COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY-AMERICAN WATER COMPANY FOR AN ADJUSTMENT OF RATES SUPPORTED BY A FULLY FORECASTED TEST YEAR	)	CASE NO. 2010-00036

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O R D E R

Kentucky-American Water Company ("Kentucky-American") proposes to adjust its base rates for water service and increase its tap-on fees. The proposed rates, which were based upon a fully forecasted test period ending September 30, 2011, would produce additional revenues of $25,848,286, or 39.9 percent, over forecasted operating revenues from existing water rates of $64,753,488.[1] By this Order, the Commission establishes rates for water service that will produce an annual increase in revenues from water sales of $18,825,137 and approves the requested increase in tap-on fees.

BACKGROUND

Kentucky-American, a Kentucky corporation, owns and operates facilities that treat and distribute water, for compensation, to approximately 118,759 customers in the counties of Bourbon, Clark, Fayette, Gallatin, Grant, Harrison, Jessamine, Owen, Scott,

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[1] As required by KRS 278.192(2)(b), Kentucky-American submitted its base period update on July 15, 2010 to report the actual results for the base period months that were originally forecasted. This update contains corrections of certain errors that result in a revised revenue increase of $25,302,362, or $545,924 below the originally proposed increase.

and Woodford.[2] It provides wholesale water service to Jessamine-South Elkhorn Water District, Harrison County Water Association, East Clark Water District, and the cities of Georgetown, Midway, Versailles, North Middletown, and Nicholasville.[3] It is a utility subject to Commission jurisdiction.[4] Kentucky-American last applied for a rate adjustment in 2008.[5]

PROCEDURE

On January 27, 2010, Kentucky-American notified the Commission in writing of its intent to apply for an adjustment of rates using a forecasted test period. On February 26, 2010, it submitted its application. The Commission established this docket[6] and permitted the following parties to intervene in this matter: the Attorney General of Kentucky ("AG"), Lexington-Fayette Urban County Government ("LFUCG"), and Community Action Council for Lexington-Fayette, Bourbon, Harrison, and Nicholas Counties, Inc. ("CAC").

On March 17, 2010, the Commission suspended the operation of the proposed rates for six months and established a procedural schedule for this proceeding. Following extensive discovery, the Commission held an evidentiary hearing in this

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[2] *Annual Report of Kentucky-American Water Company to the Public Service Commission for the Calendar Year Ended December 31, 2009* at 5, 30.

[3] *Id.* at 33.

[4] KRS 278.010(3)(d).

[5] Case No. 2008-00427, Application of Kentucky-American Water Company for A General Adjustment of Rates Supported by A Fully Forecasted Test Year (Ky. PSC Jun. 1, 2009).

[6] On February 16, 2010, the Commission granted Kentucky-American's request for the use of electronic filing procedures in this proceeding and authorization for the service of all documents upon all parties by electronic means only.

matter on August 10-11, 2010 in Frankfort, Kentucky.[7] We also held a public hearing in Lexington, Kentucky on July 28, 2010 to receive public comment on the proposed rate adjustment. All parties submitted written briefs following the conclusion of the evidentiary hearing.

On September 28, 2010, Kentucky-American notified the Commission of its intent to place the proposed rates into effect for service rendered on and after September 29, 2010. In response, we 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 twelve months ending September 30, 2011. The base period was the twelve months ending May 31, 2010.

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[7] The following persons testified at the evidentiary hearing: Patrick L. Baryenbruch, President, Baryenbruch & Company, LLC; Linda C. Bridwell, Manager-Water Supply, Kentucky-American; Keith Cartier, Vice-President of Operations, Kentucky-American; Paul R. Herbert, President, Valuation and Rate Division, Gannett Fleming, Inc.; Michael A. Miller, Assistant Treasurer, Kentucky-American; Sheila A. Miller, Manager-Rates and Service, Eastern Regional Service Company Office, American Water Service Company; Nick O. Rowe, President, Kentucky-American; John J. Spanos, Vice-President, Valuation and Rate Division, Gannett Fleming, Inc.; James L. Warren, Partner, Winston & Strawn LLP; Lance W. Williams, Director of Engineering, Kentucky-American; Ralph C. Smith, Senior Consultant, Larkin & Associates, PLLC; and Jack E. Burch, Executive Director, CAC. By agreement of the parties, the following persons submitted written testimony but did not make a personal appearance at the evidentiary hearing: James H. Vander Weide, Professor of Finance and Economics, Duke University; J. Randall Woolridge, Professor of Finance, Pennsylvania State University; Edward L. Spitznagel, Jr., Professor of Mathematics, Washington University; and Richard A. Baudino, Consultant, J. Kennedy and Associates, Inc.

Rate Base

Kentucky-American proposes a forecasted net investment rate base of $362,672,028.[8] The Commission accepts this forecasted rate base with the following exceptions:

Utility Plant in Service ("UPIS"). Kentucky-American uses capital construction budgets to determine its forecasted UPIS amount of $566,014,484.[9] A major component of Kentucky-American's forecasted UPIS is the $164 million cost of the Kentucky River Station II ("KRS II") project, which Kentucky-American placed into service on or about September 20, 2010. On April 25, 2008, the Commission granted Kentucky-American a Certificate of Public Convenience and Necessity to construct KRS II, approximately 30.6 miles of 42-inch transmission main to transport treated water to its Central Division distribution system, and a booster station in Franklin County.[10] Kentucky-American attributes $23,579,000, or approximately 91 percent, of its total requested rate increase of $25,848,000 to KRS II's construction and placement into service.[11]

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[8] Application, Exhibit 37, Schedule B-1 at 2.

[9] *Id.*

[10] Case No. 2007-00134, The Application of Kentucky-American Water Company For a Certificate of Convenience and Necessity Authorizing the Construction of Kentucky River Station II, Associated Facilities and Transmission Main (Ky. PSC Apr. 25, 2008).

[11] Direct Testimony of Michael A. Miller at 4.

Kentucky-American separates its construction budgets into three categories: normal recurring construction, construction projects funded by others,[12] and major investment projects. In prior rate proceedings, the Commission has adjusted forecasted UPIS to reflect 10-year historical trend percentages of actual-to-budgeted construction spending.[13] We noted:

> Budgeting being an inexact science, it is imperative that the historical relationship between the budgets and actual results be reviewed to determine what projects Kentucky-American is likely to have in service or under construction in the forecasted period. A forecasted period does not preclude the examination of historic data and trends but, rather, compels their examination to test the historic to forecasted relationships. Nor will an adjustment based on the historical slippage factor have a devastating impact on Kentucky-American's earning potential. Such an adjustment will have a minimal impact on revenue requirements by eliminating a return on utility plant not in service during the forecasted period due to delayed investment.[14]

These "slippage factors" thus serve as an indicator of Kentucky-American's accuracy in predicting the cost of its utility plant additions and the time period during which new plant will be placed into service.

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[12] Contributions in Aid of Construction or Customer Advances, which are forms of cost-free capital, fund these projects.

[13] Case No. 92-452, Notice of Adjustment of Rates of Kentucky-American Water Company, at 9-11 (Ky. PSC Nov. 19, 1993); Case No. 95-554, The Application of Kentucky-American Water Company to Increase Its Rates, at 2-3 (Ky. PSC Sep. 11, 1996); Case No. 97-034, The Application of Kentucky-American Water Company to Increase Its Rates, at 3-7 (Ky. PSC Sep. 30, 1997); Case No. 2000-120, The Application of Kentucky-American Water Company to Increase Its Rates, at 2-4 (Ky. PSC Nov. 27, 2000); and Case No. 2004-00103, Adjustment of the Rates of Kentucky-American Water Company, at 3-4 (Ky. PSC Feb. 28, 2005).

[14] Case No. 92-452, Order of Nov. 19, 1993, at 9.

Based upon the evidence in the record, we find the slippage factors for normal recurring construction and major investment projects are 120.86 percent and 90.80 percent, respectively.[15] By applying these factors to its capital construction budgets, Kentucky-American recalculated its forecasted UPIS to be $569,054,823, or $3,040,399 greater than the original forecasted UPIS of $566,014,484.[16]

The AG objects to the application of any slippage factor in the current proceeding. He contends that slippage factors were originally intended to protect ratepayers from Kentucky-American's historical tendency to overestimate its construction spending and to serve as a safeguard to ensure that ratepayers did not bear the cost of paying a return for UPIS that would not be placed in service in the test period.[17] A "reverse-slippage" adjustment, the AG asserts, is unnecessary because "slippage was never intended to be a double-edged sword that cuts both ways; rather, the intent of the factor was a scalpel for the purpose of excising the risk associated with Kentucky-American's over-budgeting in setting rates."[18]

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[15] Kentucky-American's Response to Commission Staff's First Information Request, Item 9.

[16] Kentucky-American's Response to Commission Staff's First Information Request, Item 36, Schedule B-1 at 2.

[17] AG's Brief at 18.

[18] *Id.*

We disagree with the proposition that slippage factors were intended solely to protect ratepayers. Their purpose is to produce a more accurate, reasonable, and reliable level of forecasted construction.[19] The application of slippage factors in this proceeding is consistent with that purpose and with the Commission's past practice in every rate case decision in which Kentucky-American proposed a rate adjustment based upon the use of a forecasted test period. Accordingly, we find that Kentucky-American's forecasted UPIS should be increased by $3,040,399 to reflect the application of slippage factors.

Accumulated Depreciation. In its application, Kentucky-American uses a 13-month average of its accumulated depreciation balances for the period from September 2010 through September 2011 to arrive at its forecasted accumulated depreciation of $110,085,251.[20] Adjusting Kentucky-American's forecasted accumulated depreciation to reflect the effect of construction slippages results in an increase of $62,956 for an adjusted balance of $110,148,207.[21]

In this application, Kentucky-American submits a recently completed depreciation study to support its forecasted depreciation. This study was based upon Kentucky-American's utility plant as of November 30, 2009.[22] In calculating the depreciation

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[19] *See, e.g.*, Case No. 95-554, Order of Sep. 11, 1996, at 5 ("The 10 year slippage factor . . . produces a more reliable estimate of the construction projects Kentucky-American will have in service or under construction in the forecasted period.").

[20] Application, Exhibit 37, Schedule B-1 at 2.

[21] Kentucky-American's Response to Commission Staff's Second Information Request, Item 36, Schedule B-1 at 2.

[22] John J. Spanos, *Depreciation Study - Calculated Annual Depreciation Accruals Related to Utility Plant at November 30, 2009*, at I-1 (Gannett Fleming, Inc. Feb. 18, 2010) ("*Depreciation Study*").

accrual rates in this study, however, Kentucky-American failed to consider KRS II's projected cost.[23] Kentucky-American subsequently revised its study to reflect the cost of its forecasted UPIS as of December 31, 2010, which included KRS II costs of $163,891,660.[24] This revision reduces forecasted accumulated depreciation by $130,773.[25]

While generally accepting the findings of Kentucky-American's revised depreciation study, the AG asserts that the findings regarding Account 333, Services, are unsupported by credible evidence and appear suspect.[26] He notes that Kentucky-American proposes a negative net salvage value of 100 percent for this account, which is much higher than the negative net salvage value for other accounts.[27] He further notes that the study is missing information from calendar years 1995, 1996, 1997, and 1998 and that, although the study period involved 30 years, approximately 42 percent of the regular retirements for Account 333 occurred in 2007 and 2008.[28] Finally, he notes that the three-year moving averages for Account 333 for the last three years vary

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[23] Direct Testimony of John J. Spanos at III-4 through III-11.

[24] Kentucky-American's Response to Commission Staff's Second Information Request, Item 43.

[25] E-mail from Lindsey Ingram III, Kentucky-American counsel, to Gerald Wuetcher, Commission Staff counsel (Sep. 15, 2010, 14:39 EDT).

[26] AG's Brief at 23.

[27] Public Direct Testimony of Ralph C. Smith at 69.

[28] *Depreciation Study* at III-106.

significantly from the study's findings.[29] Accordingly, the AG argues that Kentucky-American has failed to meet its burden of proof to demonstrate the reasonableness of the proposed depreciation rate for this account.

Notwithstanding the AG's argument, we find sufficient evidence to support the study's findings. We note that the study was based upon historical data gathered over a 30-year period and the study's methodology was systematically applied to all accounts. The AG has not suggested, nor do we find any evidence to indicate, that the utility concealed data or the report's preparers deliberately ignored data.[30] The AG has not suggested that the report's methodology was incorrectly applied or was contrary to industry-wide standards. Our review of the study indicates that its methodology is consistent with that of other depreciation studies that the Commission has accepted.[31]

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[29] AG's Brief at 23. The three year moving averages for Account 333 are shown below:

3 Year Periods	Negative Percentages
2005 – 2007	41%
2006 – 2008	17%
2007 – 2009	19%

[30] The AG's acceptance of the study's findings for accounts other than Account 333 weakens his argument regarding Account 333. Data for a four-year period was not available and therefore not used in the study to calculate net salvage value for several accounts. If the lack of available data does not render the study's findings invalid or suspect for these other accounts, it logically follows the lack of data should not affect the study's findings for Account 333.

[31] *See, e.g.*, Case No. 9093, Application of Kentucky-American Water Company for Certification of Depreciation (Ky. PSC Mar. 21, 1985); Case No. 90-321, Notice of Adjustment of The Kentucky-American Water Company Effective on December 27, 1990 (Ky. PSC May 30, 1991); Case No. 95-554, Order of Sep. 11, 1996; Case No. 2007-00143, Adjustment of Rates of Kentucky-American Water Company (Ky. PSC Nov. 29, 2007).

Accordingly, the Commission finds that the AG's proposed adjustments to accumulated depreciation should be denied. We further find that accumulated depreciation should be adjusted to reflect the impact of slippage and the results of the revised depreciation study, which results in a net decrease to accumulated depreciation expense of $67,817.

Construction Work in Progress ("CWIP"). Kentucky-American forecasts CWIP includable in rate base as $9,463,931.[32] When adjusted for slippage, CWIP balance is $9,438,488.[33]

Arguing that CWIP should not be included in rate base unless a utility demonstrates compelling reasons for that treatment, such as a large project that cannot be financed without seriously jeopardizing the utility's financial health, and that Kentucky-American has failed to offer such reasons, the AG proposes to eliminate all CWIP balance from Kentucky-American's rate base.[34] AG witness Smith argues that CWIP does not represent facilities that are used or useful in the provision of utility service.[35] Including this plant in rate base, he argues, requires current ratepayers to pay a return on plant that is not providing them with utility service. Moreover, he further argues, it creates a mismatch in the rate-making process by permitting a return on

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[32] Application, Exhibit 37, Schedule B-1, at 2.

[33] Kentucky-American's Response to Commission Staff's Second Information Requests, Item 36, at 4.

[34] Public Direct Testimony of Ralph C. Smith at 13; AG's Brief at 25-26.

[35] Public Direct Testimony of Ralph C. Smith at 14.

investment in facilities that will not be in service until after the close of the test period and that will serve new customers without consideration of the revenues that will be generated from those new customers or the possible reduction in present expense levels due to these facilities.[36]

We have previously addressed and rejected these arguments.[37] In the current proceeding, the AG has not produced, nor have we discovered, any legal authority to require us to alter our earlier holding and to find that the use of a forecasted test period prohibits the inclusion of CWIP in a utility's rate base.

