COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ADJUSTMENT OF THE RATES OF)
KENTUCKY-AMERICAN WATER COMPANY) CASE NO. 2004-00103

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COMMONWEALTH OF KENTUCKY

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ADJUSTMENT OF THE RATES OF KENTUCKY-AMERICAN WATER COMPANY	))	CASE NO. 2004-00103

O R D E R

Kentucky-American Water Company ("Kentucky-American" or "KAWC") has applied for an adjustment in its base rates for water service to generate additional annual revenues of $6,625,443,[1] an activation charge that would generate annual revenues of $672,000, a discount to certain low-income ratepayers, and an increase in its tap-on fees.[2] By this Order, the Commission establishes rates for water service that will produce an annual increase in revenues from water sales of $3,611,302 and approves the requested increase in tap-on fees and the proposed activation charge.

BACKGROUND

Kentucky-American, a Kentucky corporation, owns and operates facilities that treat and distribute water to the public for compensation in Bourbon, Clark, Fayette, Gallatin, Grant, Harrison, Jessamine, Owen, Scott, and Woodford counties. It provides wholesale water service to the cities of Georgetown, Midway, Versailles, and

[1] KAWC's Application, Exhibit 37, Schedule A at 1. $7,297,443 (Revenue Deficiency) - $672,000 (Activation Charge) = $6,625,443.

[2] In its original application, Kentucky-American requested rates that would generate an additional $6,625,443 from water sales annually. During the course of this proceeding, it amended its initial request to correct errors in its calculations and reduced its request to $6,618,776. *See, e.g.*, KAWC Brief at 5.

Winchester, Harrison County Water District, and Lexington-Elkhorn Water District. It is a utility subject to Commission jurisdiction. KRS 278.010(3)(d).

Kentucky-American is currently organized into two divisions: Northern Division and Central Division. The Northern Division consists of all facilities located in Gallatin, Grant, and Owen counties, Kentucky. The remaining facilities compose the Central Division.

PROCEDURE

On March 26, 2004, Kentucky-American notified the Commission in writing of its intent to apply for an adjustment of rates using a forecasted test period. On April 30, 2004, it submitted its application. Finding that further proceedings were necessary to determine the reasonableness of the request, the Commission suspended the proposed rates for 6 months from their effective date and initiated this proceeding.[3] We granted the Attorney General, through his Utility and Rate Intervention Division ("AG"), Lexington-Fayette Urban County Government ("LFUCG"), Community Action Council for Lexington-Fayette, Bourbon, Harrison, and Nicholas Counties ("CAC"), and Bluegrass FLOW, Inc. ("FLOW") leave to intervene in this proceeding.

After the parties engaged in extensive discovery,[4] the Commission held a public hearing in Lexington, Kentucky on November 4, 2004 to receive public comment on the

[3] See KRS 278.190(2).

[4] At Kentucky-American's request, we authorized the use of electronic filing procedures in this proceeding. While the parties and the Commission were served with paper copies of all pleadings and filings, each party also submitted an electronic version of these documents that was made available for public inspection through the Commission's Website.

proposed rate adjustment.[5] The Commission also held an evidentiary hearing in this matter on November 8-10, 12, and 23, 2004 in Frankfort, Kentucky.[6] Following these hearings, all parties submitted written briefs.

On November 30, 2004, Kentucky-American notified the Commission of its intent to place the proposed rates into effect for service rendered on and after December 1, 2004. The Commission subsequently directed Kentucky-American to maintain appropriate records of its billing to permit any necessary refunds.

ANALYSIS AND DETERMINATION

Test Period

Kentucky-American used as its forecasted test period the 12 months ending November 30, 2005. The base period used was the 12 months ending July 31, 2004.

Rate Base

Kentucky-American proposes a forecasted net investment rate base of $158,958,817.[7] This forecasted rate base is accepted with the following exceptions:

Utility Plant in Service ("UPIS"). Kentucky-American uses capital construction budgets to determine its forecasted UPIS amount of $287,861,620. Its construction budget is segregated into two categories: normal recurring construction and major investment projects. In prior rate proceedings involving a Kentucky-American

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[5] In our decision we have given the appropriate weight to the comments presented during the public comment session. The comments and documents presented during this session were not supported by written testimony or subjected to cross-examination or discovery.

[6] During this hearing, Kentucky-American presented the following witnesses: Mr. Patrick Baryenbruch, Ms. Linda Bridwell, Mr. Coleman Bush, Mr. Chris Jarrett, Mr. Bruce Lawson, Mr. Michael Miller, Dr. Kenneth Rubin, Mr. James Salser, Dr. Edward Spitznagel, Ms. Sheila Valentine, Mr. James Warren, and Dr. James Vande Weide. The AG presented the testimony of Ms. Andrea C. Crane, Mr. Scott Rubin, and Dr. J. Randall Woolridge.

[7] KAWC's Application, Exhibit 37, Schedule A at 1.

forecasted test period, the Commission has adjusted forecasted UPIS to reflect 10-year historical trend percentages.[8] These "slippage factors" serve as an indicator of Kentucky-American's accuracy in predicting the cost of its utility plant additions and when a new plant will be placed into service.

Citing the Commission's past practice, the AG proposes that a slippage adjustment be applied to Kentucky-American's UPIS in this proceeding. Although it continues to disagree with the concept of a slippage adjustment, Kentucky-American accedes to the use of the factor because of precedent.[9]

Using Kentucky-American's construction project information, we calculated the slippage factors for normal, recurring construction and major investment projects to be 105.43 percent and 86.12 percent, respectively.[10] By applying factors to its capital construction budgets, Kentucky-American recalculated its forecasted UPIS to be $287,853,455[11] or $8,165 less than its original forecast. The Commission agrees with this adjustment and has reduced Kentucky-American's forecasted UPIS by $8,165.

Utility Plant Acquisition Adjustments. Kentucky-American includes in its forecasted rate base the unamortized balance of three utility plant acquisition adjustments totaling $391,650. The acquisition adjustments represent the amounts that Kentucky-American paid in excess of book value and other incidental costs to purchase

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[8] *See, e.g.*, Case No. 2000-00120, The Application of Kentucky-American Water Company to Increase its Rates (Ky. PSC Nov. 27, 2000) at 2 - 4.

[9] KAWC Brief at 10.

[10] KAWC's Response to Commission Staff's First Set of Information Requests, Item 10.

[11] KAWC's Response to Commission Staff's Third Set of Information Requests, Item 44.

the assets of the Boonesboro Water Association ("Boonesboro"), Tri-Village Water District ("Tri-Village"), and Elk Lake Property Owners, Inc. ("Elk Lake").

In *Delta Natural Gas Co.*,[12] this Commission declared that "the net original cost of plant devoted to utility use is the fair value for rate-making purposes, unless the utility can prove, with conclusive evidence, that the overall operations and financial condition of the utility have benefited from acquisitions at prices in excess of net book value."[13] Any utility seeking recovery of an acquisition adjustment must justify its purchase decision based "on economic and quality of service criteria."[14]

To meet these criteria, a utility must present evidence that "the purchase price was established upon arms-length negotiations, the initial investment plus the cost of restoring the facilities to required standards will not adversely impact the overall costs and rates of the existing and new customers, operational economies can be achieved through the acquisition, the purchase price of utility and non-utility property can be clearly identified, and the purchase will result in overall benefits in the financial and service aspects of the utility's operations."[15]

The Boonesboro acquisition represents $77,217 of the requested acquisition costs. In Case No. 2000-00120,[16] we addressed the appropriateness of this acquisition and found that significant operational savings and greater economies of scale resulted

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[12] Case No. 9059, An Adjustment of Rates of Delta Natural Gas Company, Inc. (Ky. PSC Sep. 11, 1985) at 3.

[13] *Id.*

[14] *Id.*

[15] *Id.* at 3-4.

[16] Case No. 2000-00120, Application of Kentucky-American Water Company to Increase its Rates (Ky. PSC May 9, 2001) at 4 - 9.

from the purchase. We therefore allowed a 10-year amortization of the acquisition adjustment with the unamortized balance included in rate base. While the AG disagrees with the inclusion of the Boonesboro acquisition adjustment, he has acknowledged our earlier decision and has not proposed the removal of those costs.[17]

Kentucky-American's proposed adjustments for the Tri-Village and Elk Lake acquisitions are $208,310[18] and $106,123,[19] respectively. Kentucky-American advances several arguments in favor of the proposed adjustments. It asserts that both acquisitions benefit its Central Division customers by creating a larger customer base upon which certain expenses can be allocated and thus reducing the magnitude of any required rate adjustment.[20] Northern Division customers benefit as the acquisition provides them with access to Kentucky-American's expertise in water system operations and management and thus a more cost-effective resolution to their service and water quality problems.[21] Combining Tri-Village and Elk Lake with Kentucky-American's existing customer base also reportedly enables the Northern Division to reduce its costs through the use of Kentucky-American's national contracts to purchase materials.[22]

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[17] AG Brief at 4.

[18] KAWC's Response to Commission Staff's First Set of Information Requests, Item 1, W/P 1-2 at 2.

[19] *Id.*, Item 1, W/P 1-2 at 3.

[20] KAWC's Response to Commission Staff's Second Set of Information Requests, Item 82(c)(2).

[21] *Id.* at Item 82(c)(3).

[22] Direct Testimony of Linda Bridwell at 36.

Prior to the acquisition, Tri-Village experienced problems related to elevated levels of Trihalomethanes ("THMs"). It and its supplier, the city of Owenton, regularly issued public notices for elevated THMs. Kentucky-American made several changes to Owenton's and Tri-Village's systems that produced a significant reduction in Disinfection By-Product ("DBP") levels to enable Tri-Village to comply with new DBP restrictions and significantly improved water quality.[23]

In the case of Elk Lake, its water treatment facility was unable to meet new regulatory standards for turbidity levels that became effective on January 1, 2005.[24] By purchasing the Elk Lake and Tri-Village systems, Kentucky-American was able to tie the two water systems together, supply Elk Lake's customers through another source of water, and take Elk Lake's treatment facility out of service.[25] The purchases also enabled Kentucky-American to eliminate inadequate pressure areas within the service areas of the two systems,[26] extend service to unserved areas of Owen County,[27] and provide an emergency source of water to Peaks Mill Water District.[28]

The AG argues that, as the purchases of Tri-Village and Elk Lake represent "business development opportunities" for Kentucky-American, the acquisition adjustments are inappropriate. He maintains that business development costs should

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[23] Direct Testimony of Coleman Bush at 20-21.

[24] Rebuttal Testimony of Coleman Bush at 3.

[25] Direct Testimony of Linda Bridwell at 36.

[26] *Id.*

[27] Direct Testimony of Coleman Bush at 21.

[28] Direct Testimony of Linda Bridwell at 36.

not be borne by the ratepayers nor should the ratepayer be required to fund the profit recognized by Tri-Village and Elk Lake on the sale of their assets.[29]

Acquisition adjustments must be approached with caution to ensure that rates are not artificially inflated by excessive sales premiums. We recognize that Kentucky-American has resolved several deficiencies in the Tri-Village and Elk Lake systems and that has improved and expanded water service to the customers of those systems. We further recognize that Kentucky-American, as a subsidiary of a large international water utility, is better positioned to resolve operational and service deficiencies than smaller, non-profit water utilities. While we commend Kentucky-American for its efforts with the Tri-Village and Elk Lake systems, we find its efforts are not sufficient to meet the *Delta Natural Gas Co.* test.

Kentucky-American has failed to present adequate evidence to demonstrate that "the initial investment plus the cost of restoring the facilities to required standards will not adversely impact the overall costs and rates of the existing and new customers." To meet this standard, Kentucky-American must show that the premium paid plus the cost of restoration does not exceed what otherwise would have been incurred by the utility to remedy its operating deficiencies. Kentucky-American has not performed such analysis.[30] Absent such analysis we are unable to determine whether Kentucky-American successfully met this prong of the *Delta Natural Gas Co.* test.

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[29] Direct Testimony of Andrea C. Crane at 18.

[30] Transcript of Evidence ("T.E."), Vol. I at 163. Given that in the case of Tri-Village where the transfer of ownership was expressly conditioned upon the resolution of the water district's water quality problems, the lack of such analyses is perplexing.

Delta Natural Gas Co. also requires that the acquisition achieve operational economies and financial benefits. Expanding customer base through an acquisition does not satisfy this standard.[31] Kentucky-American has not shown where economies of scale have resulted in significant savings. While it points to savings realized through national purchasing contracts, it has not shown those savings to be significant. Moreover, in light of Kentucky-American's proposal to increase the current rates to customers previously served by Elk Lake and Tri-Village by 41.96 percent and 40.26 percent, respectively,[32] the record raises serious questions regarding the extent of the benefits that these customers have received.

In summary, we find that the Tri-Village and Elk Lake acquisitions do not meet the *Delta Natural Gas Co.* test and that the proposed acquisition adjustments should be removed from the requested revenue requirement. Our decision should not be considered as a retreat from our earlier pronouncements encouraging the development of regional water suppliers and the consolidation of smaller and less efficient water systems.[33] We continue to encourage larger water suppliers to expand their facilities and absorb smaller water systems that are incapable of meeting the rising costs of providing safe and quality water service.

Regardless of our decision today, the shareholders of Kentucky-American have benefited from the acquisitions. Kentucky-American has not only immediately expanded its rate base and thus increased its income, but also increased its potential

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[31] *See, e.g.*, Case No. 2000-00120, Application of Kentucky-American Water Company to Increase Its Rates (Nov. 27, 2000) at 7.

[32] KAWC's Application at 3.

[33] *See, e.g.*, Case No. 1989-00348, The Notice of Adjustment of the Rates of Kentucky-American Water Company Effective on January 28, 1990 (Ky. PSC Jun. 28, 1990).

for expansion into previously unserved areas for a larger rate base and greater income resulting from that expansion.

Accumulated Depreciation. The Commission has increased Kentucky-American's forecasted accumulated depreciation of $68,958,343[34] by $198,121[35] to reflect construction slippage and a reporting error. We reduced accumulated depreciation by $15,308 to reflect forecasted accumulated depreciation adjusted for construction slippage of $68,943,035.[36] We increased forecasted accumulated depreciation by $213,429 to adjust for Kentucky-American's omission of the accumulation of monthly forecasted depreciation expense. In the accumulated depreciation account included at W/P 1-3, Structures and Improvements, Kentucky-American stated the 13-month average balance as $962,615 while the corrected amount is $1,176,044.

Construction Work in Progress ("CWIP"). Kentucky-American forecasts CWIP includable in rate base as $6,124,953[37] which, after correction of an error, was restated at $5,537,960.[38] Construction slippage also impacts CWIP. Kentucky-American determined, and the Commission has accepted, the correct CWIP balance adjusted for slippage to be $5,529,656.[39]

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[34] KAWC's Application, Exhibit 37, Schedule B at 2.

[35] $198,121 = ($213,429 – $15,308).

[36] KAWC's Response to Commission Staff's Third Set of Information Requests, Item 44 at 6.

[37] KAWC's Application, Exhibit 37, Schedule B at 2.

[38] KAWC's Application, Corrected Exhibit 37 (filed August 25, 2004), Schedule B at 2.

[39] KAWC's Response to Commission Staff's Third Set of Information Requests, Item 44 at 6.

The AG proposes the elimination of the entire CWIP balance from rate base. He argues that CWIP does not represent facilities that are used or useful in the provision of utility service.[40] Including this plant in rate base, therefore, violates the regulatory principle of intergenerational equity by requiring current ratepayers to pay a return on plant that is not providing them with utility service and which may never provide current ratepayers with utility service. Allowing CWIP in rate base where a forecasted test period is utilized, he argues, "extends the time horizon on which the Company's rates are based even further out into the future."[41]

Generally, regulated utilities recognize the carrying costs of construction in rates through one of two methods: inclusion of CWIP in rate base or accrual of Allowance for Funds Used During Construction ("AFUDC"). This Commission has, in previous Kentucky-American rate proceedings, applied a hybrid approach that combines these two methods. This approach allows Kentucky-American to include all CWIP in rate base while accruing AFUDC on projects taking longer than 30 days to complete.[42] Under this approach, AFUDC revenue is reported "above the line." This approach eliminates the effects of including AFUDC bearing CWIP in rate base. It further allows Kentucky-American to accrue AFUDC as part of an asset's cost where appropriate and to earn a return on CWIP where AFUDC is not accrued.

