COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ELECTRONIC APPLICATION OF KENTUCKY-AMERICAN WATER COMPANY FOR AN ADJUSTMENT OF RATES	)))	CASE NO. 2018-00358

ORDER

On November 28, 2019, Kentucky-American Water Company (Kentucky-American), pursuant to KRS 278.180, KRS 278.190, and 807 KAR 5:001, Section 16(1)(b)(1), filed an application requesting to increase its rates and establish a Qualified Infrastructure Program (QIP) tariff to replace aging infrastructure. Kentucky-American also requested approval of a utility plant acquisition adjustment in connection with the purchase of the city of North Middletown's (North Middletown) water system assets.

BACKGROUND

Kentucky-American, a wholly owned subsidiary of American Water Works Company, Inc. (American Water), is a jurisdictional utility that distributes and sells water to approximately 130,000 customers in its Central Division, which consists of Bourbon, Clark, Fayette, Franklin, Harrison, Jessamine, Nicholas, Scott, and Woodford counties; its Northern Division, which consists of Gallatin, Owen, and Grant counties; and its Southern Division, which consists of Rockcastle and Jackson counties.[1]

In its application, Kentucky-American requested an increase in water revenues of $19,865,003 million, or 22.6 percent per year for the forecasted test period, compared to

[1] Application at paragraph 2; Direct Testimony of Ann E. Bulkley (Bulkley Direct Testimony) at 37.

the operating revenues for the forecasted test period under existing water rates. On April 15, 2019, Kentucky-American filed a base period update (Base Period Update) that reduced the requested revenue requirements by $1,382,884, to $18,482,119, or 21.01 percent per year for the forecasted test period.

There are two intervenors in this matter: The Attorney General of the Commonwealth of Kentucky, by and through the Office of Rate Intervention (Attorney General), and Lexington-Fayette Urban County Government (LFUCG) (jointly, Attorney General/LFUCG).[2] The Attorney General and LFUCG entered into a joint participation agreement and co-sponsored two witnesses. By Order entered December 5, 2018, the Commission suspended the proposed rates up to and including June 27, 2019. Following discovery, the Commission held an evidentiary hearing on May 13–14, 2019, in Frankfort, Kentucky. The Commission conducted a public meeting in Lexington, Kentucky, on May 6, 2019. All parties submitted written briefs. This matter now stands submitted to the Commission for a decision.

TEST PERIOD

Kentucky-American used as its forecasted test period the 12-month period ending June 30, 2020.[3] Its base period is the 12-month period ending February 28, 2019.[4]

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[2] The Community Action Council for Lexington-Fayette, Bourbon, Harrison, and Nicholas Counties, Inc. withdrew its request to intervene on January 8, 2019.

[3] Application at paragraph 6.

[4] *Id.* at paragraph 7.

VALUATION

Rate Base

Kentucky-American proposed a forecasted net investment rate base of $441,122,362 based on a 13-month average for that period.[5] In its Base Period Update, Kentucky-American increased the proposed rate base to $446,698,296.[6] The Attorney General/LFUCG proposed to reduce Kentucky-American's rate base to $426,623,063.[7] The Attorney General/LFUCG proposed to (1) reduce cash working capital to reflect the Attorney General/LFUCG's adjustments to Kentucky-American's lead-lag study and removal of non-cash expense; and (2) apply a slippage factor.

Cash Working Capital

Working capital is an element of rate base that recognizes the amount of investor-supplied capital used to fund the utility's day-to-day operations and to compensate shareholders for the delay in recovery of certain expenses from ratepayers. Kentucky-American's proposed $3,754,000[8] for working capital, which was increased to $3,961,000 in the Base Period Update, is based upon a lead/lag study performed on the historical data for the 12-month period ending August 31, 2018.[9]

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

[6] Base Period Update (filed Apr. 15, 2019), Exhibit 37, Schedule B-1 at 2.

[7] Direct Testimony of Lane Kollen (Kollen Testimony), Revenue Requirement Model, Kollen_KAW_Revenue_Requirement_Model_Recommendation_03.15.19.xlsx, Rate Base Tab, Line 19, Column I.

[8] Application, Exhibit 37, Schedule B-1, Page 2 of 2, and Schedule B-5.

