

EXHIBIT 3

CELESTINE ENGINEERING

MUNICIPAL UTILITY RATE ADJUSTMENTS[®]

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CELESTINE ENGINEERING

ORDER OF PRESENTATION

- Historical Background
- PSC Procedure: An Overview
- Lebanon Water Works:
A Case Study
- Appendix: Ratemaking 101

CELESTINE ENGINEERING

HISTORICAL BACKGROUND



CURRENT DEFINITION OF "UTILITY"

"Utility" means any person **except . . . a city**, who owns, controls, operates, or manages any facility used or to be used for or in connection with . . . [t]he diverting, developing, pumping, impounding, distributing, or furnishing of water to or for the public, for compensation

KRS 278.010(3)



Simpson County Water Dist. v. City of Franklin (1994)

- 1963 Contract (\$0.21/1,000 gals rate – changes OK if applied to both wholesale & retail)
- 1986 Contract Revision sets rate at \$0.84 per 1,000 gals. for 5 years
- 1990: Franklin raises rate to \$1.35 per 1,000 gallons



Simpson County Water Dist. v. City of Franklin (1994)

- 1991: Franklin raises rate to \$1.67/1,000 gallons
- Simpson County refuses to pay increases
- Franklin brings action to collect unpaid amounts & to declare contract void
- Simpson District: Courts lack jurisdiction - **PSC must approve rate increase**



Simpson County Water Dist. v. City of Franklin (1994)

KRS 278.040(2):

The jurisdiction of the commission shall extend to all utilities in this state. The commission shall have exclusive jurisdiction over the regulation of rates and service of utilities, but with that **exception nothing in this chapter is intended to limit or restrict the police jurisdiction, contract rights or powers of cities or political subdivisions.**



Simpson County Water Dist. v. City of Franklin (1994)

KRS 278.200:


The commission may, under the provisions of this chapter, originate, establish, change, promulgate and enforce any rate or service standard of any utility that has been or may be fixed by **any contract, franchise or agreement between the utility and any city,** and all rights, privileges and obligations arising out of any such contract, franchise or agreement, **regulating any such rate or service standard,** shall be subject to the jurisdiction and supervision of the commission, **but no such rate or service standard shall be changed,** nor any contract, franchise or agreement affecting it abrogated or changed, **until a hearing has been had before the commission** in the manner prescribed in this chapter.




Simpson County Water Dist. v. City of Franklin (1994)

HOLDING:

- KRS 278.040: PSC may restrict City's contract rights in area of utility rates & service
- Cities are generally exempted from PSC regulation because they are not "utilities"
- KRS 278.200 specifically addresses contracts between a city & a utility
- KRS 278.200 requires hearing before PSC before such contracts can be changed


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PROCEDURE FOR MUNICIPAL WHOLESALE RATE ADJUSTMENT



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NOTICE OF RATE ADJUSTMENT

- Municipal Utility Must Give Notice of Rate Change to
 - PSC
 - Wholesale Customer
- Notice must be made at **least 30 days prior** to the proposed increase
- Notice must conform with 807 KAR 5:011*

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NOTICE TO PSC

- File Tariff Sheet
 - Name of Wholesale Customer (if not a uniform rate)
 - Proposed Rate
 - Effective Date (**30 Days From Date of Filing**)
 - Name & Signature of Authorized Official
 - Proof of Notice to Wholesale Customer
 - Tariff Sheets Are Available from PSC Website
- Electronically Submitted  

NOTICE TO WHOLESALE CUSTOMERS

- 807 KAR 5:011, §8(4) governs
- Proposed Effective Date
- Date Filed with PSC
- Dollar & Percentage Amount of Proposed Change



NOTICE TO WHOLESALE CUSTOMERS

- Effect on Average Bill
- Location of Filing for Examination
- Right to Intervene
- Right to Comment on the Proposed Rate



CONTRACT NOTICE REQUIREMENTS

- Contract Notice Requirements still apply
- Required notice in excess of 30 days should be given prior to filing with PSC unless the Contract provides otherwise
- **Strategic Considerations:** Running out the clock vs. lost review time