We are not persuaded by the AG's argument that customers paying the rates approved in this case may never receive service from CWIP included in rate base.

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[40] Direct Testimony of Andrea C. Crane at 19.

[41] *Id.* at 20.

[42] KAWC's Response to Commission Staff's Fourth Set of Information Requests, Item 23.

Effectively, the only CWIP upon which Kentucky-American will earn a return is that which will be completed and placed into service within 30 days of its construction start date.

We find no merit to the AG's argument that CWIP should be eliminated because of Kentucky-American's use of a forecasted test year. Theoretically, the purpose of a forecasted test year is to reduce the regulatory lag experienced in historical test period rate cases by forecasting and matching revenue requirements and rates with the actual 12-month period for which the rates will first be placed into effect. Kentucky-American is entitled to a return on non-AFUDC bearing CWIP regardless of the test period employed.

Based upon the above, the Commission has included CWIP in the amount of $5,529,656 in determining Kentucky-American's forecasted rate base.

Working Capital. Kentucky-American calculates its working capital allowance using a lead/lag study based on the same methodology used in the "1996 study."[43] The Commission approved and applied this study in previous Kentucky-American rate proceedings. The AG does not dispute the reasonableness of this methodology. We find that it should be applied in this case.

Kentucky-American originally requested that $2,495,000[44] be included in rate base for working capital. It recalculated the amount as $2,479,737[45] after applying the construction slippage factors. Kentucky-American has acknowledged various errors in

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[43] Direct Testimony of James Salser at 2.

[44] KAWC's Application, Exhibit 37, Schedule B at 2.

[45] KAWC's Response to Commission Staff's Third Set of Information Requests, Item 44 at 73.

the forecasted revenues, expenses, and lead/lag days contained in its original working capital calculation. Correction of these errors results in a working capital allowance of $1,921,000.[46] This restatement does not account for construction slippage, correct the omission of payroll charges from net operating funds as stated at Exhibit 37 B, Page 82, nor correct the stated depreciation and amortization expense as shown on that exhibit. At page 82, depreciation and amortization expense is stated at $8,469,318 while the amount stated in the forecasted operating statement is $7,760,916.[47] The Commission's calculated working capital allowance takes all these omissions into account.

The restated expense lead/lag days is shown in Table I below.

TABLE I

Account	Original	Restated
Service Company	(1.34)	0.40
Group Insurance	(5.82)	(6.81)
OPEB	(0.50)	23.13
Insurance Other Than Group	(47.19)	(44.70)
Other	21.44	24.44
Federal Unemployment Taxes	69.11	69.86
Property Taxes	69.86	70.95
Current State Income Taxes	30.13	52.75
Long-Term Debt Interest	90.45	119.64
Short-Term Debt Interest	15.58	14.60
Preferred Dividends	45.49	46.40

The AG recommends that Kentucky-American be allowed a working capital allowance in the amount of $791,799. The AG calculated this amount by adjusting Kentucky-American's original calculation for: (1) the AG's recommended adjustments to forecasted revenues and expenses that are included in the lead/lag study, (2) the

[46] KAWC's Application, Corrected Exhibit 37 (filed August 25, 2004), Schedule B at 2.

[47] KAWC's Application, Exhibit 37, Schedule C at 5.

restated lead/lag days as shown in the table above except for Service Company, Group Insurance, Federal Unemployment Taxes, and Property Taxes, (3) lead/lag days different than originally used or restated by Kentucky-American for Chemicals and Service Company, and (4) elimination of depreciation expense from the study.

The Commission agrees with the AG that the lead/lag study should reflect the forecasted revenues and expenses as adjusted and found reasonable. Therefore, all adjustments to forecasted revenues and expenses found reasonable and appropriate in this Order have been incorporated into the working capital allowance approved in this case. The Commission finds that the restated lead/lag days as shown in the table above, and not contested by the intervenors, are appropriate and should be used to calculate Kentucky-American's working capital allowance.

For Group Insurance and Property Taxes the AG proposes that the original lead/lag days be used but gave no basis for such treatment. Kentucky-American has provided the basis for the restated days.[48] The Commission finds that the restated lead/lag days for Group Insurance and Property Taxes are appropriate.

The AG also proposes to use the lead/lag days as originally stated for Federal Unemployment Taxes. Kentucky-American failed to provide support for the restated days. The Commission finds that the original days for Federal Unemployment Taxes should be used to determine working capital.

Kentucky-American assigned 6.65 lag days to chemical expenses. The AG argues that a 30.49 lag day assignment is more appropriate. He states that the 6.65 lag days are the result of procurement practices in which chemicals are purchased every

[48] KAWC's Response to AG's Second Information Request, Item 29.

two days and paid for upon purchase. The AG further states that Kentucky-American has not provided any explanation for the change in chemical procurement and that generally utilities purchase chemicals on a monthly basis with payment being made the following month. He further states that its recommended 30.49 lag days reflects that of normal utility practice.[49]

Kentucky-American has not refuted the AG's arguments. We find that, absent evidence supporting a change in chemical procurement practices, all chemical expenses should be assigned 30.49 lag days in determining Kentucky-American's working capital allowance.

As shown in Table I, American Water Works Service Company ("Service Company") charges were originally assigned (1.34) lead days but were restated at 0.4 lag days. The AG proposes that 12 lag days be assigned to Service Company charges and that Kentucky-American's proposed lead/lag days represent the prepayment of those charges. He further argues that the Service Company was created to centralize duties that would otherwise be performed internally by utility personnel to create operating efficiencies for American Water Subsidiaries. Since the Service Company charges are primarily driven by payroll costs, he argues that there is no justification for prepaying those costs and that the same 12 lag days assigned to Kentucky-American's in-house payroll expenses should also be applied to Service Company charges.[50]

[49] Direct Testimony of Andrea C. Crane at 23.

[50] *Id.* at 24.

Kentucky-American concedes that 71 percent of Service Company charges are payroll and payroll overhead costs,[51] but asserts that those charges also reflect other expenses including rent for an office building, equipment and computers, maintenance of computer software, telephones, and group insurance. It states that Service Company charges are less due to the overnight investment of prepaid funds. The Service Company off-sets its fees to American Water Works Company's ("AWWC") Subsidiaries with the return on overnight investments. For these reasons, Kentucky-American argues that its proposed (1.34) lead days is more appropriate to calculate working capital.[52]

The Commission finds that, although over 71 percent of Service Company charges are related to payroll costs, the AG has not convincingly demonstrated that 12 lag days is a more appropriate value. The Service Company operates separately from Kentucky-American and incurs expenses for which it bills American Water subsidiaries. Its expenses include not only payroll but many other costs. To assign 12 lag days to all payments to the Service Company based solely on payroll costs is not appropriate.

Based upon Kentucky-American's actual payments to the Service Company, the Commission finds that 0.4 lag days should be used for Service Company charges to determine working capital. We further find that, in its next rate case, Kentucky-American should fully justify the billing practices of the Service Company and show why prepayment of these expenses is necessary and appropriate.

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[51] T.E., Vol. I at 107.

[52] Rebuttal Testimony of James Salser at 1-2.

The AG takes exception to Kentucky-American's inclusion of forecasted depreciation expense in the determination of working capital. He argues that working capital is made necessary by the timing difference between when a utility expends cash for an expense incurred to provide service and when the utility receives the cash revenue in return for that service. While acknowledging that this Commission has historically allowed depreciation in the calculation of working capital, the AG states that its inclusion is inappropriate because no cash is actually expended as a result of the recording of depreciation expense. He notes that other jurisdictions, including Pennsylvania and West Virginia, exclude depreciation expense in the calculation of working capital for this reason.[53]

Kentucky-American responds that exclusion of depreciation expense from the working capital calculation would prevent its stockholders from earning a return on their full investment. It notes that the Commission has previously addressed this issue, found that it was appropriately included in working capital calculation, and had its decision affirmed on review.

The Commission finds that depreciation should be included in the determination of working capital. The Commission continues to hold its position as stated in previous Orders that "[w]hile it is true that recording depreciation does not require the expenditure of cash at the time the expense is recorded and charged to the customer, cash was expended at the time the property was acquired, and the recorded depreciation is used to reduce the investment in that property even though

[53] Direct Testimony of Andrea C. Crane at 26-27.

approximately one-and-one-half month's depreciation (equivalent to the revenue lag) has not yet been received from the consumer."[54]

After applying all the adjustments to Kentucky-American's forecasted working capital calculation found reasonable and necessary in this Order and correcting the errors noted herein, the Commission finds the appropriate working capital allowance to be $1,711,459.

Contributions in Aid of Construction ("CIAC"). Kentucky-American originally included CIAC in the amount of $34,547,915 as a reduction to rate base. The amount was restated at $33,064,060 for the construction slippage factors and the correction of recording errors.[55] The AG concurs with the restated amount and its use to establish rates. Accordingly, we find that forecasted CIAC should be reduced to $33,064,060.

Customer Advances. Kentucky-American originally stated customer advances as $15,220,324, then increased them to $15,359,373 after applying the construction slippage factors.[56] The Commission finds that Customer Advances as originally forecasted by Kentucky-American should be increased to $15,359,373.

Deferred Taxes. Deferred taxes have been adjusted as shown in Table II to account for all adjustments made herein related to items affecting deferred taxes.

[54] Robert L. Hahne and Gregory E. Aliff, *Accounting for Public Utilities* § 5.08[2] (Matthew Bender Nov. 1991).

[55] KAWC's Response to Commission Staff's Second Data Request dated June 14, 2004, Item 115.

[56] KAWC's Response to Commission Staff's Second Set of Information Requests, Item 115.

TABLE II

Item	Rate Base Amounts	Deferred Income Taxes		
		State	Federal	Total
Legal Settlement	$ 38,716	$ 3,194	$ 12,433	$ 15,627
Security Costs	$ 2,665,378	219,894	855,920	1,075,813
Shared Services Center	$ 529,630	43,694	170,077	213,772
CustomerCare/Call Center	$ 542,835	44,784	174,318	219,102
Rate Case Costs	$ 518,675	42,791	166,560	209,350
Acq. Costs Tri-Village	$ 213,532	17,616	68,570	86,187
Acq. Costs Elk Lake	$ 100,941	+ 8,328	+ 32,415	+ 40,742
Subtotal		$ 380,301	$ 1,480,292	$ 1,860,593
Slippage				+ 74,259
Total				$ 1,934,852

Absent is an adjustment for deferred taxes related to the elimination of the Boonesboro acquisition costs. Although Kentucky-American included unamortized acquisition costs for Boonesboro in forecasted rate base twice, as discussed below, it included the related deferred taxes only once. As the Commission has allowed rate recovery of the Boonesboro acquisition, the applicable deferred taxes are appropriate and no adjustment is required.

Kentucky-American has included deferred taxes for the Tri-Village and Elk Lake acquisition costs only once while including their unamortized balances twice in rate base. Therefore, while there are two adjustments eliminating the unamortized acquisition costs from rate base for each of these acquisitions, there is only one deferred tax adjustment in the above schedule.

Deferred Maintenance. Kentucky-American incurs many maintenance expenses (e.g., tank and hydrator painting and repairs, station cleaning) for which the Commission has historically allowed deferred treatment, permitted the unamortized balance included

in rate base and permitted annual recovery of allowed amortization expense. All amounts allowed were based on actual costs from historical periods.

The AG requests that the Commission adopt a policy of normalizing maintenance and rate case costs.[57] Through normalization Kentucky-American would be entitled to recover not the historical amount of the expenditure but rather a future amount that the Commission deems reasonable. Much like the amortized historical amounts, the normalized costs would be divided by their estimated useful lives to determine the annual expense to be recovered through rates. The AG asserts that the normalization approach would eliminate the unamortized account balances from rate base since those accounts would no longer be recorded on Kentucky-American's books.

Switching to normalization would affect Kentucky-American's rates as the unamortized balances would be eliminated from rate base. Annual amortization/ normalization expense, however, would be higher through normalization since the annual expense is based on future costs that presumably would exceed historical costs. The AG presented no evidence regarding the appropriate level of normalized costs in this case. Absent such evidence, we cannot determine the reasonableness of the AG's proposal and must deny it.

The AG also questions the reasonableness of Kentucky-American's requested level of rate case expense. We find that introducing additional projected cost estimates into Kentucky-American's rate proceedings through normalization would only result in additional litigation in future rate cases and thus unnecessarily increase those rate case expenses even further. We therefore deny the proposed adjustment.

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[57] Direct Testimony of Andrea C. Crane at 77.

Deferred Debits. Kentucky-American requests a return on the unamortized balance of the deferred debits set forth in Table III:

TABLE III

Description		Balance
Cost-of-Service Study, Case No. 2000-00120	$	5,551
Cost-of-Demand Study, Case No. 2000-00120		5,855
Disinfection By-Product Study		9,325
Legal/Settlement Costs		38,716
Source of Supply		2,031,099
Acquisition Costs – Boonesboro		76,130
Acquisition Costs – Tri-Village		213,532
Acquisition Costs – Elk Lake		100,941
Security Costs		2,665,378
Shared Service Center		529,630
Customer Care/Call Center		542,835
Rate Case Cost	+	518,675
Total Unamortized Balance – Deferred Debits	$	6,737,667

The AG objects to the requested rate-making treatment. He contends that Kentucky-American isolates expenses from a prior period without any corresponding consideration of other factors from that period and then places those items in a forward looking test period. Such action, the AG contends, is inconsistent and contrary to the use of a forecasted test period.

In support of his position, the AG mistakenly relies upon our actions in Kentucky-American's last rate proceeding in which we denied certain deferred debits. In Case No. 2000-00120, Kentucky-American requested approval of 19 deferred debits unrelated to deferred maintenance or rate case expense. Of these 19, the Commission ultimately permitted rate recovery on 15 debits.

Moreover, our rejection of certain debits was not premised on the notion that deferred debits are contrary to the use of a forecasted test period, but on materiality of the proposed deferrals. We noted:

> A utility, pursuant to FASB [Financial Accounting Standard's Board Statement of Financial Accounting Standards No.] 71 is entitled to accrue a "regulatory asset" (an expense carried on the books as an asset) if it is probable that the cost will be allowed in rates and the revenue allowed is to recover the previously incurred cost rather than to provide for expected levels of similar future costs. None of these items warrant deferred treatment under FASB 71 due to their immateriality.[58]

Of the 19 deferred items, the single greatest deferred expense totaled $173,750 while the least totaled $1,003. The cost of accounting for many of the deferrals alone outweighed the benefits of their accrual.

To ensure a more orderly and appropriate use of deferrals, the Commission directed Kentucky-American to "formally apply for Commission approval before accruing an expense as a regulatory asset, regardless of the ratemaking treatment that the Commission has afforded such expense in previous rate case proceedings." Our action was intended to afford the Commission an opportunity to assess the reasonableness of each proposed deferral and its consistency with accounting standards, not its appropriate rate-making treatment.

Since our directive, Kentucky-American has made three requests for deferral treatment. On September 6, 2001,[59] it submitted a written request to the Commission's Executive Director for approval to accrue six expenses as regulatory items.[60] On September 24, 2003, Kentucky-American submitted a written request to the

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[58] Case No. 2000-00120, Application of Kentucky-American Water Company to Increase Its Rates (Ky. PSC Nov. 27, 2000) at 22.

[59] Letter of Lindsey W. Ingram, Jr., counsel for Kentucky-American, to Thomas Dorman, Executive Director, Public Service Commission (Sep. 6, 2001).

[60] Those expenses were: (1) Acquisitions; (2) Preliminary Service and Design; (3) Tank Painting; (4) Sludge Removal; (5) Customer Service Consolidation; and (6) Financial Service Consolidation.

Commission's Executive Director in which it sought the establishment of two additional regulatory assets to accrue expenses related to security costs and condemnation costs.[61] On December 18, 2003, Kentucky-American submitted a formal application[62] in which it requested formal approval to defer these expenses[63] for accounting treatment purposes.

