

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

NORTHERN KENTUCKY WATER DISTRICT'S)
APPLICATION FOR ADJUSTMENT OF RATES) Case No. 2010-00094

Brief of the Attorney General

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INTRODUCTION

The Northern Kentucky Water District (NKWD or Northern) provides retail water service to approximately 80,000 retail accounts in Boone, Campbell, and Kenton Counties and wholesale water service to three systems in Boone, Grant, and Pendleton Counties.¹ Through the pending request for an adjustment in rates, Northern seeks to increase the average residential customer's bill, through a two-step phase-in, by approximately 24.7%.² The overall increase is approximately \$8.29 million.³

In terms of the factors driving the request, Numbered Paragraph 5 of the Petition states the following.

It [Northern] proposes to gradually adjust rates in two phases over the period 2011 through 2012: (1) to fund improvements to existing facilities and related capital improvements to meet increasingly stringent and unfunded state and federal water quality standards, such as the Memorial Parkway Treatment Plant project; (2) to recover operation and maintenance expenses, which have not been adjusted for several years; (3) to recover depreciation and expenses related to aging infrastructure; (4) to recover pro forma adjustments to operating expenses; (5) to issue bonds to finance the proposed construction; and (6) to make clarifying changes to the tariffs. As explained in detail in the testimony, the District is proposing to implement a portion of the rate increase on or about January 1, 2011, depending on Commission approval. The second phase of the adjustment is expected to be implemented on or about January 1, 2012, depending on Commission approval. The two step adjustment will provide a gradual increase in the rates and will minimize the impact on customers.⁴

¹ Application for rate adjustment, Testimony of R. Lovan, Q 4 (description of system).

² Application for rate adjustment, Exhibit L, page 1 of 2 (page 596 of 817; NKWD_APP_EXA_THRU_EXS_060410.pdf).

³ Application for rate adjustment (page 694 of 817; NKWD_APP_EXA_THRU_EXS_060410.pdf).

⁴ See also Numbered Paragraph 11 of the Petition.

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Section 1 – “Wet Year” Adjustment

Northern is utilizing Year 2009 as the test period.⁵ The purpose of the test period is the justification of the reasonableness of the proposed increase in rates.⁶ Northern submits that Year 2009 was a “wet year” such that water sales were below a standard or normal amount.⁷ Thus, Northern asserts that the revenue from Year 2009 was *below* an amount otherwise expected; therefore, the Attorney General submits that if unadjusted, the use of the Year 2009 revenue amount stands to overstate Northern’s actual, reasonable revenue requirement.⁸

The Attorney General supports Northern’s “Wet Year” adjustment. The average monthly residential consumption for Year 2009 (4,294 gallons per month) is

⁵ Petition, Numbered Paragraph 35.

⁶ KRS 278.192(1); see also *In the Matter of: Application of Northern Kentucky Water District for (A) An Adjustment of Rates; (B) a Certificate of Public Convenience and Necessity for Improvements to Water Facilities if Necessary; and (C) Issuance of Bonds*, PSC Case No. 2002-00105, Order dated 30 April 2003, page 5.

⁷ TE 27 October 2010 (P. Herbert) 10:52:50 – 10:53:12; 10:53:40 – 10:55:48.

⁸ See, for description of dynamic, TE 27 October 2010 (P. Herbert) 10:56:11 *et seq.* (higher number for consumption increases the amount of revenue for the test period).

significantly below the five-year average (4,720 gallons per month) for the period 2004 through 2008.⁹ The adjustment from 4,294 gallons per month to 4,500 gallons per month is a modest upward adjustment within a range of reason supported by the evidence and professional judgment.¹⁰ By comparison to results from other recent years, the unadjusted test period amount is not a reliable basis for setting rates in that its use carries with it a significant risk that the revenue requirement will be overstated. Therefore, the Attorney General supports the adjustment.

