

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

PROPOSED ADJUSTMENT OF THE WHOLESALE)	CASE NO.
WATER SERVICE RATES OF LEBANON WATER)	2017-00417
WORKS)	

**MARION COUNTY WATER DISTRICT'S
POST-HEARING BRIEF**

Comes now Marion County Water District (“Marion District”), by counsel, pursuant to the Commission’s June 20, 2018 Order setting forth the procedure for post-hearing actions, and for its Brief in opposition to the proposed wholesale rate increase of the Lebanon Water Works Company (“Lebanon”) respectfully states as follows:

I. Introduction

Marion District and Lebanon agree that providing quality water to all citizens of the Marion County community is their first and highest priority. Moreover, Lebanon would likely agree with Marion District that the cost of providing such service should be as low as possible. There the agreement appears to end. Lebanon is seeking a wholesale rate increase based upon costs which it has not justified. And if that were not enough, Lebanon seeks to unfairly allocate a disproportionate share of the proposed rate increase to Marion District and its rural customers. Marion District has more customers than Lebanon and consumes over half of the water supply available from Lebanon, but it is unfair, unjust and unreasonable to expect that Lebanon’s “In City” customers – including the City itself – would have their water service subsidized by Marion District’s customers. As presented, this is a case where the tail is wagging the dog. The importance

and necessity of the Commission's role in providing objective oversight in situations such as this is fully described in *Simpson County Water District v. City of Franklin*, 872 S.W.2d 460 (Ky. 1994), which opined: "The manifest purpose of the Public Service Commission is to require and insure fair and uniform rates, prevent unjust discrimination, and prevent ruinous competition."¹ Marion District is grateful for the Commission's consideration of the particulars of this case, which shall now be summarized as follows.

II. Background

Marion District is a water district that was formed in 1969 under the authority of KRS Chapter 74 and is currently serving approximately 6,000 customers in Marion County, Kentucky. Marion District's customers are primarily rural and agricultural in nature.² Marion District is governed by five commissioners appointed by the Marion County Fiscal Court.³ Marion has approximately 435 miles of water mains and eight full-time employees.⁴ As a water district, Marion District is subject to the full rate and service jurisdiction of the Commission. Marion District has no water treatment facilities and must acquire 100% of its customers' water supply requirements from Lebanon. Marion District is non-profit political subdivision of the Commonwealth of Kentucky.⁵

Lebanon is a municipal water company that was authorized by a special Act of the Kentucky General Assembly in 1884.⁶ Lebanon obtains raw water from the Rolling Fork stream and the Fagan Branch Reservoir before treating it at the Calvary water treatment plant ("WTP").⁷

¹ *Simpson County*, at 464; citing *City of Olive Hill v. Public Service Comm'n*, 203 S.W.3d 68 (Ky. 1947).

² See Hearing Video Record ("HVR") 2:15:30 (June 20, 2018).

³ See *id.*, 2:11:45.

⁴ See Marion District 2016 Annual Report.

⁵ See *Davis v. Powell's Valley Water Dist.*, 920 S.W.2d 75, 77 (Ky. App. 1995) citing *Louisville Extension Water District v. Diehl Pump & Supply Co.*, 246 S.W.2d 585, 586 (Ky. 1952); *Public Service Comm'n v. Dewitt Water District*, 720 S.W.2d 725, 727 (Ky. 1986).

⁶ See Lebanon's Motion to Assign Burden of Proof (filed Jan. 31, 2018).

⁷ See Lebanon Hearing Ex. 1.

Beginning in 2018, Lebanon also began purchasing an average of 400,000 gallons per day (“GPD”) of treated water from the City of Campbellsville (“Campbellsville”).⁸ Lebanon has approximately 2,600 customers, which makes it materially smaller than Marion District.⁹ Lebanon connects to Marion District at twelve master meters (eleven of which are active) around the periphery of the Lebanon system.¹⁰ As a municipal utility, Lebanon is not subject to the Commission’s full jurisdiction and, but for the fact that it sells water to Marion District on a wholesale basis, it would not be subject to the Commission’s jurisdiction at all.¹¹

Marion District has purchased water from Lebanon pursuant to the terms of a Water Purchase Agreement that was entered into on December 23, 1988. However, the contract has been amended on many occasions and the amendments entered into following the Kentucky Supreme Court’s landmark decision in *Simpson County*,¹² have made explicit reference to the Commission’s jurisdiction over the wholesale water purchase rate charged by Lebanon.¹³ Thus, while the Agreement sets forth a process for determining when an increase in rates may occur for both the “In City” customers of Lebanon and Marion District as Lebanon’s only wholesale customer, that process is necessarily servient to the Commission’s jurisdiction as set forth in *Simpson County* as a matter of law. Indeed, the Commission has already correctly held that Lebanon bears the burden

⁸ See HVR 1:00:14.

⁹ See HVR 10:52:33; Lebanon Response to Marion District’s Post-Hearing Data Request, No. 4.

¹⁰ See Lebanon Hearing Ex. 1.

¹¹ See KRS 278.200.

¹² See *Simpson County*, at 463 (“[W]here contracts have been executed between a utility and a city...KRS 278.200 is applicable and requires that by so contracting the City relinquishes the exemption and is rendered subject to PSC rates and service regulation.”).