The requests for deferrals remain pending before us. The Commission's records indicate that no action was ever taken on Kentucky-American's first request.[64] The Executive Director denied Kentucky-American's second request on October 15, 2003.[65] The Commission established a formal proceeding to address Kentucky-American's application and subsequently consolidated that proceeding into this proceeding.[66]

Before addressing the merits of each requested deferral, we first address LFUCG's general objection. LFUCG argues that all requested deferrals should be denied because Kentucky-American failed to comply with the Commission's directive

[61] Letter from Lindsey W. Ingram, Jr., counsel for Kentucky-American, to Thomas Dorman, Executive Director, Public Service Commission (Sep. 24, 2003). The record reveals an earlier request for deferred treatment of security costs. See letter of Herbert A. Miller, Jr., counsel for Kentucky-American, to Thomas Dorman, Executive Director, Public Service Commission (July 2, 2002). There is no record of any Commission response to this letter. Commission Staff has indicated that it was unaware of the existence of this request. See T.E., Vol. III at 5 - 7.

[62] Case No. 2003-00478, Application of Kentucky-American Water Company for Approval of Accounting Deferrals.

[63] In its application, Kentucky-American omitted any request for approval to accrue condemnation costs as a regulatory asset.

[64] Commission Staff held an informal conference with representatives of Kentucky-American to discuss the request. No action resulted from this conference.

[65] Letter of Thomas M. Dorman, Executive Director, Public Service Commission, to Lindsey N. Ingram, Jr., counsel for Kentucky-American (Oct. 15, 2003).

[66] Case No. 2003-00120, Order of June 7, 2004.

regarding the establishment of regulatory assets. Noting that the Commission required the submission of a formal application before the accrual of any regulatory asset, LFUCG asserts that Kentucky-American failed to submit such application for any of the requested deferrals. While acknowledging that Kentucky-American submitted written requests, LFUCG argues that these letters did not constitute a formal application and did not meet the requirements for such application as set forth in Administrative Regulation 807 KAR 5:001. It further argues, Kentucky-American is a sophisticated and savvy utility that should recognize the difference between a letter and a formal application. It points to the utility's formal application in Case No. 2003-00478[67] in support of its argument.

Kentucky-American contends that it has fully complied with the Commission's directive. It states that it requested the establishment of regulatory assets by "formal letter" before accruing the expenses in question. It notes that, when Commission Staff failed to act upon these requests or acted upon them unfavorably, Kentucky-American submitted a formal application to the Commission for its requested relief.

We find no merit to LFUCG's objection. The record clearly demonstrates that Kentucky-American applied to the Commission for approval to establish the requested regulatory assets. Moreover, the record fails to indicate that the Commission's Executive Director or Commission Staff ever indicated that these letters were insufficient or inadequate to meet the Commission's directive. Insofar as other utilities had previously applied and obtained approval to establish regulatory assets for accounting purposes through letters, we are unable to find that Kentucky-American knowingly circumvented the requirements of our Order of November 27, 2000. To the

[67] *See* footnote 62.

contrary, given the conflict between the Commission's practices with other utilities, the lack of specific filing instructions in our Order of November 27, 2000, and Commission Staff's silence, confusion was a likely result. To avoid future misunderstandings, we have in this Order provided more specific instructions on the procedures that Kentucky-American should follow to obtain approval to establish regulatory assets for accounting purposes.

LFUCG also argues that the proposed deferrals are contrary to the conditions imposed upon Kentucky-American in Cases No. 2002-00018[68] and 2002-00317.[69] In those cases, we conditioned our approval of RWE Aktiengesellschaft's acquisition of control of Kentucky-American upon, *inter alia*, Kentucky-American making no filing before March 16, 2004 that would have the effect of increasing its rates for water service. LFUCG argues that the proposed deferrals are inconsistent with the Commission's intent by permitting the utility to recover expenses incurred prior to the base periods and thus permitting the utility to obtain a greater adjustment in rates than it would have been able to obtain had no rate moratorium been imposed.

We find no merit to this argument. LFUCG has failed to indicate a specific deferral that is directly related to the rate moratorium. While we agree that the rate moratorium may have affected a deferral's effect on Kentucky-American's rates as a

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[68] Case No. 2002-00018, Application for Approval of the Transfer of Control of Kentucky-American Water Company to RWE Aktiengesellschaft and Thames Water Aqua Holdings GmbH (Ky. PSC May 30, 2002).

[69] Case No. 2002-00317, The Joint Petition of Kentucky-American Water Company, Thames Water Aqua Holdings GmbH, RWE Aktiensgeselschaft, Thames Water Aqua US Holdings, Inc., Apollo Acquisition Company and American Water Works Company, Inc. For Approval of a Change of Control of Kentucky-American Water Company (Ky .PSC Dec. 20, 2002).

result of timing considerations, we do not accept the argument that the moratorium caused additional deferrals and higher rates.

Cost of Service Study, Cost of Demand Study, Disinfection By-Product Study, Legal Settlement Costs, and Source of Supply. The Commission addressed the rate base treatment for these items in Case No. 2000-00120 and, except for legal/settlement costs, approved their inclusion in rate base. Kentucky-American has acknowledged that inclusion of legal/settlement costs in rate base in this proceeding is inappropriate.[70] Accordingly, the Commission has removed unamortized legal/settlement costs from the forecasted rate base.

Acquisition Costs for Boonesboro, Tri-Village, and Elk Lake. Kentucky-American erroneously included these costs in rate base as deferred debits.[71] It also included each of these deferred debits in its requested rate base as acquisition adjustments. Accordingly, the Commission has removed these items from deferred debits.

Security Costs. In response to the terrorist attacks of September 11, 2001, Kentucky-American began on September 12, 2001 to increase security at its facilities. Many of the associated costs were capital in nature and recorded by Kentucky-American as part of its utility plant in service. Those capitalized costs are reflected in the proposed rates by their inclusion in rate base as utility plant in service and depreciation expense. No party to the case has questioned the reasonableness of those costs. We have made no adjustments to them.

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[70] KAWC's Response to the AG's First Information Request, Item 66.

[71] *Id.* at Item 108.

Kentucky-American also deferred additional security costs totaling $2,805,66.79. Those deferred costs would normally have been recorded as an expense in the period incurred. Kentucky-American, however, chose to defer these costs (and their associated carrying cost) to have them included in the determination of rates in this proceeding. Table IV details the additional amounts deferred.

TABLE IV

DEFERRED SECURITY COSTS[72]			
Description	Date		Amount
LFUCG Police Direct	9/12/01-3/31/02	$	326,130.61
Alliance Staffing – LFUCG Police	4/1/02-8/19/03		1,854,128.42
Murray Guard – Lobby & Gate	9/12/03-4/30/04		88,355.94
Porta Potty Rental - Police Dam #9	2001		499.76
Securing Tanks	2001		152,581.00
Concrete Barriers	2001		15,918.90
Clearing Fence Lines	2001		6,230.55
KAW Labor	2001-2002		4,436.70
SCADA Program Change	2001		8,156.92
Inactive Account Lockout	2002		45,847.93
Security Lights – KRS	2001		9,171.49
Padlocks & Locksets	2001		3.163.04
Survey Work – Tank Sites	2001		9,300.00
Attorney Fees	2001		12,675.90
Communication Equip., Fees, & Misc.	2001-2004	+	194,665.41
Total Sch. KR3, – Prior to Submitting Application Current Proceeding		$	2,731,262.57
Murray Guard approx $11,201 per month (5/1/04 through 11/30/04)		+	74,399.22
Total Deferred Security Costs		$	2,805,661.79

The AG and LFUCG object to Kentucky-American's proposal to defer the security costs. Both argue that the proposed deferral is contrary to a condition that the Commission imposed upon Kentucky-American in Case Nos. 2002-00018 and 2002-00317. The Commission, *inter alia*, required Kentucky-American to withdraw its proposed Asset Protection Tariff and prohibited Kentucky-American from applying "for

[72] Direct Testimony of Kenneth Rubin at KR Schedule 3; KAWC's Response to Commission Staff's Second Set of Information Requests, Item 91.

recovery of costs associated with the protection of water utility assets except through adjustments in its general rates" for five years.[73] Permitting the accrual of security costs and allowing recovery of those costs, they argue, would effectively circumvent this condition and frustrate the clear intent of the Commission to ensure that ratepayers benefited from RWE's acquisition of Kentucky-American.[74]

LFUCG further argues that granting Kentucky-American's requested relief would be a reward for engaging in inappropriate *ex parte* contacts with Commission Staff. It notes that on at least three occasions Kentucky-American contacted Commission Staff without notice to any interested party and requested approval to establish the requested regulatory asset. It further notes that one of these contacts occurred while Case No. 2002-00018 was pending and that during this contact "advised the Commission's Executive Director that it intended to interpret an agreed to condition in a manner that would eviscerate that condition."[75] This contact, LFUCG asserts, was never revealed to any of the parties, would have dramatically altered the proceedings, and was clearly outside acceptable conduct. *See Louisville Gas and Electric Co. v. Comm. ex rel Cowan*, Ky.App., 862 S.W.2d 897 (1993).

Kentucky-American disputes that the conditions set forth in Case Nos. 2002-00018 and 2002-00317 prohibit the creation of a regulatory asset or rate recovery of the deferred security costs. It contends that the conditions required only the withdrawal of

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[73] Case No. 2002-00018, Order of May 30, 2002, App. A at ¶ 2; Case No. 2002-00317, Order of December 20, 2002, App. A at ¶ 2.

[74] Commission Staff expressed similar reasoning in rejecting Kentucky-American's request for approval to establish a regulatory asset to accrue security expenses. *See* Letter from Thomas M. Dorman, Executive Director, Public Service Commission, to Lindsey W. Ingram, Jr., counsel for Kentucky-American (Oct. 15, 2003).

[75] LFUCG's Brief at 18.

its proposed Asset Protection Charge and expressly provided that the utility could recover costs for the protection of water utility assets "through adjustments in its general rates for water service." It further contends that the AG's and LFUCG's interpretation of the conditions is not reasonable.

Kentucky-American further disputes LFUCG's contention that it engaged in improper *ex parte* contacts with Commission Staff. It notes that all contacts with Commission Staff regarding the proposed deferrals were in written form, available to the public, and addressed to the Commission's Executive Director, who is not an "agency decision maker." These contacts, therefore, did not constitute an inappropriate *ex parte* contact. Finally, it asserts that, as no final decision has been made in response to its request for accruals, its actions cannot have influenced the ultimate decision and cannot be classified as improper.[76]

In Case No. 2002-00317, we imposed the following conditions upon Kentucky-American as necessary for finding that RWE's acquisition of control of the water utility was in the public interest:

> KAWC [Kentucky-American] will not apply to the Commission for a rate adjustment or make any other filing that has the effect of increasing its rates for water service before March 16, 2004, or one year following the date of the consummation of the proposed merger, whichever is later.
>
> . . .
>
> At no time prior to May 30, 2007 will KAWC apply to the Commission for recovery of costs associated with the protection of water utility assets except through adjustments in its general rates for water service.[77]

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[76] KAWC's Reply to LFUCG Brief at 2-3.

[77] Case No. 2002-00317, Order of December 20, 2002, App. A at ¶ 1-2

These conditions were intended to preserve the status quo between the utility and its ratepayers.[78] We noted that as a result of RWE's acquisition the utility would likely experience a number of changes in operating practices that would produce corresponding changes in its cost of service. We found this possibility especially strong in the area of infrastructure security and further found that "the introduction of any new rate mechanism regarding security costs at this time is inappropriate."[79]

Based upon our review of the Commission's Orders in Case Nos. 2002-00018 and 2002-0317, we find that the conditions attached to RWE's acquisition of control of Kentucky-American effectively prohibit Kentucky-American's requested relief. Permitting the establishment of the regulatory asset for security expenses would disrupt the status quo that the conditions were intended to preserve. It would permit Kentucky-American to transfer costs incurred during the moratorium to a post-moratorium period and recover them from its ratepayers. It thus would undermine one of the conditions necessary to our finding that RWE's acquisition of control was in the public interest.

Likewise, we find that the proposed deferral of security costs constitutes a new rate recovery mechanism that Condition 2 was intended to prohibit. We note that at the time of the proposed transfer of control, Kentucky-American and RWE were readily aware of the additional security costs that Kentucky-American was incurring in response to the perceived terrorist threat. Each was further aware that Kentucky-American had been seeking recovery of the total amount of security expenses that it had incurred since the September 11, 2001 terrorist attacks. Kentucky-American's proposed Asset

[78] Case No. 2002-00018, Order of May 30, 2002 at 17.

[79] *Id.* at 18.

Protection Tariff was only one of the mechanisms available to obtain recovery for the total amount of these expenses. Deferral of those expenses as a regulatory asset was another mechanism. Having been fully aware of the nature and extent of these security expenses and having agreed to waive any recovery of such expenses outside general rate adjustment proceedings, Kentucky-American may not properly assert a claim for recovery of those expenses through the use of deferral accounting.[80]

As to LFUCG's arguments regarding *ex parte* contacts between Kentucky-American and Commission Staff, we note that all previously known contacts between present Commission employees and Kentucky-American representatives have been disclosed. No attempts on the part of Commission employees to conceal such contacts have been alleged or discovered. No party, moreover, has provided any evidence to support the allegation of improper *ex parte* contacts between present Commission employees and Kentucky-American representatives. Insofar as LFUCG has adopted Commission Staff's arguments in support of its own objections to the establishment of regulatory accounts and has deferred to Commission Staff in the examination of the reasonableness of these expenditures during the course of this proceeding, we find little merit to the argument that our decision-making process has been improperly influenced. Accordingly, we do not adopt LFUCG's arguments as a basis for our rejection of Kentucky-American's requested relief.

<u>Shared Service Center and Customer Care/Call Center</u>. The costs deferred as Shared Service Center and Customer Call Center represent Kentucky-

[80] As we base our decision solely upon the provisions of our Order of December 20, 2002 in Case No. 2002-00317, we have not addressed the reasonableness of any of the proposed expenses or whether the circumstances under which these expenses were incurred should be considered as extraordinary circumstances.

American's allocated portion of the expenses necessary to establish those centers. Each center provides support services to Kentucky-American.

The Shared Services Center is located in Marlton, New Jersey. AWWC created this center to centralize general accounting, payroll, accounts payable, inventory, purchasing and accounts receivable functions for its subsidiaries. It has allocated to Kentucky-American for the establishment of this center costs totaling $704,179.[81] Kentucky-American began amortization of these costs in December 2003 at a monthly rate of $13,417 which was equal to the anticipated net monthly savings created by the center.[82] At the beginning of the forecasted test year, the unamortized balance stood at $557,505. At that time Kentucky-American began amortization of the unamortized costs over 10 years resulting in the average 13-month balance included in rate base of $529,630. Kentucky-American asserts that amortizing these costs at a rate equal to the anticipated savings until the beginning of the forecasted test period gives the ratepayers the benefit of those savings until rates reflecting such savings could be established.

The Customer Care/Call Center is located in Alton, Illinois. AWWC created this center to centralize and improve customer billing and inquiry services for its subsidiaries. It has allocated to Kentucky-American for the establishment of this center costs totaling $633,704.[83] Kentucky-American proposes the same amortization process for the Care Center as used for the Shared Services Center wherein amortization prior

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[81] KAWC's Response to Commission Staff's First Set of Information Requests, Item 1, Workpaper W/P 1-12 at 2.

[82] Kentucky-American reported the actual monthly savings as $13,454 ($161,445 / 12 months). See KAWC's Response to Commission Staff's Second Set of Information Requests, Item 76(d),

[83] KAWC's Response to Commission Staff's First Set of Information Requests, Item 1, Workpaper W/P 1-12 at 2.

to the forecasted test year was equal to the monthly savings created by the center. Kentucky-American then amortized the unamortized balance at the beginning of the forecasted test year over 10 years. Monthly amortization based on savings began in May 2004 in the amount of $8,900.[84] The unamortized balance at the beginning of the test year was $571,405 when the monthly amortization was restated at $4,762. The 13-month average balance included in rate base is $542,835.