We question why the inclusion of CWIP is acceptable when a historic test period is employed, but is unacceptable when a forward-looking test period is used. KRS 278.192 makes no such distinction. "[T]he 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."[38] Aside from the test period used, all other rate-making principles and methodologies should remain unchanged. The AG has provided no argument or legal authority to support a contrary result.

We also find no support for the proposition that inclusion of CWIP in rate base is limited to instances where the utility's financial health is at issue. Historically, we have permitted rate base recovery of CWIP, in large measure, to prevent rate shock. For example, in Case No. 10069, we stated:

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[36] *Id.* at 15.

[37] Case No. 2004-00103, Order of Feb. 28, 2005, at 11-12.

[38] *Id.* at 12.

> Kentucky-American is currently operating in a construction mode, which will require large additions to capital. In these circumstances rate base recovery of the actual end-of period CWIP results in a series of smaller rate increases rather than awaiting completion of the projects to impose one large rate increase. This is one of the reasons the Commission has historically allowed Kentucky-American to earn a return on its CWIP investment.[39]

Clearly, CWIP is not tied merely to the financial health of the regulated utility.

Finally, we find no merit in the AG's contention that the Commission's treatment of CWIP places an unfair and unnecessary burden on ratepayers. 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. 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.

Based upon the above, the Commission has decreased Kentucky-American's forecasted CWIP of $9,463,931 by $25,443 to recognize the effects of construction slippages.

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[39] Case No. 10069, Notice of Adjustment of the Rates of Kentucky-American Water Company, at 4-5 (Ky. PSC July 31, 1996).

Working Capital. Kentucky-American used a lead/lag study that employs the methodology approved in prior Kentucky-American rate proceedings to calculate cash working capital allowance. No party proposed adjustments to this methodology.[40]

In its application, Kentucky-American includes a cash working capital allowance of $2,634,000 in its forecasted rate base.[41] It subsequently reduced this amount by $493,000 to $2,141,000 to reflect the effect on cash working capital of its corrections to the forecasted operating expenses and to Annual Incentive Plan ("AIP") lag days.[42]

AG witness Smith recommends that Kentucky-American's working capital allowance be reduced by $980,000, to $1,654,000, to reflect the effects on working capital allowance of his other recommended adjustments.[43] He further recommends that the lead/lag study be updated to reflect the Commission's findings in this proceeding.[44]

After applying all reasonable and necessary adjustments to Kentucky-American's forecasted working capital calculation and correcting for the AIP lag days, the

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[40] AG witness Smith took exception to Kentucky-American's inclusion, with a zero-day payment lag, in the lead/lag study of non-cash items such as depreciation, amortization, deferred income taxes, and a return on equity. Recognizing that the Commission had accepted this practice in previous rate proceedings, he did not propose exclusion of these components. Public Direct Testimony of Ralph C. Smith at 17-18.

[41] Application, Exhibit 37, Schedule B, at 2.

[42] Base Period Update Filing, Exhibit 37, Schedule B, at 3 (filed July 15, 2010); Kentucky-American's Response to AG's Second Request for Information, Item 118.

[43] Public Direct Testimony of Ralph C. Smith at 19 and Exhibit RCS-1, Schedule B-3.

[44] *Id.* at 19.

Commission finds the appropriate working capital allowance to be $1,729,000, a decrease of $905,000 to Kentucky-American's forecasted level.

Contributions in Aid of Construction ("CIAC"). In its application, Kentucky-American includes CIAC of $48,865,890[45] as a reduction to rate base. We find that this amount should be increased by $916,100, to $49,781,990, to reflect the effects of construction slippage.[46]

Customer Advances. In its application, Kentucky-American identifies customer advances as $19,089,182.[47] The Commission finds that customer advances should be increased by $792,057, to $19,881,239, to reflect the effects of construction slippage.[48]

Deferred Maintenance. Kentucky-American incurs maintenance expenses (e.g., tank and hydrator painting and repairs, station cleaning) for which the Commission has historically allowed deferred accounting treatment. With such expenses, Kentucky-American is permitted annual recovery of allowed amortization expense. The unamortized balance of these expenses is generally included in rate base. All amounts allowed were based on actual costs from historical periods. In its application, Kentucky-American proposes the inclusion of $2,708,236 of deferred maintenance in its rate base.[49]

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[45] Application, Exhibit 37, Schedule B, at 2.

[46] Kentucky-American's Response to Commission Staff's Second Information Request, Item 36, Schedule B-1, at 2.

[47] Application, Exhibit 37, Schedule B, at 2.

[48] Kentucky-American's Response to Commission Staff's Second Information Request, Item 36, Schedule B-1, at 2.

[49] Application, Exhibit 37, Schedule B, at 2.

AG witness Smith proposes that Kentucky-American's deferred maintenance be reduced by 1.68 percent, or $45,500, to remove the internal labor costs.[50] In support of his recommendation, he notes that the Commission had held in Case No. 2000-120 that deferred labor expenses should not be included in a proposed acquisition adjustment[51] and that, in Kentucky-American's last rate proceeding, Kentucky-American had acknowledged that 1.68 percent of its 13-month average deferred maintenance cost balance represented deferred labor costs.

Opposing the proposed adjustment, Kentucky-American argues that AG witness Smith failed to make an independent calculation to determine if the 1.68 percent labor adjustment accurately reflects the portion of labor expense presently in deferred maintenance, but instead relied upon testimony and responses to discovery requests in a prior rate case.[52] In light of this failure and the lack of any other supporting evidence, Kentucky-American argues that Mr. Smith's testimony should be afforded little weight.

Kentucky-American further argues that the presence of a small labor component within deferred maintenance does not result in double recovery of labor expenses. Kentucky-American witness Michael Miller noted that Kentucky-American's forecasted test-year operation and maintenance labor is determined by applying an appropriate capitalization rate to total labor and labor-related benefit costs. Since the engineering

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[50] Public Direct Testimony of Ralph C. Smith at 19-20.

[51] Case No. 2000-00120, Order of May 9, 2001, at 8 (stating that "[t]o defer payroll expense between rate cases and then amortize those costs, in addition to the normal recurring payroll expense, would artificially inflate forecasted test year operations"); Public Direct Testimony of Ralph C. Smith at 20.

[52] Kentucky-American's Brief at 22.

costs charged to deferred maintenance, such as tank inspections, are embedded in the utility's capitalization rate, the utility is not recovering those costs as an expense in the forecasted test period, but is only recovering those costs through the amortization of the deferred maintenance over the life of the maintenance job.[53]

We find insufficient evidence to support the proposed adjustment. There is no evidence in the record to support the current level of labor costs within the deferred maintenance. Reliance upon a record developed almost two years ago is not sufficient. Moreover, we are not convinced that the presence of some labor expense in deferred maintenance will result in double recovery on the utility's part. Accordingly, we find that deferred maintenance of $2,708,236 should be allowed in rate base.

Deferred Taxes. In its application, Kentucky-American reduced rate base by accumulated deferred income tax of $40,026,731.[54] Included in deferred income taxes are items approved in prior rate cases: UPIS, deferred maintenance, and deferred debits.[55] Statement of Financial Accounting Standards 109 – Accounting for Income Taxes has been incorporated in the rate base deduction for income taxes and forecasted income tax expense.[56]

Accumulated deferred income taxes have been adjusted as shown in Table I to account for all adjustments made related to items affecting deferred taxes.

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[53] Rebuttal Testimony of Michael A. Miller at 18-19.

[54] Application, Exhibit 37, Schedule B-6, at 2.

[55] *Id.*

[56] Direct Testimony of Sheila A. Miller at 14.

Table I: Accumulated Deferred Income Taxes		
13-Month Average Accumulated Def. Inc. Tax - Application	$	40,026,731
Slippage		(1,474)
Deferred Compensation - Summary of Revisions		24
Adj. Dep. Rates for KRS II - Summary of Adjustments		73,262
Adj. Tax Exempt Finance - Summary of Revisions	+	(188)
Accumulated deferred Income Tax Adj.	$	40,098,355

Major Tax Accounting Change. On December 31, 2008, Kentucky-American, as a member of a consolidated group of American Water Works Company ("AWWC") subsidiaries, requested authorization from the Internal Revenue Service ("IRS") to change its accounting method for recording repairs and maintenance. Instead of capitalizing repairs and maintenance costs, the members of the consolidated group sought to deduct these costs in the current tax year. In February 2010, the IRS approved the request and Kentucky-American recognized a tax deduction for costs that previously were capitalized for tax purposes.[57] Kentucky-American and the other members of the consolidated group take the position, however, that the IRS ruling fails to address a critical component of the deduction calculation and that this failure creates uncertainty regarding the lawfulness of the deduction. In light of the uncertainty, Kentucky-American asserts, Financial Accounting Standards Board Interpretation No. 48 ("FIN 48") requires the creation of a reserve for a portion of the capitalized repairs deduction to permit payment of any potential tax liability.

[57] Kentucky-American's Response to the AG's Second Request for Information, Item 85 at 20-21.

FIN 48 requires entities to identify their uncertain tax positions, evaluate each position on its merits, and determine if the IRS is likely to sustain the deduction.[58] Kentucky-American contends that it is complying with FIN 48 by establishing a liability account to record the amount of deferred taxes that the IRS would likely deny.

There are two possible outcomes for the FIN 48 account. First, the uncertainty is removed by a formal IRS audit or the expiration of the statute of limitations or a change in existing tax laws. The FIN 48 entries are then reversed and treated as cost-free capital. Alternatively, the IRS disallows the deduction and eliminates the benefit to Kentucky-American. In that event, the interest rate that the IRS will apply is 4 percent, a rate significantly below Kentucky-American's requested weighted cost of capital of 8.58 percent. Kentucky-American has agreed not to seek recovery from its ratepayers if the IRS ultimately requires any interest or penalties on the FIN 48 account provided the Commission, pending a final IRS determination, makes no adjustment for rate-making purposes to Kentucky-American's deferred taxes because of the FIN 48 account.[59]

The AG asserts that the change in accounting method has been made and that Kentucky-American is realizing a benefit–a zero-cost capital–without passing this

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[58] Financial Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes (June 2006), available at http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820931560&blobheader=application%2Fpdf. On July 1, 2009, the Financial Accounting Standards Board ("FASB") finalized its Accounting Standards Codification ("ASC"), creating a new system of reference for all past FASB pronouncements. Under the new codification system, FIN 48 will now be referred to as ASC Topic 740, but many practitioners continue to use the "FIN 48" nomenclature.

[59] Kentucky-American's Brief at 20.

benefit to the ratepayers.[60] He proposes two options: (1) the Commission increases Kentucky-American's accumulated deferred income taxes by the FIN 48 liability and recognizes the benefit with an interest amount for the FIN 48 reserve that is recorded above the line; or (2) Kentucky-American records the interest below the line in tandem with the creation of a regulatory asset. If the first option is employed and IRS does not disallow the deduction, Kentucky-American would make a refund to its ratepayers. If the second option is selected and the IRS disallows the deduction and assesses interest against Kentucky-American, the utility may request recovery of the interest in a future rate case proceeding.[61]

Few regulatory commissions have addressed this issue in contested proceedings. Those commissions have been reluctant to apply the rate-making treatment that the AG proposes. Finding that utilities should be encouraged to take uncertain positions with the IRS since "ratepayers and shareholders benefit when . . . [a utility] takes an uncertain tax position with the IRS, because saving money on taxes benefits the company's bottom line and reduces the amount of expense the ratepayers must pay," the Missouri Public Service Commission rejected a proposed adjustment to recognize FIN 48 liabilities as deferred income taxes.[62] The Washington Utilities and

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[60] AG's Brief at 5-6.

[61] *Id.*

[62] In the Matter of Union Electric Company, d/b/a AmerenUE's Tariffs to Increase Its Annual Revenues for Electric Service, Case No. ER-2008-0318, slip. op. at 55 (Mo. PSC Jan. 6, 2009).

Transportation Commission rejected a similar proposal and noted the risks of recognizing IRS accounting changes before all uncertainty is eliminated.[63]

We agree with the holding of those decisions and decline to adopt the AG's proposed adjustment to Kentucky-American's accumulated deferred income taxes. Kentucky-American determined that some uncertainty exists regarding the legality of the deduction related to the change in accounting methods. No party challenges the reasonableness of this determination or the appropriateness of establishing a reserve in the event of an adverse IRS ruling. Kentucky-American's action, moreover, is consistent with FIN 48. If the IRS ultimately allows the deduction or the statute of limitations expires without a challenge to the deduction, ratepayers and shareholders will benefit from the tax deferral. If the IRS disallows Kentucky-American's deduction, Kentucky-American has stated that it will not seek recovery for interest and penalties imposed by the IRS and the ratepayers will not be negatively affected.

Deferred Debits. In its application, Kentucky-American includes $1,700,474 in rate base to reflect the unamortized 13-month average of several deferred debits. Approximately $2,342 of this amount represents the unamortized acquisition adjustment related to the purchase of Boonesboro Water Association's assets. Kentucky-American has acknowledged erroneously including this unamortized acquisition adjustment twice in rate base.[64] The AG proposes to reduce deferred debits by $2,342 to correct this

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[63] Washington Utilities and Transportation Commission v. Puget Sound Energy, Inc., Dockets UE-090704 and UG-090705, slip op. at 70 (Wash. UTC April 2, 2010).

[64] Kentucky-American's Response to Commission Staff's Second Information Request, Item 41.

error. Accordingly, the Commission finds that deferred debits should be reduced by $2,342.

Other Rate Base Elements. In its application, Kentucky-American included a reduction to rate base for "other rate base elements" in the amount of $2,349,854. Other rate base elements include contract retentions, unclaimed extension deposit refunds, accrued pensions, retirement work in progress, and deferred compensation. Kentucky-American subsequently discovered that the deferred compensation is no longer being deferred and that "other rate base elements" should be decreased by $188,379.[65] The correct amount of "other rate base elements" is $2,161,475. The Commission finds that other rate base elements should be reduced by $188,379, which results in an increase to rate base.

Based on the adjustments discussed above, the Commission has determined the company's net investment rate base to be as shown in Table II.

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[65] Rebuttal Testimony of Sheila A. Miller at 2; Kentucky-American's Response to AG's First Information Request, Item 25.

Table II: Rate Base Comparison			
Rate Base Component	Kentucky-American's Proposed 13-Month Average	Commission Adjustment	Commission Approved
UPIS	$ 566,014,484	$ 3,040,339	$ 569,054,823
Utility Plant Acquisition Adj.	2,342	0	2,342
Accumulated Depreciation	(110,085,251)	67,817	(110,017,434)
Net Utility Plant in Service	$ 455,931,575	$ 3,108,156	$ 459,039,731
CWIP	9,463,931	(25,443)	9,438,488
Working Capital Allowance	2,634,000	(905,000)	1,729,000
Other Working Capital	642,421	0	642,421
CIAC	(48,865,890)	(916,100)	(49,781,990)
Customer Advances	(19,089,182)	(792,057)	(19,881,239)
Deferred Income Taxes	(40,026,731)	(71,624)	(40,098,355)
Deferred Investment Tax Cr.	(76,952)	0	(76,952)
Deferred Maintenance	2,708,236	0	2,708,236
Deferred Debits	1,700,474	(2,342)	1,698,132
Other Rate Base Elements	(2,349,854)	188,379	(2,161,475)
Net Original Cost Rate Base	$ 362,672,028	$ 583,969	$ 363,255,997

Income Statement

For the base period, Kentucky-American reports operating revenues and expenses of $67,042,231 and $53,225,929, respectively.[66] Kentucky-American proposes several adjustments to revenues and expenses to reflect the anticipated operating conditions during the forecasted period, resulting in forecasted operating revenues and expenses of $68,523,625 and $53,050,358, respectively.[67] The Commission accepts Kentucky-American's forecasted operating revenues and expenses with the following exceptions:

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[66] Application, Exhibit 37, Schedule C-2.