[9] Base Period Update at 1; Direct Testimony of Melissa L. Schwarzell (Schwarzell Direct Testimony) at 23.

The Attorney General/LFUCG proposed to reduce cash working capital by $10,435,000 to reflect three proposed adjustments to Kentucky-American's lead/lag study. These adjustments have a net impact of lowering the revenue requirement by $1,051,237 million.[10]

(1) Service Company Charges

American Water Works Service Company (Service Company) has a prepayment provision under which the Service Company bills for estimated charges for its services to Kentucky-American for the current month, and then subsequently trues up the estimated and actual charges. The Attorney General/LFUCG contended that the prepayment provision is unreasonable because it allows American Water recovery at Kentucky-American's grossed-up allowed return instead of at American Water's actual and lower cost of short-term debt.[11] The Attorney General/LFUCG argued that this prepayment practice is unusual and results in negative expense lead days and artificially increases the cash working capital included in the Kentucky-American's rate base.[12] The Attorney General/LFUCG recommended that the Commission modify the expense lag days from the negative 3.50 days to 45.63 days. The Attorney General/LFUCG's modification results in a reduction in rate base of $1,309,000 and a reduction in revenue requirement of $131,871.

Kentucky-American countered that the Service Company exists to provide services to American Water affiliates at cost and that it does not make a profit from the

[10] Direct Testimony of Lane Kollen (Kollen Testimony), Revenue Requirement Model, Kollen_KAW_Revenue_Requirement_Model_Recommendation_03.15.19.xlsx, Summ Rev Req Tab.

[11] *Id.* at 8.

[12] *Id.* at 8.

provision of those services.[13] Kentucky-American maintained that the Service Company's billing terms are meant to match expenses with the receipt of payments from affiliates, which are the beneficiaries of the services.[14] According to Kentucky-American, prepayment of the at-cost Service Company bill is a reasonable provision to support cash expenses and payroll incurred on behalf of Kentucky-American.[15] Kentucky-American further noted that the data used to illustrate the differences between invoice and payment amounts looked only at the monthly impact and not the annual impact and is exaggerated, and the Attorney General/LFUCG failed to make a corresponding increase for the short-term debt costs.[16]

In his post-hearing brief, the Attorney General argued that the prepayment arrangement benefits shareholders, but not ratepayers, because the carrying cost on the capital employed is at Kentucky-American's grossed-up return instead of American Water's lower short-term debt costs.[17] The Attorney General stated that this form of arbitrage is not reasonable and the excessive cost incurred through cash working capital should be disallowed.[18]

In response, Kentucky-American argued that prepayments are a reasonable provision to support cash expenses and payroll incurred on behalf of Kentucky-

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[13] Rebuttal Testimony of Melissa L. Schwarzell (Schwarzell Rebuttal Testimony) at 11.

[14] *Id.* at 11.

[15] *Id.* at 13.

[16] *Id.* at 12.

[17] Attorney General Post-Hearing Reply Brief (Attorney General Brief) (filed June 11, 2019) at 8.

[18] *Id.* at 9.

American.[19] Kentucky-American claimed that the Service Company does not make a profit from these services and that any interest income attributable to Kentucky-American's prepayments flow back to Kentucky-American.[20]

(2) Cash Dividend Expense

The Attorney General/LFUCG contended that Kentucky-American's dividend is a cash expense paid quarterly through a disbursement of cash by Kentucky-American to its parent, American Water.[21] Thus, according to the Attorney General/LFUCG, the cash dividend should be separated from the non-cash non-dividend components of the net income "expense" in the lead/lag study.[22] The Attorney General/LFUCG recommended a 75/25 percent allocation between the cash and non-cash components and, because dividends are paid both quarterly and in arrears, the Attorney General/LFUCG suggested that the Commission apply 134.9 days, as opposed to 0 days, to the cash component.[23] The Attorney General/LFUCG's proposal would reduce the rate base by $6,418,000 and reduce revenue requirement by $646,559.[24]

Kentucky-American countered that the Attorney General/LFUCG's position conflicts with Commission precedent, is unreasonable, and should be rejected.[25]

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[19] Kentucky-American Post-Hearing Brief (Kentucky-American Brief) (filed May 31, 2019) at 29.