When requested to provide a detailed explanation for all entries to the deferred debit accounts of the Shared Service Center and Customer Care Center,[85] Kentucky-American failed to provide adequate information about the entries. It identified the vendor for most entries, but provided no description of the service or allocation method. Absent more detailed information regarding these entries, we cannot determine the reasonableness or need for the deferred costs. As Kentucky-American has failed to meet its burden of proof regarding the reasonableness of these costs, they should be denied.

Rate Case Expense. Kentucky-American includes a provision for rate case expense recovery based on its initial cost estimate of $622,409.[86] It requests that the estimated amount be amortized over 3 years for an annual expense recovery of

[84] Kentucky-American reported the actual monthly savings as $8,912 ($106,941 / 12 months). See KAWC's Response to Commission Staff's Second Set of Information Requests, Item 76(b).

[85] See Commission Staff's Second Set of Information Requests to KAWC, Items 76(a) and (c); Commission Staff's Third Set of Information Requests to KAWC, Items 25 and 27.

[86] KAWC's Response to Commission Staff's First Set of Information Requests, Item 1, r W/P 3-8 at 1.

$207,470 ($622,409 / 3 years) with the average 13-month, unamortized balance of $518,675[87] included in rate base.

The AG proposes two revisions to Kentucky-American's proposal. First, he argues that unamortized rate case expense should not be included in rate base. In support of this argument, he notes that the Commission has historically not afforded such rate-making treatment to unamortized rate case expense.[88]

The AG also proposes a $70,000 reduction in rate case expense. In support of his proposal, the AG states that Kentucky-American's rate case expense is 35 percent more than its actual costs in the utility's last rate proceeding and considerably higher than in any of its last five rate proceedings. He also notes that the utility has made extensive use of both outside consultants and Service Company personnel. He suggests that outside consulting services could have been performed in-house and notes the absence of any competitive bidding process to procure outside services. The AG's proposed adjustment is not specific to any particular portion of requested rate case expenses, but is intended to cap the increase in that expense to 20 percent over the level incurred in Kentucky-American's last rate case proceeding.

Kentucky-American responds that actual rate case expenses in this proceeding have exceeded its estimates. It terms the AG's proposed adjustment as arbitrary and inappropriate. It asserts that the higher level of rate case expenses is related to "new" issues and more extensive discovery.[89]

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[87] *Id.*, Workpaper W/P 1-12 at 2.

[88] Direct Testimony of Andrea C. Crane at 33.

[89] KAWC Brief at 39.

We find that the unamortized portion of rate case expense should not be included in rate base.[90] The Commission has historically excluded this item from rate base to share the cost of rate proceedings between the stockholders and ratepayers. Kentucky-American has presented no evidence in this proceeding to support a change in this method. Therefore, we have eliminated unamortized rate case costs from the forecasted rate base.

We further find that the AG's proposed reduction of $70,000 is arbitrary and unsupported by the record. Notwithstanding our rejection of this proposed adjustment, we are deeply concerned with the increasing level of Kentucky-American's rate case costs.[91] We find that, in its next rate application, Kentucky-American should demonstrate fully its efforts to contain these expenses. Should we find these efforts to be inadequate, we will consider adjustments to rate case expenses to ensure the level of that expense is reasonable.

Based on the aforementioned adjustments to deferred debits, the Commission has decreased the amounts included in the forecasted rate base by $4,685,837 calculated as follows:

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[90] The Commission has included $207,470 of rate case amortization in forecasted operations.

[91] See KAWC's Response to Commission Staff's Second Set of Information Requests, Item 64. Rate case expenses for KAWC's five most recent rate cases are:

Case Number	Amount
2000-00120	$459,817
1997-00034	$326,414
1995-00554	$389,982
1994-00197	$250,434
1992-00452	$437,125

TABLE V

Description	Balance
Legal/Settlement Costs	$ (38,716)
Acquisition Costs – Boonesboro	(76,130)
Acquisition Costs – Tri-Village	(213,532)
Acquisition Costs – Elk Lake	(100,941)
Security Costs	(2,665,378)
Shared Service Center	(529,630)
Customer Care/Call Center	(542,835)
Rate Case Cost	+ (518,675)
Total Unamortized Balance Deferred Debits	$ (4,685,837)

Authorization to Accrue an Expense as a Regulatory Asset. Kentucky-American requests that the Commission reconsider our prior directive that required Kentucky-American to make a formal application and obtain Commission authorization before accruing an expense as a regulatory asset.[92] In Case No. 2000-00120, we expressed our concern with Kentucky-American's frequent practice of deferring expenses as regulatory assets and imposed this requirement to ensure the proper level of regulatory oversight.[93]

Our directive represented a significant departure from past Commission practice. Previously utilities that sought to accrue an expense as a regulatory asset would make a written request to the Commission's accounting staff. No formal proceeding was established. Any approval was limited to the accounting treatment of the expense and did not address the reasonableness of the expense or the likelihood of its recovery in any future rate proceeding.

[92] Case No. 2003-00487, Application of Kentucky-American Water Company for Approval of Account Accruals (Ky. PSC filed Dec. 12, 2003), Application at 4.

[93] Case No. 2000-00120, Order of November 27, 2000 at 23.

Upon further consideration and review, we find that our directive should be revised. Our insistence upon a "formal application" has resulted in a cumbersome procedure that does not properly address principally accounting issues. Moreover, our use of a formal procedure may require us to prematurely address rate-making issues that are more appropriately deferred to the utility's next rate proceeding. Accordingly, we find that Kentucky-American should no longer be required to make a formal application to the Commission before accruing an expense as a regulatory asset.

We further find that Kentucky-American should make written request to the Commission's Executive Director for the approval of any proposed deferrals[94] and that Kentucky-American should also provide written notice of its request to the AG, LFUCG, and any other party who appeared in its most recent rate proceeding. Commission Staff's review of this request will be limited to accounting treatment of the proposed deferral and will not address the likelihood of recovery of the expense in any future rate proceeding. Commission Staff will apprise all interested parties of its decision and provide those parties the opportunity to respond. Moreover, any interested party, including Kentucky-American, that wishes to contest Commission Staff's determination may file a formal application to the Commission for review of that determination. Kentucky-American shall still be required to submit a formal application if it wishes to seek rate-making treatment at the same time it requests approval of the deferral of expenses. Except as noted above, Kentucky-American may not begin accruing any

[94] We exempt from this requirement any deferral related to recurring maintenance expenses that the Commission has previously afforded rate-making treatment. Kentucky-American may accrue these expenses as a regulatory asset for accounting purposes without obtaining any additional approvals.

expense as a regulatory asset until it has received an affirmative determination from either the Commission or Commission Staff.

This new process represents a more flexible and effective means of addressing requests for accounting deferrals. While it maintains a high level of regulatory oversight of Kentucky-American's accounting treatment of certain expenses, it will encourage more timely review of accounting treatment proposals without formal proceedings. Moreover, it affords significant protection to intervenors by providing timely notice of all requests for accounting treatment approvals and an opportunity to seek formal Commission review of any Commission Staff determination.

Other Rate Base Elements. In its application, Kentucky-American included a reduction to rate base for "other rate base elements" in the amount of ($2,154,343). Other rate base elements include contract retentions, unclaimed extension deposit refunds, accrued pensions, retirement work in progress, and deferred compensation. As Kentucky-American overstated other rate base elements by $609,399 in its initial filing and as the correct amount is ($1,544,944),[95] the Commission has reduced other rate base elements by $609,399.

Based on the aforementioned adjustments, the Commission has determined the Company's net investment rate base to be as shown in Table VI below.

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[95] Amended Exhibit 37 B at 2.

TABLE VI[96]

Rate Base Component	Kentucky-American Proposed 13-Month Average	Commission	
		Adjustments	Approved
UPIS	$ 287,861,620	$ (8,165)	$ 287,853,455
Utility Plant Acquisition Adj.	391,650	(314,433)	77,217
Accumulated Depreciation	(68,958,343)	(198,121)	(69,156,464)
Accumulated Amortization	+ (7,674)	+ 0	+ (7,674)
Net Utility Plant In Service	$ 219,287,253	$ (520,719)	$218,766,534
CWIP	6,124,953	(595,297)	5,529,656
Working Capital	2,495,000	(783,541)	1,711,459
Other Working Capital	462,149	0	462,149
CIAC	(34,547,915)	1,483,855	(33,064,060)
Customer Advances	(15,220,324)	(139,049)	(15,359,373)
Deferred Income Taxes	(26,561,822)	1,934,880	(24,626,942)
Deferred Income Tax Credits	(117,518)	0	(117,518)
Deferred Maintenance	2,453,718	0	2,453,718
Deferred Debits	6,737,667	(4,685,839)	2,051,828
Other Rate Base Elements	+ (2,154,343)	+ 609,399	+ (1,544,944)
Net Original Cost Rate Base	$ 158,958,818	$ (2,696,311)	$ 156,262,507

Income Statement

For the base period, Kentucky-American reported operating revenues and expenses of $44,246,522 and $33,460,201, respectively.[97] Kentucky-American proposed several adjustments to revenues and expenses to reflect the anticipated operating conditions during the forecasted period, resulting in forecasted operating revenues and expenses of $43,389,662 and $34,597,380, respectively.[98] The Commission's review of Kentucky-American's forecasted operations is set forth below.

[96] The amount set forth in Table VI for Deferred Income Taxes differs from that in Table II due to rounding differences.

[97] KAWC's Application, Exhibit 37 C, Schedule C-3 at 1.

[98] *Id.*

Residential and Commercial Sales. Kentucky-American projects daily residential consumption for the forecasted test period to be 165.42 gallons based upon normal weather conditions. This amount represents a reduction of approximately 19.4 gallons in daily customer usage from 1997 levels.[99] Kentucky-American's witness attributes this reduction in usage to more efficient appliances and greater consumer education.

The AG argues that Kentucky-American has understated consumption levels. His witness contends that the projections represent a significant departure from Kentucky-American's projections in other recent rate adjustment proceedings. She further contends that the projections are inconsistent with average actual residential customer usage levels for the past 5 years and projections in Kentucky-American's Strategic Business Plan. The AG proposes that projected daily residential consumption be adjusted to 174.68 gallons per day. He derives this projection by averaging the projected residential consumption level in Kentucky-American's last rate proceeding and the projected level in the current rate proceeding. The AG proposes a similar adjustment for average daily commercial consumption.

The AG also argues that Kentucky-American has understated the number of its commercial and residential customers. He recommends adjustments to the forecasted levels. The Commission has previously accepted the methodology that Kentucky-American used to derive its projected consumption levels. Notwithstanding his claims of erroneous projections, the AG has failed to identify any specific problem or error with this methodology or with the data that Kentucky-American used to make its projections.

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[99] KAWC Response to Commission Staff's Second Set of Information Requests at Item 49(a).

We further find the explanations that Kentucky-American's witness has provided regarding the decrease in consumption levels to be reasonable. Moreover, the AG has failed to provide any supporting authority for the methodology that he uses to derive his proposed adjustments. Given this lack of evidence, we decline to make his proposed adjustments.

Private and Public Fire Protection. In its application, Kentucky-American proposes forecasted revenues for fire protection in the Central Division of $2,641,175. It subsequently amended its forecast to reflect increases in fire connection installations and proposed increasing revenues from fire protection by $118,035 to $2,759,210.[100] The Commission finds that these revisions are appropriate and accepts them.

Account Activation Fee. Kentucky-American proposes to establish an account activation fee of $24 that will result in an annual increase to operating revenues of $672,000.[101] For reasons set forth below, we approve the proposed fee and have accepted the forecasted revenues resulting from this fee.

Allowance for Funds Used During Construction ("AFUDC"). In its application, Kentucky-American proposes to increase operating revenues by $470,940 to include its forecast of AFUDC. In calculating this forecast, however, Kentucky-American used 9.58 percent, the return on capital requested in its last rate proceeding, rather than the return on capital requested in this proceeding of 8.25 percent.[102] To reflect the effect of slippage on CWIP, Kentucky-American calculated an adjusted AFUDC of $417,280.

[100] KAWC's Response to LFUCG's First Information Request, Item 42.

[101] Direct Testimony of Coleman Bush at 11.

[102] KAWC's Response to Commission Staff's Post-Hearing Information Request, Item 4.

To correspond with his adjustment to eliminate CWIP from rate base, the AG proposes to reduce Kentucky-American's operating revenues by $470,940 to move AFUDC to "below-the-line" non-operating revenues. The AG states that if the Commission rejects his proposal to eliminate CWIP from rate base, then "AFUDC should be moved back to its above-the-line position for determining the revenue requirement."[103]

Kentucky-American accrues AFUDC on its forecasted construction projects that take longer than 30 days to complete.[104] The Uniform System of Accounts for Class A and B Water Companies requires AFUDC to be recorded in non-operating revenues or "below-the-line." However, for rate-making purposes the Commission allows Kentucky-American to earn a return on forecasted CWIP in rate base while offsetting the return by moving AFUDC to "above the line" operating revenues. This approach eliminates the effects of including the AFUDC bearing CWIP in rate base while allowing Kentucky-American to earn a return on CWIP where AFUDC is not accrued.

To be consistent with our decision to reject the AG's proposal to remove CWIP from rate base, the Commission finds that operating revenues should be adjusted to reflect the inclusion of AFUDC. The Commission has determined Kentucky-American's average forecasted CWIP available for AFUDC of $4,355,741[105] by dividing the AFUDC adjusted for slippage of $417,280 by Kentucky-American's AFUDC rate of 9.58 percent. By multiplying the average forecasted test period CWIP available for AFUDC of

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[103] AG Brief at 15.

[104] KAWC's Response to Commission Staff's Fourth Set of Information Requests, Item 23.

[105]

AFUDC Slippage	$	417,280
Divided by: Kentucky American AFUDC Rate	÷	9.58%
Average Forecasted Monthly CWIP Balance	$	4,355,741

$4,355,741 by the overall rate of return of 7.75 percent, the Commission calculates a forecasted level of AFUDC of $337,570. This action results in a decrease to Kentucky-American's forecasted operating revenues of $133,370.

Labor Expense. Kentucky-American includes in its forecasted operations labor expense of $5,343,663. In forecasting its labor expense, Kentucky-American uses 133 full-time equivalent employees, each scheduled to work 2,088 regular hours. Kentucky-American also includes overtime for some employees based upon historical levels. For salaried and non-union hourly employees, Kentucky-American adjusts the April 30, 2003 wage rates by 3 percent on April 1, 2004 and April 1, 2005. For union employees, the wage rate effective in the union contract is increased by 3 percent on the anniversary date of the contract. Labor costs for the non-regulated operations were removed from the forecasted labor expenses.[106]

The AG proposes to reduce Kentucky-American's labor expense by $178,181 to reflect the three vacant employee positions. He asserts that his proposal "[p]rovides a good balance between the need to provide flexibility to the company to decide when additional employees are necessary and the need to protect ratepayers from paying excessive rates."[107] It does not eliminate any specific employee position, but merely reflects that the utility never maintains a full complement of workers.

In support of his proposal, the AG notes significant change in employee vacancies while this case has been pending. When the AG filed the written testimony of his witnesses on August 27, 2004, Kentucky-American had three vacant positions.

[106] Direct Testimony of Coleman Bush at 3.

[107] Direct Testimony Andrea C. Crane at 50.

When the evidentiary hearing was conducted in November 2004, this number had increased to 15. He asserts that corporate reorganizations and realignments and the introduction of mobile technology is likely to continue this trend.

To quantify his adjustment, the AG calculated Kentucky-American's average salary and overhead payroll cost per employee to be $59,394.[108] He then multiplied the $59,394 by the 3 vacant positions to arrive at his proposed adjustment to Kentucky-American's labor expense forecast of $178,181.[109]

Kentucky-American counters that the AG's reasoning is flawed. "Implicit in this suggestion," Kentucky-American asserts, "is the idea that the quantity of work to be done can be accomplished by less than a full complement of employees."[110] It notes that its forecast includes only 14,899 hours of overtime or 69 percent of the annualized actual overtime hours worked in the 4-month period from September 2004 to December 2004. It also notes the fact that, during the first 9 months of 2004, its temporary labor expense was $120,060, but that only $90,872 was included in forecasted operations. According to Kentucky-American, the reduction in overtime hours and temporary labor costs in the forecasted period implicitly assumes that all employee vacancies are filled.[111]

The AG's adjustment recognizes only the effect of employee vacancies upon Kentucky-American's direct labor forecast. It does not consider the vacancies' effect on Kentucky-American's overtime and temporary/contract forecasts. The AG proposed a

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[108] Direct Testimony of Andrea C. Crane at ACC-22.

