

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

PROPOSED ADJUSTMENT OF THE WHOLESALE)
WATER SERVICE RATES OF THE CITY OF) Case No. 2019-00080
PIKEVILLE TO MOUNTAIN WATER DISTRICT)

POST-HEARING BRIEF OF THE CITY OF PIKEVILLE

Documentation filed in this case demonstrates the reasonableness of the City of Pikeville’s proposed wholesale water rates to Mountain Water District (“MWD”). In addition, its proposed rate-case expense surcharge is reasonable and should be approved. With these two facts in mind, Pikeville submits this initial brief.

I. Background

Recognizing that expenses have increase significantly since Pikeville’s last rate increase, Pikeville retained Samuel “Buddy” Petty with RateStudies, LLC, to recommend new rates based on Pikeville’s financial statements. Petty was initially tasked with recommending rates for all of Pikeville’s water and sewer systems.¹

Petty prepared an initial Cost of Service Analysis based on the methodology set forth in the American Water Works Manual M54, which is designed to provide small water systems with an alternative method to the Manual M1. Manual M54 states that “provides guidelines for the development of rates for utilities that lack the data and resources needed to apply the methods described in Manual M1.”²

¹ Pikeville’s Response to MWD 1-67.

² Pikeville’s Response to PSC 2-10.

Petty utilized Pikeville's audited financial statements from Fiscal Year ("FY") 2017 to calculate the revenue requirement. The financials revealed that, during FY 2017, MWD bought 50% of all water sold to inside customers and contributed only 32% of the revenue.³ Because Pikeville does not have data on peak-day or peak-hour demand, Petty engaged staff from the City and Utilities Management Group ("UMG")(the City's third-party operator) to determine the most appropriate allocation factors.⁴

Through this collaborative process, Petty assigned factors to administration, water treatment plant, and distribution for each of the 26 O&M expense items.⁵ Once the expenses for administration, water treatment plant, and distribution were determined, Petty classified those costs as either fixed or variable. He then allocated the variable operating costs across seven areas of service.⁶

No fixed costs were assigned to the wholesale customers. O&M expenses related to the water treatment plant were based on volumetric consumption ratios.⁷ Approximately 46% of distribution expenses were allocated to the wholesale customers.⁸ Based on his initial analysis using M54 methodology, Petty recommended a rate of \$2.25 per 1,000 gallons.

Pikeville distributed relevant portions of Petty's initial analysis to MWD on October 16, 2018.⁹ Representatives of Pikeville, including Petty, met with Mountain Water District

³ See Cost of Service Analysis at page 1 (Feb. 5, 2019), attached to the Testimony of Samuel Petty and filed in the record with Pikeville's Response to PSC 1-1. During this case, it was discovered that this analysis erroneously included O&M expenses from FY 2018. Pikeville provided a revised analysis with FY 17 O&M expenses in Response to PSC 2-16. The change to FY 2017 expenses decreased the revenue requirement from MWD by approximately \$2,000, which did not impact the recommended rate of \$2.30 per 1,000 gallons. This Cost of Service Analysis revised July 11, 2019 is the analysis on which Pikeville uses to support its proposed rates in this case.

⁴ Pikeville's Response to MWD 1-10.

⁵ These factors can be seen on Figure 3 (page 4) of the Cost of Service Analysis.

⁶ Testimony of Samuel Petty at 3:17-19.

⁷ For example, MWD purchases approximately 50% of the water sold by Pikeville, so 50% of treatment expenses were allocated to MWD.

⁸ See Figure 7 (page 14) of the Cost of Service Analysis.

⁹ See Letter from Philip Elswick to Daniel Stratton (Oct. 16, 2018), attached to Pikeville's Response to PSC 1-27. This analysis was marked as "Draft."

representatives on December 10, 2018, to discuss Pikeville's proposal and answer questions related to the this analysis.¹⁰ During this meeting, MWD indicated that they did not agree to the use of the AWWA-supported methodology found in the M54 Manual. One of the issues that MWD raised was the M54 Manual's support of a forecasted revenue requirement.