[67] *Id.*

AFUDC. In its application, Kentucky-American proposes to increase forecasted operating revenues by $646,180[68] to include an allowance for AFUDC. In calculating this forecast, Kentucky-American uses the weighted cost of capital requested in this proceeding of 8.58 percent.[69] To reflect the effect of slippage on CWIP, Kentucky-American adjusts AFUDC by $35,177 for an adjusted level of $629,114.[70] Kentucky-American also reduces AFUDC by $957 to reflect its correction for deferred compensation and the additional tax-exempt financing it received.

To correspond with his adjustment to eliminate CWIP from rate base, the AG proposes to reduce Kentucky-American's operating revenues by $646,180 to move AFUDC to "below-the-line" non-operating revenues. 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." 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 rejection of 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. Using CWIP available for AFUDC and the overall rate of return of 7.74 percent, the Commission calculates a forecasted level of AFUDC of $611,003.

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[68] *Id.*, Schedule D-1, at 1.

[69] *Id.*, Schedule J-1.1/J-2.1, at 1.

[70] Kentucky-American's Response to Commission Staff's Second Information Request, Item 36, at 1.

This action, when combined with Kentucky-American's revisions, results in a decrease to Kentucky-American's forecasted operating revenues of $44,094.[71]

Labor Expense. In its application, Kentucky-American includes forecasted operations labor expense of $8,039,622. In forecasting its labor expense, Kentucky-American uses 153 full-time employees, each scheduled to work 2,088 regular hours. It also includes overtime for some employees based upon historical levels. Labor costs for the sewer operations were removed from the forecasted labor expenses.[72]

- Employee Vacancies. Kentucky-American contends that, with the use of a forecasted test period, two methods are available to address employee vacancies. First, it can project the salaries and wages based upon the assumption that all employee positions are filled. This method recognizes that, while vacancies may occur throughout the year, the job requirements associated with those vacancies continue to exist and must be met. Second, it can estimate the average number of vacancies expected to occur throughout the forecasted period and quantify the level of temporary and overtime labor that will be necessary to perform the tasks associated with the vacant position. Kentucky-American employed the first option in developing its forecasted labor expense.[73]

Proposing an adjustment to eliminate the average cost of three positions,[74] the AG takes exception to Kentucky-American's approach. He argues that some vacancies

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[71] $43,137 (Slippage) + $304 (Deferred Compensation) + $653 (Tax Exempt Financing) = $44,094.

[72] Direct Testimony of Sheila A. Miller at 6.

[73] Rebuttal Testimony of Sheila A. Miller at 6.

[74] Public Direct Testimony of Ralph C. Smith at 72-73.

should be expected at Kentucky-American throughout the year due to terminations, retirements, and changing work requirements, and affords little weight to Kentucky-American's claim that the utility has coordinated its assignment of a full-employee count with its projections of overtime and temporary employees. "[I]t does not follow," he argues, "that the items are mirror images of each other (i.e., that the dollar amounts are the same under either scenario)."[75] AG witness Smith proposed the adjustment based upon his review of Kentucky-American's historic employee vacancy rate.

The AG's proposed adjustment is similar to those that we have rejected in prior Kentucky-American rate proceedings because of its failure to "consider the vacancies' effect on Kentucky-American's overtime and temporary/contract forecasts."[76] 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.

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[75] AG's Brief at 27-28.

[76] Case No. 2004-00103, Order of Feb. 28, 2005, at 44. *See also* Case No. 95-554, Order of Sep. 11, 1996, at 32 ("The AG's proposed adjustment is flawed because it did not take into consideration the total 1995 labor costs.").

• Projected Pay Increases. AG witness Smith proposes a 0.4 percent reduction in the forecasted payroll expense to compensate for the utility's alleged historic over-projection of such expenses. He contends that Kentucky-American over-projected pay increases by 0.5 percent for union employees and 0.3 percent for non-bargaining unit employees for the years 2007-2009.[77] The AG argues that the variances are significant enough to warrant some adjustment in the rate-making process, at least in regard to those employees who are not under a collective bargaining agreement.[78] Although the AG states that Kentucky-American has shown in its rebuttal evidence that the contractual increases are known and certain and that they are reliable in setting rates, he nonetheless contends that the historical evidence of over-projection warrants an adjustment to the remaining non-contractual increases.

Opposing the proposed adjustment, Kentucky-American notes that pay increases for the union employees are pursuant to an existing union contract and are therefore certain and fixed. Its current contract with union employees requires a 3 percent increase for such employees. It further notes that its forecasted payroll expense for non-union employees is based upon quantifiable salary and wage increases.[79]

Having reviewed the record, we find insufficient evidence to support the forecasted payroll expense. The existing contract between Kentucky-American and Local Union 320 of the National Conference of Firemen and Oilers ended on

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77 Public Direct Testimony of Ralph C. Smith at 74.

78 AG's Brief at 28.

79 Rebuttal Testimony Sheila A. Miller at 7.

October 31, 2010.[80] The record contains no evidence that a new contract has been negotiated or the current contract extended. As Kentucky-American has asserted that projected pay increases for its salaried employees are intended to equal the projected increases to its union employees, its failure to adequately demonstrate that its contract with its union employees requires such increases casts doubt on the reasonableness of its projected increases for salaried employees. Given the lack of evidence on the certainty and reliability of the projected wage and salary increases, we find that the proposed increases should be removed from the forecasted test-period expenses. Elimination of the forecasted wage increases for all Kentucky-American employees, excluding three employees transferred to American Water Works Service Company ("Service Company"), results in a decrease to forecasted labor expense of $186,828.[81]

- <u>Capitalization Rate</u>. In its application, Kentucky-American uses a capitalization rate of 17.34 percent to apportion the forecasted payroll between the operation and maintenance expense account and the capital accounts. It subsequently revised this rate to 17.8 percent to reflect the transfer of three employee positions from Kentucky-American to the Service Company.[82]

Witnesses for the AG and LFUCG dispute the proposed capitalization rate. AG witness Smith proposes a capitalization rate of 19.472 percent. He contends that

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[80] Kentucky-American's Response to Commission Staff's First Request for Information, Item 20, at 2-26.

[81] Assuming arguendo that Kentucky-American had provided sufficient evidence to demonstrate the certainty of the proposed increases, the Commission has concerns regarding the reasonableness of the magnitude of the proposed increase in labor expense in light of present economic conditions, both locally and nationally.

[82] Rebuttal Testimony of Sheila A. Miller at 9.

Kentucky-American's capitalization rate has fluctuated significantly in the last five years and that Kentucky-American's budgeted capitalization rates have been below actual rates for the three-year, four-year, and five-year averages through 2009.[83] In lieu of the forecasted rate of 17.8 percent, Mr. Smith proposes the use of a capitalization rate based upon a five-year average. LFUCG witness Baudino expresses similar concerns and recommends the same adjustment.[84]

Responding to these arguments, Kentucky-American notes that the capitalization rate depends on several factors, including the construction budget, the number of water main breaks that are expensed in capital accounts, and the number of water main extensions that developers fund.[85] While conceding that the capitalization rate for the forecasted period is lower than the rate presented in its last rate case proceeding, it asserts that this change is attributable to the addition of seven new employees who will be responsible for KRS II's operation.[86] If these seven new employees devote their total time to operation and maintenance functions, Kentucky-American asserts, the percentage of operation and maintenance expense must increase and the capitalization rate correspondingly decrease.

The Commission finds that Kentucky-American's explanation is reasonable and consistent with the evidence of record and the expected operation of KRS II. While the

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[83] Public Direct Testimony of Ralph C. Smithat 69.

[84] Direct Testimony of Richard A. Baudino at 48-50.

[85] Kentucky-American Brief at 26-28.

[86] Kentucky-American's Response to Commission Staff's Second Request for Information, Item 13(b).

use of averages may be appropriate to identify an area for further review, it is not sufficient to justify the proposed adjustment. Given the wide array of factors that affect the capitalization rate and the failure of the AG and LFUCG to provide any evidence on those factors, we find insufficient evidence to support the proposed increase in the forecasted capitalization rate and deny the proposed adjustment.

- Employee Transfer. Since the filing of Kentucky-American's application, three positions on Kentucky-American's payroll have been transferred to the Service Company's payroll.[87] These transfers reduce Kentucky-American's forecasted payroll expense by $240,001.[88] The Commission finds that an adjustment to reflect the employee transfer should be made to Kentucky-American's forecasted labor expense and, therefore, accepts Kentucky-American's proposed reduction of $240,001 to reflect the transfer of the three Kentucky-American employees to the Service Company.

- Incentive Compensation Plan ("ICP"). In its forecasted labor expense, Kentucky-American includes an expense of $349,529 related to incentive compensation.[89] The AG proposes the removal of this expense from forecasted labor expense. Noting that funding for any AIP award is based upon the utility meeting threshold targets tied to the utility's Diluted Earnings Per Share, the AG contends that the AIP's sole purpose is enhancing shareholder value and return. To the extent that the program primarily benefits shareholders, the AG argues, shareholders should bear

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[87] Rebuttal Testimony of Sheila A. Miller at 4-5.

[88] E-mail from Lindsey Ingram III, Kentucky-American counsel, to Gerald Wuetcher, Commission Staff counsel (Sep. 15, 2010, 14:39 EDT).

[89] Kentucky-American's Response to Commission Staff's First Request for Information, Item 1(a), WP 3-2, at 2.

the burden of funding the program.[90] The AG further argues that Kentucky-American has failed to offer any quantitative support for its claims that AIP benefits ratepayers and, therefore, has failed to meet its burden to demonstrate the reasonableness of the expense.

Kentucky-American takes strong exception to the AG's contentions. It argues that the AIP is part of Kentucky-American's overall compensation package for its employees. AIP is intended, it asserts, to benefit customers through better service and more efficient costs. The program's incentives are directly tied to an employee's performance above the standard duties in his job description. The AIP and other incentive programs, Kentucky-American further argues, are necessary because the utility must compete for qualified employees in the markets in which it operates. The lack of such programs would limit its ability to attract and retain strongly performing employees when other surrounding businesses offer more competitive compensation packages.[91]

Kentucky-American argues that the AG has incorrectly concluded from the use of financial targets in the AIP program that the program's sole purpose is increasing stockholder value. While acknowledging that incentives are awarded only if the company meets certain financial targets, Kentucky-American asserts that targets are present only to ensure that the utility is fiscally able to award the incentive

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[90] AG's Brief at 12-13.

[91] Kentucky-American's Response to Commission Staff's Second Information Request, Item 4.

compensation.[92] To do otherwise, it argues, would be financially irresponsible. Furthermore, Kentucky-American argues, several non-financial factors, such as safety, environmental goals, customer satisfaction, business transformation, and diversity, also determine the size of the incentive compensation pool.[93] Once financial targets are met and the utility is thus deemed to be financially fit to award incentives, the incentives are awarded solely on an employee satisfying or exceeding individual performance goals pertaining to specific areas of responsibility for the employee.[94]

In prior proceedings, the Commission has refused to permit Kentucky-American's recovery of AIP costs through rates and has placed the utility on notice that "[t]he mere existence of such [incentive compensation] plans is insufficient to demonstrate that they benefit ratepayers and that their costs should be recovered through rates" and that the utility must demonstrate why shareholders should not bear the costs associated with such plans.[95]

To meet this burden, Kentucky-American produced a study that allegedly "identified and quantified the benefits that inure to ratepayers pursuant to the incentive compensation plan."[96] This study compares the cumulative increase in Kentucky-

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[92] Rebuttal Testimony of Michael A. Miller at 29-30.

[93] *Id.*

[94] *Id.* at 27.

[95] Case No. 2004-00103, Order of Feb. 28, 2005 at 49; *see also* Case No. 2000-120, Order of Nov. 27, 2000, at 44 (placing Kentucky-American "on notice that, in future rate proceedings, it must demonstrate fully why shareholders should not bear a portion of these costs").

[96] Kentucky-American's Brief at 52; Rebuttal Testimony of Michael A. Miller, Exhibit MAM-6.

American's operation and maintenance expense per customer to the cumulative increase in the Consumer Price Index ("CPI") for the five-year period from 2004 through 2009. Kentucky-American claims that its study demonstrates that, since 2005, Kentucky-American's increases in operation and maintenance costs per customer have consistently been below those of the CPI and that the utility has "successfully been able to resist cost increases more successfully than others."[97]

The study's results are inconclusive at best. For three years of the five-year period that the study considered, Kentucky-American's operations and maintenance expense on a per-customer basis increased at an annual rate that exceeded the annual increase in CPI. Kentucky-American's cumulative increase in operation and maintenance expense for the five-year period exceeded the cumulative increase in the CPI. Furthermore, the study fails to demonstrate any correlation between the rate of increase in its operation and maintenance expense per customer and its use of incentive compensation plans. It provides no comparison between its performance during the study period and that of firms that offer no incentive compensation plan to their employees. It makes no effort to eliminate or isolate the effects of other factors, such as AWWC's reorganization efforts, on Kentucky-American's operation and maintenance costs per customer.

We remain unconvinced that Kentucky-American's ratepayers receive any benefit from the AIP program to support the recovery of AIP's costs through rates. While some consideration is given to non-financial criteria, the AIP appears weighted to financial goals that primarily benefit shareholders. If these goals are not met, the

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[97] Kentucky-American's Brief at 52.

program is unfunded and no Kentucky-American employee receives an incentive award regardless of how well he or she meets the customer satisfaction or service quality goals. Accordingly, we find that forecasted labor expense should be decreased by an additional $349,529 to eliminate the ICP.

- Stock-Based Compensation. Kentucky-American includes stock-based compensation of $27,228 in forecasted labor expense. This compensation involves stock-based awards and grants of stock options to employees based upon the attainment of performance goals or other conditions. The purpose of Kentucky-American's stock-based compensation plan is to "encourage the participants to contribute materially to the growth of the Company, thereby benefiting the Company's stockholders, and will align the economic interest of the participant with those stockholders."[98]

Arguing that this program primarily benefits shareholders, the AG proposes the removal of this program's costs from forecasted labor expense.[99] Opposing the proposed adjustment, Kentucky-American contends that the program benefits ratepayers by increasing management personnel's investment in the company. If management views itself as a stakeholder in the company, Kentucky-American argues, it will perform to maximize the company's success by increasing efficiency, productivity, and cost containment actions that also benefit ratepayers.

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[98] Kentucky-American's Response to AG's First Request for Information, Item 15, at 25.