[109] *Id.*

[110] KAWC Brief at 33.

[111] *Id.*

similar adjustment to labor expense in Case No. 1995-00554 to reflect that, "[o]n average Kentucky-American's actual number of employees falls short of its 'authorized' level of employees."[112] Denying the AG's proposed adjustment, we stated:

> The AG's proposed adjustment is flawed because it did not take into consideration the total 1995 labor costs. As shown by Kentucky-American, when all labor costs are considered, there is no material difference between the actual and budgeted amounts.[113]

We continue to adhere to this position. If vacant employee positions exist, work will either be shifted to other employees and thus result in an increase in overtime costs or Kentucky-American will hire additional temporary/contract labor. Kentucky-American has shown that its forecasts for overtime and temporary/contract labor have been reduced to reflect a full-workforce. The vacant employee positions to which the AG refers will result in decreased direct labor costs, but that decrease will be offset by increases in overtime or temporary labor costs. Therefore, the overall impact of these vacancies on Kentucky-American's operating expenses and ultimately its revenue requirement is unknown. Accordingly, we deny the AG's proposed adjustment.

Condemnation. The AG proposes to adjust Kentucky-American's forecasted expenses to eliminate 90 percent of the labor, overhead costs and payroll taxes associated with Kentucky-American's President and his assistant. In support of this proposal, the AG points to statements of the Chairman of Kentucky-American's Board of Directors that Kentucky-American's President had been directed to devote his full time and energies to the utility's defense in condemnation proceedings that LFUCG had

[112] Case No. 1995-00554, Application of Kentucky-American Water Company to Increase Its Rates (Ky. PSC Sep. 11, 1996) at 32.

[113] *Id.*

initiated against Kentucky-American. Since such efforts were solely related to "the promotion and protection of the interests of Kentucky-American shareholders," the AG asserts that ratepayers should not bear the internal costs associated with the President and his assistant.

The AG states that, because Kentucky-American did not track the individual employee hours spent working on condemnation issues during the base period, he is unable to identify specific costs included in Kentucky-American's forecast related to that issue. Because of the Board of Directors' direction, the AG has assumed that Kentucky-American's President was working full-time on this issue and recommended that 90 percent of the labor, overhead costs and payroll taxes for the President and his assistant, or $193,796, be removed from Kentucky-American's forecasted labor costs.[114]

Contending the AG has misinterpreted the statements of its Chairman, Kentucky-American has clarified those statements. It states that, as a result of condemnation, the workload of its President increased, but that he was continuing to perform his normal duties and responsibilities in addition to assisting the utility in its defense of the condemnation proceeding, and that this increase in duties was insufficient justification for the AG's proposal to decrease the expenses of the President's office. Kentucky-American further states that, given recent LFUCG council elections, the future of LFUCG's condemnation proceeding is uncertain.[115]

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[114] Direct Testimony of Andrea C. Crane at 53 and Schedule ACC-22.

[115] *Id.*

We find insufficient evidence in the record to support the AG's proposal. It is based upon a misstatement that was subsequently corrected. We further find that the proposed 90 percent allocation of the President's official duties to condemnation-related activities is arbitrary and without any supporting basis. The Commission is of the opinion, however, that Kentucky-American should, beginning as of the date of this Order, track all costs and employee time related to condemnation activities and be prepared to address questions on these activities at its next rate proceeding.

Incentive Compensation Plans. Kentucky-American has included in its forecasted operating expenses incentive compensation of $229,146, which is comprised of long-term incentive compensation of $23,427 ("LIP") and annual incentive plan compensation ("AIP") of $205,719.[116]

All full-time management, professional and technical employees (exempt from overtime) are eligible to participate in the AIP.[117] Kentucky-American bases AIP awards upon the following performance criteria: financial (60 percent); operational (25 percent); and individual (15 percent).[118] Approximately 40 Kentucky-American employees participate in the AIP.

The Compensation and Management Committee of American Water Works' Board of Directors administers the LIP and designates the employees who can participate. Kentucky-American's President recommends to this Committee who should

[116] Direct Testimony of Michael Miller at 51 - 53.

[117] *Id.* at 48.

[118] *Id.* at 49-50.

be designated for participation in LIP. Currently only Kentucky-American's President participates in the LIP.[119]

The AG proposes adjustment in the level of both incentive compensation plans. Since 60 percent of the AIP award is based upon Kentucky-American achieving certain financial targets, a criterion that the AG asserts directly benefits the shareholders,[120] he recommends that 60 percent or $137,488 of the AIP be allocated to Kentucky-American's shareholders. He recommends all costs related to LIP be removed because the sole criterion for its award is "achievement of cumulative net income."[121] The AG's overall adjustment to Kentucky-American's incentive plan forecast is a reduction of $160,915.

Kentucky-American opposes the proposed removals. It argues that the AG's proposed adjustment to AIP is based upon the faulty assumption that the financial health of Kentucky-American is in the best interest only of the shareholders.[122] Without a viable financial entity, Kentucky-American argues, it is unable to attract capital, meet unanticipated expenditures, provide a basis for ongoing infrastructure replacement, and provide reliable customer service. As further support of its incentive plans, Kentucky-American points to the findings of a 1991 comprehensive management and operations audit in which the auditors found that the utility required competitive compensation packages to attract and retain qualified individuals and that the cost of such packages are balanced by the likely costs of recruiting, hiring, and training replacements.

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[119] KAWC Brief at 34.

[120] Direct Testimony of Andrea C. Crane at 55.

[121] *Id.*

[122] KAWC Brief at 34.

In previous rate proceedings[123] when the appropriateness of recovery of the entire cost of its incentive compensation plans was questioned, Kentucky-American has asserted the plans were in response to the findings of a Commission-mandated management audit. While we initially accepted this argument, we rejected this position in Kentucky-American's last rate proceeding and placed the utility on notice that "in future rate proceedings, it must demonstrate fully why it should not bear a portion of these [incentive compensation plan] costs."[124]

Kentucky-American argues that its incentive plans motivate its employees to perform at high levels and to always place customer service and satisfaction at the forefront of its efforts. Despite requests for studies or analyses that would quantify these alleged benefits, Kentucky-American has failed to produce any evidence to support its position. It has provided only a report indicating that Kentucky-American's plans are in line with other surveyed utilities and that most surveyed utilities have incentive plans for upper and middle management. This report, however, does not address or quantify benefits that Kentucky-American's plans supposedly provide to ratepayers nor does it indicate how the costs of other utility plans are allocated between shareholders and ratepayers. The mere existence of such plans is insufficient to demonstrate that they benefit ratepayers and that their costs should be recovered through rates. The Commission, therefore, has eliminated the costs associated with the AIP and the LIP and reduced Kentucky-American's forecasted operating expenses by $229,146.

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[123] *See, e.g.,* Case No. 1997-00034, Application of Kentucky-American Water Company to Increase Its Rates (Ky.PSC Sept.30, 1997).

[124] Case No. 2000-00120, Order of November 27, 2000 at 44.

Waste Disposal. Included in Kentucky-American's forecasted operations is waste disposal expense of $238,996. The waste disposal forecast reflects the third-party bids for cleaning Kentucky-American's treatment facilities amortized over a 24-month period.[125]

Kentucky-American acknowledges that the ongoing waste disposal costs for the Richmond Road Station have been overstated.[126] The AG asserts that the monthly amortization of these costs should be $2,500, not $3,500, and proposes to reduce waste disposal expense by $12,000.[127] We find that the AG's adjustment should be accepted and has reduced forecasted operating expenses by $12,000.

Kentucky-American's forecasted cost also includes $70,000 for the removal of solids from Lake Ellerslie. The AG argues that, as the Richmond Road Station is cleaned periodically, not annually, these costs should be recovered over a multi-year period. He proposes to reduce waste disposal cost by $46,667 to reflect the amortization of this cost over a 3-year period.[128]

Kentucky-American objects to the proposed adjustment. It states that in recent years it has experienced increased demands, greater requirements for turbidity removal, and increased use of Kentucky River water at the Richmond Road Station. These occurrences have resulted in increased amounts of sedimentation produced at that facility and a corresponding increase in sedimentation buildup at the adjacent

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[125] Direct Testimony of Sheila Valentine at 7.

[126] KAWC's Response to Commission Staff's Second Set of Information Requests, Item 99(d).

[127] Direct Testimony of Andrea C. Crane at 61.

[128] *Id.* at 62.

reservoir.[129] This buildup will likely require annual cleaning of Lake Ellerslie on a going forward basis.[130]

The record indicates that in August 2002 Kentucky-American removed 1,109,038 gallons of sediment from Lake Ellerslie and in 2004 removed 881,969 gallons in a one-month period. It further indicates that the increased demand and use of Kentucky River water at the Richmond Road Station has produced a faster buildup of sedimentation around the discharge point. Kentucky-American witnesses have testified that increased demand has resulted in the need for greater utilization of Lake Ellerslie on a going forward basis. In its budgets, Kentucky-American has projected that "[a]pproximately 900,000 gallons of solids containing water will be removed from either the sedimentation basins, washwater holding tanks, sludge thickeners, or reservoir in 2006 and 2007 until such time that improvements are made to the solids handling capabilities of RRS."[131] We find that the increased use of Lake Ellerslie and the resulting increase in sedimentation will likely require annual removal of sedimentation from Lake Ellerslie for the foreseeable future. Accordingly, we deny the AG's proposed adjustment.

<u>Management Fees</u>. Kentucky-American has included its forecasted operations management fee expenses of $3,800,310. Management fees represent the forecasted costs for the services that American Water Works provides to Kentucky-American. Reflected in the management fees are the costs for operating the National Customer Care/Call and Shared Services Centers. Kentucky-American has also included in its

[129] Rebuttal Testimony of Linda Bridwell at 2.

[130] *Id.* at 3.

[131] KAWC's Response to Commission Staff's Fourth Information Request, Item 7.

management fee forecast $117,525 of business development costs allocated from American Water Works' regional office.

The AG proposes the reduction of management fees by $117,525 to eliminate the business development cost allocation. In support of this action, he argues that the provision of regulated water service in a franchised service territory is not a competitive situation requiring "business development." He asserts that the business development costs incurred should be booked by some entity other than Kentucky-American or borne entirely by Kentucky-American's shareholders.

Responding to this proposed adjustment, Kentucky-American observes that the Commission allowed the full recovery of a business development employee in its last rate case proceeding and that its business development costs are reasonable. "As a regional supplier of water and the most logical entity for consolidation of water purveyors," it argues that it is, "not only pursuing legislative mandates and Commission encouragements, but is attempting to obtain efficiencies through expansions."[132]

While we allowed the cost of a business development employee in Kentucky-American's last rate proceeding, we did so only after Kentucky-American clearly identified and documented that employee's duties. In this proceeding the Service Company is providing the services at issue, the fees are included in the management fee forecast, and the only description of the services is "Salary, salary overheads, and incidental expenses of the business development employees in the SE Region office who performed functions directly related to business development activities in Kentucky

[132] KAWC Brief at 40.

on behalf of Kentucky American Water."[133] Given Kentucky-American's inability to appropriately document and separate forecasted management fees between those that are directly assignable and those that are allocated, we find that Kentucky-American has failed to demonstrate that the forecasted business development costs are reasonable or are appropriately included in Kentucky-American's regulated operations and have reduced forecasted operating expenses by $117,525.

During the evidentiary hearing, the Chairman of Kentucky-American's Board of Directors disclosed the recent reassignment of several Kentucky-American employees to the Service Company's Southeast Region. In the previous rate proceeding, we advised Kentucky-American that it should provide assurances that "management of operations and policy decisions will remain under local control and that decisions are made in the best interests of the ratepayers of Kentucky."[134] The hearing disclosure increases this concern. While recognizing that certain organizational changes may create beneficial efficiencies, we remain concerned that the best interests of Kentucky-American's customers are prominently considered when the Southeast Region makes its decisions. Therefore, Kentucky-American should, within 60 days from the date of this Order, provide a detailed report in which it describes the organization of AWWC, the Southeast Region, and Kentucky-American. At a minimum, it should identify the functions performed by each entity, the development of strategic policy for each entity, and the role that Kentucky-American has in the formation and development of policies that affect its customers. It should also identify all services provided by the Southeast

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[133] KAWC's Response to Commission Staff's Fourth Set of Information Requests, Item 39.

[134] Case No. 2000-00120, Order of Nov. 27, 2000 at 18-19.

Region and other affiliated entities to Kentucky-American. Any planned but incomplete organizational changes that affect Kentucky-American should also be disclosed.

Group Insurance. Kentucky-American includes in its forecasted operations group insurance expense of $1,724,407. The forecasted expense is comprised of group insurance costs for the current associates and post retirement employee benefit costs ("OPEB") for both Kentucky-American's current and retired employees. To forecast the cost of current group insurance, Kentucky-American increased the current group insurance rates by 8.94 percent to reflect the rates that will be in effect on January 1, 2005. It then applied these rates to the number of Kentucky-American's full-time employees.[135] Towers Perrin prepared a report to update the 2003 actuarial report to estimate Kentucky-American's 2004 OPEB expense. Kentucky-American increased the 2004 OPEB estimate by 9 percent to arrive at its forecasted OPEB expense of $798,734.[136]

The AG proposes to reduce group insurance expense by $51,381. In support of his proposal, he argues that, because OPEB expense is dependent upon a variety of factors, forecasting annual OPEB is a complex process. Merely isolating one factor or assuming that OPEB expenses follow the same trends as health care costs does not produce a reliable forecast. The AG argues that an actuarial report is the best support for an OPEB projection. In this case, the most recent Towers Perrin report supports the

[135] Direct Testimony of Shelia Valentine at 7-8.

[136] KAWC's Response to Commission Staff's Fourth Information Request, Item 43.

use of $904,227 reduced by the amount capitalized by Kentucky-American,[137] or a reduction to group insurance expense of $51,381.[138]

Kentucky-American argues that it is generally recognized that health care costs, particularly for the age group covered by the OPEB, are increasing annually and dramatically. It refers to newspaper reports of predictions of increased health care costs.[139] Kentucky-American's average annual OPEB cost increase between 1999 and 2003 was 7.7 percent.[140]

We concur that budgeting for OPEB expense is a complex process that is dependent on many factors. Factors that would influence future OPEB costs are health care costs, return on assets investments, employment levels, and the ages of the employees being covered. The record does not demonstrate that Kentucky-American has considered those other factors in developing its forecast of future OPEB expenses. Moreover, as the forecast is based upon an estimate of 2004 OPEB costs, not actual costs, we have serious concerns about the reliability and accuracy of these forecasted costs.

The Commission notes that Commission Staff has requested on two occasions that Kentucky-American provide the 2004 actuarial report when such report becomes available. Kentucky-American has yet to file such report. While we recognize that the current trend in health care costs supports some level of increase in 2004 OPEB expense, we cannot accept a forecast that is mere conjecture. Absent the 2004

[137] AG Brief at 20.

[138] Direct Testimony of Andrea C. Crane, Schedule ACC-26.

[139] KAWC Brief at 37.

[140] Rebuttal Testimony of Michael Miller at 39.

actuarial study, we find that Kentucky-American has failed to meet its burden of demonstrating that the forecasted expense level is reasonable and that the forecasted expense level should be reduced by $51,381.

Rents. Kentucky-American has included in its forecasted operations rent expense of $111,438, which reflects signed and anticipated agreements for copiers and postage machines.[141] The AG proposes to reduce forecasted rent expense by $58,295 to reflect the following changes to Kentucky-American's forecast: (1) eliminate lease payments for lab equipment that has been purchased; (2) remove the lease payment for a copier that is no longer leased; (3) eliminate lease payments for office equipment no longer at the Tri-Village office.[142] Kentucky-American agrees that its forecast for rent expense is overstated by that amount.[143] We find that this adjustment should be accepted and that forecasted operating expenses should be reduced by $58,295.