[20] *Id.* at 29.

[21] Kollen Testimony at 10.

[22] *Id.* at 10; Attorney General Brief at 9.

[23] Kollen Testimony at 12; Attorney General Brief at 9.

[24] Kollen Testimony, Revenue Requirement Model, Kollen_KAW_Revenue_Requirement_Model_Recommendation_03.15.19.xlsx, Summ Rev Req Tab.

[25] Schwarzell Rebuttal Testimony at 10; Kentucky-American Brief at 29.

Kentucky-American argued that, in prior decisions, the Commission found that investors are entitled to a return when service is rendered and are entitled to daily reinvestment of the earnings.[26] Kentucky-American asserted that how it finances its ongoing operations, relative to dividend payment, is purely a financing decision that has no effect on whether a cash return is expected at the time that service is rendered.[27]

(3) Non-cash Items

The Attorney General/LFUCG argued that a cash working capital study should not include non-cash expenses.[28] The Attorney General/LFUCG asserted that depreciation and amortization expense, deferred income tax expense, and a non-cash, non-dividend component of net income expense should be excluded because such expenses do not require a cash disbursement.[29] The Attorney General/LFUCG claimed that applying zero expense lag days to these expenses assumes that they will actually be paid in cash when they are incurred and have no expense lag days.[30] Because these expenses are never paid in cash, the Attorney General/LFUCG contended that "the correct expense lag days for never is infinity, which essentially removes the non-cash items from cash working capital."[31] In his post-hearing brief, the Attorney General noted that at the hearing, Kentucky-American's expert witness, Ms. Melissa L. Schwarzell, confirmed that not only

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[26] *Id.*

[27] *Id.*

[28] Kollen Testimony at 13.

[29] *Id.* at 13–14.

[30] *Id.* at 14.

[31] *Id.* at 15.

does depreciation never get paid in cash, but is not paid at all.[32] The Attorney General/LFUCG recommended removing the non-cash items, which results in a decrease in rate base of $2,708,000 and revenue requirement of $272,808.[33]

Kentucky-American argued that the Attorney General made similar recommendations to exclude non-cash items from Kentucky-American's lead/lag study in past cases and that the Commission has repeatedly rejected the Attorney General's recommendations.[34] Kentucky-American stated that the same working capital methodology used in this case has been used for numerous prior rates cases.[35] Kentucky-American argued that the Commission has consistently found that deferred taxes and depreciation should be included in the cash working capital calculation in order for investors to be made whole.[36]

The Commission notes that Kentucky-American's lead/lag study uses the same methodology that we have accepted since 1983.[37] We agree with Kentucky-American that the Attorney General has consistently presented, and the Commission has consistently refused to adopt, the arguments raised here regarding the inclusion of non-

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[32] Attorney General Brief at 10.

[33] Kollen Testimony, Revenue Requirement Model, Kollen_KAW_Revenue_Requirement_Model_Recommendation_03.15.19.xlsx, Summ Rev Req Tab.

[34] Schwarzell Rebuttal Testimony at 7.

[35] *Id.*

[36] *Id.* at 9.

[37] Case No. 8314, *Notice of Adjustment of Rates of Kentucky-American Water Company* (Ky. PSC Feb. 8, 1982) at 6.

cash items in the calculation of working capital.[38] The Attorney General/LFUCG offered no new evidence or arguments in the current proceeding to disturb our previous findings or to support a change in our position on this matter. Therefore, consistent with precedent and based upon the evidence in the record, we find the Attorney General/LFUCG's proposal regarding cash working capital should be denied.