¹³ For instance, the Second Addendum to the Agreement adopted in 1997 expressly provides that a proposed rate change is “subject to approval of the Public Service Commission for the Commonwealth of Kentucky....” See Thompson Testimony in Support of Motion to Assign Burden of Proof, Exhibit 5, p. 4.

of proof in this case to demonstrate that its proposed rate increase is fair, just and reasonable both in amount and with respect to how it is designed to recover any increase.¹⁴

Lebanon's Application was filed on September 13, 2017. Twelve days later, Marion District filed a protest wherein it alleged that the proposed rate increase was unfair, unjust and unreasonable in multiple respects. Marion District's protest was not filed casually or without attempting to work with Lebanon to assure that any increase was necessary and equitable in application. Unfortunately, however, the fact that Marion District was only given a few hours' notice of the first reading of the rate increase ordinance and was greeted with non-cooperation in subsequent discussions with Lebanon thwarted any meaningful effort to arrive at a rate increase that met Lebanon's needs without punishing Marion District's rural customers.¹⁵

III. Argument

A. Lebanon's Proposed Revenue Requirement is Unjustified and Unsupported

Marion District agrees that the purpose of a rate case is to look at all the expenses and income incurred during a test year to determine a utility's true financial condition.¹⁶ There is no formula that sets forth in mathematical precision how Lebanon's rates are to be developed,¹⁷ and traditional ratemaking principles applied by the Commission historically provide the best framework for evaluating the merit of Lebanon's claims.¹⁸

¹⁴ See Order, Case No. 2017-00417 (March 19, 2018).

¹⁵ See HVR 2:08:50.

¹⁶ See *id.*, 2:03:58.

¹⁷ See Marion District Hearing Ex. 4, p. 1; HVR 9:26:11.

¹⁸ See Marion District Hearing Ex. 4, p. 8; HVR 9:27:00.

1. Lebanon's Claim to a \$798,208 Rate Increase Should be Rejected

Until the filing of its brief, Lebanon's test year was based upon a historical twelve-month period ending on June 30, 2016.¹⁹ However, the audited income before capital contributions for the test year showed a positive income of \$252,436.²⁰ Given Lebanon's relative size, this is a healthy margin which tends to suggest that no increase in its rates would be justified based upon the audited financials alone. Perhaps for this reason, Lebanon now claims for the first time in its brief that the test year that should be used in this case is the Fiscal Year ending on June 30, 2017.²¹ Switching test years following the filing of the application – and, for that matter, after the hearing – is unprecedented,²² and highlights the degree to which Lebanon has failed to sustain its burden of proof in this case. The fact that Lebanon relies primarily upon the law of Vermont to support its “bait and switch” test year is sufficient basis alone to reject its rate request *in toto*. Lebanon's ten-month quest to manufacture the most favorable test year must eventually come to an end.

¹⁹ See Marion District Hearing Ex. 1, HVR 9:17:49. Mr. Thompson clearly stated that the twelve-month period ending June 30, 2016 was the test year used by Lebanon. His sworn testimony is repudiated in Lebanon's brief, however, which states, “The Company has not expressly proposed that the Commission use FY 2016 as the test period.” See Lebanon Brief, p. 10.

²⁰ See Marion District Hearing Ex. 1.

²¹ See Lebanon Brief, pp. 1-2.

²² Lebanon makes the absurd argument that no test year is necessary to justify a rate increase in the context of a wholesale rate increase. Its primary argument is that KRS 278.192 is discretionary and not mandatory. See Brief, p. 10, n. 16. However, everyone who has worked more than ten minutes at the Commission understands that the enactment of KRS 278.192 in 1992 was for the purpose of *giving utilities the option* to use a forecasted test year in addition to a historic test year. See *In the Matter of Kentucky-American Water Company's Application for an Adjustment of Rates*, Order, Case No. 1992-00452 (Ky. P.S.C. Nov. 19, 1993) (“The 1992 General Assembly authorized filing a rate case based on a future test year.”). The enactment of KRS 278.192 was a change to Kentucky law which previously recognized – indeed required – only the use of a historic test year to support a request to change rates. Likewise, Lebanon's reliance upon the omission of KRS 278.192 from a 2007 letter from the Commission's former Executive Director is a thin argument. The letter does not cite the statutory requirement in KRS 278.030(1) that wholesale rates must be “fair, just and reasonable.” but that statutory obligation is still obviously part of the regulatory framework. In other words, it would appear Lebanon seeks to use correspondence containing a discussion of *procedural* matters as a means to potentially evade *evidentiary* obligations inherent throughout KRS Chapter 278. While clever, the argument ultimately demonstrates the ridiculousness of what Lebanon asks the Commission to sanction. Under Lebanon's logic, there would be no structure for evaluating the legitimacy of a proposed wholesale rate increase.

Nevertheless, Lebanon is seeking a \$798,208 rate increase.²³ That rate increase reflects the total requested revenue requirement increase attributable to both Marion District and Lebanon's retail customers.²⁴ Lebanon's request should be rejected on the basis that it omits key data, fails to support its broad claims with specific information and generally fails to follow well-settled Commission precedent.

a. Lebanon Fails to Include Significant Relevant Income

Lebanon's revenue requirement calculation correctly includes a pro forma with entries for: (1) non-operating income attributable to collecting wastewater and garbage fees, tap fees and developer contributions; and (2) interest income.²⁵ However, Lebanon's pro forma inexplicably omits \$34,344 in revenues from late fees and penalties.²⁶ Late fees and penalties are most assuredly a form of income for a utility and should not be excluded from Lebanon's pro forma. To argue that this income should not be apportioned to Marion District because it has not contributed to the late fees and penalties income as a result of timely paying its water bill creates a perverse incentive to *not* pay a water bill when it is due, which is illogical. Moreover, Lebanon's claim is inconsistent with its own allocation of the late fees and penalties income to its retail customers when it has many retail customers who – like Marion District – have paid their water bills on time. It is unfair, unjust and unreasonable to inflate Lebanon's revenue requirement by omitting \$34,344 in legitimate, stable income. Accordingly, Lebanon's revenue requirement calculation should be decreased by \$34,344 to account for this additional source of operating revenue.