NOTICE TO WHOLESALE CUSTOMERS


- PSC has previously required **strict compliance** with notice regulation
- Acceptable Methods of Notice: Mail - Personal Delivery - Newspaper
- Mailed/Delivered/Published **NLT Date of Filing**
- Notice to the Public is **NOT** required

ADDITIONAL DOCUMENTS

- Cost-of-Service Study **OR** Rate Study
- Financial Reports
- Historical Narrative
- Explanation for Increase
- Ordinance Establishing New Rates*
- Wholesale Customer's Statement of No Objection/Waiver of Hearing


PSC'S RESPONSE

- Posts proposed contract/rate to PSC Website
- Reviews for compliance with filing requirements
- If filing requirements are met, PSC must act before proposed effective date

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PSC'S RESPONSE

- KRS 278.190: Before a rate becomes effective, PSC may suspend operation of that rate for 5 months beyond its proposed effective date to further review
- Waits for comments/objections
- May request additional information

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WHOLESALE CUSTOMER'S OPTIONS


- No Response Required
- Notice of No Objection
- Request PSC Review/Investigation
- Identify Specific Areas of Concern or Objections

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STANDARD FOR PSC INVESTIGATION

- Does a **customer** object to the proposed increase?
- Does the propose rate/rule conflict with existing PSC regulations/rulings?
 - Rate Indexing [Case No. 2006-00007](#)
 - Service Practice that conflicts with PSC Regulations [Case No. 2002-00007](#)


YES – Suspend **NO** – No Action (Rate Takes Effect)

STOLLERMAN GUIDES 

PSC INVESTIGATION: PROCEDURAL RULES


Following the [Supreme] Court's decision in *Simpson County*, the Commission has allowed city-owned utilities to file rate adjustments by a tariff filing, and if a hearing is requested and the Commission suspends the proposed rate, the requirements, and procedures set forth in KRS Chapter 278, and the Commission's regulations *apply equally to filings by a city-owned utility or a jurisdictional utility.*

Case No. 2017-00417, Order of 7/12/2018

STOLLERMAN GUIDES 

PSC INVESTIGATION: PROCEDURAL RULES

- Formal Proceeding Established
- Proposed Rate Suspended For 5 Months
- Scope Of Review: Reasonableness Of Rate
- Burden of Proof on Municipal Utility

STOLLERMAN GUIDES 

PSC INVESTIGATION: PROCEDURAL RULES

- Proposed Rate May Be Assessed After 5 Months subject to refund
- Final Decision Due Within 10 Months Of Filing (Case No. 2006-00403)
- Extensive requests for information possible*
- Written Testimony required*

VERBODEN TOEGANG

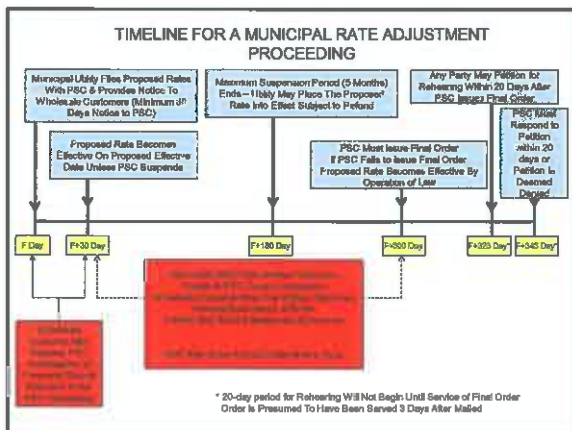
PSC INVESTIGATION: PROCEDURAL RULES

- No cost-of-service study required (But Recommended)
- Intervening Parties not required to present testimony or participate in proceedings

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PSC INVESTIGATION: PROCEDURAL RULES

- Hearing
 - No opening/closing statements
 - Cross-examination only
 - PSC Staff participates
- Decision issued within 240-280 days
- Agreement terminates Investigation



