

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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

REPLY BRIEF OF
LEBANON WATER WORKS COMPANY

FILED: July 6, 2018

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I. INTRODUCTION

In its Post-Hearing Brief, Marion County Water District (the “Marion District”) urges the Public Service Commission (the “Commission”) to turn a blind eye to the use of the most recent fiscal year operations for which an audit is available to evaluate the reasonableness of Lebanon Water Works Company’s (the “Company”) proposed rates. Marion District also rehashes previously contested issues that the Company had already conceded for purposes of this case. Nothing in Marion District’s Post-Hearing Brief overcomes the clear evidence of record that the Company’s proposed rates will produce revenues substantially less than is necessary to meet reasonable operating expenses, service its debt, and maintain an adequate level of working capital. Accordingly, the Commission should approve the Company’s requested rates.

II. ARGUMENT

A. Use of FY 2017 Operations to Evaluate the Reasonableness of Proposed Rates is Permissible, Consistent with Existing Law, and Allows for a Review Based Upon Representative Conditions.

The Company is not advocating that no test period be used to evaluate the reasonableness of the proposed rates. When evaluating the proposed rates, however, the Commission should use a test period that will establish with a reasonable degree of accuracy the revenue and expenses that the Company will experience during the period the proposed rates are likely to be in effect. The 12-

month period ending June 30, 2017 (the “FY 2017”) is the most representative period.

The Commission’s use of FY 2017 as the test period to evaluate the Company’s proposed rates is neither unprecedented nor improper. The Commission is not bound to use the 12-month period ending June 30, 2016 (the “FY 2016”) merely because the Company originally used that period as a starting point to develop its rate proposals to Marion District and to the Lebanon City Council. The selection of the test period to assess the reasonableness of the Company’s proposed rate is solely within the Commission’s discretion. Marion District has identified no statute or regulation that limits the Commission in its choice of a test period when evaluating the reasonableness of a **municipal utility’s proposed rate revision**. In fact, no statute or regulation requires a municipal utility to select a test period upon which to base its rates.

The only statute that addresses the rates assessed by a city or municipal utility to a public utility is KRS 278.200. It requires only that a hearing be held prior to any change in those rates. The Commission has promulgated no regulation that specifically addresses municipal utility rate adjustments. 807 KAR 5:001, Section 16, which addresses applications for rate adjustments, is not applicable

since the Company did not file an application for rate adjustment, but merely filed notice of its proposed revision.¹

Admittedly, there are some limitations upon the Commission's selection of a test period to evaluate the reasonableness of a **public utility's** proposed rates. KRS 278.192 establishes a specific period that must be used when a **public utility** proposes the use of a future test period, but places **no** limit on the test period when a public utility's rates are based upon historic operations. The Commission's Rules of Procedure do not prohibit the Commission from evaluating a historic period of operations upon which a **public utility** bases its proposed rates, determining that such period is unrepresentative of the public utility's current and future operations, and selecting another period upon which to evaluate the proposed rates. There are **no** limitations, however, on selecting a test period for a

¹ In *Simpson County Water District v. City of Franklin*, 872 S.W.2d 460 (Ky. 1994), the Kentucky Supreme Court provided no guidance as to how the Commission was to review municipal utility rate changes or the process to be followed. It held only that a hearing before the Commission was required. In *Submission of Contracts and Rates of Municipal Utilities Providing Wholesale Utility Service To Public Utilities*, Administrative Case No. 351 (Ky. PSC Aug. 1, 1994), the Commission specified only that the municipal utility was required to furnish the Commission with thirty day's notice of any change in wholesale rates upon rate schedules conforming to 807 KAR 5:011. In subsequent proceedings, the Commission stated that a municipal utility could apply to change its wholesale rate pursuant to 807 KAR 5:001 or could continue to file a tariff sheet in accordance with the Commission's Order in Administrative Case 351. In 1995, 1998 and 2007, the Commission provided written guidance to municipal utilities on the procedures to follow when revising wholesale rates. Letter from Don Mills, Executive Director, Kentucky Public Service Commission to All Municipal Utilities Providing Wholesale Utility Service to Jurisdictional Public Utilities (Nov. 8, 1995); Letter from Helen C. Helton, Executive Director, Kentucky Public Service Commission to All Municipal Utilities Providing Wholesale Utility Service to Jurisdictional Public Utilities (Dec. 18, 1998). Letter from Beth O'Donnell, Executive Director, Kentucky Public Service Commission to All Municipal Utilities Providing Wholesale Utility Service to Jurisdictional Public Utilities (Oct. 16, 2007). This guidance addressed only the initial notice of the proposed increase and not the procedures to be followed if the Commission chose to initiate an investigation of the proposed rate.