²³ See Marion District Hearing Ex. 2; HVR 9:20:35.

²⁴ See *id.*, 9:20:46.

²⁵ See Marion District Hearing Ex. 2; HVR 1:39:12.

²⁶ See White Direct Testimony, pp. 6-7; HVR 9:28:37. The pro forma also omits \$4,300 in bad debts which should serve to increase the revenue requirement under a traditional ratemaking approach. See Staff Hearing Exhibit 1.

b. New Pricing From Campbellsville Reduces Lebanon's Revenue Requirement

Lebanon received new prices from Campbellsville earlier this year for the purchase of 400,000 GPD of treated water.²⁷ As a result, Lebanon agrees that the projected expense of purchased water set forth in the pro forma should be reduced by \$54,020.²⁸ Moreover, based upon Lebanon's own forecast for the costs of purchased water in Fiscal Year 2019, an additional \$2,140 should be excluded from the Company's pro forma.²⁹

c. Lebanon Failed to Establish the Need for 400,000 GPD from Campbellsville

Lebanon's twenty-year water purchase agreement with Campbellsville calls for it to purchase between 300,000 GPD and 1,000,000 GPD. Initially, Lebanon has elected to purchase 400,000 GPD to allow it to "catch-up" on overdue maintenance at its WTP. The nexus between the election to purchase 400,000 GPD and the ability to repair the WTP has not been clearly established. On a typical day, Lebanon produces between 2 million and 2.6 million gallons of water.³⁰ Purchasing 400,000 GPD will allow Lebanon to close its WTP for up to eighteen hours at a time to initiate and complete repairs.³¹ The math does not work. In any given year, Lebanon will be purchasing water far in excess of the amount of lost production time associated with its WTP repairs and maintenance.

Other factors indicate that Lebanon has over-subscribed in its purchase of water from Campbellsville as well. For instance, Mr. Thompson testified that Campbellsville did not mandate or request a minimum purchase from Lebanon (other than the contractual minimum, of course) to

²⁷ See Thompson Direct Testimony, p. 15; HVR 9:29:18.

²⁸ See *id.*, 9:29:42. This proposed adjustment is based upon the most recent pricing provided by Lebanon using a 400,000 GPD purchase quantity. If the Commission were to only allow recovery for a 300,000 GPD purchase amount, this adjustment would have to be updated to reflect different pricing for a lower quantity.

²⁹ See Marion District Hearing Ex. 1.

³⁰ See Lebanon Response to Marion District's First Request for Information No. 28.

³¹ See HVR 9:45:01.

service its debt financing of the interconnection pipeline.³² When this is weighed against the fact that Lebanon's cost of production is below that of its water purchases from Campbellsville,³³ it becomes perfectly obvious that the bare minimum purchase of water makes the most financial sense. Likewise, it must be noted that in the event Lebanon chooses to reduce the quantity of its water purchases from Campbellsville in future years, its rates will continue to reflect the cost of a 400,000 GPD purchase obligation. Given that there is no foreseeable need for Lebanon to increase the quantity of its purchases in the next several years,³⁴ the risk presented by Lebanon's ability to elect a different quantity of water to purchase is asymmetrical and falls principally upon Marion District.

Lebanon claims that it will "optimize" its purchases of water from Campbellsville,³⁵ however, it has not provided any actual evidence to support how a 400,000 GPD purchase requirement optimizes anything. Lebanon concedes that it would incur \$57,670 less each year if it were to reduce its water purchases to 300,000 GPD.³⁶ In the absence of a long-term contractual obligation to purchase 400,000 GPD, and in light of the substantial reasons why Lebanon would have no incentive to do so, Lebanon's revenue requirement should be reduced by \$57,670 to reflect a more reasonable estimate of its true requirement to purchase water from Campbellsville.

d. Lebanon Overstated its Salary and Payroll Tax Benefits

Lebanon's audited test year expense for salaries is \$528,862, however, its pro forma claims \$615,200 in salaries, a difference of \$86,338 for the test year.³⁷ Likewise, there is a difference of

³² See HVR 9:49:07.

³³ See *id.*, 9:34:34.

³⁴ See *id.*, 1:08:30. Mr. Thompson characterized Lebanon's own sales as being "flat".

³⁵ See Thompson Direct Testimony, p. 16.

³⁶ See HVR 9:47:41.

³⁷ See Marion District Hearing Ex. 1, Ex. 2.

\$8,729 between Lebanon's audited test year figure and its pro forma in the payroll tax expense category. The gap between its historical, audited expense and its claimed expenses is not fully explained other than by the statement that Lebanon added two new employees to its payroll in 2017.³⁸ In the absence of supporting documentation as to the need for the increase, Lebanon's revenue requirement attributed to salaries and payroll taxes should be established based upon a normalized figure, which results in a decrease of \$52,413 and \$8,729 respectively from the proposed revenue requirement.³⁹

e. Lebanon's Depreciation Expense is Unreasonable

Lebanon's claimed depreciation expense is unreasonable in every sense of the word. Lebanon's Capitalization Policy is far more aggressive than the NARUC guidelines that have historically been utilized by the Commission in setting depreciation rates.⁴⁰ In addition, the record establishes that Lebanon has used a depreciation schedule that is even more aggressive than that which its own Capitalization Policy allows.⁴¹ As if this were not enough, Lebanon has accumulated depreciation expense that exceeds the actual cost of some of its assets.⁴² By its own admission, Lebanon has significantly departed from historical Commission ratemaking principles in its calculation of depreciation expense.⁴³ It would seem that Lebanon is using principles of tax depreciation in its calculation of book depreciation.⁴⁴ Kentucky law is clear that a utility's accounting records are not dispositive as to the reasonableness of the utility's accounting

³⁸ See HVR 9:52:09.