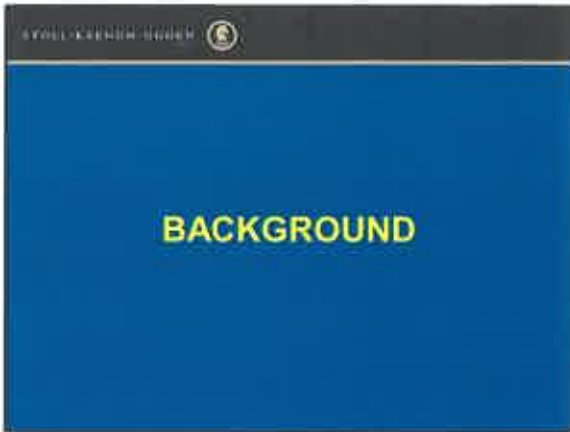
APPEAL PROCESS

- Request Rehearing NLT 23 days after Order's Issuance
- PSC Must Rule Within 20 Days of Request
- Action for Review in Franklin Circuit Ct NLT 23 days of Rehearing Order

APPEAL PROCESS

- Party May Bring Action For Review NLT 33 days of Initial Order Without Requesting Rehearing
- Appealing Party Must Demonstrate that Order is Unlawful or Unreasonable

**LEBANON WATER WORKS:
A CASE STUDY**







FINAL OUTCOME


- Requested: 34% ↑
- Approved: 16% ↑
- Rate Case Expense Surcharge
 - \$72,000
 - \$2,000 per Month
 - 36 Months

BACKGROUND

- Lebanon Annual Revenues: \$2,640,000
- Marion County WD Purchases >50%
- No Wholesale Rate
- Marion County WD Pays Retail Rate
- Flat Rate: \$2.50 per CCF
- No Cost of Service Study


BACKGROUND

- Contractual Limitations (1988)
 - Several Amendments
 - Uniform Rate
 - 60-day Advance Notice
 - PSC Approved Contract
- Ordinance
- No Negotiation Room

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BACKGROUND

- Customers
 - Lebanon: 2,650
 - MCWD: 5,800
- Last Rate Increase: 2013
- Revenue Increase: \$798,000

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REASONS FOR RATE ADJUSTMENT

- Campbellsville Water Line
 - Water Purchases \$490,000
 - Debt Service \$128,000
 - Depreciation \$ 63,000
- Other New Debt Service
- Deferred Maintenance
- Fully Funded Depreciation
- Increased Operating Expenses


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TIMELINE

Spring 2017	Rate Review
07-07-2017	Lebanon & MCWD Rate Discussions
07-10-2017	First Reading of Ordinance
July 2017	Numerous Public Meetings
08-07-2017	2d Reading Postponed (at MCWD's Request)
08-15-2017	Lebanon & MCWD Meet

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TIMELINE	
09-11-2017	Rate Ordinance Enacted
09-12-2017	Lebanon Notifies MCWD
09-20-2017	Rate Ordinance Published
09-27-2017	Retail Rates Implemented
11-15-2017	Proposed Effective Date (Wholesale Rate)
06-20-2018	Hearing
07-12-2018	Final Decision Issued

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RATE CASE PREPARATION AND MANAGEMENT

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COMMUNICATIONS

PRE-FILING DISCUSSIONS


- Explain reasons for rate adjustment
- Provide supporting data/documents
- Negotiate before filing the rate with PSC
- Supplier should consider any objections & critiques of supporting data
- Customer should voice all reasonable objections and concerns

CONTRACT REVIEW

- Limitations on frequency of rate adjustment
- Contract formula?
- Notice Requirements
- Is wholesale rate tied to retail rate adjustment?
- Other Concerns


RATE CASE PREPARATION

- Assemble documents/materials necessary for response to 1st PSC Info Request
- Obtain a working knowledge of PSC process
- Research potential issues
- Begin tracking rate case expenses
- Retain attorney & rate expert & include them in preparation & negotiations


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IF AGREEMENT IS REACHED

- Wholesale customer's agreement should be in writing
- Ask for/prepare Wholesale Customer's letter stating no objection to proposed rate
- Include Acknowledgement of Notice & Waiver of right to a hearing
- File Letter/Acknowledgement with tariff sheet


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COST OF SERVICE STUDY

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WHAT IS A COST OF SERVICE STUDY?