General Office Expense. Kentucky-American has included in its forecasted operations general office expense of $348,606. This expense includes, but is not limited to: dues and memberships; employee travel and meal expenses; office supplies; and general office utility costs. The forecast for customer accounting is below the base period amount and considerably less than the prior 3 years.[144]

The AG proposes to reduce general office expense by $5,228 to eliminate social club dues from Kentucky-American's forecast.[145] The forecasted amount includes

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[141] *Id.*

[142] Direct Testimony of Andrea C. Crane at 67.

[143] KAWC's Response to the AG's First Information Request, Item 138.

[144] *Id.*

[145] Direct Testimony of Andrea C. Crane at 67.

social club dues for Spindletop Hall, the Keeneland Club, the University of Kentucky Faculty Club, the Lafayette Club, Rotary Club, Kiwanis, and Audubon Society. The AG contends that these dues are not necessary for the provision of safe and adequate utility service and therefore should not be borne by ratepayers.

Kentucky-American agrees that the dues paid for Spindletop Hall and the Keeneland Club should be excluded from forecasted operations.[146] It argues that memberships in the University of Kentucky Faculty Club and the Lafayette Club are for business purposes only. Since these locations have private rooms, Kentucky-American uses them for off-site business meetings, business luncheons, seminars, and training sessions. It notes that the Rotary Club and Kiwanis are minor expenses when compared to the benefits that are derived from the interaction of its employees with community business leaders. As to the Audubon Society's annual fee of $90, Kentucky-American claims this fee is an extension of its commitment to conservation and the environment.[147]

The Commission has previously found that community organization expenses benefit utility community relations and are a form of charitable contribution that should not be recovered through utility rates.[148] We find nothing in the record to require us to reconsider this holding. Accordingly, we have reduced operating expenses by $5,228.

<u>Miscellaneous</u>. Kentucky-American has included in its forecasted operations miscellaneous expense of $2,978,873. This category includes items that are necessary

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[146] Rebuttal Testimony of Coleman Bush at 5.

[147] *Id.*

[148] Case No. 1997-00034, Application of Kentucky-American Water Company to Increase its Rates (Ky PSC Sep. 30, 1997) at 42.

to carry out the normal day-to-day business functions such as: janitorial; legal; advertising; employee training programs; uniforms; telephone; amortizations; conservation; and security costs.[149]

The Commission, on its own motion, has decreased forecasted Miscellaneous Expense of $99,244 to remove the amortization of community education costs approved in Kentucky-American's rate proceeding in Case Number 2000-00120. In that proceeding, we provided that this allowance for community education costs "shall be allocated to developing more extensive conservation efforts than those anticipated for the forecasted test year."[150] FASB 71 provides that a deferral of an expense is appropriate only where "future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs." As our action in the last rate proceeding was clearly intended to provide future levels of similar costs, it clearly conflicted with the requirements of FASB 71 and was inappropriate.

The AG proposes to reduce miscellaneous expense by $72,415 to remove institutional advertising. He argues that the purpose of institutional advertising is to promote the corporate name of Kentucky-American or its parent, RWE. He refers to specific Kentucky-American advertisements that he views as constituting institutional advertising and asserts that they are totally unrelated to the provision of utility service.[151]

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[149] Direct Testimony of Shelia Valentine at 10.

[150] Case No. 2000-00120, Order of May 9, 2001 at 11.

[151] Direct Testimony of Andrea C. Crane at 68.

According to Kentucky-American, the source for the AG's proposed adjustment, Schedule F-4, was incorrectly prepared. Kentucky-American states that the actual amount of the forecasted advertising expense is $134,704 and that it can be found on W/P-3-13, page 1. Kentucky-American contends that the language cited by the AG is from past ads, which it does not believe constitutes institutional advertising. Kentucky-American further contends that the outline of its ads[152] for the forecasted period only includes advertising that is allowed for rate-making purposes and therefore, the AG's adjustment should be denied.[153]

Administrative Regulation 807 KAR 5:016 prohibits the recovery of institutional advertising in rates. As this proceeding involves a forecasted test period, the only information available regarding future advertisements is a brief outline of advertisements that Kentucky-American plans. The specific language of these advertisements has not yet been prepared. Based upon our review of the advertisement outline, we find that the advertisements set forth in Table VII are for community education purposes and should be included in forecasted operations.

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[152] Rebuttal Testimony of Coleman Bush at CDB Exhibit 1.

[153] *Id.* at 6.

TABLE VII

Description	Forecasted Cost
Customer Service Guide Inserts	$ 2,050
Public Education Materials	3,076
Newsletters Community	8,200
Hydrant Flushing	1,230
Water Quality Reprint	2,563
From the Tap	10,252
Consumer Confidence Report	20,500
Immunocompromised Customers	5,124
Customer Appreciation	5,127
TV Tips	27,587
TV Leak Detection	4,509
Conservation Radio	20,500
Conservation Bill Inserts	+ 10,247
Total Community Education	$ 120,965

We find that the remaining $25,035[154] of forecasted community education costs involves institutional advertising and should be eliminated.

Maintenance – Other. Kentucky-American has included in its forecasted operations its maintenance expense of $972,706. It states that maintenance expense included in its forecast is greater than in the base period amounts because of greater upkeep and maintenance activities on existing plant such as tank inspections and general plant maintenance."[155]

The AG proposes to decrease maintenance expense by $211,477.[156] He states that Kentucky-American has failed to provide adequate evidence to support the significant increase in maintenance expense. He proposed to use the 3-year average of

[154] $146,000 (Community Education Forecast) - $120,965 (Allowable Community Education Advertisements) = $20,035.

[155] Direct Testimony of Sheila Valentine at 10.

[156] Direct Testimony of Andrea C. Crane at 64 and Schedule ACC-29.

maintenance costs for the period of 2001 through 2003 to establish the appropriate level of maintenance expense.

Kentucky-American opposes the use of a historical averaging of costs to adjust maintenance expense. It argues that the practice is unreasonable and arbitrary and fails to take into account the cost of necessary preventive maintenance.[157]

That a forecasted expense is higher than the amount reported in the base or a historical period is insufficient basis for an adjustment. While the AG's methodology of comparing the test period to the historical levels would be appropriate in a rate case using an historical test period, it is of limited value when a forecasted test period is used. In rate proceedings using a forecasted test period, the accuracy of a utility's ability to forecast or budget for an expense is the more critical issue. The accuracy of Kentucky-American's forecast can be gauged by comparing its maintenance budgets to its actual results. A comparison of Kentucky-American's maintenance expenses budgets to actual results for the calendar years 2000 through 2003,[158] which is set forth in Table VIII, shows that Kentucky-American has accurately forecasted its maintenance expense. In light of this comparison and in the absence of any evidence to demonstrate that a 3-year historical average is an accurate measure of future maintenance costs, we find that the AG's proposed adjustment should be denied.

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[157] Brief of KAWC at 38.

[158] KAWC's Response to Commission Staff's Fourth Set of Information Requests, Item 8. Maintenance expenses are net of the amortizations.

TABLE VIII

Maintenance Expense			
Year	Actual	Budget	Percentage of Actual to Budget
2000	$ 746,355	$ 795,290	93.8%
2001	897,888	776,886	115.6%
2002	701,080	719,673	97.4%
2003	+ 746,157	+ 909,557	82.0%
Total	$ 3,091,480	$ 3,201,406	96.6%

Low Income Discount. Kentucky-American proposes to discount its service charge by 25 percent for all residential customers whose household income is certified as being equal to or below the federal poverty level. For the reasons set forth later in this Order, we deny the proposed discount and decrease forecasted operating expenses by $30,000.

Depreciation. Kentucky-American includes depreciation expense of $7,065,762 in its forecasted operations. Based on the Commission's treatment of forecasted rate base with regard to slippage, an adjustment has been made to increase forecasted depreciation expense by $1,770.

Amortization Expense. Kentucky-American includes in forecasted test period operations amortization expense of $695,154. Of this amount, Kentucky-American includes $13,248 and $19,296 for its Boonesboro and Pineville acquisitions, respectively. In Case No. 2000-00120, the Commission included amortization expense of $13,051[159] for the Boonesboro acquisition, which is $197 less than the amount that Kentucky-American includes. The Commission has reduced amortization expense by $197 to correct for this error. We have further reduced forecasted amortization by an additional $19,296 to remove the amortization of the Pineville acquisition, which

[159] Case No. 2000-00120, Order of May 17, 2001 at 17.

Kentucky-American has acknowledged was incorrectly included in its amortization forecast.

General Taxes. Kentucky-American includes a forecast of general tax expense of $1,712,673, which includes property taxes and payroll taxes of $2,223,673 and $410,283, respectively, but was decreased to $2,221,770 after application of the construction slippage factors. Based on our treatment of forecasted rate base with regard to slippage, we have decreased forecasted property taxes expense by $1,903. We have also reduced payroll taxes by $17,530 to reflect the effects of our removal of the costs of incentive pay plans.

Income Taxes. The AG proposes that Kentucky-American's forecasted current and deferred income tax expenses be adjusted to reflect the use of a consolidated tax return. He notes that Kentucky-American calculates federal income taxes on a stand-alone basis.[160] Kentucky-American, however, is part of a consolidated group, which is held by Thames Water Aqua U.S. Holdings ("TWUS"), that files a combined federal income tax return to take advantage of the tax losses experienced by some of the group's members.[161] The use of a consolidated tax filing, the AG states, permits the tax loss benefits generated by one group of subsidiaries to be shared by the other consolidated group members, thus resulting in a reduced effective federal income tax rate. The AG proposes that these tax benefits should be flowed to Kentucky-American's ratepayers to reflect the actual taxes paid rather than calculate the amount of taxes based upon stand-alone methodology. To do otherwise, he argues, would

[160] Direct Testimony of Andrea C. Crane at 73.

[161] AG Brief at 27.

overstate Kentucky-American's federal income tax. Regulatory commissions in three other jurisdictions in which American Water Works affiliates are located[162] have adopted consolidated tax adjustments for rate-making purposes.[163] Use of the AG's consolidated tax adjustment results in a $551,151 credit to forecasted income available for federal income taxes and a decrease to federal income taxes of $192,903.

Kentucky-American describes the AG's proposal as "unprecedented and unique" and as representing a significant departure from established Commission precedent. It argues that the extraction of tax benefits from one subsidiary that participates in the filing of a consolidated tax return and transferring that benefit to another subsidiary in the "family" is a cross-subsidy. Its witness testified that the advantage of a consolidated return is only to the entity that actually incurs the tax loss as the tax benefit attributable to the operating loss is given to that entity. As Kentucky-American has not incurred a tax loss, it accrues actual benefit from the filing of a consolidated tax return. Imposing a consolidated tax adjustment, Kentucky-American argues, will only preclude it from earning its allowed rate of return. Kentucky-American further notes that the proposed adjustment raises serious extra-territorial jurisdictional issues.

We find that Kentucky-American's present position on this issue conflicts with its stated position in Case No. 2002-00317. In that proceeding, Kentucky-American and others sought approval of the transaction that enabled RWE's acquisition of control of Kentucky-American. One feature of this transaction was the creation of TWUS, an

[162] These jurisdictions are Pennsylvania, New Jersey, and West Virginia.

[163] Testimony of Andrea C. Crane at 73.

intermediate holding company that would hold the stock of American Water and all of Thames Water Aqua Holdings GmbH's other U.S. affiliates. Kentucky-American asserted the creation of TWUS would permit the filing of consolidated U.S. tax returns. The ability to file such a tax return, Kentucky-American argued, benefited the public because it would reduce administrative expenses by eliminating the need to file multiple tax returns and permit some tax savings by allowing payment of taxes calculated on the net profits of all entities within the consolidated group.

We note that when approving the proposed transaction, we rejected specific proposals to condition our approval on the Joint Petitioners treating any tax savings achieved through the write-off of losses incurred in unregulated U.S. operations against regulated U.S. earnings as a benefit of the transaction and sharing that benefit with Kentucky-American ratepayers. We took that action, not because the proposals were without merit, but because we had previously directed that a portion of any merger savings be allocated to Kentucky-American ratepayers and that additional conditions were unnecessary. Kentucky-American did not take exception to or protest our reasoning.

Having previously indicated the savings resulting from the filing of a consolidated tax filing would be viewed as a merger benefit, subject to allocation, we do not believe that acceptance of the AG's proposal represents a radical departure from past regulatory practice. Moreover, Kentucky-American and its corporate parents having previously touted TWUS's filing of consolidated tax returns as a benefit to obtain approval of the merger transaction, have no cause to object if we now act upon their

representation. Accordingly, we find that the AG's proposed consolidated income tax is reasonable and have reflected it in our calculation of federal income taxes.

We further find certain errors in Kentucky-American's calculation of income taxes at present rates that result in an overstatement of those taxes. The overstatement resulted from adding amortization of plant acquisition adjustments for Tri-Village and Elk Lake in the amounts of $5,676 and $2,688, respectively, to the reconciling items shown at Exhibit 37-E, Pages 5 and 7. On those pages, these items were erroneously excluded from the stated depreciation and amortization expense making their inclusion as a reconciling item unnecessary and inappropriate. This adjustment is reflected in the Commission's calculation of forecasted income tax expense.

To reflect interest synchronization, Kentucky-American proposed a forecasted interest expense of $5,325,120 based on forecasted rate base and weighted cost of debt. The Commission has recalculated this expense to be $5,234,794[164] based on the rate base and weighted cost of debt found reasonable herein.

Adjusting Kentucky-American's income tax forecast, the Commission arrives at its current income tax expense of $2,761,192 as shown in Table IX below.

[164]

Commission Approved Rate Base	$	156,262,507
Commission Approved Weighted Cost of Debt	+	3.35%
Interest Synchronization	$	5,234,794

TABLE IX

Item	Commission Adjustments	Current Income Tax Expense State	Federal	Total
Kentucky-American's Forecasted Taxes		$ 492,887	$ 1,939,211	$ 2,432,098
Public Fire Hydrants	$ 89,015	7,344	28,585	35,929
Private Fire Hydrants	$ 29,020	2,394	9,319	11,713
Activation Charges	$ 672,000	55,440	215,795	271,235
AFUDC	$ (133,370)	(11,003)	(42,828)	(53,831)
Incentive Pay Plans	$ (229,146)	18,905	73,584	92,489
Waste Disposal	$ (12,000)	990	3,854	4,844
Business Development	$ (117,525)	9,696	37,740	47,436
OPEB's	$ (51,390)	4,240	16,503	20,743
Rents	$ (58,295)	4,809	18,720	23,529
Social Club Dues	$ (5,228)	431	1,679	2,110
Advertising	$ (25,035)	2,065	8,040	10,105
Low Income Discount	$ (30,000)	2,475	9,634	12,109
Depreciation	$ 1,770	(146)	(568)	(714)
General Taxes	$ (19,433)	1,603	6,240	7,843
Interest Synchronization	$ (90,326)	7,452	5,629	36,458
Income Tax Consolidation	$ (551,151)	+ 0	+ (192,904)	+ (192,904)
Commission Current Income Tax Expense		$ 599,582	$ 2,161,610	$ 2,761,192

Based upon the adjustments to deferred debit amortization and community education amortization, the Commission arrives at its level of deferred income tax expense of $(12,084) shown in Table X.

TABLE X

Item	Commission Adjustments	Deferred Income Tax Expense State	Federal	Total
Kentucky-American's Forecasted Tax Expense		$ (9,636)	$ (209,182)	$ (218,818)
Community Education	$ (99,243)	8,188	31,869	40,057
Deferred Security Costs	$ (280,566)	23,147	90,097	113,244
Shared Service Transition	$ (55,751)	4,599	17,903	22,502
Customer Care/Call Center	$ (57,141)	4,714	18,349	23,063
Acquisition - Boonesboro	$ (197)	16	64	80
Acquisition – Pineville	$ (19,296)	+ 1,592	+ 6,196	+ 7,788
Commission Deferred Income Tax Expense		$ 32,620	$ (44,704)	$ (12,084)

Based on the aforementioned adjustments to forecasted revenues and expenses the Commission has determined Kentucky-American's forecasted net operating income at present rates to be $9,971,59 as shown in Table XI.