Rather than fighting over the reasonableness of rates determined by the M54 Manual's methodology, Pikeville requested that Petty complete another cost-of-service study based on the Debt Service Coverage methodology commonly used by Commission Staff for its staff reports.¹¹ Pikeville produced that Cost of Service Analysis to MWD on February 5, 2019, and continued negotiations.¹²

The Cost of Service Analysis recommended a rate of \$2.30 per 1,000 gallons. The primary difference between this Cost of Service Analysis that was based on a Debt Service Coverage methodology and earlier analyses related to an increased revenue requirement. This Cost of Service Analysis did not include any expenses related to this rate case.¹³

MWD responded by letter dated February 13, 2019, in which it requested additional time to allow for its Board to approve the retention of a professional consultant and receive information back from that consultant. MWD indicated that it could have a substantive response to Pikeville by March 29, which was two days after its March Board meeting. It further explained that it wanted "sufficient time to do [its] due diligence, and allow our Board to make an informed decision on how to respond." MWD concluded that, if the City believed that it needed "to move forward to the PSC, we understand."¹⁴

¹⁰ Pikeville's Response to PSC 2-4.

¹¹ Testimony of Philip Elswick at 4.

¹² *Id.*

¹³ Testimony of Samuel Petty at 4.

¹⁴ See Correspondence attached to Response to PSC 1-27.

Recognizing MWD's interest in performing due diligence and enabling its Board to make an informed decision, Pikeville agreed that it would propose rates to be effective on April 5, 2019. This proposal enabled Mountain Water District to perform the tasks it outlined in its February 13 letter.

On February 20, Pikeville filed its proposed tariff with the Commission. In that tariff, Pikeville proposed to set the volumetric rate for wholesale water service at \$2.30 per 1,000 gallons, as recommended by the Cost of Service Analysis. In its proposed tariff, Pikeville maintained the minimum 28,000,000 gallon purchase requirement for MWD, as set by contract. Pikeville did not propose a declining block, two-tier rate based on the recommendation in the Cost of Service Analysis. Petty indicated that industry standards are moving away from tiered wholesale rates and that there was no reason to have two separate rates.¹⁵ Pikeville also proposed a rate-case expense surcharge if the Commission established a case to determine the reasonableness of Pikeville's proposed rate.

On February 27, however, Mountain Water District notified Pikeville that it would protest the proposed rates. It is apparent that Mountain Water District made this decision without performing the due diligence that it previously requested through the end of March to conduct. Mountain Water District filed its protest letter with the Commission without requesting a meeting with Pikeville or its rate consultant.

On March 28, 2019, the Commission established this case and suspended the proposed effective date of the rates for a five-month period. Pikeville responded to four rounds of discovery requests. An evidentiary hearing was held in this matter on September 11, 2019, at which Pikeville presented the following witnesses: Tonya Taylor, Philip Elswick, Grondall

¹⁵ VR: 11:40:00.

Potter, and Samuel “Buddy” Petty. MWD presented two witnesses: Roy Sawyers and Connie Allen.

The evidence in this case demonstrates that \$2.30 per 1,000 gallons is fair, just and reasonable. In addition, Pikeville should be able to recover rate-case expenses through its proposed surcharge. The following analysis discusses some of the issues that have been raised in this matter.

II. Analysis

A. Revenue Requirements

The Cost of Service Analysis determined that Pikeville should recover \$1,065,428 from MWD for the provision of wholesale water service. MWD did not propose an alternate revenue requirement. In fact, MWD’s witness Connie Allen stated that she was not testifying that Pikeville was not entitled to a rate increase.¹⁶

1. Pikeville’s accounting division of inside-city and outside-city is reasonable.

Pikeville distinguishes between inside-city and outside-city water accounts. Based on Pikeville’s current understanding, the City first wanted separate inside city and outside city rates in 2006 when Pikeville acquired the Sandy Valley Water District, whose customers would have been considered outside-city customers. In order to determine appropriate rates for those formed Sandy Valley customers, Pikeville tracked expenses and revenues separately.¹⁷

Pikeville has historically grouped expenses and revenues associated with MWD in its inside-city accounts. This continues to be reasonable because of the unique nature of Pikeville’s metering points for MWD, which surround the periphery of the city limits.¹⁸ In contrast, the

¹⁶ VR: 2:10:43.