³⁹ See Lebanon Hearing Ex. 2.

⁴⁰ Compare Marion District Hearing Ex. 5 and Ex. 6; see White Direct Testimony, p. 5.

⁴¹ See White Direct Testimony, p. 4; HVR 9:59:38.

⁴² See White Direct Testimony, p. 4; HVR 9:59:28.

⁴³ See *id.*, 9:58:01.

⁴⁴ See *id.*, 2:00:00.

practices.⁴⁵ The Commission is free to ignore accounting practices that are unreasonable,⁴⁶ and should do so in this case.

The fact of the matter is that Lebanon did not prepare a depreciation study in preparation for the filing of this case.⁴⁷ Indeed, it has never prepared a depreciation study at any point in memory.⁴⁸ In a post-hearing data request, for the first time, we learn that the actual test year depreciation expense using the NARUC useful life guidelines is \$90,016 lower than what Lebanon originally included in its revenue requirement calculation.⁴⁹ Using the NARUC useful life illustrates the substantial degree to which Lebanon's Capitalization Policy is too aggressive and inconsistent with the actual situation confronting Lebanon.⁵⁰ For this reason, the Commission should reduce Lebanon's revenue requirement by \$90,016.

f. Lebanon Failed to Include Savings from Changes to its Insurance Costs

In testimony, it emerged that Lebanon had garnered savings from requiring its employees to pay a portion of the health insurance premium for family coverage and by switching to a high-deductible plan.⁵¹ However, Lebanon failed to include such savings in its pro forma when

⁴⁵ See *Kentucky Indus. Utility Customers, Inc. v. Kentucky Utilities Co.*, 983 S.W.2d 493, 501 (Ky. 1998) ("The PSC is not required to set any rate based on the accounting entries of the utility it supervises.") citing *Fern Lake Co. v. Public Service Comm'n*, 357 S.W.2d 701 (Ky. 1962).

⁴⁶ See *South Cent. Bell Tel. Co. v. Public Service Comm'n*, 702 S.W.2d 447, 453 (Ky. App. 1985) ("Regulatory commissions have substantial discretion to specify their own accounting treatment of selected ratemaking items.") citing *Pacific Tel. & Tel. Co., v. PVC*, 401 P.2d 353 (Cal.1965).

⁴⁷ See HVR 9:55:05; Lebanon Response to Marion District's First Request for Information, Nos. 7-8.

⁴⁸ See HVR 9:55:15.

⁴⁹ See Lebanon Response to Marion District's Post-Hearing Data Request, Exhibit 1-1.

⁵⁰ Lebanon was unable to explain the discrepancy between using very short useful lives for its principal plant assets while at the same time complaining that its assets were extremely old and in need of repair or replacement. See HVR 9:57:42. Given the fact that Lebanon has a reasonable water lost ratio, its assets would appear to be used and useful well beyond the lifespan cited in the Capitalization Policy. The discrepancy between the purported disrepair to the Lebanon system and the fact that its assets appear to still be performing well further calls into question the doomsday scenario painted by its new management. Perhaps Lebanon's former management was not as inept as suggested at the hearing?

⁵¹ See Thompson Direct Testimony, p. 34.

calculating the original revenue requirement.⁵² In response to post-hearing data requests, Lebanon quantified the amount of the savings as being \$54,144.⁵³ This amount should also be included as an offset to the revenue requirement using Lebanon's test year.

g. Lebanon Failed to Collect Substantial Income by Giving Free Water to the City

Lebanon admitted in discovery that it gave away 3.7 million cubic feet of water to the City of Lebanon during the test year.⁵⁴ There is no formal agreement to support the provision of free water and it is a practice that has continued for decades.⁵⁵ The value of this foregone sales revenue equals \$123,950.⁵⁶ When the issue was raised by Marion District, Lebanon sought to justify it by suggesting that other services provided by the City to Lebanon were sufficient to offset all or a good portion of the foregone revenue.⁵⁷ However, these justifications were based upon estimates. The bottom line is that the City of Lebanon has received a substantial amount of free water for as long as anyone can remember and, through its own payment of rates to Lebanon, Marion District and its customers have subsidized this free, discriminatory service.

Lebanon confirmed that there is no reason it could not charge the City for the water it provides, nor is there any reason that Lebanon could not be invoiced for the services provided to it by the City.⁵⁸ Keeping a clear record of transactions between Lebanon and the City would instill confidence in the working of local government by providing transparency for those customers who must pay the utility's rates. Regardless of whether Lebanon adopts the better practice of tracking

⁵² See HVR 10:03:08.

⁵³ See Lebanon Response to Marion District's Post-Hearing Data Request, No. 5.

⁵⁴ See Lebanon Response to Marion District's Supplemental Information Request, No. 8.

⁵⁵ See HVR 10:05:45.

⁵⁶ See White Direct Testimony, p. 6 (as corrected in the Errata Sheet).

⁵⁷ See Thompson Rebuttal, p. 6.