[99] Public Direct Testimony of Ralph C. Smith at 46-47.

The Commission finds that, based upon the stated purpose of the program, the program primarily benefits shareholders. In the absence of clear and definitive quantitative evidence demonstrating a benefit to the utility's ratepayers, the ratepayers should not be required to bear the program's costs. Accordingly, we find that forecasted labor expense should be decreased by $27,288 to eliminate the stock-based compensation plan.

Fuel and Power. In its forecasted operations, Kentucky-American includes fuel and power expense of $4,375,584. It used an unaccounted-for water loss percentage of 14 percent to forecast pumpage.[100] Kentucky-American's present unaccounted-for water loss is 11.8 percent.[101] Using this percentage, Kentucky-American calculated a revised fuel and power expense of $4,297,587, which is $77,997 below its original forecast.[102] Accordingly, the Commission finds that Kentucky-American's forecasted fuel and power expense should be decreased by $77,997.

Chemicals. In its forecasted operations, Kentucky-American included chemical expense of $1,772,730. As with its forecasted fuel and power expense, Kentucky-American used an unaccounted-for water loss of 14 percent to forecast chemical

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[100] Kentucky-American's Response to Commission Staff's First Request for Information, Item 1(a), WP 3-2, at 18.

[101] VR: 8/10/10; 15:45:45 -15:46:05. The present level represents a significant achievement for Kentucky-American. For the three-year period from January 1, 2006 through December 31, 2008, Kentucky-American's average line loss was 13.51 percent. For the year ending December 31, 2006, Kentucky-American experienced a line loss of approximately 14.94 percent. The Commission applauds Kentucky-American's efforts in this area.

[102] Kentucky-American's Response to Hearing Data Requests, Item 7, at 1.

expense.[103] Using the current water-loss percentage of 11.8 percent, Kentucky-American calculated a revised chemical expense of $1,729,077, which is $43,653 below its original estimate.[104] Accordingly, the Commission finds that Kentucky-American's forecasted chemical expense should be decreased by $43,653.

Waste Disposal. In its forecasted operations, Kentucky-American includes waste disposal expense of $340,226. This expense includes the amortization of the forecasted cost of $245,000 over a 24-month period, or $122,500, for the cleaning of Kentucky River Station I's lagoon in June 2011.[105] Kentucky-American developed its forecasted cost by averaging the three lowest bids received for lagoon cleaning in 2009.[106]

The AG offers two alternative methods to the forecasted expense. AG witness Smith argues that the most appropriate means to forecast the expense is to average the actual costs of the four lagoon cleanings that have occurred since 2001. He proposes an annual cost of $90,000, which is the average cost of the last four lagoon cleanings, amortized over 24 months.[107] The AG also suggests that this expense be based upon the lowest bid that Kentucky-American received for lagoon cleaning conducted in

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[103] Kentucky-American's Response to Commission Staff's First Request for Information, Item 1(a), WP 3-3.

[104] Kentucky-American's Response to Hearing Data Requests, Item 7, at 1.

[105] Kentucky-American's Response to Commission Staff's First Request for Information, Item 1(a), WP 3-4.

[106] Rebuttal Testimony of Keith Cartier at 2.

[107] Public Direct Testimony of Ralph C. Smith at 76-77.

2009.[108] This methodology produces the same result as AG witness Smith recommends.

Noting that AG witness Smith's methodology requires the use of dated and potentially inaccurate information, Kentucky-American opposes the proposed adjustment. Kentucky-American witness Cartier testified that lagoon cleaning occurs approximately every three years. Relying on the average cost of the four prior lagoon cleanings as the AG recommends requires reliance on some cost information that is at least twelve years old and that does not consider the effects of inflation or changing market conditions.[109]

The Commission finds that Kentucky-American's methodology for forecasting lagoon cleaning expense is reasonable and further finds that the AG's proposed methodology, as it fails to consider the effects of inflation and relies upon dated information, is inappropriate. Accordingly, we decline to accept the AG's proposed adjustment to Kentucky-American's forecasted waste disposal expense.

Management Fees. Kentucky-American has included management fee expense of $9,028,121 in its forecasted operations.

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[108] AG's Brief at 28.

[109] Rebuttal Testimony of Keith Cartier at 1-2.

- Revised Service Company Budget. The AG proposes to decrease forecasted management fees by $133,865 to reflect adjustments in the Service Company's budget.[110] Kentucky-American does not contest the proposed adjustment.[111] Kentucky-American informed the Commission that its forecasted management fee should be reduced by $133,865 to reflect a revision to the Service Company budget that had been finalized after the application in this proceeding had been filed. Accordingly, the Commission has decreased Kentucky-American's forecasted management fee by $133,865 to reflect the updated actuarial information.

- ICP and Stock-based Compensation. Included in Kentucky-American's management fee forecast is incentive compensation of $436,987 and stock-based compensation of $179,208. For reasons previously stated,[112] the Commission finds that Kentucky-American's forecasted management fee should be decreased by $616,195 to eliminate the ICP and stock-based compensation plan.

- Donations and Miscellaneous Expenses. The AG proposes a reduction of $65,793 in management fees to eliminate charitable contributions, advertising, dues and other miscellaneous expenses.[113]

Kentucky-American opposes the proposed adjustment as it relates to advertising expenses, membership dues, and employee meals. As to the proposed removal of

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[110] Public Direct Testimony of Ralph C. Smith, Exhibit RCS-1, Schedule C-6.

[111] Rebuttal Testimony of Michael A. Miller at 47-48.

[112] *See supra* text accompanying notes 89-99.

[113] Public Direct Testimony of Ralph C. Smith at 56-58; Exhibit RCS-1, Schedule C-8.

advertising expenses of $11,909, Kentucky-American witness Michael Miller testified that these expenses consisted primarily of job placement ads and are related to recruitment and hiring efforts to maintain adequate personnel staffing.[114] As to the membership fees of $23,961,[115] which include memberships for Service Company employees in the American Bar Association, American Water Works Association, Kentucky Bar Association, and American Institute of Certified Public Accountants, Kentucky-American asserts that the memberships are necessary to ensure professional certification for the Service Company employees and to ensure these employees have access to valuable and pertinent information in their respective fields and the water industry and, therefore, benefit ratepayers.[116] Finally, Kentucky-American notes that it and the Service Company have policies prohibiting reimbursement for any meals except those having a legitimate business purpose and the meals in question complied with those policies.

The Commission finds that the expenses at issue that are related to advertising expenses, membership dues, and employee meals should not be disallowed or excluded. The record contains substantial evidence that each is for legitimate purposes. The AG has presented no evidence to support a contrary finding. We find the advertising expenses in question relate to a legitimate business function and provide a material benefit to Kentucky-American customers. We further find that recovery of

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[114] Rebuttal Testimony of Michael A. Miller at 53.

[115] For a list of these organizations, see Kentucky-American's Response to AG's First Request for Information, Item 1a.

[116] *Id.*

fees related to an employee's membership in a professional organization is generally appropriate and beneficial to ratepayers in those instances in which the employee's membership is required to comply with professional licensing requirements or provides the employee access to technical training and assistance in specialized areas involving utility management or operations.

As to the other items that the AG has identified, the Commission finds those expenses are not appropriately borne by ratepayers and that Kentucky-American's forecasted management fee should be decreased by $9,735[117] to reflect their removal.

- Business Development. In its forecasted management fee, Kentucky-American includes business development costs of $223,380 that the Service Company has allocated to Kentucky-American. Of this amount, the Commission has deducted $23,834 to reflect the elimination of costs related to AIP or stock-based compensation.[118]

AG witness Smith proposes a further reduction of business development costs of $198,342. He contends that these expenses are "unnecessary for the provision of safe, reliable and reasonably priced water and wastewater utility service in Kentucky."[119] In his brief, the AG argues that business development advances the interest of shareholders and that such activity contains no assurance or certainty of benefits for Kentucky-American ratepayers. Until Kentucky-American has demonstrated a clear

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[117] $4,728 (Charitable Contributions) + $3,499 (Community Relations) + $1,427 (Company Dues Membership) + $81 (Penalties) = $9,735.

[118] *See supra* text accompanying notes 86-96; Public Direct Testimony of Ralph C. Smith, Exhibit RCS-1, Schedule C-7.

[119] Public Direct Testimony of Ralph C. Smith at 56.

benefit to ratepayers, he further argues, these costs should not be assigned to ratepayers.

Opposing the proposed adjustment, Kentucky-American contends the proposal is unsupported and contrary to the existing evidence. It notes that AG witness Smith made no effort to determine what comprises business developments costs and has not performed an independent analysis to determine if the ratepayers benefited from those activities.[120] It further contends that Kentucky-American's existing customers benefit from the revenue growth produced from development activities and from efficiency gains, cost-saving measures and growth that acquisitions spur. It noted that Kentucky-American's recent contract to perform billing services for LFUCG will provide $364,000 in annual revenues and will benefit ratepayers by reducing Kentucky-American's revenue requirement.[121]

The Commission has previously placed Kentucky-American on notice that business development expenses allocated to the utility from the Service Company would be considered reasonable and appropriate for rate recovery only in those instances in which the utility was able to "appropriately document and separate forecasted management fees between those that are directly assignable and those that are allocated."[122] In the present proceeding, the Commission sought a detailed listing and description of business development costs included in forecasted management

[120] Rebuttal Testimony of Michael A. Miller at 51.

[121] *Id.* at 51-52.

[122] Case No. 2004-00103, Order of Feb. 28, 2005, at 53. Placing this burden upon Kentucky-American is consistent with Kentucky-American's statutory duty as an applicant to demonstrate that its proposed rates are reasonable. *See* KRS 278.190(2).

fees. Kentucky-American provided a breakdown of the business development costs by object account but could not describe the business development services that would be provided for each identified cost.[123]

In light of its failure to identify or describe the business development services that the Service Company provides, we find that Kentucky-American has failed to meet its burden to demonstrate the reasonableness of the business development expenses and that the AG's proposed adjustment to reduce forecasted management fees by $198,342 should be accepted.

- Employee Transfer. To reflect the transfer of three employees from Kentucky-American to the Service Company, Kentucky-American proposes to increase management fees by $370,765.[124] The Commission finds that Kentucky-American's forecasted management fee should be increased by $370,765 to reflect the transfer of three Kentucky-American employees to the Service Company.

- Labor Costs. LFUCG witness Baudino proposes a reduction of $2,146,000 in management fee expense to eliminate the labor allocations that Kentucky-American has failed to show were prudently incurred. He testified that Kentucky-American's application indicates that the Service Company labor costs are greater than if no reorganization or restructuring of Kentucky-American and the Service

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[123] Kentucky-American's Response to Commission Staff's Second Information Request, Item 20(c).

[124] E-mail from Lindsey Ingram III, Kentucky-American counsel, to Gerald Wuetcher, Commission Staff counsel (Sep. 15, 2010, 14:39 EDT).

Company had occurred and that none of the stated benefits of the restructuring justify the greater level of costs.[125]

The Commission finds that LFUCG has not provided sufficient evidence to support the proposed adjustment. In his testimony, Mr. Baudino provides little justification or factual evidence to support his position. Moreover, he ignores the previously filed testimony of Kentucky-American witness Baryenbruch, who testified extensively on the benefits that the Service Company provides to Kentucky-American and who concluded that Kentucky-American's arrangement with the Service Company resulted in a savings of $1.5 million to Kentucky-American and its ratepayers. In light of the absence of any attempt to contradict or rebut Mr. Baryenbruch's findings, we afford little weight to Mr. Baudino's testimony on this issue and decline to make the proposed adjustment.

Group Insurance. Kentucky-American included in its forecasted operations group insurance expense of $2,313,543.[126] The forecasted expense is comprised of group insurance costs for the current associates and post-retirement employee benefit costs ("OPEB") for Kentucky-American's current and retired employees. Kentucky-American based OPEB expense upon the projections of the actuarial firm of Towers Watson. The current group insurance costs reflect the use of Kentucky-American's current group insurance premium statement rates in effect as of January 1, 2010.[127] After filing its application, Kentucky-American proposed to decrease forecasted group

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[125] Direct Testimony of Richard A. Baudino at 44-46.

[126] Application, Exhibit 37, Schedule C-2.

[127] Direct Testimony of Sheila A. Miller at 5-6.

insurance by $52,206[128] to reflect the latest Towers Watson actuarial projections for the forecasted test year[129] and by an additional $47,202[130] to reflect the transfer of three employees to the Service Company.[131] Group insurance expense has been decreased by an additional $65,247 to reflect the elimination of projected employee wage increases. The Commission finds that these proposed adjustments are reasonable and that Kentucky-American's forecasted group insurance expense should be decreased by $164,835.

Pension. Kentucky-American includes pension expense of $1,267,732 in its forecasted operations.[132] Towers Watson's projected pension costs are allocated to each of AWWC's subsidiaries based upon the ratio of valuation earnings for that company to total valuation earnings for AWWC.[133] After filing its application, Kentucky-American proposed to decrease forecasted pension expense by $253,262 to reflect

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[128] Kentucky-American's Response to Commission Staff's Second Information Request, Item 23.

[129] Rebuttal Testimony of Michael A. Miller at 38; Kentucky-American's Response to Commission Staff's Second Request for Information, Item 23; Kentucky-American's Response to AG's Second Request for Information, Item 67(e).

[130] $42,300 (Group Insurance) + $3,995 (401(k) + $846 (DCP) + $61 (Retiree Medical) = $47,202.

[131] E-mail from Lindsey Ingram III, Kentucky-American counsel, to Gerald Wuetcher, Commission Staff counsel (Sep. 15, 2010, 14:39 EDT).

[132] Direct Testimony of Michael A. Miller at 28.

[133] KAWC's Response to Commission Staff's First Information Request, Item 1(a) Workpaper WP3-7, at 3.

Towers Watson's most recent projections[134] and by an additional $56,027 to reflect the transfer of the three employees to the Service Company.[135] Pension expense has been decreased by an additional $29,407 to reflect the elimination of the employee wage increases. The Commission finds that these proposed adjustments are reasonable and that Kentucky-American's forecasted pension expense should be decreased by $340,751.

Regulatory Expense. Kentucky-American includes regulatory expense of $366,462 in its forecasted operations.[136] This forecasted expense includes the cost of its depreciation study, amortized over a five-year period; the preparation and litigation costs of the present case,[137] amortized over a three-year period; and the amortized rate case expenses associated with its previous two rate cases. Since filing its application, Kentucky-American has proposed to adjust the forecasted level to $391,328 to correct its failure to include the final two months of amortization of rate case expenses for Case No. 2007-00143.[138] Following the evidentiary hearing in this matter, Kentucky-American

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[134] Rebuttal Testimony of Michael A. Miller at 38; Kentucky-American's Response to Commission Staff's Second Request for Information, Item 23.

[135] E-mail from Lindsey Ingram III, Kentucky-American counsel, to Gerald Wuetcher, Commission Staff counsel (Sep. 15, 2010, 14:39 EDT).

[136] Kentucky-American's Response to Commission Staff's First Request for Information, Item 1(a), W/P 3-8, at 1; Rebuttal Testimony of Michael A. Miller at 38-39.

[137] Kentucky-American originally projected the level of this expense at $590,000. Kentucky-American's Response to Commission Staff's First Request for Information, Item 1(a), W/P 3-8, at 2.