municipal utility.² Even if the restrictions that applied to a public utility were to apply to the Company, they would not prevent the Commission from exercising its discretion to select the most representative period of operations as the test period.

The principle that a test year should be based upon a utility's most recent operations is not limited to the state of Vermont, as Marion District dismissively suggests, but is widely recognized and endorsed.³ To ignore such precedent would place the Commission outside the mainstream of utility regulation.

The record of this proceeding does not support Marion District's claims of a "bait and switch." While the Company has repeatedly acknowledged its use of FY 2016 to develop its initial proposals to Marion District and to the Lebanon City Council, it did so only because FY 2016 was the most recent period of operations. In its first response to Commission Staff's First Request for Information, submitted in early March 2018, the Company provided a detailed explanation on its use of

² Marion District asserts that the Company has argued that "no test year is necessary to justify a rate increase in the context of a wholesale rate increase." Marion County Water District's Post-Hearing Brief at 5, n. 22. The Company has never contended that a test period is unnecessary to evaluate the reasonableness of a proposed rate. In its Post-Hearing Brief the Company in fact proposes the use of FY 2017. The Commission has long employed the test period concept to evaluate proposed rates. Unlike other types of rate proceedings, however, a municipal utility does not select a test period when it submits its proposed rate changes. It does not submit a detailed application containing test period revenues and expenses nor does it identify a specific test period upon which its application is based. The lack of such an application affords the Commission greater flexibility in the selection of a test period to use to evaluate the reasonableness of the proposed rates and its review of the municipal utility's proposed rates.

³ See, e.g., *Cent. La. Elec. Co. v. La. Pub. Serv. Comm'n*, 508 So.2d 1361, 1365 (La. 1987) ("The initial determination that must be made is the utility's future revenue requirement. As a guide to such a determination, data is generally gathered from some twelve month period taken as a 'test year.' Customarily, the test year selected is the most recent annual period from which actual operating data is available.") (citations omitted); *New England Tel. & Tel. Co. v. Pub. Utilities Comm'n*, 376 A.2d 1041, 1046 (R.I. 1977) ("The commission must make rates for the future. In so doing, it cannot shut its eyes to the company's actual operating results, nor can it rely on prophecy when the company's real experience is available."); *Gulf Power Co. v. Bevis*, 289 So.2d 401, 404 (Fl. 1974) ("In regulatory rate making, it is customary to select a test year or period for the purpose of testing the revenue requirements of the utility under consideration. The judicial decisions on the subject of the appropriate test year in a utility rate case uniformly adhere to the rule that the test period should be based on the utility's most recent actual experience with such adjustments as will make the test period reflect typical conditions in the immediate future.").

FY 2016 operations and the need to make numerous changes because FY 2016 was a transition period.⁴ Mr. Thompson testified⁵ that the Company regarded FY 2016 as unrepresentative of its current operations. In developing the proposed rates, the Company adjusted FY 2016 operations with actual changes occurring in FY 2017 and budgeted changes expected to occur in FY 2018 to ensure a more representative test period.

Throughout this proceeding, Marion District has echoed these concerns. It repeatedly asserted that the Company's FY 2016 operations do not accurately reflect its current operations and frequently urged that specific FY 2017 expenses and revenues be used to determine the Company's Revenue Requirements. In Marion District's letter of September 25, 2017 in which it requested Commission review of the proposed rates, Marion District objected to the use of FY 2016 as the test period upon which to review those rates. It specifically expressed its concerns regarding the use of FY 2016⁶ as the test period as well as the Company's use of budgeted expenses for FY 2018 rather than information contained in the completed audit report for FY 2017 operations. Charles White, Marion District's witness who analyzed the proposed rates, relied heavily upon the Company's FY 2017

⁴ Response of Lebanon Water Works Company to Commission Staff's Request for Information, Item 2(3).