Section 2 – Tap-on Fees

“The Commission has long viewed tap-on fees as a form of cost-free capital to the water utility rather than a source of operating revenue.”¹¹ Further, “since Northern District’s [tap-on] fees are cost based, the costs would offset the fees and there would be nothing available to apply to debt service.”¹² Thus, Commission precedent excludes tap-on fees as operating revenue.¹³

Northern, in support of its Petition, includes tap-on fees as revenue. Northern, nonetheless, acknowledges a difference between accounting for financial reporting and regulatory accounting.¹⁴ To the extent that there is a dispute between the financial

⁹ NKWD Response to PSC 3-15 (page 3 of 3; NKWD_PSCDR3_15_091601.pdf).

¹⁰ TE 27 October 2010 (P. Herbert) 10:52:50 – 10:53:12.

¹¹ PSC Case No. 2002-00105, Order dated 30 April 2003, page 13.

¹² *Id.*

¹³ *Id.*

¹⁴ TE 27 October 2010 (J. Bragg) 14:33:40 *et seq.*

reporting and regulatory accounting treatment, the regulatory accounting treatment prevails for the purpose of rate-setting.

The only caveat: If the rate-making treatment controls the presentation of the information in financial reporting (and it is not clear to the Attorney General that this is the case), then the rate-making treatment will have an impact on the debt coverage ratio. To this end, the Attorney General supports any corresponding adjustment that is necessary for Northern to be in compliance with the mandates of its bonded-indebtedness consequent to the Commission's treatment of tap-on fees as cost-free capital rather than operating revenue.

Section 3 – Check Explanations

During the evidentiary hearing, there was inquiry into several expenditures by Northern Kentucky Water District. As a consequence of this inquiry, Northern provided, as a response to a Commission Staff data request, a description of selected expenses from the test year.

The Attorney General submits that a number of the selected expenses fall outside of the scope of the District's lawful authority. Payments to organizations such as the Covington Rotary Club, the Chamber of Commerce, Healthpoint Family Care (for the Hopebox Derby), and STARS (for a 5K run) do not provide any tangible, material benefit to ratepayers. For the investor-owned utility, the payments would be items assigned to shareholders. For a water district, such payments, however noble, are

outside of the scope of the district's authority (and are, at best, uncomfortably on the border of a lawful action). All such payments should be excluded from the test period (and avoided in the future).

Northern is entitled to exercise its business discretion, and this discretion necessarily includes decisions regarding the compensation of its employees (and benefits bestowed upon them) and its interaction with the public. Still, the law regarding expenditures and rate-making is remarkably clear. "The burden of proof to show that the increased rate or charge is just and reasonable *shall* be upon the utility (emphasis added)."¹⁵ For inclusion as items justifying an increase in rates, the expense must be proven to be beneficial to the ratepayers in furnishing utility service.¹⁶

A number of the expenditures at issue are relatively modest (for example, lollipops for the children of customers who visit the District's office in order to pay a bill), and the Attorney General does not seek to second-guess the District for these items in that they do not manifest any abuse of discretion. Further, there are other items which do not raise any concern (for example, a subscription to the American Water Works Association Research Foundation). But, for an item such as a payment to the Metropolitan Club, the Attorney General's concern is that the pursuit of "education and communication" with the business community in the absence of a specific, material

¹⁵ KRS 278.190(3).

¹⁶ See *In the Matter of: Notice of Adjustment of Rates of Kentucky-American Water Company*, Case No. 9482, Order dated 8 July 1986, page 22; see also *In the Matter of: Adjustment of Rates of Columbia Gas of Kentucky, Inc.*, Case No. 10498, Order dated 6 October 1989, page 30.

connection with regard to providing utility service does not rise to the level of evidence justifying rate recovery. The Attorney General openly questions how evidence of this nature satisfies the requirements of KRS 278.190(3), and he requests the exclusion of these types of payments.