[138] E-mail from Lindsey Ingram III, Kentucky-American counsel, to Gerald Wuetcher, Commission Staff counsel (Sep. 15, 2010, 14:39 EDT); Kentucky-American's Response to AG's Second Request for Information, Item 69(e).

revised its forecast of preparation and litigation costs of the present case to $553,121, which is $36,879 below its original projection.[139]

The AG objects to the inclusion of all rate case expenses associated with Cases No. 2007-00143 and No. 2008-00426. He notes that in neither proceeding did the Commission make a finding regarding the reasonableness of these expenses, expressly authorize their recovery through general rates, or authorize Kentucky-American to record the costs as regulatory assets. Furthermore, the AG contends, as both cases involved settlement agreements which were silent on the recovery of rate case expenses, Kentucky-American's current efforts to recover the rate case expenses constitute an attempt to unilaterally amend the settlement agreements in those proceedings.[140]

Responding to the AG's objection, Kentucky-American argues that longstanding Commission precedent supports the practice of amortizing over a three-year period reasonably incurred rate case expenses.[141] It has provided evidence that the expenses in question were incurred in the course of preparing for and litigating rate case proceedings. It further notes that the AG has presented no evidence in this proceeding to suggest that the expenses in question were not incurred or were unreasonable. While the issues in Cases No. 2007-00147 and No. 2008-00426 were resolved by settlement agreements that were silent on the issue of rate case expenses, Kentucky-American notes, no party in those proceedings contested Kentucky-American's

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[139] Kentucky-American's Response to Hearing Data Requests, Item 20.

[140] AG's Brief at 15-16; Public Direct Testimony of Ralph C. Smith at 60-61.

[141] Kentucky-American's Brief at 36 & n.49.

recovery of rate case expenses through general rates. It is unreasonable, Kentucky-American asserts, that shareholders should bear the full cost of these rate cases because those cases ended in agreement.[142]

It is a well-settled principle of utility law that rate case expenses "must be included among the costs of operation in the computation of a fair return."[143] Kentucky-American, however, has presented no evidence to demonstrate that the rates agreed to and approved in Cases No. 2007-00147 and No. 2008-00426 failed to include rate case expense. As the settlement agreement in each proceeding is silent on this issue, we cannot assume that parties agreed to the amortization of rate case expense any more than we can assume that parties did not establish rates providing for the immediate expensing of the full rate case expense. Accordingly, we find that the AG's proposed adjustment should be accepted.

Any utility that enters a settlement agreement in a rate case proceeding and wishes to amortize the rate case expense incurred in that proceeding should ensure that the settlement agreement specifically addresses the issue of rate case expenses <u>or</u> request the creation of a regulatory asset for its rate case expenses for accounting purposes. Such practice is consistent with our prior holdings that the establishment of a regulatory asset for accounting purposes is a pre-condition for rate recovery in a later

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[142] Rebuttal Testimony of Michael A. Miller at 43.

[143] *West Ohio Gas Co. v. Public Utilities Comm'n*, 294 U.S. 63, 74 (1935).

rate case proceeding and that the Commission's prior approval is necessary before the establishment of a regulatory asset.[144]

The AG further proposes a 30.4 percent reduction of Kentucky-American's forecasted rate case expense amortization amount for the current case. He asserts that Kentucky-American has consistently overstated its forecasted rate case expenses. He proposes to normalize the current estimated rate case expense using the ratio of actual costs to projected costs from Kentucky-American's last two general rate case proceedings.[145]

For several reasons, we find no merit in this proposal. First, the Commission has historically used actual costs to determine rate case expense, even in proceedings in which a forward-looking test period is used. This practice ensures greater accuracy than the normalization method that the AG proposes. Second, the rate case proceedings which the AG uses to develop his normalization ratio ended with settlement agreements and truncated hearings. Those proceedings generally do not require extensive hearing preparation or the preparation of written briefs and hence the level of expense incurred in them is generally much less than fully contested rate case proceedings. Third, normalization implicitly assumes that all rate cases are roughly equivalent. In practice, the number and complexity of issues, the intensity of discovery, and the number of parties in a proceeding, all factors affecting rate case expense, may significantly vary. Fourth, as normalization generally involves an average of historical

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[144] *See, e.g.*, Case No. 2003-00426, Application of Louisville Gas and Electric Company for an Order Approving an Accounting Adjustment to Be Included in Earnings Sharing Mechanism Calculations for 2003, at 4 (Ky. PSC Dec. 23, 2003).

[145] Public Direct Testimony of Ralph C. Smith, Exhibit RCS-1, Schedule C-11.

costs, it will not reflect inflationary increases in the legal, accounting and other costs that are incurred in preparing and litigating a rate case proceeding.

The AG has further proposed that we abandon our long-standing practice of amortizing rate case expense and, instead, normalize that expense. Through normalization, Kentucky-American would be entitled to recover not the historical amount of the expenditure but a future amount that the Commission deems reasonable. Much like 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 since those accounts would no longer be recorded on Kentucky-American's books. He asserts that "the purpose of the rate case allowance should be to include in rates a representative and normal annual level of reasonably and prudently incurred regulatory expense, rather than to provide the utility with a single-issue focus and what could otherwise become a guaranteed dollar-for-dollar recovery for this cost."[146]

The AG's arguments closely resemble those that he presented in Case No. 2004-00103. For the same reasons set forth in our decision in that proceeding, we decline to follow the AG's suggested course of action.[147] Based upon our review of the record, we find that forecasted regulatory expense should be decreased by $148,128, from $391,328 to $243,200, to reflect the elimination of amortized rate case expense

[146] *Id.* at 66.

[147] Case No. 2004-00103, Order of Feb. 28, 2005, at 20.

from Cases No. 2007-00143[148] and No. 2008-00426, and the reduction of $12,293 of amortized rate case expense related to the current proceeding.[149]

Insurance Other Than Group. Kentucky-American includes in its forecasted operations insurance other than group expense of $742,262.[150] This forecast reflects the current annual premiums for the following insurance coverages: general liability; property liability; fiduciary liability; commercial crime coverage; flood liability; and worker's compensation. Kentucky-American proposed to reduce its forecast by $47,931 to reflect the 2010 insurance premiums and by an additional $804 to reflect the transfer of three Kentucky-American employees to the Service Company.[151] The Commission finds that the proposed adjustments are reasonable and that forecasted insurance other than group expense should be decreased by $48,735.

Customer Accounting. Kentucky-American includes customer accounting expense of $1,712,517 in its forecasted operations.[152] This expense includes, but is not

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[148] The only cost included from Case No. 2007-00143 is $6,000 for the 2007 depreciation study.

[149] $590,000 (original forecast) - $553,121 (revised forecast) = $36,879.
$36,879 ÷ 3-years = $12,293 (reduction in amortized rate case expenses).

[150] Application, Exhibit 37, Schedule C-2; Direct Testimony of Sheila A. Miller at 7.

[151] E-mail from Lindsey Ingram III, Kentucky-American counsel, to Gerald Wuetcher, Commission Staff counsel (Sep. 15, 2010, 14:39 EDT); Rebuttal Testimony of Sheila A. Miller at 4; Base Period Update Filing, Exhibit 37, Schedule D-2.3 (filed July 15, 2010).

[152] Direct Testimony of Sheila A. Miller at 7; Application, Exhibit 37, Schedule C-2.

limited to the following: postage; telephone; forms for customer service and billing; uncollectible accounts; and collection agencies.[153]

The AG proposes to reduce uncollectible accounts by $27,580.[154] He notes that Kentucky-American did not use budget information to develop its forecasted uncollectible expense, but instead developed an "Uncollectibles Factor" based upon the ratio of its 2009 uncollectible expense to its billed revenue and then applied this factor to pro forma revenues for the forecasted test year.[155] This factor is significantly higher than the Uncollectible Factor for most recent years. As the "Uncollectibles Factor" fluctuates, AG witness Smith argues, it is more appropriate to use a three-year average rather than place undue reliance upon any one year.[156]

Kentucky-American did not directly respond to AG witness Smith's proposed adjustment. In a response to a discovery request, however, it stated that its "experience for 2009 was the best indicator of the uncollectible expense likely to be present in the forecasted test-year in this case, given the current and expected economic conditions during the forecasted test-year."[157] In his rebuttal testimony, Kentucky-American

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[153] Direct Testimony of Sheila A. Miller at 7.

[154] Direct Testimony of Ralph C. Smith at 80.

[155] *Id.* at 78-79.

[156] *Id.*

[157] Kentucky-American's Response to Commission Staff's Third Request for Information, Item 7.

witness Michael Miller noted that the AG's proposal was an acceptable method of rate-making.[158]

Based upon our review of the evidence, we find that Kentucky-American has failed to demonstrate that its proposed method of forecasting uncollectible accounts is reasonable and that the AG's proposed methodology is reasonable and more appropriate in this case. Accordingly, we accept the AG's adjustment to reduce Kentucky-American's forecasted customer accounting expense by $27,589 to reflect the average uncollectible rate of 0.741 percent.

Miscellaneous Expense. Kentucky-American includes general office expense of $3,440,139 in forecasted operations.[159] This expense includes, but is not limited to the following: dues and memberships; employee travel and meal expenses; office supplies; and general office utility costs.[160] Kentucky-American includes the following in this expense: $14,420 for an employee recognition banquet; $5,150 for a United Way rally; and $5,500 for a holiday event.[161]

The AG proposes to reduce miscellaneous expense by $25,070 to remove the three specific expenses listed above.[162] He contends that none of the expenses are

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[158] Rebuttal Testimony of Michael A. Miller at 33 ("As Mr. Smith suggests regarding uncollectible expense, you can use an average, or adjust based on historical actual to budget much like the Commission historically treats forecasted test-year capital spending.").

[159] Application, Exhibit 37, Schedule C-2; Direct Testimony of Sheila A. Miller at 8.

[160] Direct Testimony of Sheila A. Miller at 8.

[161] Application, Exhibit 37, Schedule F-2.3.

[162] Public Direct Testimony of Ralph C. Smith at 71.

necessary to provide safe, adequate and proper utility service and are more properly borne by utility shareholders.

Contending that the expenses are appropriate and benefit utility customers, Kentucky-American opposes the proposed reduction. It asserts that its employee recognition banquet is an appropriate means of recognizing employees' contributions and enhances customer service and satisfaction by promoting a cohesive and motivated work force. The United Way, it argues, promotes employee participation and contribution in an important community program that directly benefits many of the company's customers.[163]

In prior rate case proceedings, the Commission has found that the costs related to employee recognition banquets and gifts should not be borne by utility ratepayers.[164] As to the United Way function, while the community and thus Kentucky-American's customers indirectly receive some benefit from the function, the expense is a form of charitable contribution which the Commission has generally found should be borne by utility shareholders.[165] Accordingly, we accept the AG's proposed adjustment.

<u>Depreciation</u>. Kentucky-American includes depreciation expense of $11,086,076 in its forecasted operations.[166] Based on the Commission's treatment of forecasted rate base with regard to slippage and the effect of revisions to Kentucky-American's

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[163] Rebuttal Testimony of Michael A. Miller at 72.

[164] *See, e.g.*, Case No. 97-034, Order of Sep. 30, 1997, at 40; Case No. 95-554, Order of Sep. 11, 1996, at 43.

[165] *See, e.g.*, Case No. 95-554, Order of Sep. 11, 1996, at 43.

[166] Application, Exhibit 37, Schedule I-1; Kentucky-American's Response to Commission Staff's First Request for Information, Item 1(a), W/P 4-1, at 9.

depreciation study, an adjustment has been made to decrease forecasted depreciation expense by $201,593.[167]

General Taxes. Kentucky-American includes a forecast of general tax expense of $5,160,307, which includes property taxes and payroll taxes of $4,419,174 and $621,307. Based on our treatment of forecasted rate base with regard to slippage, we have increased forecasted property taxes expense by $15,539. We have also reduced payroll taxes by $63,473 to reflect the effects of our removal of the costs of incentive pay plans, the elimination of the employee wage increases, and the transfer of three Kentucky-American employees to the Service Company.

Income Taxes. Kentucky-American includes a forecast of current income tax expense of $1,066,982 in test-period operations. Adjusting Kentucky-American's income tax forecast, the Commission arrives at its current income tax expense of $23,182 as shown in Table III.

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[167] $60,553 (Slippage Adjustment) + ($262,146) (Depreciation Study Revision) = ($201,593).

Table III: Current Income Tax				
	Adjustments	Income Taxes		
	Revenue/	State	Federal	
	Expense	6.0000%	35.0000%	Total
KAWC's Forecasted Taxes		$ (164,573)	$ (902,409)	$(1,066,982)
AFUDC	$ (44,094)	(2,646)	(14,507)	(17,153)
Labor	$ (803,586)	48,215	264,380	312,595
Fuel & Power - 11.8% Line Loss	$ (77,997)	4,680	25,661	30,341
Chemicals - 11.8% Line Loss	$ (43,653)	2,619	14,362	16,981
Management Fees	$ (587,372)	35,242	193,246	228,488
Group Insurance	$ (164,835)	9,890	54,231	64,121
Pensions	$ (340,751)	20,445	112,107	132,552
Regulatory Expense	$ (160,421)	9,625	52,779	62,404
Insurance Other than Group	$ (48,735)	2,924	16,034	18,958
Customer Accounting	$ (27,589)	1,655	9,077	10,732
Miscellaneous	$ (25,070)	1,504	8,248	9,752
Depreciation - Slippage	$ (201,593)	12,096	66,324	78,420
Property & Capital Stock	$ 15,539	(932)	(5,112)	(6,044)
Payroll	$ (63,473)	3,808	20,883	24,691
Interest Synchronization	$ (89,181)	5,351	29,341	34,692
Book Depreciation	$ (60,553)	3,633	19,922	23,555
Tax Depreciation	$ 138,010	(8,281)	(45,405)	(53,686)
Taxable Customer Advances & CIAC	$ (263,660)	15,820	86,744	102,564
Tax AFUDC	$ (41,651)	2,499	13,703	16,202
		$ 3,574	$ 19,609	$ 23,183

Consolidated Income Tax Adjustment. 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.[168] Kentucky-American, however, is part of a consolidated group, which AWWC owns, that files a combined federal income tax return to take advantage of the tax losses experienced by some of the group's members.[169] 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

[168] AG's Brief at 7; Public Direct Testimony of Ralph C. Smith at 29.

[169] Public Direct Testimony of Ralph C. Smith at 29-30.

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 overstate Kentucky-American's federal income tax. Regulatory commissions in three other jurisdictions in which AWWC affiliates are located have adopted consolidated tax adjustments for rate-making purposes.[170] Use of the AG's consolidated tax adjustment results in a decrease of $1,361,624 to Kentucky-American's forecasted income tax expense.[171]

The AG's proposed adjustment relies heavily upon our decision in Case No. 2004-00103 in which we found the use of a consolidated tax adjustment was warranted and appropriate in view of representations that Kentucky-American, AWWC and RWE Aktiengesellschaft ("RWE") had made in an earlier proceeding[172] to secure Commission approval of RWE's acquisition of control of Kentucky-American and the conditions that we had imposed as part of our approval. We stated in that decision:

> In that proceeding [Case No. 2002-00317], 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 [Thames Water Aqua US Holdings, Inc.], an intermediate holding company that would hold the stock of American

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[170] These jurisdictions are Pennsylvania, New Jersey, and West Virginia. Oregon and Texas also impose a consolidated tax adjustment. Rebuttal Testimony of James I. Warren at 24.