⁵⁸ See HVR 10:08:09.

and recording expenses, its choice to forego \$123,950 in revenue for water that it delivers to the City cannot be used to punish Marion District. Accordingly, Lebanon's revenue requirement should be reduced by \$123,950 to account for the revenue which it is voluntarily refusing to collect on a service it is already providing.

h. Lebanon Failed to Demonstrate the Reasonableness of Other Extraordinary Expenses

As set forth in the final version of Exhibit 6 to the Direct Testimony of Charles White,⁵⁹ Lebanon's pro forma included several expenses which greatly exceeded the historical three year average for such expenses.⁶⁰ While it is appropriate to make deviations for changes that are "known and measurable," Lebanon has not sustained its burden of proof in this regard for its maintenance and repair costs, outside services and miscellaneous expenses. Accordingly, it is consistent with Commission practice – in the absence of evidence to the contrary – to normalize and annualize such expenses.⁶¹ Doing so in this case results in a lowering of Lebanon's revenue requirement by an additional \$119,645.⁶²

2. Lebanon's Claim to Support an Additional \$365,958 in Post-Test Year Costs and Expenses is Equally Inflated and Unsupported.

Although Lebanon is not seeking anything beyond the proposed \$798,208 rate increase,⁶³ it has suggested that it could justify a total rate increase of \$1,164,166.⁶⁴ Tellingly, Lebanon has made no effort to impose an additional rate increase on its City customers,⁶⁵ nor has it taken any

⁵⁹ See Lebanon Hearing Ex. 1

⁶⁰ See White Direct Testimony, p. 7 (as corrected in the Errata Sheet).

⁶¹ See *Public Service Comm'n of Ky. v. Continental Tel. Co. of Ky.*, 692 S.W.2d 794, 799 (Ky. 1985) ("Generally accepted rate-making principles permit matters within the test year to be both normalized and annualized. There is also a provision for an adjustment because of known and measurable changes outside the test year.").

⁶² See Lebanon Hearing Ex. 1. To arrive at this figure, Marion District subtracted \$52,413 from the \$172,058 set forth in the Exhibit. This was done because Lebanon's salary figures are discussed elsewhere.

⁶³ See HVR 9:24:01.

⁶⁴ See Marion District Hearing Ex. 2.

⁶⁵ See HVR 11:53:20.

affirmative steps to do so.⁶⁶ As with its test year expenses, the post-test year expenses referenced by Lebanon throughout its rebuttal testimony and at the hearing are also inflated or generally unsupported by specific factual evidence. Accordingly, if the Commission were to look outside the test year proposed by Lebanon, it would be necessary to take into account *all* of the relevant adjustments.⁶⁷

a. Lebanon's Income has Increased Substantially Following the Test Year Close

Lebanon's projected operating revenues increased by \$356,181 over the amount stated in the audited test year pro forma.⁶⁸ Moreover, Lebanon agreed that one could have a high degree of confidence in its projected operating revenue calculation based upon the fact that the estimate is based upon eleven months of historical data.⁶⁹ Accordingly, any consideration of significant post-test year expenses must include a \$356,181 offset to account for the known and measurable increase in Lebanon's operating revenues.

b. Lebanon's Additional Salary Expense Increases are Unreasonable

In addition to the increases in salary and payroll expenses above and beyond the audited test year expense that are included in Lebanon's original rate increase request, Lebanon has added an additional \$35,821 in salary expense to its revenue requirement for a new grand total of \$122,159 in incremental salary expense incurred outside the test year.⁷⁰ Again, the basis for the increases is justified on the grounds of new employees,⁷¹ however, it is not as well-established what value is added by the new employees to Lebanon's operations. In addition to excluding the

⁶⁶ See HVR 11:28:12.

⁶⁷ See HVR 10:09:13; 1:49:28.

⁶⁸ See Marion District Hearing Ex. 1.

⁶⁹ See HVR 10:09:56.

⁷⁰ See Marion District Hearing Ex. 1.

⁷¹ See HVR 10:10:52.

salary expense discussed above with regard to Lebanon's original rate request, the Commission should exclude the \$35,821 in incremental salary expense if it decides to look beyond the test year.

**c. Lebanon Failed to Demonstrate that Various
"Service Agreements" are Recurring Expenses**

Lebanon claimed in rebuttal testimony that it was incurring an additional \$70,440 in expenses related to various service agreements it had entered into following the conclusion of the test year.⁷² However, prior to the hearing, Lebanon did not produce an actual agreement that supports its request. In response to a post-hearing data request, Lebanon produced a few documents purporting to establish the continuing nature of the various services to be provided, however, upon closer review, it has failed to produce tangible evidence that the expenses reflected in its documentation are likely to be recurring and ongoing expenses of the utility.⁷³ For instance, there is no contract for future Clearwell Cleaning services. Lebanon bases its request for a \$16,075 revenue requirement on two invoices.⁷⁴ However, the frequency of the service or whether the price will go up, go down or stay the same is left to speculation. The same is true for most of the other service agreements for which the services appear to be obtained on an as-needed basis without any long-term commitment.

Lebanon testified at the hearing that it was substantially behind in its efforts to maintain the existing WTP.⁷⁵ However, once it brings the system back in line with expectations, there is no direct evidence to suggest that these expenses will continue to be incurred, and certainly not as frequently as they are currently being incurred. It is well-settled that a utility may only obtain its "known and measurable" expenses. Projected expenses must be supported with specific data to

⁷² See Thompson Direct Testimony, p. 23.

⁷³ See Lebanon's Response to Marion District's Post-Hearing Data Request, No. 2.

⁷⁴ See *id.*, Exhibit 2-1.