- Used to determine the cost of providing service to customer groups based upon each group's water use characteristics and service requirements
- Used to determine a supplier's cost of providing service to a wholesale customer

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BENEFITS OF A COST OF SERVICE STUDY


- Produces critical information about Muni's cost to serve all customer groups
- Identifies the specific cost to serve a wholesale customer
- Allows assessment of the applicant's case for rate adjustment prior to proceeding
- Facilitates rate negotiations

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PSC VIEW OF COST OF SERVICE STUDY

"The Commission is of the opinion that a cost-of-service study is a **valuable tool** to developing fair, just and reasonable rates. It provides a thorough analysis of a utility's expenses and revenues and serves as a starting point for ratemaking."


Case No. 2009-00373, Order of 7/2/2010 at 7.

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TIME TO PREPARE COST-OF-SERVICE STUDY

"[T]he better practice in municipal rate adjustment proceedings is for the applicant to undertake and complete its cost-of-service study **prior to filing notice of its proposed wholesale adjustment**. Regardless of whether the municipal utility chooses to strictly adhere to the study's results, the study provides critical information regarding costs for the wholesale supplier and customer that, if widely known, is likely to result in agreement on prospective rate adjustments."


Case No. 2009-00373, Order of 7/2/2010 at 9.

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TIME TO PREPARE COST-OF-SERVICE STUDY


"We place . . . all municipal utilities on notice that, in future proceedings where a municipal utility has failed to conduct such studies **prior** to the filing of its proposed rate adjustment, the additional litigation costs incurred by all parties will be a factor that will be considered in assessing the reasonableness of the costs related to an "after-filing cost-of-service study."

Case No. 2009-00373, Order of 7/2/2010 at 9.

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MUNICIPAL TAKEAWAYS

- Consider performing COSS as part of rate case preparations
- If study recently performed (< 5 years), across the board rate adjustment may be appropriate
- Provide wholesale customer with copy of COSS and access to COSS preparer


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CUSTOMER TAKEAWAYS


- Request a copy of the COSS from Supplier
- Request opportunity to question COSS preparer
- Closely review the COSS's assumptions to determine if realistic
- If assumptions are unrealistic, propose alternative assumptions
- Consider retaining own expert to review COSS

REGULATORY GUIDANCE 

RATE CASE ISSUES

REGULATORY GUIDANCE 

TEST PERIOD

REGULATORY GUIDANCE 

TEST PERIOD

- A consecutive 12-month period
- Generally the 12 month-period reflected in the utility's most recent annual report or audit.

TEST PERIOD


- Lebanon proposed a test period based on FY 2016 actual but adjusted for FY 2018 budget
- Significant changes in operations occurred in FY 2017 and were planned for FY 2018
- Significant Post-FY 2016 construction
- Audit Reports/Accounting Records for FY 2016 & FY 2017 filed in record Per PSC Staff Request

TEST PERIOD

- (At close of hearing) Lebanon argues FY 2017 most representative of present operations
- PSC denies "request" for use of FY 2017 test period
- PSC: Proceeding was "conducted to determine the results, as adjusted, of" FY 2016 test period
- No discussion re: which period most representative


TEST PERIOD

- PSC: Pro forma adjustments based on **budgetary projections** are neither known nor measurable and should be **disallowed**
- Actual FY2016 used – most adjustments based upon FY 2018 budget rejected
- PSC based salary/wage expense on **current wages & salaries**

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TEST PERIOD

- Employee retirement expense based on **current CERS contribution rate** (Not FY 2016)
- Depreciation based upon **existing facilities** (including post-test year construction)

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TEST PERIOD: MUNICIPAL TAKEAWAYS

- Use the most current year as test period
- Do not base adjustments upon budget projections
- Inflation factors unlikely to be accepted
- Time Rate Filing with completion of audit
- If major construction projects in progress, consider completion date

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TEST PERIOD: MUNICIPAL TAKEAWAYS