⁵ Hearing Video Transcript 9:18:24 A.M. (June 20, 2018).

⁶ In his letter requesting Commission review of the proposed rates, one of the concerns that Marion District's counsel expressed with the proposed rates was the "[u]se of a test period in which it [the Company] employed two General Managers during a transition." Letter from Kaelin G. Reed, Counsel for Marion District, to John S. Lyons, Acting Executive Director, Kentucky Public Service Commission (Sept. 19, 2017) at 2. FY 2016 was the time period in which the Company employed two general managers.

operations to develop his analysis.⁷ In its Post-Hearing Brief, Marion District again takes issue with the use of FY 2016 operations. For example, it requests that the Commission use the Company's 2017 employee health insurance costs rather than the 2016 costs.⁸

Marion District's efforts to selectively substitute portions of the Company's FY 2017 operations for FY 2016 operations is a tacit admission that the Company's FY 2016 operations are not representative of current operations. Rather than pick and choose FY 2017 revenues and expenses to replace FY 2016 revenues and expenses – why not use them all? Fairness dictates this action, especially since Marion District has argued that a test period based upon audited operations is more reliable. Why not use the most recent audited results – those for FY 2017?

B. Marion District's Post-Hearing Brief Ignores the Company's Acceptance of Many Contested Items.

In its Post-Hearing Brief, the Company acknowledges the merits of some Marion District arguments. Marion District, however, ignores the Company's acceptance of the contested items individually addressed below. The Company's acceptance of Marion District's proposed adjustments leaves few disputed issues and results in a revenue requirement that is higher than the revenue that will be

⁷ For example, see Direct Testimony of Charles M. White at 3.

⁸ Marion County Water District's Post-Hearing Brief at 10-11.

produced by the proposed rates. Once again, the Company has understated its Revenue Requirements.

1. Revenue from Penalties and Late Fees.

The Company acknowledges that any revenue from penalties and late fees should be considered in the calculation of the Company's revenue unless the Commission elects not to continue the use of the uniform rate.⁹ In its calculation of the Revenue Requirements using FY 2017, the Company has included operating revenues of \$35,886 from penalties and late payment fees.¹⁰ In addition, the Company has included \$11,424 in revenues earned for collecting garbage fees for Marion County Fiscal Court.¹¹

2. Reduction in Campbellsville's Wholesale Water Rate.

The Company did not incur any purchased water expense in FY 2017. It proposes to include purchased water expense of \$436,540 as shown in Appendix A to its Post-Hearing Brief.¹² This amount is lower than the original amount it proposed because Campbellsville's rate has been reduced from \$3.36 per 1,000 gallons to \$2.99 per 1,000 gallons.

3. Salaries and Payroll Tax.

The Company proposes to use the actual salaries incurred in FY 2017 for purposes of the determination of its Revenue Requirements. Such use eliminates

⁹ Lebanon Water Works Company's Post-Hearing Brief at 10-11.

¹⁰ *Id.*, Appendix A, Note B.

¹¹ *Id.*, Appendix A, Note L.

¹² *Id.*, Appendix A, Note D; *see also* Direct Testimony of Daren Thompson at 16-17.

any need to adjust or modify FY 2016 salaries to reflect the transition period when several employees who were preparing to retire and their replacements were on the Company's payroll. Marion District has proposed the elimination of salaries of two (2) employees hired in FY 2017.¹³ As a management decision, the Company's hiring of employees is presumed to be reasonable.¹⁴ Marion District has the burden to overcome the presumption of managerial good faith,¹⁵ which it has not done.

4. Savings in Health Insurance Cost.

The Company has proposed to use actual health insurance expense incurred in FY 2017 in calculating its Revenue Requirements. This expense includes the savings achieved through changes in the Company's health insurance plan and improved procurement efforts.

5. Imputed Revenue from Provision of Water Service to the City of Lebanon.

Proforma FY 2017 Revenue Requirements shown in Appendix A of the Company's Post-Hearing Brief includes the revenue that would have been received if the Company had charged the City of Lebanon for the water at the rates in effect during FY 2017. The proposed rates should not be used to

¹³ Marion County Water District's Post-Hearing Brief at 13-14.