¹⁷ Pikeville’s Response to PSC 3-10.

¹⁸ Pikeville’s Response to PSC 3-11.

outside-city customers are located primarily beyond the north and northwest sections of the city limits.¹⁹

Utilizing only the inside-city accounts to determine a reasonable wholesale rate to MWD is appropriate. There would be redundancy if anyone attempted to combine both inside-city and outside-city expenses to determine a wholesale water rate because those expenses would then have to be separated (or reallocated in the analysis) to determine the appropriate cost to serve each of the systems.²⁰

2. Expenses paid to UMG are reasonable.

UMG provides operational and management services for several of Pikeville departments, including drinking water, sanitary sewer, garbage, streets, parks, landscape, and natural gas.²¹ Pikeville's contractual relationship with UMG began in 2007. The initial contract required Pikeville to pay UMG \$4,026,174 in compensation and up to \$494,904 for repairs and maintenance. Over the years, the annual compensation has increased. This increase is occasionally based on CPI increases and changes in scope of work. For example, in 2018, additional UMG employees were required to address increases in litter and refuse along roads and streets and within parks. Accordingly, the parties agreed to an additional contractual increase of \$63,112 for UMG to hire two additional workers.²²

Pikeville allocates the UMG expenses to the various departments for which UMG provides services. In FY 2017, Pikeville allocated \$1,162,040 of the annual UMG contractual amount and \$141,565 of the UMG repairs and maintenance amounts to inside-city accounts. The repairs and maintenance expenses are only assigned inside-city water if the repair or

¹⁹ *Id.*

²⁰ Pikeville's Response to PSC 3-12.

²¹ Pikeville's Response to PSC 2-20.

²² See Contracts attached to Pikeville's Response to PSC 2-20.

maintenance directly relates to the inside-city water system. The allocation of the contractual amount was based on a joint effort between UMG and Pikeville administrators to achieve departmental allocations when the contractual relationship was initiated.²³ Over the years, the initial allocation to inside-city water has been increased based on the overall percentage increase. The expense allocated to inside-city water would not increase for unrelated changes in the scope of work, such as additional employees to clean litter along roads and streets.

There are several reasons why the expenses related to UMG are reasonable. First and foremost, the contract between Pikeville and UMG is an arms-length transaction between two independent parties. This Commission has followed a long history of judicial and administrative cases finding that contracts negotiated at arms-length deserve a presumption of reasonableness.²⁴ This Commission has previously held that Pikeville's decision to contract for the operation and maintenance of its water system is a management decision that is presumed to be reasonable.²⁵ Accordingly, "[t]he burden of overcoming the presumption of managerial good faith falls on the party challenging it," which is MWD in this case.²⁶ MWD has not presented any evidence that the UMG expense allocated to inside-city water customers is unreasonable.

Second, a comparison of UMG's calculation of its own expenses to Pikeville's allocation is remarkably similar. UMG provided a breakdown of expenses related to providing operational and management services for Pikeville's drinking water system, and UMG's total expenses for those services were \$1,670,884.²⁷ In FY 2017, Pikeville allocated \$1,162,039 to inside-city

²³ Pikeville's Response to PHDR 3.

²⁴ See *West Ohio Gas Co. v. Ohio Pub. Util. Comm'n*, 294 U.S. 63 (1935); *Pa. Publ. Util. Comm'n v. Phila. Elec. Co.*, 561 A.2d 1224 (Pa. 1989).

²⁵ *City of Pikeville*, Case No. 2002-00022 at 8 (Ky. PSC Oct. 18, 2002).

²⁶ See *id.*

²⁷ Pikeville's Response to PSC 2-24.

water and \$509,145 to outside-city water for a total of \$1,671,184 for both accounts. This is within \$300 of UMG's reported costs to provide the services.