⁷⁵ See HVR 10:14:40.

satisfy the known and measurable standard, otherwise it is entirely appropriate to both normalize and annualize the data.⁷⁶ This should be especially true in a situation such as this where Lebanon's projected maintenance budget far exceeds its historical average.⁷⁷ Lebanon has not crossed the finish line on making such a showing and the Commission should exclude the incremental costs of the various service agreements. Not all of its dramatic increases in expenses can be fairly characterized as ordinary.⁷⁸ Accordingly, if the Commission considers looking outside the test year, it should reduce Lebanon's revenue requirement by \$70,440.

d. Lebanon's Depreciation Expense Continues to be Inflated and Unreasonable

Lebanon suggested in rebuttal testimony that it could include an additional \$206,086 in depreciation expense if the assets that it brought online following the close of the test year on June 30, 2016 were taken into account.⁷⁹ However, all of the same depreciation problems associated with Lebanon's initial rate request carry over and apply with equal force and effect to the calculation of incremental depreciation expense.⁸⁰ Using the NARUC guidelines instead of its own unreasonable Capitalization Policy, Lebanon concedes that its depreciation expense would be reduced by \$168,648.⁸¹ Accordingly, should the Commission decide to look beyond the original test year, it should use the correct depreciation expense and reduce Lebanon's claimed depreciation expense by \$168,648.

⁷⁶ See *Public Service Comm'n of Ky. v. Continental Tel. Co. of Ky.*, 692 S.W.2d 794, 799 (Ky. 1985) ("Generally accepted rate-making principles permit matters within the test year to be both normalized and annualized. There is also a provision for an adjustment because of known and measurable changes outside the test year.")

⁷⁷ See White Direct Testimony, p. 7.

⁷⁸ See *id.*, p. 7; HVR 1:56:45.

⁷⁹ See Thompson Rebuttal Testimony, Ex. 1; Marion District Hearing Ex. 2.

⁸⁰ See Notes 40-50 and accompanying text, *supra*.

⁸¹ See Marion District Hearing Ex. 8; HVR 10:26:07.

e. Lebanon's Debt Service Requirement is Unsupported

Lebanon claimed in testimony that it required a 1.25 debt service coverage requirement to adequately service its debt.⁸² The incremental increase in the debt service ratio would purportedly result in a \$77,060 increase in Lebanon's revenue requirement.⁸³ However, Lebanon cannot produce any documentation to demonstrate that the 1.25 debt service ratio applies to its debts. For instance, it was conceded at the hearing that neither the debt issued by the Kentucky Infrastructure Authority nor the commercial loans issued by Citizens National Bank include such a formal debt service coverage requirement.⁸⁴

In fact, the only debt to which the 1.25 requirement could possibly apply are bonds that were issued by Rural Development ("RD") in 1992, 1997 and 2002, all of which incorporate by reference the terms of an earlier 1991 Bond Ordinance adopted by the City of Lebanon which expressly included the 1.25 debt coverage requirement.⁸⁵ However, the RD debt no longer exists. Citizens National Bank "refinanced" the 1997 and 2002 bonds in 2012, as reflected in Loan Number 76735, and "refinanced" the 1992 bonds in 2013, as reflected in Loan Number 77049.⁸⁶ Contrary to the legal assertion of Mr. William Thompson's affidavit that Citizens National Bank "stepped into the shoes" of RD, the documentation does not support the claim. By refinancing the bonds, Lebanon extinguished its debt to RD using proceeds of a new and completely separate loan from Citizens National Bank. Lebanon agreed that there is nothing in the record to positively demonstrate that the RD debt was somehow assigned to Citizens and there is nothing in the two

⁸² See Thompson Direct Testimony, p. 32; Nicholas Rebuttal Testimony, p. 7.

⁸³ See Marion District Hearing Ex. 2.

⁸⁴ See HVR 10:44:35.

⁸⁵ See Thompson Direct Testimony, Exhibits 8, 9 and 10; Lebanon's Response to Staff's Second Request for Information, No. 5.

⁸⁶ See Marion District Hearing Ex. 9, p. 2.

sets of loan documents to evidence a new or continuing obligation to maintain a 1.25 debt coverage ratio.⁸⁷ A 1.20 debt service coverage ratio would appear to be entirely reasonable in this instance. Accordingly, in the absence of a document specifically applying to Lebanon’s current debt and setting forth a 1.25 debt service requirement, the \$77,060 in incremental debt service coverage expense should be excluded from any post-test year revenue requirement calculation.

3. Summary of Proposed Adjustments to Lebanon’s Revenue Requirements

Based upon the foregoing, it is evident that Lebanon has failed to carry its burden of proof to establish that a \$798,208 rate increase (or a \$1,164,166 alternative calculation) is reasonable.

The adjustments proposed by Marion District are as follows:

Lebanon’s Request	\$798,208	\$1,164,166
Omitted Income for Late Fees/Penalties	(\$34,344)	
Lower Pricing from Campbellsville	(\$54,020)	(\$54,020)
Updated Purchased Water Costs Based upon FY19 Projection	(\$2,140)	(\$2,140)
Reduced Water Purchases from Campbellsville	(\$57,670)	(\$57,670)
Overstated/Unsupported Salary Expense Increase	(\$52,413)	(\$86,338)
Overstated/Unsupported Payroll Tax Expense Increase	(\$8,729)	(\$8,729)
Recalculated Depreciation Expense Using NARUC Guidelines	(\$90,016)	(\$168,648)
Omitted Health Insurance Savings	(\$54,144)	
Free Water Provided to the City	(\$123,950)	(\$123,950)
Annualized/Normalized Expenses	(\$119,645)	(\$119,645)
Increase in Revenue		(\$356,181)
Additional Incremental Salary Expense		(\$35,821)
Eliminate Undocumented “Service Agreement” Expenses		(\$70,440)
Use 1.20 Debt Service Coverage Requirement		(\$77,060)
Bad Debts	\$4,300	\$4,300
ADJUSTED REVENUE REQUIREMENT:	\$205,437	\$8,824

Lebanon’s original and updated revenue requirement calculations are both substantially overstated and lack specific evidentiary support in many instances. Accordingly, its revenue requirements should be adjusted as set forth above.