Slippage

Kentucky-American segregates its construction budgets into three categories: (1) normal recurring construction; (2) construction projects funded by others; and (3) major investment projects. In response to a data request, Kentucky-American provided a cumulative slippage factor of 101.89 percent based upon its calculation of a ten-year average slippage factor of 110.46 percent for all recurring projects and 91.08 percent for all investment projects.[39] Also, in response to a data request, Kentucky-American revised its rate base calculation from $441,122,362 to $441,111,572, which increased the revenue requirement in its application from $19,865,003 to $20,001,661, or $136,657.[40]

The Attorney General/LFUCG argued that Kentucky-American historically spends less than its annual capital budget, and therefore the Commission should apply a slippage

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[38] *See* Case No. 10069, *Notice of Adjustment of the Rates of Kentucky-American Water Company* (Ky. PSC July 31, 1996) at 6–8; Case No. 92-452, *Notice of Adjustment of the Rates of Kentucky-American Water Company* (Ky. PSC Nov. 19, 1993) at 17–21; Case No. 95-554, *Notice of Adjustment of the Rates of Kentucky-American Water Company* (Ky. PSC Sept. 11, 1996) at 21–24; Case No. 97-034, *Notice of Adjustment of the Rates of Kentucky-American Water Company* (Ky. PSC Sept. 30, 1997) at 25–28; Case No. 2004-00103, *Adjustment of the Rates of Kentucky-American Water Company* (Ky. PSC Feb. 28, 2005) at 17.

[39] Kentucky-American Response to Commission Staff's Second Request for Information (Staff's Second Request), Items 2–3; Kentucky-American Brief at 30. Kentucky-American applied a ten-year historical slippage factor, which is consistent with Commission previous decisions in Kentucky-American rate case.

[40] Kentucky-American's Response to Commission Staff's Fourth Request for Information, Item 5; Base Period Update at Exhibit 37.

factor of 91.968 percent based on a comparison between the annual actual construction expenditures and the annual original construction budget for 2008 through 2017.[41] The Attorney General/LFUCG's proposed adjustment, based on a slippage factor of 91.968 percent, reduced rate base by $4,064,299 and expenses by $554,000, which included the impact on the grossed-up return on the reduction in the rate base and the reduction in depreciation and property tax expenses.[42]

Kentucky-American countered that the Attorney General/LFUCG's use of the 91.968 percent slippage factor is inaccurate because it omits much of Kentucky-American's actual spend.[43] Kentucky-American maintained that the Attorney General/LFUCG based the information on a response to a data request that Kentucky-American asserted does not appropriately compare budgeted and actual spend because it omits $21 million of infrastructure investment.[44] Kentucky-American asserted that the slippage percent of 101.89 percent as set forth in Item 3 of Commission Staff's Second Request for Information is consistent with Commission precedent and should be applied.[45]

In his post-hearing brief, the Attorney General argued that this is the first time that Kentucky-American proposed a slippage factor as part of its Base Period Update that

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[41] Kollen Testimony at 16, 18; Attorney General Brief at 10.

[42] Kollen Testimony at 18–19; Attorney General Post-Hearing Reply Brief at 11.

Slippage Plant Additions	$(409,443)
Depreciation and Property Tax	$(145,028)
Total	$(554,471)

[43] Rebuttal Testimony of Brent E. O'Neill (O'Neill Rebuttal Testimony) at 2; Kentucky-American Brief at 30–32.

[44] O'Neill Rebuttal Testimony at 2–4.

[45] *Id.* at 5; Kentucky-American Brief at 30.

increased the revenue requirement.[46] The Attorney General questioned why Kentucky-American did not initially apply a slippage factor in its application, given that historically the Commission has applied it, and it is beneficial to the shareholders.[47] The Attorney General recommended that the Commission follow the established precedent and apply the adjustment proposed by Attorney General/LFUCG.[48]

In its reply brief, Kentucky-American reiterated that the Attorney General/LFUCG's proposed slippage adjustment is unreasonable but noted that all parties agree that a slippage factor should be applied based upon Kentucky-American's budget.[49] Kentucky-American also reiterated that the Attorney General/LFUCG's recommendation ignores the $21 million of actual capital spent and is not a reasonable representation of budgeted and actual amount spent.[50] Kentucky-American argued that it followed Commission methodology, which is consistent with precedent, and therefore Kentucky-American's proposed slippage adjustment should be approved.[51]

The Commission agrees that the Attorney General/LFUCG's recommended slippage factor is incorrect because it excludes projects actually constructed and that were included in Kentucky-American's capital plan. Additionally, the Attorney General/LFUCG did not include the impact the slippage factor has on other components

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[46] Attorney General Brief at 11.