Third, Pikeville has compared its expenses with the expenses identified in annual reports of twenty utilities under Commission jurisdiction.²⁸ The results of this comparative analysis demonstrate that Pikeville's expenses related to the services that UMG provides is reasonable. The first comparison is based on consumption, and it reveals that only one out of twenty water utilities has a lower cost per thousand gallons for similar services than Pikeville's expenses. This comparison had three separate data points to demonstrate the reasonableness of Pikeville's expenses.²⁹

The second comparison is based on expense per customer for four other utilities that produce nearly all of their own water and have more than 40% of consumption from wholesale purchases.³⁰ This comparison revealed that Pikeville's expenses related to UMG were squarely in the middle of the comparative utilities' expenses, and Pikeville's expense for each of the three factors was below the median cost per customer of each of the four utilities.³¹

There is no reason why the Commission should deviate from its long-standing policy that arms-length transactions are presumed to be reasonable. But even if there was no presumption of reasonableness, Pikeville has provided quantifiable data to support the reasonableness of its expenses related to UMG services.

3. Expenses related to the Marion's Branch Industrial Park project are appropriately allocated to MWD.

In her testimony, Allen suggested that expenses related to the Marion's Branch water tank should not be recovered from MWD because the tank is used to serve the industrial park.

²⁸ Pikeville's Response to PSC 3-17.

²⁹ *Id.* ("Comparison by Customers").

³⁰ Pikeville was only able to locate data for four utilities meeting this criteria.

³¹ Pikeville's Response to PSC 3-17 ("Comparison by Customers").

Documentation from MWD, however, undoubtedly demonstrates the benefit that the Marion's Branch project had for MWD.³²

On May 27, 2015, the MWD Board of Commissioners approved a resolution supporting Pikeville's project. The minutes from that meeting provided additional information on how MWD would benefit from the project:

The project will benefit approximately 7,250 MWD customers and will provide approximately 300,000 gallons of storage for the MWD and will provide service to residents at the end of Smiley Fork Road that are currently not served. It will also provide a backup pump station for the Indian Hills pump station. When you [MWD] have high usage or a major issue, there is excess water in that tank allocated for the District to serve those customers. . . . Mr. Sawyers talked to them [the City] and said if they would make it a million gallons and let us [MWD] have 1/3 of it for additional storage, that would be great. Chairman Casey confirmed that this was for the City of Pikeville. Mr. Potter confirmed that as correct. . . . Mr. Potter stated that all of the infrastructure will be maintained by the City of Pikeville, [and that] they are just working in conjunction with us.

It is quite clear from this documentation that the Marion's Branch project benefits MWD and that expenses related to that project are appropriately allocated to MWD.

4. Pikeville's meter expense is appropriately allocated to MWD.

In the Cost of Service Analysis, seven percent of the annual cost of meters was allocated to MWD. This allocated amount totals \$3,844. In MWD's testimony, Allen questions whether these expenses should be allocated to MWD. She indicates that the allocation is appropriate if it relates to customer accounting or service, but not if it relates to replacing or repairing meters.³³

Allen bases her opinion on the MWD contract, which states that Pikeville "shall furnish, install, operate, and maintain at its own expense at the points of delivery . . . the necessary metering

³² See MWD Responses to PHDR.

³³ Testimony of Connie Allen at 7:18-21.

equipment” but that MWD would be responsible for additional lines and metering equipment for new points of service.

The contractual provision merely identifies which party will bear the responsibility for ownership of metering equipment. There is nothing in that provision (or elsewhere in the contract) that forbids Pikeville from recouping the normal operating expenses associated with metering equipment.

If the contract were to be interpreted the way Allen suggests, absurd results would occur. For example, the contract also requires Pikeville to provide service to MWD “at reasonable constant pressure(s)” and that MWD would be required to bear the costs of additional pressure. If the provision on metering equipment were read to prevent recovery of operating expenses associated with meters, it could likewise be read to prevent recovery of operating expenses related to pumping stations and elevated tanks. Likewise, the contract requires Pikeville to meet minimum water quality standards. It would be absurd to think that Pikeville could not recover expenses related to water treatment from MWD.