[171] Public Direct Testimony of Ralph C. Smith, Schedule C-2.

[172] 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).

> 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.[173]

RWE's recent divestiture of AWWC, however, significantly limits the application of the holding in Case No. 2004-00103. In approving the proposed divestiture, the Commission expressly declared that all terms and conditions imposed as part of our

[173] Case No. 2004-00103, Order of Feb. 28, 2005, at 64-66. In the current proceeding, Kentucky-American argues that the Commission misunderstood and misinterpreted RWE and AWWC's representations regarding potential tax savings related to the transaction before us in Case No. 2002-00317. Our review of the record of Case No. 2002-00317 indicates considerable merit to Kentucky-American's position.

approval of RWE's acquisition of control of Kentucky-American would terminate upon RWE's complete divestiture of its interests in AWWC.[174] That divestiture occurred on November 30, 2009.[175] To the extent that the Commission has based the use of a consolidated tax adjustment on the premise that any savings resulting from the TWUS's use of a consolidated tax return was a benefit of the RWE acquisition and should be shared with ratepayers, the RWE divestiture renders that premise invalid.

Except for Case No. 2004-00103, which involves unique circumstances, the Commission has consistently rejected proposals to apply a consolidated tax adjustment and treated utilities on a stand-alone basis.[176] We have found that use of such an adjustment would result in the subsidization of ratepayers by the utility's non-regulated operations. Moreover, many utility regulatory commissions appear to disfavor

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[174] Case No. 2006-00197, The Joint Petition of Kentucky-American Water Company, Thames Water Aqua Holdings GmbH, RWE Aktiengesellschaft, Thames Water Aqua U.S. Holdings, Inc., and American Water Works Company, Inc. for Approval of a Change In Control of Kentucky-American Water Company, at 36 (Ky. PSC April 16, 2007).

[175] *See* Case No. 2009-00359, Kentucky-American Water Company's Application for Approval of Payment of Dividend for Third Quarter of Calendar Year 2008 (Ky. PSC Dec. 28, 2009).

[176] *See, e.g.*, Case No. 2009-00549, Application of Louisville Gas and Electric Company for an Adjustment of Electric and Gas Rates (Ky. PSC July 30, 2010); Case No. 2009-00548, Application of Kentucky Utilities Company for an Adjustment of Electric Rates (Ky. PSC July 30, 2010); Case No. 2003-00434, An Adjustment of the Gas and Electric Rates, Terms, and Conditions of Louisville Gas and Electric Company (Ky. PSC June 30, 2004); Case No. 2009-00548, An Adjustment of the Gas and Electric Rates, Terms, and Conditions of Kentucky Utilities Company (Ky. PSC June 30, 2004).

the use of consolidated tax adjustments.[177] In light of the RWE divestiture and the absence of any compelling argument to jettison the "stand-alone" rate-making principle, we find that the AG's proposed income tax consolidation adjustment should be denied.

Deferred Income Taxes. Kentucky-American includes a forecast of deferred income tax expense of $2,177,869 in test-period operations. Adjusting Kentucky-American's income tax forecast for slippage, the tax-exempt financing, and the revision of the depreciation study, the Commission arrives at a deferred income tax expense of $2,328,717.

Based on the accepted adjustments to forecasted revenues and expenses, the Commission finds Kentucky-American's forecasted net operating income at present rates to be $16,441,382 as shown in Table IV.

Table IV: Income Statement Comparison

Account Titles	Kentucky-American Forecasted Revenues & Expenses	Recommended Adjustments	Forecasted Revenues & Expenses
OPERATING REVENUES			
Water Sales	$ 64,753,488	$ -	$ 64,753,488
Other Operating Revenues	3,770,137	(44,094)	3,726,043
Operating Revenues	$ 68,523,625	$ (44,094)	$ 68,479,531
OPERATING EXPENSES			
Operation & Maintenance Exp.	$ 35,459,367	$ (2,280,009)	$ 33,179,358
Depreciation & Amortization	11,319,797	(201,593)	11,118,204
General Taxes	5,160,307	(47,934)	5,112,373
Income Tax Expense	1,110,887	1,241,012	2,351,899
Total Operating Expenses	$ 53,050,358	$ (1,288,524)	$ 51,761,834
Net Operating Income	$ 15,473,267	$ 1,244,430	$ 16,717,697

[177] *See, e.g., Re SourceGas Distribution LLC*, 280 PUR 4th 226 (Neb. PSC Mar. 9, 2010); *Re Delmarva Power and Light Company*, 278 PUR4th 419 (Md. PSC Dec. 30, 2009); *Washington Utilities and Transportation Commission v. PacifiCorp dba Pacific Power & Light Co.*, 257 PUR4th 380 (Wash. UTC June 21, 2007); *Northern States Power Company dba Xcel Energy*, 253 PUR4th 40 (Minn. PUC Sep. 1, 2006); *Re Ohio Bell Telephone Company*, 8 PUR3d 136 (Ohio PUC Dec. 30, 1954).

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 in Table V.

TABLE V		
Components	Kentucky-American's Capitalization	Assigned Costs
Short-Term Debt	2.315%	2.085%
Long-Term Debt	52.060%	6.410%
Preferred Stock	1.652%	7.750%
Common Equity	+ 43.973%	11.500%
Total Capitalization	100.000%	

Although the AG states that he is employing Kentucky-American's proposed capital structure in developing his recommended weighted cost-of-capital,[178] the actual capital structure that he uses is shown in Table VI.

TABLE VI		
Components	AG's Capitalization	Assigned Costs
Short-Term Debt	2.32%	0.63%
Long-Term Debt	52.06%	6.32%
Preferred Stock	1.65%	7.75%
Common Equity	+ 43.97%	9.25%
Total Capitalization	100.000%	

The Commission is adjusting Kentucky-American's capital structure as shown in Table VII.

[178] Direct Testimony of J. Randall Woolridge at 13.

TABLE VII					
	Short-Term Debt	Long-Term Debt	Preferred Stock	Common Equity	Total Capital
Proposed Capital Structure	$ 8,319,538	$187,073,668	$ 5,935,810	$158,013,385	$359,342,401
Slippage Adjustment	1,249,182	(1,448)	(52)	(1,315)	1,246,367
Working Capital AIP Days	(458,956)	571	18	484	(457,883)
Deferred Compensation	185,788	(234)	0	(190)	185,364
Tax Exempt Financing	(11,214)	9	9	9	(11,187)
Capital Structure	$ 9,284,338	$187,072,566	$ 5,935,785	$158,012,373	$360,305,062
Capital Rates	2.577%	51.921	1.647%	43.855%	100.000%

Short-Term and Long-Term Debt. Kentucky-American originally projected short-term and long-term interest rates of 2.085 percent and 6.41 percent, respectively.[179] It subsequently revised its original projections to reflect the current financial market conditions, which results in short-term and long-term interest rates of 1.90 percent and 6.38 percent, respectively.[180] Using its analysis of the current federal funds rate, the AG proposed short-term and long-term interest rates of 0.63 percent and 6.32 percent, respectively.[181] Upon review of the supporting calculations, the Commission finds that Kentucky-American's revised projections result in a more current projection of the forecasted debt rates. For this reason, we find the proposed cost of debt is reasonable and should be accepted.

[179] Direct Testimony of Michael A. Miller, Exhibit MAM-3.

[180] Rebuttal Testimony of Michael A. Miller at 6 and Rebuttal Exhibit MAM-1; Base Period Update Filing, Exhibit 37, Schedule J-3 (filed July 15, 2010).

[181] Direct Testimony of J. Randall Woolridge at 14.

Preferred Stock. Kentucky-American proposed an embedded cost of preferred stock of 7.75 percent.[182] No party objected to this forecasted cost rate. We find that the proposed embedded cost of preferred stock is reasonable and should be accepted.

Return on Equity. Kentucky-American recommends a return on equity ("ROE") ranging from 10.8 percent to 12.1 percent and specifically requests an ROE of 11.5 percent based on its discounted cash flow model ("DCF"), the ex ante risk premium method, the ex post risk premium method, and Capital Asset Pricing Model ("CAPM").[183]

To perform its analysis, Kentucky-American witness Vander Weide employed two comparable risk proxy groups in its analysis. The first proxy group consists of eleven water companies included in the *Value Line Investment Survey* ("*Value Line*") that: pay dividends; did not decrease during any quarter for the past two years; have at least one analyst's long-term growth forecast; and are not part of an ongoing merger. All of these water companies have a *Value Line* Safety Rank of at least 3, which is the average of all *Value Line* companies.[184]

Dr. Vander Weide's second proxy group consisted of twelve natural gas local distribution companies. Each company was in the natural gas distribution business; paid quarterly dividends over the last two years; had not decreased dividends over the last two years; was not involved in an ongoing merger, and had at least two analysts'

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[182] Application, Exhibit 37, Schedule J-1.

[183] Direct Testimony of Michael A. Miller at 15; Direct Testimony of James H. Vander Weide at 3-4.

[184] *Id.* at 22-23.

estimates of long-term growth included in the I/B/E/S consensus growth forecast.[185] Each also had a *Value Line* Safety Rank of 1, 2 or 3 and an investment grade bond rating.[186]

Dr. Vander Weide applied a quarterly DCF model to the water company and gas proxy groups. He relied upon the gas company proxy group solely for the ex ante risk premium ROE estimation. He relied upon Standard & Poor's ("S&P") 500 stock portfolio and the S&P Public Utility Index to derive the ex post risk premium ROE estimation. Though Dr. Vander Weide performed CAPM analyses using both proxy groups, he did not rely upon the CAPM estimations in reaching his recommended ROE. He rejected the CAPM analyses because the average beta coefficient for the proxy companies was significantly below a value of 1 and because several of the water companies have relatively low market capitalization.[187] As part of his ROE recommendations, Dr. Vander Weide also made adjustments for flotation costs.

AG witness Woolridge takes issue with several aspects of the methodology that Kentucky-American used to develop its proposed ROE. First, he argues that Dr. Vander Weide has made an inappropriate adjustment to the spot dividend yield. Second, he asserts that the Kentucky-American study relies exclusively on the

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[185] *Id.* at 27. I/B/E/S is a division of Thomson Reuters that reports analysts' earnings per share ("EPS") growth forecasts for a broad group of companies. The I/B/E/S growth rates are widely circulated in the financial community, include the projections of reputable financial analysts who develop estimates of future EPS growth, are reported on a timely basis to investors, and are widely used by institutional and other investors.

[186] *Id.* at 27.

[187] *Id.* at 3.

forecasted growth rates of Wall Street analysts and *Value Line* to compute the equity cost rate, that the long-term earnings growth rates of Wall Street analysts are overly optimistic and upwardly-biased, and that the estimated long-term EPS growth rates of *Value Line* are overstated. Third, Dr. Woolridge contends that the risk premium and CAPM approaches require an estimate of the base interest rate and the equity risk premium. In both approaches, he asserts, Dr. Vander Weide's base interest rate is above current market rates.[188]

Dr. Woolridge also takes strong exception to Dr. Vander Weide's position in measuring the equity risk premium, as well as the magnitude of equity risk premium. He contends that Dr. Vander Weide has used excessive equity risk premiums that do not reflect current market fundamentals. Dr. Vander Weide uses a historical equity risk premium which is based on historic stock and bond returns and calculates an expected risk premium in which he applies the DCF approach to the S&P 500 and public utility stock. Risk premiums based on historic stock and bond returns, Dr. Woolridge asserts, are subject to empirical errors which result in upwardly biased measures of expected equity risk premiums. Dr. Woolridge further asserts that Dr. Vander Weide's projected equity risk premiums, which use analysts' EPS growth rate projections, include unrealistic assumptions regarding future economic and earnings growth and stock returns.[189]

Contending that the utility has failed to identify any actual flotation costs and questioning whether the necessary conditions that support the use of a flotation cost

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[188] Direct Testimony of J. Randall Woodridge at 3-4.

[189] *Id.* at 73-75.

adjustment are present in the current case, Dr. Woolridge challenges the appropriateness of Dr. Vander Weide's use of flotation cost adjustment in his DCF analysis.[190]

Finally, Dr. Woolridge takes issue with Kentucky-American's proxy group. He notes that Dr. Vander Weide's proxy group of water companies includes a water company with less than two years of dividend payments and another which has agreed to be sold to an investor group.[191] Six of the twelve members of the gas proxy group, he further notes, have a low percentage of revenues derived from the regulated gas distribution business or are engaged in riskier business ventures. As Dr. Vander Weide's gas proxy group has a number of companies with significant non-regulated gas activities and is riskier than regulated water and gas companies, the AG argues, the results for that group should be ignored.[192]

Dr. Woolridge conducted his own analysis, applying the DCF model and the CAPM methods to a water proxy group and a gas proxy group and affording primary weight to the results of the DCF analysis. Based upon that analysis, he proposes an ROE range from 7.3 percent to 9.3 percent and recommends an awarded ROE of 9.25.[193]

To perform his analysis, Dr. Woolridge uses a proxy group of nine publicly-held water utility companies covered by *AUS Utility Reports* and a second proxy group of

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[190] *Id.* at 71-73.

[191] *Id.* at 53.

[192] *Id.* at 53-54.

[193] *Id.* at 2.

nine natural gas distribution companies covered by the Standard Edition of *Value Line*. The water proxy group received 92 percent of its revenues from regulated water operations and had a common equity ratio of 49.0 percent. The gas proxy group received 63 percent of revenues from regulated gas operations and had a common equity ratio of 52 percent.[194]

Dr. Woolridge argues that the use of natural gas distribution companies as a proxy for Kentucky-American is appropriate since the financial data necessary to perform a DCF analysis on the members of the water proxy group, as well as analysts' coverage of water utilities, is limited. He also argues that the return requirements of gas companies and water companies should be similar as both industries are capital intensive, heavily regulated, and provide essential services with rates set by state regulatory commissions.[195]

Dr. Woolridge places significant emphasis on current economic conditions and concluded that short- and long-term credit markets have "loosened" considerably and that the stock market has rebounded significantly from 2009's lows.[196] He further states that the investment risk of utilities is currently very low and that the cost of equity for utilities is among the lowest of all industries in the U.S. as measured by their betas.[197]

LFUCG witness Baudino also takes exception to several aspects of Kentucky-American's ROE analyses. First, he notes the presence of highly diversified gas

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[194] *Id.* at 11-12.

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

[196] *Id.* at 10.