[47] *Id.*

[48] *Id.*

[49] Kentucky-American Post-Hearing Reply Brief (Kentucky-American Reply Brief) (filed June 14, 2019) at 25.

[50] *Id.* at 26.

[51] *Id.*

of revenue requirement, including construction work in progress (CWIP), contributions in aid of construction (CIAC), deferred income taxes, and short-term debt. For the above reasons, the Commission does not accept the Attorney General/LFUCG's proposed adjustment.

The Commission notes that Kentucky-American's 91.08 percent slippage factor for investment projects correctly included construction projects approved by its capital investment management committee (CIMC) but not included in the capital plan. However, the 91.08 slippage factor for investment projects did not reflect the estimated costs that were approved by the CIMC. Because the estimated costs approved by the CIMC were not included, Kentucky-American's slippage calculation includes the total capital spent for each year, but not the overall budgeted capital investment plan. As a result, Kentucky-American overstated the slippage factor for investment projects because it included only the actual costs expended to construct the CIMC-approved projects and did not include the offsetting estimates. Including the cost estimates approved by the CIMC in the calculation of the slippage factors for the investment projects, the Commission has determined that the ten-year average slippage factor for investment projects should be decreased from 91.08 percent to 81.45 percent.[52]

Regarding the slippage factor for recurring projects, the Commission finds that the evidence in the record supports Kentucky-American's slippage factor of 110.46 percent.

For the above reasons and based on the evidence in the record, the Commission finds that applying a ten-year average slippage factor of 81.45 percent should be applied

[52] Kentucky-American's Responses to Commission Staff's Fourth Request for Information (Staff's Fourth Request), Item 4(a).

to investment projects, and a ten-year average slippage factor of 110.46 percent should be applied to recurring projects.

Rate Base Adjustments

(1) Utility Plant in Service (UPIS):[53]

For the reasons discussed above, the Commission finds that applying a slippage factor of 81.45 percent for investment projects and a slippage factor of 110.46 percent for recurring projects to UPIS results in adjustments that reduce the forecasted UPIS by $1,016,411 and revenue requirement by $112,996.

(2) Accumulated Depreciation

Kentucky-American forecasted the accumulated depreciation to be $197,770,499 based on a 13-month average of its accumulated depreciation balances from June 1, 2019, through June 30, 2020.[54] Because the Tax Cuts and Jobs Act (TCJA) made CIAC and customer advances taxable income for water and sewer utilities, Kentucky-American included the impact that the federal income tax gross-up on CIAC and customer advances would have on accumulated depreciation.[55] Once Kentucky-American became aware that the Commission does not permit water utilities such as Kentucky-American to gross-up CIAC and customer advances,[56] Kentucky-American informed the Commission that it

[53] To calculate UPIS, Kentucky-American used capital construction budgets, which are separated into three categories: normal recurring construction, major investment projects, and construction projects funded by others (CIAC). Of the three categories, normal recurring construction and major investment projects are relevant to the calculation of UPIS in regard to slippage factors.

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

[55] Schwarzell Rebuttal Testimony at 2–4.

[56] *See* Administrative Case No. 313, *The Effects of the Tax Reform Act Of 1986 on Contributions In Aid Of Construction and Customer Advances* (Ky. PSC July 8, 1988).

had ceased collecting tax gross-ups for new contributions and had refunded the tax gross-up on contributions that had already been collected.[57]

In its Base Period Update, Kentucky-American increased its accumulated depreciation by $41,484 to reflect the elimination of the impact of CIAC and customer advances tax gross-up and the construction slippage factors that it used in adjusting UPIS.

The Commission finds that the forecasted accumulated depreciation should be adjusted to reflect the effect of construction slippage discussed above and to reflect the elimination of the CIAC and Customer Advances tax gross-up. This results in a decrease in rate base of $19,206 and decrease in revenue requirement of $2,134.[58]

(3) Construction Work in Progress (CWIP)

Kentucky-American included $7,859,210 in forecasted CWIP based upon its capital construction budgets for the period from June 1, 2019, through June 30, 2020.[59] In its Base Period Update, Kentucky-American increased its accumulated depreciation by $87,868 to reflect the impact of the construction slippage factors it used to adjust UPIS. Using the Commission approved slippage, the CWIP balance decreases by $203,005 and revenue requirement decreases $22,568.