- Implement wage/salary changes NLT rate filing date
- Review operations for all known and measurable changes


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TEST PERIOD: CUSTOMER TAKEAWAYS

- Identify use of budgeted amounts or assumptions
- Can "Matching Principle" be applied to proposed adjustment?
- Identify the use of inflation factors

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DEPRECIATION

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DEPRECIATION EXPENSE

- Lebanon's proposed depreciation expense based on internally developed schedule of useful lives
- MCWD: Depreciation should be calculated using NARUC mid-point instead
- Use of NARUC mid-point reduced depreciation expense by \$168,648



DEPRECIATION EXPENSE

- No evidence offered in support of Lebanon's schedule of useful lives
- Lebanon conceded issue for current proceeding, but reserved right to challenge future proceedings



PSC POSITION ON DEPRECIATION

- Utility bears burden of proof to demonstrate appropriateness of its useful lives
- In absence of evidence to the contrary, mid-point on NARUC Guide will be used
- PSC is skeptical of expert testimony questioning the use of NARUC Guide
- Consistent use of NARUC Guide mid-point since 2016 in all cases – jurisdictional & municipal utilities
- No successful challenge in last two years



DEPRECIATION: MUNICIPAL TAKEAWAY

- Compare your useful lives to NARUC Guide mid-point when calculating proposed rate
- If significant difference, determine if any support to justify continued use of current useful lives
- Retain engineer to assist in analysis & to prepare evidentiary support for present useful lives
- Perform cost-benefit analysis of accepting NARUC mid-point vs. cost of litigating issue
- Consider adjustments to useful lives when developing proposed rate

DEPRECIATION: MUNICIPAL TAKEAWAY

- **Tactical Consideration:** Request rates based upon current useful life revision, but consider conceding issue in negotiations or PSC proceeding
- Make no permanent concession but reserve right to challenge in future proceedings

DEPRECIATION: CUSTOMER TAKEAWAY

- Request & examine Muni's depreciation schedule
- Compare Muni's useful lives to NARUC Guide mid-points – note variances
- Highlight significant variances at **each stage** of proceeding
- Depreciation on debt-financed assets is inappropriate: requires customer to pay 2X

FRINGE BENEFITS

FRINGE BENEFITS

- Lebanon in FY 2017 achieved 22.3% (\$54,144) reduction in employee health insurance costs
- PSC ordered disallowance of \$130,767 (\$76,623 more than savings)
- Reason for disallowance: Employees not required to pay a portion of the costs of single health insurance coverage

PSC POLICY

- PSC reviewing employers' contribution for health insurance cost
- If employer's contribution (%) exceeds BLS estimate of national average, recovery for excess **DENIED**
- PSC **encouraging** utility policies requiring employees to pay portion of health & dental insurance costs

BLS: Estimate of National Average

Coverage	Average	Private Industry	State & Local Government
Family	68/32	67/33	71/29
Single	80/20	79/21	86/14



MUNICIPAL UTILITY TAKEAWAYS

- Use Good Procurement Practices
 - Request Bids/Seek cost estimates from various providers annually
 - Document costs/efforts to reduce costs
- Determine the amount of likely disallowance prior to filing and if cost-effective to contest likely disallowance
- If not cost-effective, still document the record



MUNICIPAL UTILITY TAKEAWAYS

- Compare **Total Compensation Cost** vs. Other Regulated Utilities/Municipal Utilities
- Offer comparisons of benefits/costs by other regional/state utilities (Use KRWA/KLC Surveys)
- Provide evidence on local labor markets
- Emphasize unique aspects of your workforce



MUNICIPAL UTILITY TAKEAWAYS

- Consider differences between the quality of your insurance coverage & National Average Policy (e.g. deductibles, benefits)
- Propose use of BLS State/Local Government Category or Private Firm Utility or KY State Contribution Rate
- Argue for use of different study to determine National Average (e.g., Kaiser Family Foundation)