[197] *Id.* at 20-21.

companies in Kentucky-American's gas proxy group whose businesses are more diverse, unregulated and tend to have great risk. As such, he argues, they are "poor proxies for . . . [Kentucky-American's] low-risk water distribution operation" and tend to inflate Kentucky-American's DCF analysis.[198]

Mr. Baudino contends that Dr. Vander Weide erred by failing to include forecasted dividend growth in his DCF analyses. With respect to regulated utility companies, he argues, dividend growth provides the primary source of cash flow to the investor. While earnings growth fuels dividend growth, *Value Line*'s dividend growth forecasts are widely available to investors and can reasonably be assumed to influence their expectations with respect to growth. *Value Line*'s dividend growth forecasts, Mr. Baudino states, suggest that near-term dividend growth will be less than forecasted earnings growth. Dr. Vander Weide's failure to include this information, Mr. Baudino concludes, led to a significant overstatement of all of his DCF results.[199]

Mr. Baudino further contends that Dr. Vander Weide's use of a quarterly DCF model is unnecessary and overcompensates investors. This model, he argues, compensates investors twice for the reinvestment effect associated with the quarterly payment of dividend. Moreover, he states, quarterly compounding is likely already accounted for in a company's stock price since investors know that dividends are paid quarterly and that they may reinvest those cash flows.[200]

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[198] Direct Testimony of Richard A. Baudino at 15.

[199] *Id.* at 33, 37-38.

[200] *Id.* at 38-39.

Mr. Baudino also argues that the use of a flotation adjustment is unnecessary. To the extent that investors even account for such costs, he states, current stock prices already account for flotation costs. The adjustment, he states, essentially assumes that the current stock price is wrong and must be adjusted downward to increase the dividend yield and the resulting cost of equity.[201]

Mr. Baudino also alleges several problems with Dr. Vander Weide's risk premium approach. He argues that Dr. Vander Weide's assumption that investors require an unchanging risk premium based on historic returns of stocks over bonds fails to take into account that changing economic conditions will affect investors' risk premium requirements. Under current economic conditions, Mr. Baudino asserts, investors' requirements may differ significantly from a long-term historical risk premium.[202]

Mr. Baudino next argues that Dr. Vander Weide failed to adjust his historical risk premium, which uses the S&P 500 stock portfolio, for the risk premium expectations for utility companies. Investor-expected risk premiums for water utility stocks over bonds, Mr. Baudino states, are likely much lower than the expected risk premium for unregulated companies in the S&P 500. Using the S&P 500 risk premium, Mr. Baudino argues, overstates the risk premium ROE for a low-risk water company such as Kentucky-American.[203]

Mr. Baudino also contends that Dr. Vander Weide's use of S&P utilities to calculate the expected risk premium ROE for Kentucky-American is inappropriate. Low-

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[201] *Id.* at 39-40.

[202] *Id.* at 41.

[203] *Id.* at 41-42.

risk water companies, he contends, are likely to have a lower expected ROE than the S&P Utilities and thus a risk premium using the S&P Utilities will overstate the risk premium ROE for regulated water companies.

Mr. Baudino also disputes Dr. Vander Weide's decision to disregard his CAPM results because CAPM underestimates required returns for securities with betas of less than one. Mr. Baudino argues that there is little evidence that the CAPM bias has any applicability to regulated utilities. Regulated water utilities, he asserts, have low betas because they are low in risk.[204]

Mr. Baudino performed several DCF analyses for two comparison groups of utilities, one composed of regulated water utilities and one composed of regulated natural gas distribution utilities.[205] He also performed two CAPM analyses. Based upon the results of these analyses, he recommended a ROE range from 9.0 percent to 10.0 percent and a ROE of 9.50 percent.[206]

In his rebuttal testimony, Dr. Vander Weide addresses the criticism of his analysis and critiques the analyses of Intervenor witnesses. Countering criticism of his proxy group selections, he notes that his proxy group of natural gas utilities has a higher *Value Line* safety rating and higher average bond rating than AWWC and his proxy group of water utilities has a higher S&P bond rating than AWWC and the same *Value Line* safety ranking.[207]

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[204] *Id.* at 42-43.

[205] *Id.* at 13-16.

[206] *Id.* at 31.

[207] Rebuttal Testimony of James Vander Weide at 5.

As to his use of EPS growth rates in his DCF analysis, Dr. Vander Weide argues that differences in EPS growth rates and historical growth rates for water utilities do not reduce the reliability of his analysis. He contends that differences in historical and projected growth rates for the water utilities indicate that water utilities are likely to grow more rapidly in the future than they have in the past. His DCF model, he asserts, is intended to capture investors' expectations about the future. Moreover, he argues, historical growth rates are inherently inferior to analysts' forecasts because analysts' forecasts already incorporate all relevant information regarding historical growth rates and also incorporate the analysts' knowledge about current conditions and expectations regarding the future. He refers to several studies that "demonstrate that stock prices are more highly correlated with analysts' growth rates than with either historical growth rates or the internal growth rates."[208]

Dr. Vander Weide rejected criticism of his use of a quarterly DCF model. He testified that all of the companies within his proxy groups paid quarterly dividends and noted that the same applied for those companies in Dr. Woolridge's proxy group. He further testified that, as the DCF model is based on the assumption that a company's stock price is equal to the expected future dividends associated with investing in the company's stock, an annual DCF model cannot be based upon this assumption when dividends are paid quarterly.[209]

Dr. Vander Weide takes exception to Dr. Woolridge's internal growth method. He argues that this method underestimates the expected growth of his proxy companies

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[208] *Id.* at 13-25.

[209] *Id.* at 62.

by neglecting the possibility that such companies can grow by issuing new equity at prices above book value. He notes that many of the proxy companies are currently engaging in this practice or are expected to do so in the future. This possibility is noteworthy, he asserts, because the water industry is expected to undertake substantial infrastructure investments in the near future and to finance those investments in part through this practice.[210]

Dr. Vander Weide also expresses concerns about aspects of Mr. Baudino's analysis. He contends that the use of DPS growth forecasts to estimate the growth component of Baudino's DCF model understates long-run future growth and that such forecasts are less accurate indicators of long-run future growth than earnings growth forecasts.[211]

Based upon our review of the record, we find that Kentucky-American's proposed ROE should be denied. We find Kentucky-American's use of natural gas distribution companies as proxies for water utilities to be inappropriate. While natural gas distribution companies and water utilities have similar types of fixed investments, the nature of the risks that each industry faces is sufficiently different to prevent the use of natural gas companies as a proxy. While both industries deliver a commodity through underground pipes, several of the companies within the natural gas proxy group that Kentucky-American has used engage in exploration, production, transmission, and other non-regulated and non-distribution activities. These activities extend well beyond a distribution function and have greater risk.

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[210] *Id.* at 12.

[211] *Id.* at 55-59.

We find that an ROE of 9.7 percent provides Kentucky-American with a fair and reasonable rate of return. In reaching our finding, we have focused upon the water utilities within the proposed proxy group. This group consists of large and small publicly traded water utilities. While Kentucky-American is a relatively small water utility, it is part of a large, multi-state operation that has access to investment capital under conditions that few small water utilities could obtain. Accordingly, we are of the opinion that this group is a more accurate indicator of risk and market expectations.

This finding also reflects Kentucky-American's recent regulatory history. Kentucky-American's frequency of rate case applications since 1992 clearly demonstrates management's focused efforts to minimize regulatory risk and the risk associated with the recovery of capital investments. Kentucky-American has applied for rate adjustments on a more frequent basis than other water utilities within the proxy group. Furthermore, Kentucky-American has used a forecasted test period with each rate application–a mechanism that also tends to reduce the risk associated with the recovery of capital investments.

In reaching our finding, we have also excluded any flotation cost adjustment from our analysis and have placed much greater emphasis on the DCF and the CAPM model results of the water utility proxy groups. While recognizing the value of historic data for use in obtaining estimates, we have also considered analysts' projections regarding future growth. Finally, in assessing market expectations, we have given considerable weight to present economic conditions.

Weighted Cost of Capital. Applying the rates of 6.38 percent for long-term debt, 7.75 percent for preferred stock, 1.90 percent for short-term debt, and 9.70 percent for common equity to the adjusted capital structure produces an overall cost of capital of 7.74 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 $28,116,014. We further find that this level of net operating income requires an increase in forecasted present rate revenues of $18,825,137.[212]

Cost-of-Service Study

Kentucky-American included with its application a cost-of-service allocation study[213] that is based upon the base-extra capacity method. This methodology is widely recognized within the water industry as an acceptable methodology for allocating costs.[214] This Commission has also accepted the use of this methodology for cost allocation and development of water service rates. No party has objected to the findings of the cost-of-service study. We accept the study's findings.

General Water Rates

The rates and charges contained in the Appendix to this Order are based on findings contained in the cost-of-service study, as adjusted by our findings regarding the

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Net Investment Rate Base	$ 363,255,997
Multiplied by: Rate of Return	x 7.7400%
Operating Income Requirement	$ 28,116,014
Less: Forecasted Net Operating Income	- 16,717,697
Operating Income Deficiency	$ 11,398,317
Multiplied by: Revenue Conversion Factor	x 1.651571600
Increase in Revenue Requirement	$ 18,825,137

[213] Application, Exhibit 36.

[214] American Water Works Association, *Principles of Water Rates, Fees and Charges* 50 (5th Ed. 2000).

reasonableness of the costs in the proposed test period. Those rates and charges will produce the required revenue requirement based upon the forecasted sales. For a residential customer who uses an average of 5,000 gallons per month, these rates will increase his or her monthly bill from $27.46 to $35.40, or approximately 28.9 percent.

Service to Low-Income Customers

The Commission recognizes that a significant portion of Kentucky-American's customers have annual incomes that are at or below the Federal Poverty Guideline.[215] We further recognize that the approved rate adjustment will more adversely affect these customers than those with higher annual incomes. CAC has presented several proposals to provide some relief to the customers. Having carefully considered each of these proposals, we find that each should be implemented or given further study and consideration.

CAC has proposed that Kentucky-American be required to maintain more complete records regarding customer payment and termination of service for non-payment in a manner that permits systematic analysis. It notes that Kentucky-American presently cannot ascertain the number of customers who make late payments, a customer's frequency of late payments, the number of terminations for late payments, or

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[215] In 2008, approximately 15.4 percent of Fayette County residents were living at or below the Federal Poverty Guideline. Of the remaining eight counties in which Kentucky-American provides water service, the percentage of persons living at or below the poverty line in 2008 ranged from 9.7 percent to 17.0 percent. It is estimated that 15.4 percent of Fayette County residents were at or below the Federal Poverty Guideline in 2008. Of the remaining eight counties in which Kentucky-American has operations, the percentage of individuals at or below the poverty line ranged from 9.7 percent to 17.0 percent. *See* U.S. Census Bureau Small Area Income and Poverty Estimates, *available at* http://www.census.gov/did/www/saipe/data/index.html (last visited Nov. 2, 2010).

the specific service (e.g., water, sewer, water quality) for which non-payment has occurred and serves as the basis for termination.[216] CAC witness Burch testified this information would provide a better means of assessing the affordability of Kentucky-American's rates and developing policies to assist low income customers.[217] Kentucky-American confirms that its present records system will not allow quick and cost-effective analysis on these subjects.[218]

If the Commission is to properly review and assess the affordability of Kentucky-American's rates, we must have accurate and reliable information regarding customer payment. Given the limitations of Kentucky-American's record systems, that information is presently unavailable. Accordingly, we find that Kentucky-American should develop and implement as soon as possible a plan to accurately record and determine the number of customers making payments after the due date, the frequency of late payments by each customer, the number of service terminations for nonpayment for each customer account and company-wide, and the specific services that were not paid when water service is terminated for non-payment.

CAC urges the Commission to restructure Kentucky-American's proposed rate design to create a graduated, tiered rate structure. It asserts that an inclining block structure that provides for a minimum quantity of water at an inexpensive level and increasing rates based upon increased usage would benefit all customers. Such a rate

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[216] CAC's Brief at 6-7.

[217] VR: 8/11/10; 15:41:45-15:43:20.

[218] Kentucky-American's Response to CAC's Second Request for Information, Item 1.

structure, CAC argues, would make a minimum quantity of water affordable to low-income customers and would promote conservation. As an alternative to immediately implementing such rate design, CAC requests that Kentucky-American be directed to "work with the Attorney General, low income advocates, and other interested parties to design a rate system on this concept."[219] It further proposes that the Commission establish a collaborative effort that includes all interested parties and Commission Staff to address affordability issues. All other parties appear in agreement with the proposal to create a working group to study rate design issues.

We find insufficient evidence in the record to support CAC's rate design proposal or to clearly demonstrate that the implementation of such proposal will benefit low-income customers or create appropriate pricing signals. Accordingly, we have not incorporated CAC's rate design proposal into Kentucky-American's rates. We find, however, that CAC's proposal should be further studied and additional customer data gathered to permit a thorough assessment of the proposal's potential effects.

Recognizing that the affordability of water service is a complex and multi-faceted subject that must be approached on several levels, the Commission finds considerable merit to CAC's proposal to undertake a collaborative effort to study this subject. Such an effort, however, should not be limited to examining potential rate design options to enhance the affordability of water service, but should consider all potential regulatory and legislative solutions to this perplexing issue. We find that Kentucky-American should initiate this collaborative effort by arranging, within 60 days of the date of this Order, a meeting of all interested parties to discuss and study potential regulatory and

[219] CAC's Brief at 8.

legislative solutions to the increasing lack of affordability of water service for low income customers. Moreover, Kentucky-American should file with the Commission periodic written reports on the status of these meetings and submit a final written report on the collaborative group's efforts no later than November 1, 2011. We direct Commission Staff to assist the collaborative group's efforts to the fullest extent that its limited resources permit and encourage all interested parties, including those groups that did not intervene in this proceeding, to actively participate.

Other Issues

Tap-On Fees. Kentucky-American proposes to increase its tap-on fees from 13 percent to 22 percent to reflect the five-year average cost of a service connection. Kentucky-American's tap fees are currently based upon an average of actual costs of connections from 2005 to 2007. Kentucky-American witness Bridwell testified that significant increases in connection costs have occurred since that time. Raw material costs increased dramatically in 2008 and have not yet returned to pre-2008 levels. Additionally, the number of new service connections significantly decreased in 2008 and 2009 due to a reduction in economic activity. As a result, there were fewer installations over which to spread the fixed costs related to such installations.[220]

Kentucky-American has historically used a three-year average of connection costs to establish its tap-on fees. In the present case, it proposes to base these fees on a five-year average to reduce the effect of increasing costs and current economic conditions. The Commission acknowledges and supports Kentucky-American in its

[220] Direct Testimony of Linda C. Bridwell at 2-3.

efforts to lessen the increase in tap-on fees for its customers and accepts the change in the calculation of the average costs over a five-year period.

Based upon our review of the record, we find that the proposed revisions to tap-on fees will not result in fees that exceed the cost of the service connection, are reasonable, comply with 807 KAR 5:011, Section 10, and should be approved.

Reduced Rate/Free Service for Public Fire Hydrants.[221] Kentucky-American currently provides water service to approximately 7,388 public fire hydrants.[222] LFUCG owns approximately 6,811 of these hydrants.[223] Approximately 6,920 of these hydrants are located in Fayette County. Under the terms of Kentucky-American's present rate schedules, governmental bodies pay a monthly or annual charge for each hydrant.

LFUCG argues that a reasonable portion of the public fire hydrant costs should be assigned to other customer classes to reflect the benefits that other users of the water distribution system receive from the existence of public fire protection service (for example, lower insurance rates and enhanced public safety) and the existence of hydrants (for example, improved water quality due to greater line-flushing capability). It

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[221] Under the terms of Kentucky-American's tariff, a public fire hydrant is a fire hydrant contracted for or ordered by Urban County, County, State or Federal Governmental agencies or institutions and connected to a municipal or private fire connection used solely for fire protection purposes. Tariff of Kentucky-American Water Company, P.S.C. Ky. No. 6, Twenty-Third Revised Sheet No. 53.