(4) Cash Working Capital

Using the lead-lag study that it presented, Kentucky-American calculated a base working capital requirement of $3,754,000.[60] In its Base Period Update, Kentucky-

[57] Schwarzell Rebuttal Testimony at 4.

[58] Slippage adjustment of $(29,220) + FIT Gross-Up Elimination of $10,014.

[59] Application, Exhibit 37, Schedule B-4.1 at 2.

[60] Application, Exhibit 37, Schedule B-1, page 2 of 2 and Schedule B-5.

American increased cash working capital by $207,000. By applying its adjustments to the forecasted revenues and expenses to Kentucky-American's lead-lag study, the Commission calculated a revised cash working capital requirement of $3,553,000, a rate base reduction of $201,000. The cash working capital adjustment decreases revenue requirement by $22,346.

(5) Contributions in Aid of Construction (CIAC).

In its application, Kentucky-American included CIAC of $73,319,577 as a reduction to rate base.[61] To reflect the elimination of the impact of CIAC and Customer Advances, tax gross-up, and the construction slippage factors it used in adjusting UPIS, Kentucky-American decreased forecasted CIAC by $ 1,108,255 to $72,211,322 in its Base Period Update.

The Commission rejects this adjustment and instead adjusts CIAC for the Commission-approved slippage. The resulting slippage and FIT Gross-Up impact results in an increase in rate base of $1,108,225 and an increase in the revenue requirement of $123,203.[62]

(6) Customer Advances

In its application, Kentucky-American included $(13,508,680) in forecasted customer advances.[63] Subsequently, in its Base Period update, Kentucky-American decreased forecasted customer advances by $1,042,381 to reflect the elimination of the

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[61] *Id.*

[62] Slippage adjustment of $(678,712) + FIT Gross-Up Elimination of $1,786,967.

[63] Application, Exhibit 37, Schedule B-1.

impact of CIAC and customer advances tax gross-up and the construction slippage factors it used in adjusting UPIS.

Adjusting Consumer Advances for the Commission approved slippage and eliminating the FIT Gross-Up results in an increase in the rate base of $1,042,381 and an increase in the revenue requirement of $115,880.[64]

(7) Accumulated Deferred Income Taxes (ADIT)

In its application, Kentucky-American deducted $90,721,671 of ADIT from its forecasted rate base.[65] In calculating its forecasted ADIT, Kentucky-American followed the requirements of the Accounting Standards Committee (ASC) 740.[66] Kentucky-American described ASC 740 as a balance sheet approach to deferred income taxes that requires the deferred income tax provision be shown in total, and recognized the regulatory assets and liabilities that will be recovered in rates in future years.[67] According to Kentucky-American, the largest portion of excess forecasted ADIT is associated with the TCJA.[68] Kentucky-American was unable to calculate the impact the TCJA would have on its excess ADIT or the amortization of the excess ADIT, therefore, the full amount of the TCJA liability was originally deducted from rate base.[69]

Kentucky-American included a negative amortization expense amount, and the corresponding increase in rate base, in the forecast year revisions filed with its Base

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[64] Slippage adjustment of $(218,411) + FIT Gross-Up Elimination of $1,260,792.

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

[66] Direct Testimony of John R. Wilde (Wilde Direct Testimony) at 5.

[67] *Id.* at 5.

[68] Schwarzell Direct Testimony at 24.

[69] *Id.*

Period Update.[70] Kentucky-American increased rate base ADIT by $455,188 to remove the 13-month average of the amortization of the excess federal ADIT and state ADIT.