¹⁴ *City of Newport v. Campbell County Kentucky Water District and Kenton County Water District No. 1 and Charles Atkins and Steven J. Franzen v. Campbell County Kentucky Water District*, Case No. 89-014, Order at 5-7 (Ky. PSC Jan. 31, 1990).

¹⁵ *Id.*

determine the imputed amount of the water service since those proposed rates were not in effect at any time in FY 2017.

In its Post-Hearing Brief, Marion District did not contest an adjustment of \$64,980 to Pump and Filter Plant Expense to reflect the cost of the sludge disposal services received from the City of Lebanon in exchange for water service. The Company has reasoned, and Marion District has not disputed, that the imputation of the revenue from the provision of water service also requires the recognition for the cost of the services received in exchange for the water service.

6. Depreciation Expense.

As noted in the Company's Post-Hearing Brief, the Company has agreed, for purposes of this proceeding, to accept and apply the Commission's practice of using the mid-point of the range of useful lives recommended in "Depreciation Practices for Small Water Utilities." In the Revenue Requirements calculation in Appendix A of the Company's Post-Hearing Brief, Depreciation Expense for FY 2017 has been adjusted to reflect the calculation of depreciation using the mid-point.¹⁶

7. Revenue Increase After FY 2016.

The audit report for FY 2017 reflects an increase in revenues of approximately \$34,000. The Revenue Requirements calculation in Appendix A of the Company's Post-Hearing Brief reflects this increase in revenue as well as the

¹⁶ Lebanon Water Works Company's Post-Hearing Brief, Appendix A, Note J.

imputation of revenue from the provision of water service to the City of Lebanon. Marion District asserts that projected revenue for FY 2018 increased by \$356,181.¹⁷ The Company agrees. Revenue for FY 2018 increased because the proposed rates were in effect for a portion of FY 2018. The Company placed the proposed rates into effect for retail customers in September 2017 and for Marion District, subject to refund, in April 2018. These rates were not in effect in FY 2017. Inclusion of this “new” revenue into the revenue requirement determination is inappropriate as the revenue will not be available unless the Commission approves the proposed rates.

In summary, the Company’s acceptance of several of Marion District’s proposed adjustments leaves few disputed issues and results in a revenue requirement that is higher than the revenue that will be produced by the proposed rates.

C. The Company’s Rate Design Should Not Be Modified.

The rate design proposed by the Company is fair, just, and reasonable. Marion District continues to focus solely on the portion of the rate increase itself that Marion District will bear, not the overall result of the proposed rates. Using Marion District’s logic, if the amount of the increase of the retail customers and

¹⁷ Marion County Water District’s Post-Hearing Brief at 13.

Marion District's rates were exactly the same in percentage terms, but it paid only 10% of the total revenues while using 80% of the water, the increase would be fair.

As the Company stated in its Post-Hearing Brief, under the proposed rates, Marion District will fund approximately the same percentage of total revenue from rates as its water usage percentage.¹⁸ Notably, Marion District does not contest this fact in its Post-Hearing Brief, thus recognizing that those numbers show that the uniform rate produces a reasonable allocation of cost in relation to the amount of water being used by Marion District and the Company's retail customers. Marion District's focus on the rate increase itself and not the end result contradicts the Supreme Court's landmark decision in *Federal Power Commission v. Hope Natural Gas Co.*, in which the Court held: "Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling."¹⁹

Additionally, Marion District faults the Company for its proposed rate design, but has offered no evidence to support a different rate design. Marion District states, "Likely because it 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."²⁰ The Company has never performed a cost of service study to support its rate adjustments and found no need to incur additional costs to

¹⁸ Lebanon Water Works Company's Post-Hearing Brief at 29.

¹⁹ 320 U.S. 591, 602 (1944).