TABLE XI

Category	Kentucky-American's Forecasted Income Taxes	Commission Adjustments	Commission Adjusted Income Taxes
Operating Revenues			
Water Sales	$ 41,803,9866	$ 118,035	$ 41,922,001
Other Operating Rev.	+ 1,585,696	+ 538,630	+ 2,124,326
Total Operating Rev.	$ 43,389,662	$ 656,665	$ 44,046,327
Operating Expenses			
Operation & Maintenance	$ 21,910,724	$ (1,021,320)	$ 20,889,404
Depreciation & Amort.	7,760,916	(17,723)	7,743,193
General Taxes	2,712,460	(19,433)	2,693,027
Income Taxes	+ 2,213,280	+ 535,828	+ 2,749,108
Total Operating Exp.	$ 34,597,380	$ (522,648)	$ 34,074,732
Net Operating Income	$ 8,792,282	$ 1,179,313	$ 9,971,595

Rate of Return

Capital Structure. Kentucky-American's proposed capital structure based on the projected 13-month average balances for the forecasted test period and the costs assigned to each capital component is shown Table XII.

TABLE XII

Components	Ky-American's Capitalization	Assigned Costs
Short-Term Debt	3.719%	2.700%
Long-Term Debt	51.376%	6.330%
Preferred Stock	3.780%	7.720%
Common Equity	+ 41.125%	11.20%
Total Capitalization	100.000%	

The AG proposes adjustments in the capital structure used to calculate rates. He contends that Kentucky-American consistently uses short-term debt as a capital source. In reviewing the period of 2001 through 2003, the AG found that the average quarterly short-term debt as a percentage of capitalization was 7.78 percent. In comparing this

average to the proposed percentage of 3.719 percent, the AG concludes that Kentucky-American's forecast of short-term debt is understated. The AG argues that the requirement of 807 KAR 5:001, Section 10, that rate base and capitalization be based upon a 13-month average for the forecasted period does not preclude the examination of the reasonableness of Kentucky-American's proposed capital structure. He proposes adjusting the capitalization to reflect the quarterly averages for the calendar years 2001 through 2003. This adjustment would produce the capital structure shown in Table XIII:[165]

TABLE XIII

Components	AG's Capitalization
Short-Term Debt	7.780%
Long-Term Debt	46.410%
Preferred Stock	4.600%
Common Equity	+ 41.210%
Total Capitalization	100.000%

Kentucky-American contends that its capital structure has been formulated with a careful consideration of the expected capital demands in the forecast period and of the most efficient and cost-effective means to meet those demands. It asserts that the AG's proposed capital structure ignores financing the $14 million of long-term debt in March 2004, the refinancing of the $5.5 million debt that matures in September 2005, and retained earnings that has been generated in 2004 and will be generated in 2005. It further asserts that the AG's proposed capital structure is a hypothetical capital structure that does not exist and is not reflective of Kentucky-American's capital needs.[166]

[165] AG Brief at 32-33.

[166] KAWC Brief at 49-50.

The Commission declines to accept the AG's proposed capital structure. As previously noted, we find the use of historical averages to be of limited relevance. Our central focus is with Kentucky-American's ability to forecast its capital requirements rather than comparisons of a forecasted capital structure with historical quarterly averages. The record shows that Kentucky-American's forecast is based upon current projections of its construction investment and capital requirements. The Commission finds that Kentucky-American's capital structure, after adjustments to reflect the effects of slippage, is shown in Table XIV below.

TABLE XIV

Components	Commission Capitalization
Short-Term Debt	3.697%
Long-Term Debt	51.388%
Preferred Stock	3.781%
Common Equity	+ 41.134%
Total Capitalization	100.000%

Short-Term and Long-Term Debt. Kentucky-American proposes short-term debt and long-term debt rates of 2.77 percent and 6.33 percent, respectively. No party objected to these forecasted cost rates. We find the proposed cost of debt is reasonable and should be accepted.

Preferred Stock. Kentucky-American proposed an embedded cost of preferred stock of 7.72 percent. No party objected to this forecasted cost rate. We find that the proposed embedded cost of preferred stock proposed by Kentucky-American appears reasonable and should be accepted.

Return on Common Equity. Kentucky-American recommends a return on equity ("ROE") of 11.2 percent based on its discounted cash flow model ("DCF"), the ex ante risk premium method and the ex post risk premium method. Kentucky-American

applied these models to two proxy groups, one consisting of water distribution companies and the other comprised of natural gas local distribution companies ("LDC"). Kentucky-American claims that its estimate is conservative because, in comparison to the proxy companies, it has greater financial risk because of its higher financial leverage.[167]

Kentucky-American used both water companies and LDCs because of the low number of analysts following water companies. Kentucky-American argues that LDCs are similar in risk to water companies and supply a larger number of analyst-followed companies that can act as a reasonableness measure for the water company results. In support, Kentucky-American provided an example from the Florida Public Service Commission, which uses LDCs as proxies for water companies.[168] DCF analyses on both sets of proxy companies produce a result of 10.7 percent cost of equity, which includes a five percent allowance for flotation costs.[169] Kentucky-American's two risk premium analyses, the ex ante risk premium and the ex post risk premium method, were performed on only the natural gas LDCs, since Kentucky-American believes there is insufficient information on the water companies to perform this type of analysis. The ex ante approach produces a cost of equity of 11.45 percent and the ex post method produces a range of 10.9 to 11.5, which includes a flotation cost adjustment of 25 basis-points.

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[167] Direct Testimony of Dr. James H. Vander Weide at 4.

[168] KAWC's Response to Commission Staff's Second Set of Information Requests, Item 11(d).

[169] *Id.* at 28.

The AG recommends an ROE of 8.75 percent using a DCF analysis and the Capital Asset Pricing Model ("CAPM"). The AG uses two comparison groups for its analysis, a Small Water Company Group and a Large Water Company Group. Both contain companies listed as water companies by C.A. Turner Utility Reports and are limited to companies whose water revenues are at least 80 percent of total revenues. The AG includes a discussion of three economic factors that have influenced the cost of equity recently: (1) the declining yields on A rated public utility bonds, (2) the declining dividend yields for the fifteen utilities in the Dow Jones Utilities Average over the past decade and (3) the increasing average earned returns on equity and market to book ratios. The AG argues that the overall investment risk of public utilities is below most other industries.[170]

The AG identifies three primary errors in Kentucky-American's cost of equity analysis: 1) the growth rates used in the DCF analysis; 2) the flotation cost adjustment; and 3) upwardly biased ex ante and ex post risk premium studies. The AG also takes issue with Kentucky-American's choice of comparison companies. Finally, he argues that lower interest rates are also indicators of a need for a lower cost of equity than that proposed by Kentucky-American.[171]

In its rebuttal testimony, Kentucky-American criticizes the AG's proxy companies, stating that most of the proxy companies are small and not widely followed in the investment community. Kentucky-American notes that only two of the AG's five small proxy companies are followed by Value Line and that Value Line presents growth

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[170] Direct Testimony of Dr. J. Randall Woolridge at 13.

[171] *Id.* at 49 - 73.

forecasts for only three of the AG's nine companies in both the small and large proxy groups. It also takes issue with the AG's use of only water companies in its analysis. It argues that the small, thinly traded and not widely followed companies in the AG's analysis indicate the need to employ equity models on other proxy companies that are similar in risk to water companies and are more widely followed in the investment community.

Kentucky-American also disagrees with the AG's approach in the DCF Model. It argues that the DCF model should have been modified to account for the quarterly payment of dividends by the proxy companies. Kentucky-American also states that the AG's method of estimating the dividend yield and his use of historical growth rates to estimate an investor's expectation of future growth are incorrect.

In critiquing the AG's CAPM analysis, Kentucky-American disagrees with the AG's use of the 10-year Treasury note to estimate the risk-free rate and the risk premium used by the AG. It suggests that the AG should have included a small company premium because of the size of the companies used in the proxy groups. It asserts that if the AG's analysis had used the correct factors and methodology described earlier, the result would have been a cost of equity of 13.5 percent.

The Commission agrees with some of Kentucky-American's criticisms of the AG's methodology employed in the DCF analysis. The use of ten-year Treasury bills as the risk free rate in the AG's CAPM analysis does not appear to be the most appropriate risk free rate for the model. While awards to American Water affiliates in other states is not a basis for an award for Kentucky-American, the Commission notes that the AG's ROE recommendation of 8.75 percent is significantly below most awards in 2004.

While the available data on water companies is limited, we find that the use of other industries, such as gas, to determine the return needed for a water company to be inappropriate. The Commission has addressed this issue on another occasion when asked to consider analysis performed on electric companies to determine the cost of equity for a gas company.[172] The fact that Kentucky-American's DCF analysis on both water and gas companies produces the same result indicates there is still merit in using water companies.[173]

In addition, the Commission is reluctant to consider a flotation cost adjustment when the subsidiary involved does not actually incur such cost and Kentucky-American was unable to provide any information on how RWE itself treats these costs. Furthermore, the Commission is not persuaded that Kentucky-American faces any greater risk as a result of its high degree of fixed costs or demand uncertainty compared to most other water companies. Kentucky-American has a history of filing rate cases on a regular basis. Frequent rate cases, coupled with its use of a forecasted test-year, mitigate some of the risk that Kentucky-American contends requires a higher return on equity.

Having considered the evidence of record, the Commission finds that Kentucky-American's cost of equity falls within a range of 9.5 percent to 10.5 percent. We further find that the midpoint of that range, 10 percent, is a reasonable level and should be used to determine Kentucky-American's overall revenue requirement.

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[172] Case No. 2000-00080, The Application of Louisville Gas and Electric Company to Adjust its Gas Rates and to Increase Its Changes for Disconnecting Service, Reconnecting Service and Returned Checks (Ky. PSC Sep. 27, 2000).

[173] Direct Testimony of Dr. James H. Vander Weide at 28.

Weight Cost of Capital. Applying the rates of 6.33 percent for long-term, 7.72 percent for preferred stock, 2.70 percent for short-term debt, and 10.00 percent for common equity to the adjusted capital structure produces an overall cost of capital of 7.75 percent. We find this cost to be reasonable.

Authorized Increase

The Commission finds that Kentucky-American's net operating income for rate-making purposes is $12,110,344. We further find that this level of net operating income requires an increase in forecasted present rate revenues of $3,611,302.[174]

Rate Determination

Kentucky-American proposes to increase water rates across the board by 15.3 percent for its Central Division customers, 42 percent for Northern Division customers that Elk Lake previously served, and 40.3 percent for customers that Tri-Village previously served. Kentucky-American did not perform a cost-of-service study to determine these increases. It states that the level of the increase for Northern Division customers would have been greater had all costs and expenses related to providing service to this division been allocated to that division.

The AG proposes that the Northern Division's rates remain at their current level and that only the rates for the Central Division customers be increased across the board. He argues that as a cost-of-service study has not been performed, Kentucky-

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Net Investment Rate Base	$	156,262,507
Multiplied by: Weighted Cost-of-Capital	x	7.75%
Net Operating Income	$	12,110,344
Less: Forecasted Operating Income	-	9,971,595
Operating Income Deficiency	$	2,138,749
Multiplied by: Gross-up Factor	x	1.6885112
Revenue Requirement Increase	$	3,611,302

American cannot reasonably assign costs with the proposed across the board increase when the percentages differ from division to division. Noting that Kentucky-American intends to seek a unified rate in its next rate proceeding and that such action would likely produce a significant reduction in the rates charged to Northern Division customers, the drastic fluctuations would produce confusing and inappropriate pricing signals to Northern Division customers and be inconsistent with generally accepted rate design principles.[175]

The Commission agrees with the AG that the rates assessed to Northern Division customers should remain at their current level. Given Kentucky-American's intent to unify its rates in its next rate proceeding, we find that the dramatic shifts in the rates assessed to Northern Division customers that are likely to occur are inconsistent with generally accepted principles of sound rate design. We further find that an across-the-board percentage increase should be applied to Central Division rates.

The AG proposes that all revenues collected from the Account Activation fee be used to reduce or eliminate any increase to the 5/8-inch customer charge. We find that, as the activation fee is assessed to all customer classes, applying all the revenues from the fee to benefit one customer class is inappropriate. Moreover, it is contrary to the very purpose for which Commission regulations permit the assessment of non-recurring charges. We decline to follow the AG's proposal.

LFUCG argues that the proposed percentage increase applied to public-owned fire hydrants without a cost-of-service study is unreasonable. It asserts that, based upon the previous cost-of-service study submitted in Kentucky-American's last rate proceeding, public-owned fire hydrants generate only 4 percent of the total water sales

[175] Direct Testimony of Scott J. Rubin at 16.

revenue from rates. In the absence of a new cost-of-service study, LFUCG argues, any adjustment to public-owned fire hydrant rates should not increase this share above 4 percent.[176] We find no evidence within the record to support LFUCG's argument and further find that the across-the-board increase should apply to public-owned fire hydrant rates.

Other Issues

Activation Fee. Kentucky-American proposes to establish an account activation fee of $24 that will result in an annual increase to operating revenues of $672,000. The activation fee will be assessed when a new account is established at a pre-existing service location. The costs associated with the account activation fee include field costs to turn on service and office costs to set up the account.[177] Kentucky-American argues that the cost incurred to provide the service should be recovered from the individual who receives the service.

The AG opposes the fee contending that lower-income customers are statistically more likely to move and thus incur the fee. He asserts that the fee will fall more heavily on those who are less likely to have the ability to pay it.[178] He contends that the proposed fee fails to meet all of the standards for special charges set forth in the American Water Works Association's ("AWWA") *Manual M1*.[179] Finally, the AG

[176] LFCUG Brief at 7-8.

[177] *Id.*

[178] Direct Testimony of Scott J. Rubin at 10-13.

[179] *Id.* at 10-11.

contends that Kentucky-American has failed to adequately demonstrate the reasonableness of the proposed fee.[180]

LFUCG opposes the account activation fee on the basis of its negative effect on low-income customers. It argues that the fee should be approved only if (1) the increased revenue from the fee is used to reduce or eliminate any increase in the 5/8-inch meter charge, (2) Kentucky-American agrees that the fee is subject to LFUCG's franchise fee, and (3) households qualifying for the proposed low-income tariff are excluded from the fee's coverage.[181]

The proposed activation fee is a non-recurring charge. Non-recurring charges are

> charges to customers due to a specific request for certain types of service activity for which, when the activity is completed, no additional charges may be incurred. Such charges are intended to be limited in nature and to recover the specific cost of the activity. Nonrecurring charges include reconnection charges, late payment fees, service order changes and hook-on or tap fees.

Administrative Regulation 807 KAR 5:011, Section 10. The Commission's regulations permit a utility to assess such charges to "recover customer specific costs incurred which would otherwise result in monetary loss to the utility or *increased rates to other customers to whom no benefits accrue from the service provided or the action taken*. Administrative Regulation 807 KAR 5:006, Section 8(1) (emphasis added). They expressly list an activation fee or "turn-on" charge as a permissible charge.[182]

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[180] AG Brief at 45.

[181] LFUCG Brief at 23-24.

[182] 807 KAR 5:006 at Section 8(3).

While we acknowledge that the proposed fee may affect those social groups that are more likely to change residences, we find that effect is not sufficient to find the proposed fee unreasonable or deny its assessment. The fee is facially neutral and does not distinguish between any social group. It focuses solely on the costs directly imposed by a customer's specific actions. Moreover, to deny the fee is to require customers to subsidize the cost of another's service.

We found no evidence to support the AG's contention that the proposed charge fails to comply with accepted standards. The AWWA has established six guiding principles to consider when establishing various service charges.[183] Our review indicates that the proposed charge is consistent with at least four of these principles. We find nothing within the AWWA's guidelines that requires that all guidelines must be met. Moreover, the AWWA recognizes the proposed charge as a charge common to many water utilities.[184]

Our review of the record shows adequate evidence to support the reasonableness of the proposed charge. Kentucky-American has provided evidence to demonstrate all activities included within the proposed charge and the cost of each

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[183] These principles are:

- Beneficiaries of a service should pay for that service.
- Services provided for the benefit of a specific individual, group, or business should not be paid from general utility revenues.
- Services provided to persons or entities that are not customers of the utility should not be paid from water revenues or other general utility revenues.
- Services for which there are charges are generally voluntary.
- The price of services may be used to change user behavior and demand for the good or service.
- The level of the charges should be related to the cost of providing the service.