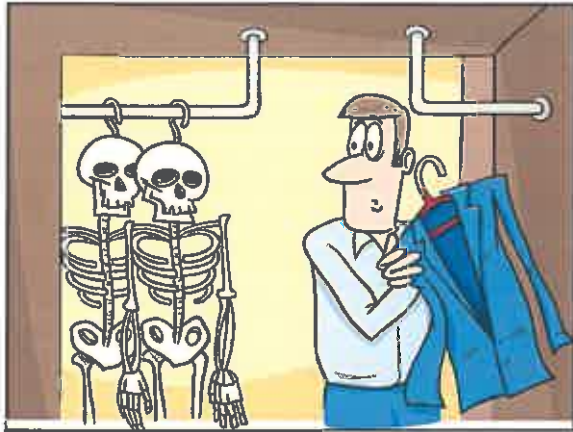
CUSTOMER TAKEAWAYS

- Conduct discovery on employee's required contribution for the cost of health, vision, and dental insurance
- Argue for application of the PSC's rules on fringe benefits

PSC AUTHORITY TO MANDATE EMPLOYEE CONTRIBUTION

- Employer Contribution is a **matter of managerial (Board) discretion**
- PSC jurisdiction limited to ratemaking
- PSC **CANNOT** restrict what employer pays for employee health insurance
- PSC **CANNOT** mandate employees contribute to health insurance cost

FREE WATER



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FREE WATER SERVICE

- Lebanon provided 3,700,000 cf of water to City for sludge disposal service
- Not disclosed in initial testimony
- Revealed in responses to discovery
- Total Cost: \$92,500
- Estimated Cost of Sludge Disposal: \$64,980

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FREE WATER SERVICE

- MCWD: Revenue Requirement should be reduced to reflect water transfer
- Lebanon: Water revenues should be increased by \$92,500; Treatment costs increased by \$64,980
- PSC: Water revenues increased by \$92,500

FREE WATER SERVICE: MUNICIPAL TAKEWAYS

- Muni will not be allowed to recover cost related to free services in wholesale rate
- Identify all free services
- City government should pay at minimum actual cost of service
- In-kind transactions should be avoided

FREE WATER SERVICE: MUNICIPAL TAKEWAYS

- Execute separate agreements for the provision of in-kind services
- Water service to City should be metered or measured

FREE WATER SERVICE: CUSTOMER TAKEWAYS

- Request information on all services provided to various city departments
- Ensure a cost is assigned to such service & revenue requirement calculation reflects imputed income from such service
- Other services may be provided (e.g., billing and collection services for sewer/garbage/911 operations)



RATE CASE EXPENSE



PAST PRECEDENT

- US Supreme Court (1939): "the utility should be allowed its fair and proper expenses for presenting its side to the commission"
- *City of Owenton* (1998): City entitled to recovery regardless of when requested
- *City of Danville* (2015): City must provide notice of proposed recovery in its notice to PSC



RATE CASE EXPENSE PROPOSAL

- Separate charge to recover reasonable rate case expense
- PSC determines "reasonable level"
- Recovery over 36 Months
- Equal Installments
- Notice contains example (\$72, 000)
- Actual Expense: \$162,696

PSC RESPONSE

- Level of rate case expense “excessive”
- Limits Recovery to \$72,000
- Compares Lebanon’s expense to MCWD’s Expense to determine reasonableness
- Magnitude of Rate Case Expense to Requested Revenue Increase

PSC RESPONSE

- Lebanon had “duty to reasonably manage & control its expenditures” based upon original estimate
- Lebanon failed to give notice of actual amount
- Re-notice when estimated level exceeded

MUNICIPAL TAKEAWAYS

- Surcharge is most effective means of rate recovery
- Must be identified in initial notice
- If estimate of costs used, base estimate on robust litigation from PSC & customer
- Estimate will likely serve as cap
- Consider “actual costs” ILO estimate



MUNICIPAL TAKEAWAYS

- Avoid re-notice for increased expense level – resets statutory clock
- Require Attorney to provide detailed invoices
- Be prepared to address comparisons with customer's expense level