²⁰ Marion County Water District's Post-Hearing Brief at 18-19.

perform such a study for this rate adjustment. Marion District could have requested for the Company to perform a cost of service study and did not. Notably, Marion District has also never performed a cost of service study to analyze the cost of the Company's provision of water service to Marion District.²¹

Furthermore, Marion District's request to change the rate design is a request to alter the terms of the Master Agreement. The Commission has previously held that where a party seeks to modify the contract, it bears the burden to show the contract unreasonable.²²

Marion District also attempts to mislead the Commission by stating that a shift of the rate increase from the volumetric charge to the fixed meter charge would be beneficial to the Company. It stated, "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"²³ During Mr. Thompson's live testimony, Marion District's counsel cross-examined Mr. Thompson about the Company's electric costs charged by Kentucky Utilities Company (the "KU").²⁴ Mr. Thompson stated that KU's recent rate increase included a shift of KU's rate

²¹ See Marion County Water District's Response to Lebanon Water Works Company's Request for Information, Question No. 9 (Ky. PSC June 4, 2018).

²² *Proposed Revision of Rules Regarding the Provision of Wholesale Water Service By the City of Versailles To Northeast Woodford Water District*, Case No. 2011-00419, Order at 12 (Ky. PSC Aug. 12, 2014); *East Clark County Water District v. City of Winchester, Acting By and Through Winchester Municipal Utilities Commission*, Case No. 2005-00322, Order at 2 (Ky. PSC Apr. 3, 2006).

²³ Marion County Water District's Post-Hearing Brief at 19.

²⁴ Hearing Video Transcript 9:39:50 A.M. (June 20, 2018).

from volumetric charges to demand charges.²⁵ Marion District's counsel asked Mr. Thompson whether, from KU's perspective, the shift of KU's rates to a fixed charge helped to stabilize revenue and reduce volatility.²⁶ Mr. Thompson stated: "Correct, from KU's standpoint."²⁷ Mr. Thompson never represented that a shift of the Company's rate increase from the volumetric charge to the fixed meter charge would be beneficial to the Company.

D. A Debt Service Coverage Ratio of 1.25 Should Be Applied To All Company Debt.

The Company's annual principal and interest payments total \$558,096. This amount is undisputed. This amount will continue for the foreseeable future. The Company has included this amount in its Revenue Requirements and seeks recovery of this amount through its proposed rates.

In addition, the Company is entitled to a Debt Service Coverage (the "DSC") ratio of 1.25 on all of its debt. Using a DSC ratio of 1.25 will produce an annual revenue stream of \$139,524 ($\$558,096 \times 0.25 = \$139,524$). Contrary to Marion District's statement in its Post-Hearing Brief that the Company "cannot produce any documentation to demonstrate that the 1.25 debt service ratio applies to its debts,"²⁸ the Company has produced and explained the requirements of Ordinance

²⁵ Hearing Video Transcript 9:41:20 A.M. (June 20, 2018).

²⁶ Hearing Video Transcript 9:41:40 A.M. (June 20, 2018).

²⁷ Hearing Video Transcript 9:41:50 A.M. (June 20, 2018).

²⁸ Marion County Water District's Post-Hearing Brief at 16.

No. 91-9 and the Affidavit of William P. Thompson, President and CEO of Citizens National Bank, which show that a DSC ratio of 1.25 is required.

Further, Marion District's requested removal of \$77,060 is incorrect. After arguing that the Company lacks support to enforce a 1.25 debt service coverage ratio, Marion District then arbitrarily suggests that "[a] 1.20 debt service coverage ratio would appear to be entirely reasonable in this instance."²⁹ Marion District then suggests an adjustment of (\$77,060) for the use of a 1.20 DSC requirement. First, Marion District's request is contradictory. It argues that the Company lacks sufficient support for a 1.25 DSC ratio, but then suggests a 1.20 DSC ratio would be appropriate. There is certainly no support for a 1.20 DSC ratio. Further, even if a 1.20 DSC ratio were to be used, the reduction in the Revenue Requirements would not be \$77,060, but \$27,905 (difference in 1.25 and 1.20 is 0.05; $\$558,096 \times 0.05 = \$27,905$).

E. The Company's Rate Case Expense Should Be Recovered Through The Proposed Rate Case Expense Surcharge.

The Company is entitled to recover its rate case expense incurred in this proceeding from Marion District. The rate case expense is not confined to the Company's initial estimate and is appropriately recoverable from only Marion District.

²⁹ *Id.* at 17.