Section 4 – Energy Cost Recovery

In terms of a water utility's Operating and Maintenance Expense, "the cost of energy is typically one of the largest components of a utility's operating costs, accounting for as much as 35% (AwwaRF, 2005)."¹⁷ Given the conditions specific to Northern, energy is a significant expense.¹⁸ It may well be the case that an energy cost recovery mechanism could help Northern maintain or improve its ability to access capital at the lowest cost rate reasonable.¹⁹ The Attorney General encourages Northern to consider the development and proposal of such a mechanism.²⁰

Section 5 – Gradualism

Northern, mindful of the potential of an unduly harsh impact of a rate increase of this magnitude, proposes to mitigate the effect of the rate adjustment through a two-step phase-in.²¹ Operating under the premise that the rates ultimately approved by this Commission for each step will be sufficient to satisfy Northern bonded-indebtedness

¹⁷ S. Reiling, J. Roberson, and J. Cromwell, *Drinking water regulations: Estimated cumulative energy use and costs*, American Water Works Association Journal, March 2009, page 46.

¹⁸ TE 27 October 2010 (J. Bragg) 14:28:00 – 14:29:00.

¹⁹ TE 27 October 2010 (J. Bragg) 14:30:35 – 14:31:09.

²⁰ The Attorney General notes that he does not propose including chemical expense as an item for recovery through or as part of an energy recovery mechanism.

²¹ TE 27 October 2010 (J. Bragg) 14:27:20 – 14:27:44; (R. Lovan) 15:54:20 – 15:54:38.

mandates, the Attorney General has no objection to a phased-in approach. Further, with regard to the proposed customer charges, Northern has a commitment to move toward “cost-of-service based rates.”²² In view of these facts, the rate-making principle of gradualism, through which short-term variations from the actual cost-of-service are allowed, seems well-suited to setting fair, just, and reasonable rates in this situation.

Section 6 – Safe Drinking Water Act

The Safe Drinking Water Act was enacted in 1974.²³ It is “the principal law governing drinking water safety in the United States.”²⁴ “The act required promulgation of primary drinking water regulations designed to ensure safe drinking water for consumers.”²⁵ One such rule is the Surface Water Treatment Rule and the inseparably-related Disinfectant and Disinfection Byproducts Rule. Specifically, Congress directed:

The [EPA] Administrator shall promulgate an Interim Enhanced Surface Water Treatment Rule, a Stage I Disinfectant and Disinfection Byproducts Rule, and a Stage II Disinfectant and Disinfection Byproducts Rule.²⁶

As a consequence of this Congressional mandate, the EPA promulgated a Surface Water Treatment Rule, an Interim Enhanced Surface Water Treatment Rule (IESWTR), a Long-Term1 Enhanced Surface Water Treatment Rule (LT1), a Long-Term 2 Enhanced

²² TE 27 October 2010 (P. Herbert) 11:23:08 – 11:23:52.

²³ See 42 U.S.C. Chapter 6A, Subchapter XII, § 300f *et seq.*

²⁴ Lauer, Scharfenaker, and Stubbart, *Field Guide to SDWA Regulations*, page 1 (American Water Works Association 2006).

²⁵ *Id.*

²⁶ 42 U.S.C. Chapter 6A, Subchapter XII, § 300g-1(b)(2)(C) (Disinfectants and disinfection byproducts).

Surface Water Treatment Rule (LT2), a Stage 1 Disinfectants/Disinfection By-product Rule (Stage 1 D/DBPR), and a Stage 2 Disinfection/Disinfection By-product Rule (Stage 2 D/DBPR).²⁷

Northern has three treatment plants, and it utilizes surface water as its source of water supply.²⁸ Consequently, Northern, which falls under the Safe Drinking Water Act, is subject to the Surface Water Treatment Rule and the inter-related Disinfectant and Disinfection By-product Rule.²⁹ During the evidentiary hearing, it became readily apparent that this Petition, in terms of funding for meeting water quality standards, relates to compliance with the Stage 2 of the Disinfectant/Disinfection By-product Rule (Stage 2 D/DBP).³⁰

A disinfectant is “a chemical (commonly chlorine, chloramines, or ozone) or physical process (e.g., application of ultraviolet light) that kills microorganisms such as bacteria, viruses, and protozoa.”³¹ When a disinfectant, such as chlorine, reacts with plant matter and other naturally occurring materials in the water, a chemical known as a disinfectant by-product may form.³² These disinfectant by-products “may pose health risks in drinking water.”³³

²⁷ *Field Guide to SDWA Regulations*, pages 22 to 26, 28, and 29.