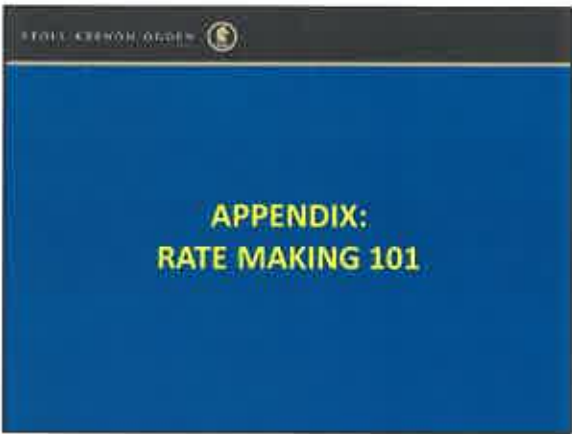
CUSTOMER TAKEAWAYS

- Request and review Muni invoices
- Argue for longer recovery period
- Remember: Assessed rate case expense can be recovered through PWA




CONCLUSION








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WHAT IS A REVENUE REQUIREMENT?

- The reasonable level of revenue required for a utility to properly operate and maintain its system and meet its financial obligations.
- A revenue requirement provides a basis for determining the amount of revenue to be collected from rates.

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REVENUE TO BE COLLECTED FROM RATES


TOTAL REVENUE REQUIREMENT

- Miscellaneous Operating Revenues
- Unrestricted Interest Income
- = **Operating Revenue from Rates**

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DETERMINING REVENUE REQUIREMENTS: DEBT SERVICE METHOD

- Adjusted Operating Expenses
- + Average Annual Debt Service Requirement
- + Debt Service Coverage
- = **Total Revenue Requirement**

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AVERAGE ANNUAL DEBT SERVICE REQUIREMENT


- Principal + Interest payable on long-term debt
- PSC generally uses a 5-year average

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DEBT SERVICE COVERAGE


Debt service coverage (DSC) is calculated based on the DSC required to issue bonds. This requirement is generally stated in the bond indenture.

- RD Debt 120% or 1.2x
- KIA Debt 110% or 1.1x
- Private Debt Varies

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TEST YEAR

- A consecutive 12-month period
- Generally the 12 month-period reflected in the utility's most recent annual report or audit.

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REVIEW OF TEST YEAR

- Reconciliation of books to test year
- Review accountant's adjusting journal entries
- Review for proper accrual accounting
- Review of test year expenses

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ADJUSTMENTS TO TEST YEAR

- Test year operations are adjusted to reflect 12 months representative of the utility's on-going, normal operations
- Adjustments must be **BOTH** known and measurable
- Adjustments must be **adequately documented**

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PRO FORMA ADJUSTMENTS

- **Known or anticipated** increases or decreases in revenues and expenses
 - Increase in wage rates
 - Changes in Insurance – Taxes - CERS Contributions
- Supporting documentation required

NORMALIZING ADJUSTMENTS


- Adjustments to reflect a full 12 months of operations for items that changed during the test period
- Example: Electric Rate Increased During Test Period
- Supporting documentation required

OPERATION & MAINTENANCE EXPENSES

- Salaries & Wages
- Employee Benefits
- Purchased Power
- Purchased Water
- Rent
- Chemicals


OPERATION & MAINTENANCE EXPENSES

- Materials & Supplies
- Repairs & Maintenance
- General Overhead
- Includes Allocated Portion of **Common or Shared Costs** Between Utility Divisions

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DEPRECIATION EXPENSE

- Included in Revenue Requirement Determination for Non-Profit Water Districts & Water Associations
- Depreciation Expense for Non-contributed Property
- PSC Uses NARUC Guide

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ALLOCATION OF COMMON COSTS

- Combined Water/Sewer/Public Works Operations share costs
- Necessary to prevent subsidies
- Methodology to allocate expenses needed
- PSC will impose methodology if none

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OTHER ADJUSTMENTS

- Non-recurring expenses may be amortized over the life of expense
 - Tank painting
 - Rate case expense
- Capitalization of improperly classified expenses



ESTABLISHING RATES

- Cost of Service Study Used
- Across the Board Increase
- Balancing of Ratepayer Interests
- Rates must produce revenue requirement from rates