⁸⁷ See HVR 10:51:51.

B. Lebanon's Proposed Rate Design is Unfair and Forces Marion District's Rural Customers to Subsidize the Water Service Provided to Lebanon's In-City Customers

Lebanon has proposed to recover its rate increase by imposing an 8.9% increase in its customer meter charge (from \$6.75 per month to \$7.35 per month) and a 34% increase in its volumetric rate (from \$2.50 per hundred cubic feet to \$3.35 per hundred cubic feet).⁸⁸ It is not disputed that Marion District has twelve master meters connecting to the Lebanon distribution system,⁸⁹ which means that Marion District comprises approximately 0.5% of Lebanon's meters.⁹⁰ Moreover, Lebanon's own data indicates that Marion District accounted for approximately 56% of its total water sales during the test year.⁹¹

Notwithstanding these statistics, Lebanon's proposed rate design would result in Marion District paying an additional \$508,596 each year for water, which represents a monthly increase of \$42,383.⁹² Thus, approximately 64% of the proposed rate increase would be paid by Marion District's customers.⁹³ While this disparity is plainly evident, the actual prejudice to Marion District's customers is even greater when one takes into account the amount of free water provided to the City of Lebanon which further inflates Marion District's proportion of water purchases from Lebanon. Unfortunately, Lebanon has proposed its rate increase without having the benefit of a cost of service study,⁹⁴ which would accurately demonstrate which customers account for its costs and expenses as a preliminary step in designing a fair and equitable rate design. Likely because it

⁸⁸ See Marion District Hearing Ex. 3.

⁸⁹ See HVR 10:53:25. Only eleven of the twelve meters are currently used.

⁹⁰ See *id.*, 10:53:20.

⁹¹ See Lebanon's Response to Marion District's First Request for Information, No. 5; Lebanon Brief, p. 29.

⁹² See Marion District Hearing Ex. 3.

⁹³ Lebanon's answer to this mathematical reality is to claim that Marion District is mystically engaged in manipulative hocus pocus. See *e.g.* Lebanon Brief, p. 29 ("Although Marion District has attempted to manipulate the numbers to show that the rate increase has a disparate impact..."). Lest one forget, it was Lebanon that omitted the actual rate impact figures from its comparative analysis document. See Marion District Hearing Ex. 12; HVR 11:12:15.

⁹⁴ See *id.*, 1:30:13.

is easy to anticipate what a cost of service study would prove, Lebanon said at the hearing that it did not see the need for such an analysis to be performed. Although Marion District is the only wholesale customer of Lebanon, it is ironically (perhaps tragically) charged a rate that exceeds the rate impact offered to the City's retail customers who require significantly more infrastructure to support their service requirements.

The "protection" against discriminatory rates afforded by the "single, uniform rate" which Lebanon relies upon and cites frequently offers all the safeguards that empty rhetoric typically affords. Lebanon's bold claim that "it is mathematically impossible for the proposed rate increase to have a greater impact upon Marion District than upon [Lebanon's] 'In City' customers," is downright false.⁹⁵ The burden of the proposed rate increase most certainly falls heaviest upon Marion District, which Lebanon – if it didn't choose to outright conceal – conveniently failed to accurately disclose.⁹⁶ While the average user will experience a 24% rate increase, Marion District's increase will amount to 34%.⁹⁷

A different rate design is necessary. It is possible to shift the design of any rate increase to equitably distribute the impact upon customers in a manner that is fair and equitable. Moreover, such a shift of the rate increase from the volumetric charge to the fixed meter charge would be beneficial to Lebanon. Mr. Thompson agreed and confirmed that a utility's revenues are more stable when a greater percentage of its revenue is collected through a fixed charge or customer charge as opposed to being collected through a volumetric charge.⁹⁸ In response to post-hearing data requests, Lebanon confirmed that a significantly lower increase in rates paid by Marion

⁹⁵ See Marion District Hearing Ex. 10, p. 8.

⁹⁶ See e.g. Marion District Hearing Ex. 11, Ex. 12.

⁹⁷ Compare Marion District Hearing Ex. 11 and Ex. 3.

⁹⁸ See HVR 9:41:41.

District could still achieve the revenue requirement necessary to secure its requested revenue requirement.⁹⁹ Such an adjustment hardly qualifies as the “extraordinary” increase in the meter charge that Lebanon claimed would be necessary.¹⁰⁰

The response is particularly troubling in light of the revelation at the hearing that Lebanon’s consultant prepared multiple scenarios to apply the proposed rate increase.¹⁰¹ However, the rationale behind the rate design that was ultimately chosen was never fully explained by Lebanon. The concern that it is an unfair, inequitable and discriminatory attempt to shift the costs created by Lebanon’s retail customers to Marion District’s rural customers is entirely un rebutted.