[222] Kentucky-American's Response to LFUCG's First Request for Information, Item 9.

[223] *Id.*

requests that the Commission order or otherwise encourage Kentucky-American to develop a free or reduced public fire hydrant rate for use in a future rate proceeding.[224]

While KRS 278.170(3) permits a utility to provide free or reduced-rate service for fire protection purposes, LFUCG's proposal raises a number of difficult policy issues. Free or reduced-rate fire hydrant service effectively shifts the fire protection service costs from governmental bodies to other users and thus requires a corresponding increase in the rates for general water service customers. Because Kentucky-American has a unified tariff and serves areas outside of Fayette County for which no fire protection service is provided, the potential exists that Kentucky-American customers who reside outside of Fayette County will be subsidizing through their rates fire protection services for Fayette County residents.[225]

LFUCG's proposal will produce an income transfer from Kentucky-American customers to local, state, and federal government entities. The public, which includes Kentucky-American ratepayers, currently pays indirectly for public fire hydrant service through local, state and federal taxes. Government agencies use collected tax revenues to pay Kentucky-American directly for public fire hydrant service. Allocating the costs of providing public fire hydrant service to general service customers will reduce or eliminate the charges that government entities must pay and effectively provide those agencies with additional funds for other uses. It will also require general

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[224] LFUCG's Brief at 8.

[225] To the extent that public fire hydrant service benefits non-customers who own property in Kentucky-American's service area, the effect of allocating the costs of public fire hydrant service to general service customers is to provide a subsidy to those non-customers.

service customers to pay higher rates for water service. Unless a reduction occurs in these customers' taxes to offset the increased amount for water service, these customers will be paying a larger portion of their income for the same level of services.

Allocating public fire hydrant service costs to general service rates also increases the likelihood that pricing signals will be distorted and public accountability will be lessened. Under the current pricing scheme, the cost of public fire hydrant service is clearly known to the public. Kentucky-American bills the governmental entity for that service. The governmental entity must allocate and pay those bills from its available funds. Its records and budgeting process are subject to public review and inspection. The decisions regarding the availability of public fire hydrant service and amount of public funds (and assessed private funds) to be devoted to such service are made in full public view and with the opportunity for public comment. Allocating public fire hydrant service costs to general service users effectively hides these costs from public view and discussion and renders informed public decisions on the availability and appropriateness of such service more difficult.

In light of these concerns and as LFUCG will be the primary beneficiary of any free or reduced public fire hydrant rate, the Commission finds that LFUCG, not Kentucky-American, is the most appropriate party to develop a proposal for such rate. We respectfully decline LFUCG's request to order or otherwise encourage Kentucky-American to develop a free or reduced public fire hydrant rate for future use without adequate evidence. By this Order, however, we direct that Kentucky-American make its records available to LFUCG and respond to all reasonable inquires from LFUCG regarding public fire hydrant service to enable LFUCG to develop its own proposal.

Should Kentucky-American fail to comply with this directive, LFUCG should inform the Commission of this failure and request our assistance in obtaining the required information.

Tariff Revisions Related to Fire Protection Mains. Kentucky-American currently does not meter water usage provided through fire service connections. Despite restrictions in Kentucky-American's tariff that require that water from these connections be used solely for fire protection purposes,[226] Kentucky-American employees have observed water withdrawals from some fire service connections for other purposes.[227] As a result, Kentucky-American proposes revisions to its present tariff to permit the installation of meters on fire service connections and the assessment of usage charge on all non-fire related flows when a reasonable belief exists that water is being used for non-fire protection purposes.

The Commission finds that the proposed revisions are reasonable and should be approved. They are consistent with the findings and recommendations of a recently completed report on Kentucky-American's non-revenue water.[228] Enforcement of Kentucky-American's proposed tariff language will likely reduce the level of non-revenue water by permitting Kentucky-American to track and charge usage on these previously unmetered service connections. It will also provide a means through which Kentucky-American can enforce its prohibition against non-fire protection usage on such connections.

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[226] Kentucky-American Water Company Tariff No. 6, Sheet 10 (Feb. 17, 1983).

[227] Direct Testimony of Linda C. Bridwell at 7.

[228] Gannett Fleming, Analysis of Non-Revenue Water, Task 5 (Sep. 2009).

Demand Management Plan. In its brief, LFUCG requests that the Commission order Kentucky-American to develop a new demand management plan. In support of its request, it notes that Kentucky-American's existing plan was developed in 2001 and that significant changes to Kentucky-American's operations have occurred since then. It further asserts that a new plan is essential to determining whether Kentucky-American has sufficient water to provide wholesale service to other water utilities within the central Kentucky area and the direction of Kentucky-American's planning. The Commission agrees and by this Order directs Kentucky-American to file such plan no later than the filing of its next application for general rate adjustment.

Termination of Water Service for Debts Owed to LFUCG. Pursuant to an agreement with LFUCG, Kentucky-American bills and collects from its Fayette County customers LFUCG Water Quality Management Fee, LFUCG Landfill Charges, and LFUCG Sewer charges. This agreement provides that monies received from its customers will be applied to unpaid charges in the following priority: (1) water service charges; (2) LFUCG Water Quality Charges, (3) LFUCG Landfill Charges, and (4) LFUCG Sewer charges.[229] The agreement provides that water service will be terminated for failure to pay LFUCG sewer charges. Given the agreement's priority provisions which effectively allocate a customer's payment of LFUCG sewer charges to LFUCG Water Quality Charges and Landfill Charges, Kentucky-American has agreed to terminate a customer's water service for a customer's failure to pay LFUCG Water Quality Charges or LFUCG Landfill Charges.[230]

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[229] Kentucky-American's Response to Hearing Data Request, Item 13.

[230] *Id.*, Item 14.

In Case No. 95-238,[231] Kentucky-American applied for approval of its initial agreement with LFUCG and for a deviation from 807 KAR 5:006, Section 14, to permit the discontinuance of water service to any customer who failed to pay sanitary sewer charges owed to LFUCG. While noting that that 807 KAR 5:006, Section 14, "permits a utility to discontinue service only for nonpayment of charges for services which it provides," we found that KRS Chapter 96 expressly authorized such agreements[232] and required a water supplier to discontinue water service to premises for a customer's failure to pay sewer service charges when the governing body of the municipal sewer facilities identifies the delinquent customer and notifies the water supplier to discontinue service.[233] We further found that, as the provisions of KRS Chapter 96 and 807 KAR 5:006, Section 14, were in conflict and that KRS Chapter 96 was more specific, those provisions controlled.[234] Hence, we reasoned, no deviation from 807 KAR 5:006, Section 14, was required and no Commission approval of the Agreement between Kentucky-American and LFUCG was required.

[231] Case No. 95-238, An Agreement Between Lexington-Fayette Urban County Government and Kentucky-American Water Company for the Billing, Accounting and Collection of Sanitary Sewer Charges, at 3 (Ky. PSC June 30, 1995). The agreement addressed only billing and collection of sanitary sewer charges and did not address either water quality fees or landfill fees.

[232] *See* KRS 96.940.

[233] *See* KRS 96.934.

[234] Case No. 95-238, Order of June 30, 1995, at 3-4. The conflict existed between provisions of KRS Chapter 96 and KRS 278.280(2), which provides the Commission "shall prescribe rules for the performance of any service or the furnishing of any commodity of the character furnished or supplied by" a utility.

Kentucky-American's present practice of discontinuing service for failure to pay landfill fees and water quality management fees, however, has no statutory basis. KRS Chapter 96 requires a water supplier to discontinue water service only to a premise that fails to pay municipal sanitary sewer charges. It makes no reference to landfill fees or water quality or storm drainage charges. Consequently, there is no conflict between KRS Chapter 96 and 807 KAR 5:006, Section 14, nor are there any restrictions on that regulation's application to the water utility's practice of discontinuing water service for failure to pay a landfill fee or water quality management fee.

As a general rule, a public utility "cannot refuse to render the service which it is authorized to furnish, because of some collateral matter not related to that service."[235] The purpose of the water quality management fee is to fund LFUCG's storm water management program and surface water runoff facilities.[236] The fee is based upon the size and the condition of a real estate tract. Similarly, LFUCG's landfill fee is intended to fund "the operational and capital costs of solid waste disposal" and is based on the

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[235] Maurice T. Brunner, Annotation, *Right of Municipality to Refuse Services Provided By It to Resident for Failure of Resident to Pay for Other Unrelated Services*, 60 A.L.R. 3d 760 (1974). *See also* 64 Am. Jur. 2d *Public Utilities* § 23 (2010); OAG 79-417 (July 17, 1979). *But see Cassidy v. City of Bowling Green, Ky.*, 368 S.W.2d 318 (Ky. 1963).

[236] LFUCG Ordinance No. 73-2009.

number and type of waste disposal containers.[237] We can find no relationship between storm water management or garbage collection and water service.[238]

Absent express statutory authorization or a deviation from 807 KAR 5:006, Section 14, Kentucky-American may not terminate water service because of a customer's failure to pay charges related to storm water service or garbage service. Kentucky-American, however, has effectively engaged in this practice by applying any amounts billed and collected for LFUCG to landfill disposal and water quality management fees before sanitary sewer charges. The Commission finds that Kentucky-American should cease this practice immediately and should instead apply any monies collected for LFUCG first to LFUCG sanitary sewer charges and then to landfill disposal and water quality management fees.[239]

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 those found reasonable herein and should be denied.

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[237] LFUCG Code, Section 16-16.

[238] In contrast, Kentucky courts have found the use of water service and sanitary sewer service to be "interdependent." *See, e.g., Rash v. Louisville and Jefferson County Metropolitan Sewer Dist.*, 217 S.W.2d 232, 239 (Ky. 1949).

[239] 807 KAR 5:006, Section 27, authorizes deviations from the Commission's General Rules for good cause. Kentucky-American may apply to the Commission for a deviation from 807 KAR 5:006, Section 14, to continue its current practice. Our action should not be construed as expressing a position on the merits of such application.

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

3. Kentucky-American's proposed rules related to fire protection mains are reasonable and should be approved.

4. The rates in the Appendix to this Order are fair, just, and reasonable and should be charged by Kentucky-American for service rendered on and after September 28, 2010.

5. Kentucky-American should, within 60 days of the date of this Order, refund to its customers with interest all amounts collected from September 28, 2010 through the date of this Order that are in excess of the rates that are set forth in the Appendix to this Order. 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 on the date of this Order.

IT IS THEREFORE ORDERED that:

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

2. The rates set forth in the Appendix to this Order are approved for service rendered on and after September 28, 2010.

3. Within 60 days of the date of this Order, Kentucky-American shall refund to its customers with interest all amounts collected for service rendered from September 28, 2010 through the date of this Order that are in excess of the rates set forth in the Appendix to this Order.

4. 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 on the date of this Order. Refunds shall 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 September 28, 2010.

5. 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 the Appendix to this Order.

6. 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.

7. Kentucky-American's proposed revisions to Tariff Sheets No. 52, No. 53, and No. 53.1 are approved.

8. LFUCG's request that Kentucky-American develop a free or reduced public fire hydrant rate for use in a future rate proceeding is denied.

9. Kentucky-American shall make all records related to fire protection service and public fire hydrant service available for LFUCG's inspection and review and shall respond to all reasonable inquiries from LFUCG regarding public fire hydrant service within a reasonable time.

10. Within 60 days of the date of this Order, Kentucky-American shall develop and file with the Commission a plan to accurately record and determine the number of customers making payments after the due date, the frequency of late payments by each customer, the number of service terminations for non-payment for each customer account and company-wide, and the specific service(s) that are not paid when water

service is terminated for non-payment. This plan shall further identify the cost of implementing such plan and the time necessary for implementation.

11. Unless the Commission otherwise directs, Kentucky-American shall implement the plan submitted in accordance with ordering paragraph 10 within 120 days of the date of this Order.

12. No later than the filing of its next application for general rate adjustment Kentucky-American shall file a revised demand management plan with the Commission.

13. a. Within 60 days of the date of this Order, Kentucky-American shall initiate the collaborative effort described in this Order by convening a meeting of all interested parties, to include all parties of record in this case, to identify and study potential regulatory and legislative solutions to enhance and improve the affordability of water service for low-income customers.

b. No later than January 31, 2011, and every month thereafter, Kentucky-American shall file with the Commission a written report on the efforts of the collaborative group to develop potential regulatory and legislative solutions to enhance and improve the affordability of water service for low-income customers.

c. No later than November 1, 2011, Kentucky-American shall file with the Commission a final written report on the collaborative group's efforts.

14. Until granted a deviation from 807 KAR 5:006, Section 14, authorizing such practice, Kentucky-American shall refrain from its practice of applying monies collected from a customer for LFUCG to landfill disposal and water quality management fees before applying those monies to LFUCG sanitary sewer charges and from terminating water service to a customer who has failed to pay fully all LFUCG fees and

charges where the amount paid is equal to or exceeds all outstanding charges for LFUCG sanitary sewer service.

15. Any documents filed with the Commission pursuant to ordering paragraphs 5, 6, 10, 12, and 13 shall reference this case number and shall be retained in the utility's general correspondence file.

By the Commission

ENTERED
DEC 14 2010
KENTUCKY PUBLIC
SERVICE COMMISSION

ATTEST:

Executive Director

APPENDIX

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2010-00036 DATED DEC 14 2010

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.

Meter Charge Rates

Meter Size	
5/8-Inch	$8.90
3/4-Inch	13.35
1-Inch	22.25
1 1/2-Inch	44.50
2-Inch	71.20
3-Inch	133.50
4-Inch	222.50
6-Inch	445.00
8-Inch	712.00

Consumption Rates

Customer Category	Rate Per 100 Cubic Feet All Consumption	Rate Per 1,000 Gallons All Consumption
Residential	$3.97530	$5.30040
Commercial	3.62100	4.82800
Industrial	2.92100	3.89467
Municipal & Other Public Authority	3.18390	4.24520
Sales for Resale	3.15700	4.20933

Municipal or Private Fire Protection Service

Size of Service	Rate Per Month	Rate Per Annum
2-Inch	$ 8.11	$ 97.29
4-Inch	32.63	391.56
6-Inch	73.40	880.76
8-Inch	130.49	1,565.88
10-Inch	203.94	2,447.31
12-Inch	293.75	3,525.05
14-Inch	399.89	4,798.70
16-Inch	522.19	6,266.32

Rates for Public or Private Fire Service

Rates for Public Fire Service	Rate Per Month	Rate Per Annum
For each public fire hydrant contracted for or ordered by Urban County, County, State or Federal Governmental Agencies or Institutions	$37.84	$454.03
Rates for Private Fire Service		
For each private fire hydrant contracted for by Industries or Private Institutions	$72.52	$871.22

Tapping (Connection) Fees

Size of Meter Connection	
5/8-Inch	$817.00
1-Inch	1,569.00
2-Inch	3,536.00
Service larger than 2-Inch	Actual Cost

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