In the below Revenue Requirement section titled Deferred Income Tax Expense, the Commission discusses the impact of the TCJA and, among other things, modifies the amortization period for the unprotected federal excess ADIT and state excess ADIT to a 10-year amortization period. This adjustment increases rate base ADIT by $545,796. When adjusting the ADIT for slippage and the deferred maintenance revision, rate base increases by $234,092 and the revenue requirement increases by $26,024.[71]

(8) Unamortized Deferred Maintenance

Based upon actual expenditures and the forecasted expenditures for 2019 through June 2020, as adjusted for amortizations, Kentucky-American included deferred maintenance totaling $9,539,974 in its application, based upon a 13-month average of actual and forecasted deferred maintenance projects.[72] Subsequently, in the Base Period Update, Kentucky-American added two new tank-painting projects to deferred maintenance.[73]

According to Kentucky-American, one scheduled project was delayed while Kentucky-American determined whether it would adversely affect the service to customers.[74] Kentucky-American revised its deferred maintenance schedule to include the rehabilitation and painting of Kentucky River Station Hydrotreators 9 and

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[70] Wilde Rebuttal Testimony at 4.

[71] Slippage $75,070 + Deferred Maintenance $(395,774) + ADIT $554,796

[72] Schwarzell Direct Testimony at 21.

[73] O'Neill Rebuttal Testimony at 19.
[74] O'Neill Rebuttal Testimony at 9 and 20.

Hydrotreators 10, which were scheduled to be painted after the forecasted period. Kentucky-American explained that it rescheduled the hydrotreator tank project to take advantage of contractor availability and to complete the project ahead of peak demands period during 2019.[75] Kentucky-American further notes that work has begun on the hydrotreator projects.[76]

In his post-hearing reply brief, the Attorney General argued that Kentucky-American improperly updated its forecasted test year to include the hydrotreator projects because 807 KAR 5:001, Section 16(6)(d), prohibits updating forecasted test years in rate cases within 30 days of a scheduled hearing. The Attorney General recommended that the Commission reject the $109,119 increase to deferred maintenance because it was made within 30 days of the scheduled hearing. LFUCG did not address this issue in its post-hearing reply brief.

We note that Kentucky-American filed the Base Period Update on April 15, 2019, which was 29 days prior to the original hearing date of May 14, 2019.[77] We also note that while the Attorney General objects to the increase in deferred maintenance, he has not objected to the $1,382,884 reduction in the revenue requirement reflected in the Base Period Update. According to 807 KAR 5:001, Section 22, the Commission is permitted to deviate from the provisions of 807 KAR 5:001, Section 16(6)(d), for good cause. Here, evaluating the totality of the facts, we find that good cause exists to permit Kentucky-American to deviate from the requirement by filing the Base Period Update within 29 days

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[75] *Id.* at 19.

[76] Base Period Update at 1.

[77] By Order entered April 26, 2019, the Commission revised the hearing dates to begin on May 13, 2019, and continue on May 14, 2019.

of the scheduled hearing. First, the update was filed within one day of the regulatory deadline. Second, the Attorney General has taken an inconsistent position, objecting to one line item in the Base Period Update while tacitly accepting all other line items in the Base Period Update. Finally, by rescheduling the projects, Kentucky-American was able to avoid demobilizing contractors, which ultimately benefits ratepayers by advancing with necessary maintenance while contractors are available.

The Commission further finds that Kentucky-American's deferred maintenance, including the incremental increase from the Base Period Update, is reasonable, and therefore should be allowed for ratemaking purposes an increase in rate base of $1,586,270 and an increase to revenue requirement of $176,343.

Summary of Rate Base Adjustments

Based on the adjustments discussed above, the Commission has determined that Kentucky-American's net investment rate base is $443,653,707.

Rate Base Component	Application 13-Month Average Forecasted Rate Base	Commission Adjustments	Commission 13-Month Average Forecasted Rate Base
Utility Plant at Original Cost	$ 790,806,081	(1,016,441)	$ 789,789,640
Utility Plant Acquisition Adjustment	225,195	0	225,195
Deduct:			
Accumulated Depreciation	(197,770,499)	(19,206)	(197,789,705)
Net Utility Plant in Service	$ 593,260,777	$ (1,035,647)	$ 592,225,130
Construction Work In Progress	7,859,210	(203,005)	7,656,205
Working Capital Allowance	3,754,000	(201,000)	3,553,000
Other Working Capital	807,789	0	807,789
Contribution In Aid of Construction	(73,319,577)	1,108,255	(72,211,322)
Customer Advances	(13,508,680)	1,042,381	(12,466,299)
Deferred Income Taxes	(90,721,671)	234,092	(90,487,579)
Deferred Investment Tax Credits	(10,001)	0	(10,001)
Deferred Maintenance	11,816,493	1,586,270	13,402,763
Deferred Debits	1,198,681	0	1,198,681
Other Rate Base Elements	(14,660)	0	(14,660)
Net Original Cost Rate Base	$ 441,122,361	$ 2,531,346	$ 443,653,707

