COMMONWEALTH OF KENTUCKY

BEFORE THE KENTUCKY PUBLIC SERVICE COMMISSION

In the Matter of:

NOTICE OF ADJUSTMENT OF THE RATES OF KENTUCKY-AMERICAN WATER COMPANY	) CASE NO.) 92-452

O R D E R

On January 22, 1993, Kentucky-American Water Company ("Kentucky-American") filed its application with the Commission seeking to increase its rates and charges utilizing a forecasted test period, pursuant to 807 KAR 5:001, Section 10(1)(b). Kentucky-American proposed rates and charges to become effective February 22, 1993, which would generate an increase in annual revenue of $2,706,568, an increase of approximately 9.27 percent over existing revenues.

To determine the reasonableness of the request, the Commission suspended the proposed rates and charges for 6 months after the effective date pursuant to KRS 278.190(2). Public hearings were conducted on June 29, 1993 at Lexington, Kentucky and on June 30-July 2, 1993, at the Commission's offices in Frankfort, Kentucky. The Utility and Rate Intervention Division of the Attorney General's Office ("AG"), the Lexington-Fayette Urban County Government ("LFUCG"), Chetan Talwalkar, and the Bluegrass Sierra Club ("Sierra Club") intervened. Jennifer L. Newman was granted limited intervention.

Kentucky-American presented the following witnesses: Robert A. Edens, its Vice President and Manager; Cecil Sasher, its Vice increased number of customers."[37] Upon rehearing of the issue,[38] the Commission also found that the original fund contributors provided Kentucky-American an interest free loan which, when combined with the increased number of customers, resulted in lower rates to existing customers.

The evidence presented by the AG/LFUCG is unclear and unpersuasive. In light of the decision in Case No. 10481, the AG/LFUCG's proposed adjustment is denied.

Cash Working Capital. Kentucky-American proposed a cash working capital allowance of $2,137,000[39] based on the lead/lag study performed on the historical data for the 12-months ended March 31, 1992.[40] Kentucky-American gave this description of its lead/lag method:

> This method measures the net time lag between the date when the customers receive services from the Company and the date when they pay for those services (revenue lag) and the lag between the date the Company receives goods and services and the date they pay for those goods and services (expense lag).[41]

Net earnings and non-cash items such as depreciation, amortization, and deferred taxes were included in the lead/lag

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[37] Case No. 10481, Notice of Adjustment of the Rates of Kentucky-American Water Company Effective February 2, 1989, Order dated August 22, 1989, page 12.

[38] Case No. 10481, Notice of Adjustment of the Rates of Kentucky-American Water Company Effective February 2, 1989, Rehearing Order dated March 7, 1990.

[39] Prefiled Testimony of Edward J. Grubb, page 12.

[40] Id., page 10.

[41] Id., page 11.

study, each assigned a zero expense lag. The following reasons were given for including these items.

Kentucky-American's investors provided the cash to fund the plant investment. The depreciation expense represents their recovery of that investment from the customers over the respective plant lives. There is a considerable delay in the recovery of depreciation charges from the customers. Kentucky-American explained that with a 58 day lag between customers' receipt of service and payment, depreciation will similarly not be collected from the customer as cash for 58 days. If this 58 day depreciation expense lag is not reflected in rate base, investors will not have an opportunity to earn a return on their full investment.[42]

According to Kentucky-American, deferred taxes are similar to depreciation. Using the same 58 day expense lag, when Kentucky-American makes a cash expenditure for an asset, it begins recording deferred taxes. However, there is a 58 day delay between the recording of deferred taxes and the collection from customers.[43]

Amortization represents various expenses that are pro-rated over time for book and rate-making purposes. As with depreciation and deferred taxes, Kentucky-American's investors are entitled to recover amortization expenses on a daily basis.[44]

As water service is rendered, net earnings will be retained and reinvested until paid to investors as dividends. Investors are

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[42] Id., pages 17 and 18.

[43] Id., page 19.

[44] Id., pages 16 and 17.

entitled to receive a return on their reinvested earnings on a daily basis.[45]

Kentucky-American noted that similar lead/lag studies were previously accepted by the Commission and in two prior cases the Commission's adoption of Kentucky-American's working capital calculation was affirmed by the Franklin Circuit Court.[46] Kentucky-American also cited the following discussion by the Commission:

> A cash working capital allowance, in appropriate instances, is approved in recognition of the fact that investor-supplied cash is needed to finance operating costs during the time lag before revenues are collected. The most accurate way to measure this is a lead/lag study.[47]

The lead/lag study being new, the AG/LFUCG recommend exclusion of any expenses not requiring a cash payment. Because the study included the revenue lag and expense lead/lags, they argue that including net income is double counting. The AG/LFUCG recommend that net working capital be no greater than $1,399,000 to reflect the elimination of depreciation, amortization, deferred taxes, and net income. Finally, they question why the lead/lag study produces about the same result as the formula method.[48]

The AG/LFUCG are correct that depreciation, amortization, and deferred taxes are noncash items, but noncash items can produce a

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45 Id., page 16.

46 Brief of Kentucky-American, pages 32 through 35.

47 Case No. 91-217, Adjustment of Rates of the Salem Telephone Company, Inc., Order dated February, 28, 1992.

48 Brief of the AG/LFUCG, pages 18 through 21.

need for cash working capital. Depreciation expense does not require a cash payment, although cash was expended at the time the property was acquired, and the recorded depreciation is used to offset the investment in property even though it has yet to be received from the customer through rates.[49] The same applies to amortization and deferred taxes.

Theoretically, net earnings are earned when customer service is provided, and become the property of the stockholders. This requires that a cash working capital requirement should be recognized for the lag in receipt of operating income.[50]

The lead/lag study here is similar to the one performed in Case No. 8314.[51] While in that case the Commission expressed concern with certain expense lead/lag days, Kentucky-American's methodology was found to be appropriate.[52]

Although some commissions exclude them, the record evidence persuades the Commission that including net earnings and noncash items is theoretically sound. Furthermore, the lead/lag study and the formula method should produce similar results due to Kentucky-American's use of quarterly billing cycles.

Therefore, Kentucky-American's lead/lag study is accepted. The cash working capital allowance has been increased $31,000 to

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49 Accounting for Public Utilities, 5.08[2], pages 5-20.

50 Id., 5.08[5], page 5-22.

51 Case No. 8314, Notice of Adjustment of Rates of Kentucky-American Water Company, Order dated February 8, 1992.

52 Id., page 6.