American Water Works Association, *Principles of Water Rates, Fees and Charges AWWA Manual M1* (5th ed. 2000) at 246.

[184] *Id.* at 255.

activity. The record reflects that the proposed charge does not exceed the cost of these activities.

We find that LFUCG's proposed conditions should not be attached to the assessment of the activity fee. We note that LFUCG's dispute with Kentucky-American regarding the applicability of LFUCG's franchise fee to revenue generated from the proposed charge is not within the Commission's jurisdiction and is more properly addressed in other forums. Second, as discussed below, KRS 278.170 does not permit the exclusion of low income customers from the charge's applicability. Third, while all revenue from the proposed charge will not be used to reduce or eliminate any increase in Kentucky-American's 5/8-inch meter charge, a portion of such revenue will be used for that purpose.

Low Income Water Discount. Kentucky-American proposes a 25 percent discount in the meter charge of Central Division residential customers whose annual income is equal to or below the federal poverty level and in the initial blocks of similar Northern Division customers. The estimated cost of this discount is estimated at $30,000.

Kentucky-American sets forth two reasons for the proposed discount. First, it argues that the discount is consistent with the utility's social conscience and its position as an integral part of the central Kentucky community. "Permanently discontinuing water service to the neediest customers," it argues, "is not an acceptable option because potable water is a necessity of life."[185] Second, it suggests that, by assisting low-income customers to meet their obligations, the proposed discount is likely to

[185] KAWC Brief at 44.

reduce costs associated with disconnection notices, late payments, and bad debt write-offs and thus reduce the cost of service for all customers.

The AG argues that the proposed discount is unlawful. He states that KRS 278.170 establishes the factors under which the Commission may permit a utility to free or reduced rate service. KRS 278.170 does not list the level of a person's income as one of those factors. As the Commission is a creature of statute and has only those powers statutorily granted and as it has no express statutory authorization to permit discounts based upon a customer's income level, it does not have the authority to authorize the proposed discount.[186]

Disputing the AG's interpretation, CAC argues that 278.170(1) expressly permits a utility to grant reasonable preferences or advantages to persons within the same class, even if the service provided is substantially the same.[187] It contends that because of the size of the proposed discount and because of the additional costs that low-income customers impose upon Kentucky-American, the proposed discount is a reasonable preference. CAC notes that the cost of the proposed discount is only $30,000 or approximately 0.3 of one percent of the overall rate increase. It further notes that the discount, by making water service more affordable to persons who have difficulty paying for such service, is likely to reduce reconnection and collection costs. CAC further argues that, as "rising utility costs, particularly the increased rates and fees proposed in this case, place those living below the federal poverty level in 'dire

[186] AG's Response to Commission Staff's First Set of Information Requests, Item 3.

[187] CAC Brief at 4.

distress,'"[188] low-income customers fall within the groups for which KRS 278.170(2) permits free service or reduced rate.

Noting that the "cost is minimal and the potential benefit for the proposed recipients is great," LFUCG does not oppose the proposed discount.[189] LFUCG asserts that, given its minimal cost, the proposed discount does not appear to create an unreasonable preference or advantage for any customers. LFUCG further advocates that any Commission approval of the proposed charge should clearly state that "the proposal will not create any precedent to be used to argue for similar programs."[190]

Based upon our review of the proposed discount, we find insufficient support to establish a new customer class based solely on customer income. None of the proponents of the proposed discount have provided any convincing empirical data to demonstrate that Kentucky-American's cost of providing water service to residential customers whose annual income is equal to or less than the national poverty level significantly differs from those whose annual income is greater than the national poverty level. Discount proponents have also failed to provide any statutory or decisional authority for the proposition that customer income levels may constitute a reasonable basis to distinguish customers for cost-of-service purposes. In the absence of both empirical evidence and statutory or decisional legal authority, we must conclude the proposed discount is a unreasonable preference or advantage to a class of customers

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[188] *Id.* at 7.

[189] LFUCG Brief at 29.

[190] *Id.*

for "a like and contemporary service under the same or substantially the same conditions" and is one that KRS 278.170(1) prohibits.

We find the reliance of Low Income Water Discount proponents on Commission acceptance of other income assistance programs to be misplaced. Both programs to which proponents refer involve home energy assistance plans. The General Assembly has expressly authorized the use of such programs. *See* KRS 278.285(1) and (4). No such authorization has been extended to programs involving water utilities. Moreover, the programs in question were implemented as part of unanimous settlement agreements in rate proceeding. Such agreement is lacking in the present case.

The Commission further finds no merit to the contention that KRS 278.170(2) authorizes the Low Income Water Discount. That statute provides:

> Any utility may grant free or reduced rate service to its officers, agents, or employees, and may exchange free or reduced rate service with other utilities for the benefit of the officers, agents, and employees of both utilities. Any utility may grant free or reduced rate service to the United States, to charitable and eleemosynary institutions, and to persons engaged in charitable and eleemosynary work, and may grant free or reduced rate service for the purpose of providing relief in case of flood, epidemic, pestilence, or other calamity.

While the effects of low-income may present significant hardship, we do not accept CAC's argument that it is a "calamity" that permits a utility to grant reduced rate service. Our review of the statute indicates that the General Assembly intended this statute to address the results of natural disasters and other similar calamities, not socio-economic conditions.

The Commission questions the reasonableness and effectiveness of the proposed discount. Assuming an average monthly customer consumption of 5,000

gallons of water, the average customer's monthly bill under the proposed rates is $21.31. The proposed monthly discount would be only $2.11. As this discount represents less than 10 percent of an average monthly bill, we fail to see how the discount will achieve any of the objectives for which it is intended.

While we applaud Kentucky-American for its willingness to search for solutions to the problems of its low-income customers, the Commission is of the opinion that any successful low-income assistance program requires greater effort from the utility. Funding for the proposed discount comes completely from ratepayers.[191] Kentucky-American provides no shareholder contribution. If a proposed assistance program is to be more than merely a transfer of income from one customer group to another, the utility must also make significant contributions.[192]

Based upon the above, we find that the proposed Low Income Water Discount is unreasonable and deny Kentucky-American's request to implement the proposed reduced rate.

Tapping Fees. Kentucky-American proposes to increase tapping fees assessed to Central Division customers and to establish tapping fees for 1-inch meters and 2-inch meters for Northern Division customers who Tri-Village previously served. Kentucky-American states that the increase is due to increased costs of supplies, materials, insurance and labor costs. Kentucky-American uses a 3-year average in setting the

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[191] We acknowledge that Kentucky-American contributes $5,000 annually to its "Water For Life Fund." This amount, however, represents only one-sixth of the ratepayer contribution for the proposed low-income water discount.

[192] *See, e.g.,* Case No. 2001-00323, Joint Application of Louisville Gas and Electric Company, Metro Human Needs Alliance, People Organized and Workers for Energy Reform, Kentucky Association for Community Action, and Jefferson County Government for the Establishment of a Home Energy Assistance Program (Ky. PSC Dec. 27, 2001).

charges for the tap fees for the 5/8-inch meters, 1-inch meters, and 2-inch meters. The Commission has historically accepted this methodology.[193] We find the proposed fees reflect the actual cost of providing the service and are reasonable.

New and Expanded Economic Development Tariff. In its application, Kentucky-American submitted a proposed New and Expanded Economic Development Tariff. It subsequently advised the Commission at hearing that its submission of the tariff was for discussion purposes only and that it did not presently intend to implement the tariff.[194] We take no position on the submission, but we admonish Kentucky-American that it should avoid in future rate proceedings the submission of extraneous matters that are not ripe for review. Other forums outside a rate proceeding, such as informal conferences, are readily available for Kentucky-American to solicit the comments of interested parties and Commission Staff. Kentucky-American should use those forums to the fullest extent before submitting its proposals for formal review.

Emergency Pricing Tariff ("EPT"). In its application, Kentucky-American proposes an EPT. On June 15, 2001, Kentucky-American filed its water shortage response plan ("Demand Management Plan") with the Commission. This plan outlines the steps and procedures to be implemented in the event Kentucky-American lacks system capacity to meet customer demand. The EPT portion of the plan was in development when Kentucky-American filed its Demand Management Plan.

Kentucky-American's proposal revises the Demand Management Plan. It adds public notification to the emergency phase of the Demand Management Plan to alert

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[193] Direct Testimony of Linda Bridwell at 29-31.

[194] T.E., Vol. III at 85.

customers of the emergency pricing tariff rates that would become effective during the rationing phase. On an individual customer basis, a base usage amount will be determined during the rationing phase. The method used to determine the base usage amount differs by classification of customer. Customer usage in excess of the base will be billed at a multiple of the regular tariff rate.[195]

Noting that its current billing software is incapable of performing the calculations necessary to implement the proposed EPT and that the estimated programming cost to make the necessary upgrades to its billing software is approximately $165,600, Kentucky-American requests that the Commission also authorize the accrual of the programming costs as a regulatory asset to be considered for recovery in future rate proceedings.[196]

The AG and LFUCG oppose the EPT tariff. The AG argues that Kentucky-American has failed to demonstrate that the proposal is a cost-effective method to reduce demand during an emergency. He notes that the tariff does not contain a method for a customer to appeal the fairness of the base usage determination. He asserts that the proposal fails to address significant regulatory consequences and risk of over-collection and under-collection.[197] While not opposing the concept of an EPT, LFUCG argues that the parties should develop a mutually agreeable EPT and urges the Commission to establish an administrative proceeding separately from this case to address the subject.[198]

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[195] Direct Testimony Coleman D. Bush at 11 - 19.

[196] KAWC Brief at 46-48.

[197] AG Brief at 40-41.

[198] LFUCG Brief at 24-25.

The Commission accepts Kentucky-American's proposed EPT as a starting point. Its provisions concerning entitlement usage levels and conservation rates are consistent with practices of other jurisdictional water utilities that we have accepted. We stress that additional efforts in this area are necessary and that a collaborative process should be used to refine and improve the existing EPT. We therefore direct Kentucky-American to meet with all interested parties and develop a consensus on such outstanding issues as an appeals process for the determination of the base usage and the over-collection, under-collection of revenue. It should seriously consider and to the fullest extent possible address the concerns that the AG and LFUCG have raised in this proceeding. Kentucky-American should file periodic reports on the progress of its efforts.

As to the cost of billing software revisions, we deny without prejudice Kentucky-American's request to establish a regulatory asset. At such time as the level of costs become known, it may renew its request for deferral treatment. We place Kentucky-American on notice that the costs in question will be closely reviewed to ensure their reasonableness. Nothing in this Order should be construed or interpreted as approval of any level of expense.

SUMMARY

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

1. Kentucky-American's proposed rates would produce revenues in excess of that found reasonable herein and should be denied.

2. Kentucky-American's proposed activation charge and tap-on fees are reasonable and should be approved.

3. The rates in Appendix A are the fair, just, and reasonable and should be charged by Kentucky-American for service rendered on and after December 1, 2004.

4. Kentucky-American should within 60 days of the date of this Order refund to its customers with interest all amounts collected from December 1, 2004 through February 27, 2005 that are in excess of the rates that are set forth in Appendix A. Interest should be based upon the average of the Three-Month Commercial Paper Rate as reported in the Federal Reserve Bulletin and the Federal Reserve Statistical Release.

IT IS THEREFORE ORDERED that:

1. Kentucky-American's proposed rates are denied.

2. The rates set forth in Appendix A, are approved for service rendered on and after December 1, 2004.

3. Within 60 days of the date of this Order, Kentucky-American shall refund to its customers all amounts collected from December 1, 2004 through February 27, 2005 that are in excess of the rates that are set forth in Appendix A. Kentucky-American shall pay interest on the refunded amounts at the average of the Three-Month Commercial Paper Rate as reported in the Federal Reserve Bulletin and the Federal Reserve Statistical Release. Refunds will be based on each customer's usage while the proposed rates were in effect and shall be made as a one-time credit to the bills of current customers and by check to customers that have discontinued service since December 1, 2004.

4. Within 75 days of the date of this Order, Kentucky-American shall submit a written report to the Commission in which it describes its efforts to refund all monies collected in excess of the rates that are set forth in Appendix A.

5. Within 20 days of the date of this Order, Kentucky-American shall file its revised tariff sheets containing the rates approved herein and signed by an officer of the utility authorized to issue tariffs.

6. In its next application for rate adjustment, Kentucky-American shall provide a full and complete description of the Service Company's billing practices and a detailed explanation why any prepayment of expenses related to the Service Company is appropriate and necessary.

7. Kentucky-American shall not accrue any expense, except recurring maintenance expenses that the Commission has previously afforded rate-making treatment, as a regulatory asset for accounting purposes without prior written authorization from Commission Staff or an Order of the Commission.

8. Kentucky-American shall make any request for authority to accrue an expense as a regulatory asset for accounting purposes in writing to Commission Staff and at the time of making such request shall serve a copy of its request upon all persons or entities that were parties to its most recent rate proceeding. Kentucky-American may also request such authority by formal application to the Commission in accordance with the general procedures set forth in Administrative Regulation 807 KAR 5:001.

9. Starting from the date of this Order, Kentucky-American shall track all costs and employee time related to activities involving its defense in condemnation proceedings that LFUCG has initiated.

10. Within 60 days of the date of this Order, Kentucky-American shall submit to the Commission a written report containing a description of the organization of Kentucky-American, the Southeast Region, and the American Water System. At a minimum, this report shall

a. Identify the functions that each entity performs, the development of strategic policy for each entity, and Kentucky-American's role in the formation and development of policies that affect its customers;

b. Identify all services that the Southeast Region and other affiliated entities provide to Kentucky-American; and,

c. Describe all planned organizational changes that affect Kentucky-American.

11. Kentucky-American's request to accrue expenses related to the computer software revisions to implement EPT pricing is denied without prejudice.

12. Kentucky-American shall engage in discussions regarding its EPT with the AG, LFUCG, and all other interested parties for the purpose of developing a consensus on the implementation of EPT Tariff.

13. Within 90 days and 180 days of the date of this Order, Kentucky-American shall file written reports with the Commission in which it describes its efforts to obtain a consensus on the EPT, such as an appeals process for the base usage determinations and the use of over-collections of revenue. This report shall identify each of the parties

involved in these efforts, the issues that have been examined as a result of these efforts, each party's position on those issues, and the areas of agreement.

14. Subject to the filing of timely petition for rehearing pursuant to KRS 278.400, these proceedings are closed. The Executive Director shall place any future filings in the utility's general correspondence file or shall docket the filing as a new proceeding.

Done at Frankfort, Kentucky, this 28th day of February, 2005.

By the Commission

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2004-00103 DATED February 28, 2005.

The following rates and charges are prescribed for the customers in the area served by Kentucky American Water Company. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of the Commission prior to the effective date of this Order.

Monthly Water Rates
Central Division

SERVICE CHARGE

5/8"	$7.95
3/4"	$11.94
1"	$19.89
1 1/2"	$39.77
2"	$63.64
3"	$119.32
4"	$198.86
6"	$397.73
8"	$636.36

RATES FOR CONSUMPTION CHARGE

	Per 100 Cubic Feet	Per 1000 Gallons
RESIDENTIAL	$1.82375	2.43167
COMMERCIAL	$1.68873	2.25164
INDUSTRIAL	$1.37803	1.83737
OPA	$1.61771	2.15695
SALE FOR RESALE	$1.61771	2.15695

FIRE SERVICE CHARGES

	Per Month	Per Annum
2" DIAMETER	$4.35	$52.23
4" DIAMETER	$17.41	$208.93
6" DIAMETER	$39.13	$469.57
8" DIAMETER	$69.56	$834.67
10" DIAMETER	$108.69	$1,304.23
12" DIAMETER	$156.53	$1,878.39
14" DIAMETER	$213.09	$2,557.02
16" DIAMETER	$278.24	$3,338.93
PUBLIC FIRE HYDRANTS	$26.07	$312.87
PRIVATE FIRE HYDRANTS	$39.13	$469.57

Account Activation Fee	$24.00

TAP FEES

Central Division	
5/8” Meter	$510.00
1” Meter	$945.00
2” Meter	$4,250.00

Northern Division Tri-Village	
1” Meter	$945.00
2” Meter	$4,250.00