First, the Company is entitled to recover rate case expense above the expense estimated at the beginning of this proceeding. The Supreme Court has recognized that an applicant is entitled to its reasonable rate case expense, not to its reasonable **estimated** rate case expense.³⁰ The Commission has held that even when the water supply agreement that was the subject of a case was found to be unreasonable, recovery of rate case expenses were proper because the expenses incurred “were at least in part to defend the reasonableness of . . . existing rates.”³¹ Recently, the Commission approved an applicant’s rate case expense that was greater than the amount originally estimated.³²

Second, Marion District also proposes that “rate case expense should be apportioned such that [Marion District] is only required to reimburse Lebanon in proportion to the overall rate increase percentage that is payable by Marion District.”³³ Marion District states that to do otherwise would cause the City’s retail customers to be “free riders on the benefits of Marion District’s expenditures.”³⁴ As the Company stated in its Post-Hearing Brief, a municipal utility’s rate case

³⁰ See, e.g., *Driscoll v. Edison Light & Power Co.*, 307 U.S. 104, 120-21 (1939) (“Even where the rates in effect are excessive, on a proceeding by a commission to determine reasonableness, we are of the view that the utility should be allowed its fair and proper expenses for presenting its side to the commission.”); *West Ohio Gas Co. v. Pub. Utilities Comm’n*, 294 U.S. 63, 74 (1935); *Southern Bell Tel. & Tel. Co. v. Georgia Pub. Serv. Com.*, 49 S.E.2d 38 (Ga. 1948).

³¹ *Application and Notice of Campbell County, Kentucky Water District (A) To Issue Revenue Bonds in the Approximate Principal Amount of \$5,535,000 (B) To Construct Additional Plan Facilities of Approximately \$4,523,000 (C) Notice of Adjustment of Rates Effective May 1, 1989 (D) Submission of Long Term Water Supply Contract*, Case No. 89-029, Order at 2 (Ky. PSC Mar. 6, 1990).

³² *Application of Big Sandy Rural Electric Cooperative Corporation for a General Adjustment of Existing Rates*, Case No. 2017-00374, Order at 4-5 (Ky. PSC Apr. 26, 2018).

³³ Marion County Water District’s Post-Hearing Brief at 21.

³⁴ *Id.*

expense should be recovered from only the wholesale customer.³⁵ The Company's retail customers are not "free riders" of Marion District's expenditures. To the contrary, retail customers began paying the increased rates seven (7) months prior to Marion District paying the rate increase.

Marion District also raises concerns about the specificity of the proposed surcharge, the recovery period, and the recovery of the surcharge through a volumetric charge. The Company is not opposed to the recovery of the rate case expense over a longer period of time or other modifications to the proposed rate case expense surcharge, as long as the Company is able to recover all of its rate case expense incurred in this proceeding.

III. CONCLUSION

The Company's requested rate adjustment is fair, just, and reasonable. For the reasons stated herein and throughout this proceeding, the Company requests the Commission permit it to continue with its use of the single, uniform rate structure that has been consistently applied over the last 30 years whereby Marion District and the Company's "In City" retail customers pay the same rate.

In particular, the Company requests the Commission approve its proposed rate adjustment which increases the Meter Charge to **\$7.35** and the volumetric rate to **\$3.35** per 100 cubic feet. These rates will generate additional annual revenues

³⁵ *Proposed Adjustment of the Wholesale Water Service Rates of the City of Owenton, Kentucky*, Order at 9, Case No. 98-283 (Ky. PSC Feb. 22, 1999).

of \$798,208 from all customers. Additionally, the Company requests the Commission approve recovery of its rate case expense via a 36 month surcharge.

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Respectfully submitted,



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CERTIFICATE OF SERVICE

In accordance with 807 KAR 5:001, Section 8, I certify that Lebanon Water Works Company's July 6, 2018 electronic filing of this Reply Brief is a true and accurate copy of the same document being filed in paper medium; that the electronic filing has been transmitted to the Commission on July 6, 2018; that there are currently no parties that the Commission has excused from participation by electronic means in this proceeding; and that an original and one copy in paper medium of this Reply Brief will be delivered to the Commission on or before July 10, 2018.


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