The contractual provision related to metering equipment merely designates who owns and, therefore, is responsible for the metering equipment. Because there is no provision precluding the recovery for that expense in rates, Pikeville’s meter expense is appropriately allocated to MWD.

B. Pikeville’s Cost of Service allocation is reasonable.

AWWA’s M1 manual explains how to determine cost of providing service to different customer classifications using detailed and complex calculations. It requires certain data related to the demands placed on the system by those customers.³⁴ Most small utilities do not have this type of demand information. In fact, Pikeville does not have data on peak-day or peak-hour

³⁴ See Testimony of Connie Allen at 22:5-16.

demands. In order to reasonably allocate expenses, Pikeville needed to utilize a different methodology—one that did not require data on peak consumption.

Accordingly, Petty engaged staff from the City and UMG to determine the most appropriate allocation factors for various expenses.³⁵ Through this collaborative process, Petty assigned factors to administration, water treatment plant, and distribution for each of the 26 O&M expense items.³⁶ Once the expenses for administration, water treatment plant, and distribution were determined, Petty classified the functional costs as either fixed or variable. He then allocated the variable operating costs across seven areas of service.³⁷

This process through which expenses were allocated is not identical to the steps articulated in the M1 Manual—and Petty has never suggested that it was. But Petty, nor any other rate analyst, could perform a full M1-type analysis because daily and hourly demand data is not available for Pikeville’s system. Rather, Petty did the best he could considering the fact that Pikeville does not have peaking data.³⁸

During the evidentiary hearing, Petty acknowledged that he did not records to reflect the precise information that the City and UMG provided in order for him to determine an appropriate allocation factor for the various expenses. Although such documentation may make it easier to make calculations and adjustments for future rate calculations, the lack of documentation does not impact the accuracy of the work that was originally performed.

The accuracy of most of the assignments can be determined at face value. For example, Petty assigned 16 of the 26 categories of expenses entirely to administration. These expenses include bank charges, office supplies, salaries, and benefits. Because MWD was not allocated

³⁵ Pikeville’s Response to MWD 1-10.

³⁶ These factors can be seen on Figure 3 (page 4) of the Cost of Service Analysis.

³⁷ Testimony of Samuel Petty at 3:17-19.

³⁸ VR: 1:20:28.

any administration expenses, they would not impact MWD's rate. In addition, repair and maintenance expense related to the plant was assigned entirely to the water treatment plant. Similarly, repair and maintenance expense related to the distribution system were assigned entirely to the distribution system. Ninety percent of the vehicle expenses for insurance and gasoline were allocated to the distribution system, which is logical because most vehicle expense would be incurred in working with the distribution system.

Not only is Petty's Cost of Service Analysis the most reliable information presented in this case on Pikeville's cost of service, it is the only information affirmatively presented in the record of this case related to Pikeville's cost of service. MWD's witness Allen indicated that she could not perform an analysis based on M1 Manual standards because she did not have sufficient information.³⁹ Petty agrees that there is insufficient peak-demand for an M1-type analysis, but he was able to analyze the circumstances through collaboration with the City and UMG. In addition, there is some suggestion that an M1-based study would support a higher rate to MWD. Pikeville's monthly peak to average demand ratio for MWD was 1.21 for 2017 and 1.37 for 2018. The peak monthly to average demand ratio for all other inside customers was 1.17 in 2017 and 1.12 in 2018. This suggests that a detailed M1 analysis would result in a higher rate increase for MWD if peak-hour and peak-day demands were similar.⁴⁰

Ultimately, Petty's Cost of Service Analysis is the only one presented in this case. And although Pikeville could not provide him with peak-hour and peak-day demand information to produce a study based on AWWA's M1 Manual, he was able to process the information that he was given and prepare—in his expert opinion—reasonable and reliable allocation factors. Accordingly, this Commission should accept those factors in this case.

³⁹ See generally Testimony of Connie Allen.

⁴⁰ Pikeville's Response to MWD 1-48.

