specifically rejects each party's arguments that the other failed to comply with the Water Purchase Contract's terms. The record clearly shows that both parties failed to request the performance of a cost-of-service study by an independent party and that both made only lukewarm attempts to negotiate a resolution to their dispute. Neither party comes to the Commission with clean hands.

Based upon its review of the record, the Commission finds that Owenton incurred reasonable rate case expenses of \$11,346. The Commission has disallowed that portion of the claimed expense for which no invoices have been submitted. The Commission further finds that Owenton should be permitted to recover its rate case expenses over a 3-year period through a temporary surcharge on the rate that it charges Tri-Village.

The Commission denies Tri-Village's objections that the request for rate case expense recovery is untimely and deprives it of a meaningful opportunity to review those expenses. The issue of rate case expense was timely raised at the hearing in this matter, and Tri-Village had the opportunity to review and voice its objections to any expense in its post-hearing brief.

SUMMARY

After review of the evidence of the record and being otherwise sufficiently advised, the Commission finds that:

1. Based upon its adjusted operations for Fiscal Year 1997, Owenton requires \$459,997 annually to meet its reasonable operating expenses, including depreciation, to provide water service to all customers.

2. During Fiscal Year 1997, approximately \$200,872 of Owenton's operating expenses was incurred to provide water service to Tri-Village.

3. During Fiscal Year 1997, approximately \$17,591 of Owenton's debt service requirement was related to providing service to Tri-Village.

4. Owenton's total annual revenue requirement to provide water service to Tri-Village is \$218,463.

5. A complete allocation of Owenton's cost of serving Tri-Village is set forth in Appendix B to this Order.

6. Based upon Owenton's sales to Tri-Village during Fiscal Year 1997, a wholesale rate of \$2.11 per 1,000 gallons of water will produce annual revenue sufficient to meet Owenton's cost of serving Tri-Village.

7. Owenton should be permitted to recover \$11,346 of rate case expenses through a temporary surcharge assessed over a 3-year period.

8. The rates in Appendix A to this Order are the fair, just, and reasonable rates for Owenton.

9. The rate proposed by Owenton is unjust and unreasonable and should be denied.

IT IS THEREFORE ORDERED that:

1. The rates set forth in Appendix A are approved for water service rendered by Owenton to Tri-Village on and after the date of this Order.

2. The rate proposed by Owenton is denied.

3. Owenton is authorized to assess a surcharge of \$.04 per 1,000 gallons on water sales to Tri-Village for a period of 3 years from the date of this Order, or until it has collected revenues of \$11,346 from this surcharge, whichever occurs first.

4. Within 30 days of the date of this Order, Owenton shall file revised tariff sheets reflecting the rates approved herein.

Done at Frankfort, Kentucky, this 22th day of February, 1999.

By the Commission

ATTEST:

Executive Director

APPENDIX A

AN APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 98-283 DATED FEBRUARY 22, 1999

The following rates are prescribed for the City of Owenton, Kentucky to be assessed to Tri-Village Water District to be effective on and after the effective date of this Order.

Wholesale Water Service	\$2.11 per 1,000 gallons
Rate Case Expense Surcharge*	\$0.04 per 1,000 gallons

* This surcharge shall terminate 3 years from the date of this Order or upon collection of \$11,346 in revenues, whichever occurs first.

APPENDIX B

AN APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 98-283 DATED FEBRUARY 22, 1999

City of Owenton		Gallons
Plant Use		22,456,000
Line Loss		36,636,900
Sales to Resale		10,053,000
Sales to Owenton		61,051,100
Sales to Tri-Village		103,772,000
Unmetered Water		5,475,000
Water Used by Owenton		6,904,000
Total Produced and Purchased		246,348,000
Total Sales		180,351,100
Water Loss Percentage		14.87%
Plant Use Percentage		9.12%
Total Line Loss and Plant Use		23.99%
(Total Sales Includes Unmetered Water)		

City of Owenton				
Total Miles			Shared Miles	
Size	Miles	Inch Miles	Miles	Inch-Miles
12"	2.08	24.96	2.08	24.96
8"	9.47	75.76	9.47	75.76
6"	6.68	40.08	4.21	25.26
4"	14.39	57.56	0.52	2.08
3"	0.66	1.98	0	0
2"	4.45	8.9	0	0
Total	37.73	209.24	16.28	128.06
Jointly Used Miles of Line = 128.06 / 209.24				61.20%

1997 Expense	Total System	Allocation of Treatment Expense	Allocation of Distribution Expense
Bad Debt	2,987	0	0
Chemicals	39,799	22,900	0
Electricity			
River Pumping Facilities	25,582	14,720	0
Water Treatment Plant	22,690	13,056	0
Truck Loading Station	432	0	0
Tank Telemetry	175	0	62
Insurance			
Employee	11,733	3,890	1,570
Workers Comp	7,445	2,469	996
Truck	5,165	1,712	691
Building	1,631	872	0
Bond	523	0	0
Misc.	516	166	72
Office Expense	4,286	1,383	599
Operating Supplies	3,425	1,832	0
Payroll Expenses	10,747	3,563	1,438
Professional Fees	3,800	1,226	531
Repairs and Maintenance			
Distribution Materials	26,142	0	9,207
Service Facilities	8,010	0	0
Treatment Plant	14,746	7,886	0
Miscellaneous	6,395	1,032	1,573
Retirement Contributions	6,607	2,191	884
Salaries and Wages			
Distribution	36,651	0	12,908
Treatment	77,464	41,428	0
Meters	22,283	0	0
Sampling Expense	3,676	0	1,295
Telephone	1,547	499	216
Tractor and Truck	7,502	2,421	1,048
Travel and School	1,153	382	154
Uniforms	2,653	880	355
Withdrawal Fees	5,420	0	0
Depreciation			
Buildings and Improvements	333	0	117
Office Furniture and Fixtures	804	259	112
Distribution System	40,857	0	14,390
Equipment	9,993	0	3,520
Service Facilities	1,243	0	0
Treatment Plant	45,457	24,310	0
Miscellaneous	125	31	24
Total Operating Expenses	459,997	149,108	51,764
Rates		\$1.44	\$0.50
Treatment Rate		\$1.44	
Distribution Rate		\$0.50	
Debt Service Rate	17,591	\$0.17	
Wholesale Rate to Tri-Village		\$2.11	

City of Owenton		
Allocation Factors		
Test Year Gallons Sold		180,351,000
Sales to Tri-Village		103,772,000
Line Loss		0.1487
Plant Use		0.0912
Total		0.2399
Owenton Water Production Multiplier		
$1 / 1 - .2399$		1.3156
Tri-Village Water Production Multiplier		
Tri-Village Inch Mile Ratio		
$128.06 / 209.24$		0.6120
Tri-Village Share of Line Loss		
$.6120 * .1487$		0.0910
Joint Share of Line Loss and Plant Use		
$.0910 + .0912$		0.1822
Tri-Village Water Production Multiplier		
$1 / 1 - .1822$		1.2228
Tri-Village Water Production Factor		
$103,772,000 / 180,351,100 \times$		
$1.2228 / 1.3156$		0.5348
Pipeline Transmission Factor		
$(103,772,000 / 180,351,100) \times .6120$		0.3522
Commodity Allocation Factor		
$103,772,000 / 180,351,100$		0.5754