²⁸ TE 27 October 2010 (R. Harrison) 13:02:00 – 13:02:55.

²⁹ *Id.*

³⁰ TE 27 October 2010 (R. Harrison) 13:07:50 *et seq.*; 13:09:25 *et seq.*; 13:16:30 – 13:17:07; and 13:27:50 – 13:29:14.

³¹ *Field Guide to SDWA Regulations*, Appendix B.

³² *Id.*

³³ *Id.*

Because of a concern that disinfectant by-products pose a health risk, the US Environmental Protection Agency has promulgated rules regarding the by-products. In promulgating the D/DBP Stage 2 Rule, the EPA convened a Federal Advisory Committee (which in layman's terms means that the EPA sought the participation of a variety of different groups in putting the rule together).³⁴ The EPA's rule-making was done through an open process (and consequent to an express Congressional mandate).

While anyone is free to question the balance struck (in terms of the cost versus health benefit) by D/DBP Stage 2,³⁵ the rule is the law that Northern must follow.³⁶ While the Attorney General certainly encourages Northern (and the water industry in general) to consider better tracking of the capital and O&M costs associated with compliance with the National Drinking Water Standards (for use in prospective rule-making), the Attorney General cannot state, suggest, infer, or otherwise imply that Northern should disobey this law which has been duly enacted after public participation in the rule-making process – regardless of any argument that the law is unfair.

³⁴ See Federal Register Vol. 65, No. 251, Friday, 29 December 2000 (83023) for list of Advisory Committee Members for the Stage 2 Rule.

³⁵ On this point, the EPA's projections of the cost of compliance with the various aspects of the Surface Water Treatment Rule and the stages of the D/DBP Rule are certainly open to debate if not some measure of skepticism.

³⁶ TE 27 October 2010 (R. Harrison) 13:17:10 – 13:18:35; (R. Lovan) 15:53:55 – 15:54:16; 15:57:00 – 15:57:22.

Conclusion

The Attorney General, for the foregoing reasons, requests the Commission give consideration to these observations while determining the merits of Northern's Petition.³⁷

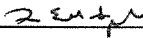
Notice of Filing, Certifications, and Notice of Service

Undersigned counsel provides this notice regarding the filing of material, certifications for the filing, and notice of the service of information to the other parties of record. Per Ordering paragraph 2 of the Commission's 27 April 2010 Order, the OAG files the original and one copy in paper medium and one copy in electronic medium. Per Ordering paragraph 6 of the April 27th Order, counsel certifies that the electronic version is a true and accurate copy of the material filed in paper medium, the electronic version has been transmitted to the Commission, and notice has been provided to the Commission and the other parties of record, by electronic mail, of the transmission. With regard to the electronic filing, in conformity with Ordering paragraph 4 of the February 16th Order, the OAG has submitted his electronic copies of the information by uploading the material to the PSC's Web Application Portal at https://psc.ky.gov/psc_portal/. The original and paper copy, the material will be filed at

³⁷ Northern has the burden of proof. KRS 278.190(3). The lack of discussion by the Attorney General regarding any aspect of Northern's Petition should not be taken as a concession or admission that Northern has satisfied its burden of proof on that point.

the Commission's offices on the next business day following the electronic filing (consistent with ordering paragraph 12 of the April 27th Order).

The OAG has provided notice to the Commission and other parties, by electronic mail, of this filing to: jnhughes@fewpb.net (Counsel for Northern) and dskavdahl@smithrolfes.com (Counsel for the Northern Kentucky Tea Party). The electronic filing took place on 30 November 2010 with the filing of the documents in paper medium scheduled for 1 December 2010.



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