C. Rate Design

Pikeville proposes to set a uniform volumetric wholesale rate to Mountain Water District at \$2.30 per 1,000 gallons. It has not proposed to alter the contract minimum of 28,000,000 gallons per month. The rate of \$2.30 per 1,000 gallons would be used to set the minimum bill, as well as the volumetric usage above 28,000,000 gallons per month. Pikeville's current rate structure to MWD has the minimum bill based on a rate of \$1.68 per 1,000 gallons and additional usage at a rate of \$1.30 per 1,000 gallons.

Pikeville's proposed elimination of the declining-block tiers is based on Petty's recommendation contained in the Cost of Service Analysis. Petty indicated that industry standards are moving away from tiered wholesale rates and that there was no reason to have two separate rates for usage above and below the minimum 28,000,000 gallons per month.⁴¹

Nothing in the contract requires two tiers. If the Commission determines that the declining block, two-tiered rate must remain in place, the rate assigned to the minimum 28,000,000-gallon level would be significantly higher than \$2.30 per 1,000 gallons. It appears that MWD does not want a declining-block structure.⁴²

D. Rate-Case Expense Surcharge

Pikeville has proposed a rate-case expense surcharge based on the amount of rate-case expense incurred in this proceeding and to be recovered over a 36-month period. In its most recent updated response on rate-case expense, Pikeville demonstrated actual costs incurred in conjunction with this rate case to be \$85,813.64, plus an additional estimated \$3,675 for additional legal work to be performed through the final order in this case. This amount totals

⁴¹ Pikeville's Response to PSC 2-2.

⁴² VR: 2:21:49.

\$89,488.64.⁴³ Accordingly, Pikeville proposes that the Commission set the 36-month surcharge at \$2,485.80.

This amount of actual rate-case expense is reasonable in comparison to other municipal rate cases filed within the last 10 years before this Commission, including City of Lebanon (\$162,695), City of Augusta (\$69,535), City of Danville (\$57,190), Hopkinsville Water and Environment Authority (\$153,416), and Frankfort Electric and Water Plant Board (\$78,405).⁴⁴

In addition, it is important to note that Pikeville is not seeking to recover all expenses associated with this rate case. The City Attorney has invested significant time in this matter, but his expenses are not included in Pikeville's request. In addition, Pikeville has removed legal fees that were associated with the rate increase to Southern Water District. And, with respect to the initial contract with RateStudies whereby the company agreed to prepare a rate analysis for water and sewer, a factor of 20.44% has been applied based on a comparison of the recommended revenue requirement.⁴⁵ Accordingly, Pikeville's proposal for rate-case expense surcharge only recovers expenses directly associated with the wholesale rate to MWD.

Accordingly, the Commission should approve the proposed rate-case expense surcharge.

III. Conclusion

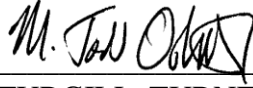
The record of this case demonstrates the reasonableness of Pikeville's proposed rates, including support for the revenue that should be recovered from MWD, the allocation of various expenses to MWD, the uniform-tiered rate design, and the rate-case surcharge. Accordingly, Pikeville respectfully requests an order approving the tariff filed on February 21, 2019, with a reduction of the rate-case expense surcharge from \$2,500 to \$2,485.80 to be recovered over 36 months.

⁴³ Pikeville's Supplemental September Response to PSC 2-34.

⁴⁴ Pikeville's Response to PSC 2-34.

⁴⁵ Pikeville's Supplemental September Response to PSC 2-34.

Respectfully submitted,



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CERTIFICATE OF COMPLIANCE

In accordance with 807 KAR 5:001, Section 8(7), this is to certify that the City of Pikeville's October 4, 2019, electronic filing is a true and accurate copy of the documents being filed in paper medium; that the electronic filing has been transmitted to the Commission on October 4, 2019; that there are currently no parties that the Commission has excused from participation by electronic means in this proceeding; and that an original and a copy of the filing are being delivered to the Commission within two (2) business days.



Counsel for City of Pikeville.