It is likely for each of the reasons cited above that Lebanon once again makes the erroneous legal claim that Marion District bears the burden of proof for showing that the proposed rate design is unreasonable.¹⁰² That postulation has been rejected both as a matter of general Kentucky law and as the law of this case.¹⁰³ Lebanon is the applicant. The burden of proof is its alone. In authorizing any rate increase upon Marion District, the Commission should give due consideration to what rate design would fairly and equitably accomplish Lebanon’s need to raise revenue without punishing Marion District and its customers.

⁹⁹ See Lebanon’s Response to Marion District’s Post-Hearing Data Request, Ex. 3-1.

¹⁰⁰ See HVR 1:32:00.

¹⁰¹ See HVR 1:14:12; Lebanon’s Response to Marion District’s Post-Hearing Data Request, No. 4.

¹⁰² See Lebanon Brief, pp. 28-29.

¹⁰³ See *Energy Regulatory Comm’n v. Kentucky Power Co.*, 605 S.W.2d 46, 50 (Ky. App. 1980) citing *Lee v. International Harvester Co.*, 373 S.W.2d 418 (Ky. 1963); Order, Case No. 2017-00417 (“Having reviewed the record, the Commission finds that pursuant to KRS 278.200, KRS 278.190(3), and the Kentucky Supreme Court’s decision in *Simpson County Water District v. City of Franklin*, 827 S.W.2d 460 (Ky. 1994), Lebanon Water has the burden of proof to show that its proposed adjustments to its existing rates for wholesale water service to Marion District are fair, just, and reasonable.”).

C. Lebanon's Reasonable Rate Case Expense Should Be Allocated Fairly

Based upon Commission precedent cited by Lebanon,¹⁰⁴ capping the amount of rate case expense to that originally estimated appears to be appropriate in this case. And to the extent that the Commission may reduce the amount of Lebanon's proposed rate increase, it is reasonable to assume that any savings would be shared by Lebanon with its retail customers through the process available to it through interactions with the Lebanon City Council. Accordingly, Marion District asserts that any award of rate case expense should be apportioned such that it is only required to reimburse Lebanon in proportion to the overall rate increase percentage that is payable by Marion District. Otherwise, once again, the City's retail customers who lack any direct forum to raise their objections to a proposed rate increase, will be free riders on the benefits of Marion District's expenditures to assure that any final rate increase is fair, just and reasonable.

Moreover, Marion District believes that the proposed tariff surcharge covering rate case expense is not specific enough. To the extent that a surcharge is employed to recover reasonable rate case expense, it should explicitly provide for termination of the surcharge upon the earlier of the recovery of the expense or the passage of a specific period of time. Likewise, given the fact that the proposed rate increase relies heavily upon a volumetric charge, Marion District questions whether rate case expense should be recovered in a fixed amount or whether a volumetric rate may be more appropriate. Regardless, due to the amount of the rate case expense incurred in proportion to the overall rate request, a recovery period of longer than three years also appears to be appropriate.¹⁰⁵

¹⁰⁴ See Lebanon Response to Staff's Second Request for Information, No. 20.

¹⁰⁵ The \$162,695.30 of rate case expense incurred by Lebanon is approximately 20% of the \$798,208 that Marion District believes would be a reasonable rate increase. See Lebanon Supplemental Response to Staff's Second Request for Information, No. 20.

D. Merger

Though beyond the scope of the issues presented in Lebanon's proposed rate increase, the subject of a possible merger of Lebanon and Marion District arose in the course of the hearing. As stated at the hearing, Marion District remains open to a consolidation of the two water utilities within the county, however, it is critical that such a merger be accomplished in a way that the interests of both urban and rural customers are protected. The best protection, of course, is to have the Commission as an independent subject-matter expert provide the regulatory oversight afforded under Kentucky law over the new entity. Indeed, the Kentucky Supreme Court has recognized the importance of this protection for customers of a municipal utility who have no electoral remedies available to them.¹⁰⁶ However, that point appears to be a deal-breaker for Lebanon who – as this case demonstrates – has significant reason to continue to eschew outside regulatory oversight.

IV. Conclusion

Wherefore, on the basis of the foregoing, Marion District respectfully requests the Commission to deny Lebanon's requested rate increase and to instead:

1. Authorize a rate increase no greater than the amount set forth herein, as adjusted;
2. Implement a rate design whereby Marion District is not prejudiced or harmed to the extent that it subsidizes the provision of water to Lebanon's "In City" customers;
3. Apportion and allow recovery of only those rate case expenses incurred by Lebanon which are deemed to be reasonable and allow such recovery to be made over a reasonable period of time;

¹⁰⁶ See *Grayson Rural Electric Corp. v. City of Vanceburg*, 4 S.W.3d 526, 529 (Ky. 1999) (“[O]ur predecessor Court recognized that voting power gave residents of a city some means of protection against excessive rates or inadequate service of a utility owned by the city. However, customers outside the city have no such protection.”) citing *Louisville Water Co. v. Public Service Comm'n*, 318 S.W.2d 537, 539 (Ky. 1958).

4. Require Lebanon to refund all excess amounts recovered subject to refund during the pendency of this proceeding; and
5. Grant such relief as Marion District may be entitled.

This 3rd day of July, 2018.

Respectfully submitted,



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CERTIFICATE OF SERVICE

This is to certify that foregoing electronic filing is a true and accurate copy of the document being filed in paper medium; that the electronic filing was transmitted to the Commission on July 3, 2018; that there are currently no parties that the Commission has excused from participation by electronic means in this proceeding; and that a copy of the filing in paper medium is being hand delivered to the Commission within two business days.



Counsel for Marion County Water District