REVENUE REQUIREMENT

For the base period, Kentucky-American reports operating revenues and expenses of $91,907,987 and $63,263,822, respectively.[78] In its Base Period Update, Kentucky-American updated these to $90,802,120 in revenue and $62,787,006 in expenses.[79] Kentucky-American proposed several adjustments to revenues and expenses to reflect the anticipated operating conditions during the forecasted period, resulting in forecasted operating revenues and expenses for the Base Period Update of $88,512,827 and $65,547,123, respectively.[80] The Attorney General/LFUCG proposed adjustments to Kentucky-American's revenue requirement totaling $7,217,411.[81] The Commission accepts Kentucky-American's forecasted operating revenues with the following exceptions:[82]

Trane

The Attorney General/LFUCG proposed to reduce test-year revenues to reflect the announced plant closure of Trane Lexington by the end of 2019.[83] Specifically, the Attorney General/LFUCG recommend that Kentucky-American defer these revenues as a regulatory liability and amortize them over two years for a revenue impact of $7,934.[84] Kentucky-American disagreed with Attorney General/LFUCG, arguing that revenues from

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[78] Application, Exhibit 37, Schedule C-1.

[79] Base Period Update, Exhibit 37, Schedule C-2.

[80] Base Period Update, Exhibit 37, Schedule C-1.

[81] Kollen Testimony, Revenue Requirement Model, Kollen_KAW_Revenue_Requirement_Model_Recommendation_03.15.19.xlsx, Summ Rev Req Tab.

[82] See Appendix A.

[83] Kollen Testimony at 19–20.

[84] Kollen Testimony at 19. Grossed-Up Expense.

the plant closure are uncertain and that a deferral would be difficult to estimate, but due to the relatively minor impact, conceded to the adjustment.[85] Accordingly, the Commission will make an adjustment to reduce revenues by $7,845.

Allowance for Funds Used During Construction (AFUDC)

In its application, Kentucky-American proposed to increase forecasted operating revenues by $554,026 to include AFUDC.[86] In calculating this forecast, Kentucky-American used an 8.25 percent weighted cost of capital.[87] Subsequently, in the Base Period Update, Kentucky-American decreased AFUDC by $ $6,023 for a revised level of $548,003, which reflects the effect of slippage on CWIP and Kentucky-American's reduction of the weighted cost of capital to 8.21 percent.

The Commission finds that AFDUC should be reduced by $79,324 to reflect our adjustments to CWIP for slippage and the overall rate of return of 7.69 percent, which is discussed below.

Fuel and Power Expense

Kentucky-American's purchased power expense for the forecasted test period was impacted by four adjustments: (1) power usage of the new I-75 Booster Station; (2) an expected rate increase resulting from Kentucky Utilities' (KU) general rate case; [88] (3) installation of high-efficiency pumps; and (4) the installation of variable frequency drives.[89]

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[85] Schwarzell Rebuttal Testimony at 13.

[86] Application, Exhibit 37, Schedule C-1 page 2 of 9.

[87] *Id.*, Schedule J-1.1/J-2.1.

[88] Case No. 2018-00294, *Electronic Application of Kentucky Utilities Company for an Adjustment of Its Electric Rates* (Ky. PSC Apr. 30, 2019). Kentucky-American receives electric service from KU.

[89] Direct Testimony of Kevin Rogers (Rogers Direct Testimony) at 29.

The Attorney General/LFUCG raised two issues related to Kentucky-American's fuel and power expenses: the impact on Kentucky-American's purchased power expense from the KU rate case; and Kentucky-American's proposal to apply a different rate for unaccounted-for water loss than permitted by Commission regulation.

(1) Purchased Power Expense Correction

Kentucky-American included a purchased power expense of $4,470,870 in forecasted operations.[90] Because Kentucky-American's figures were based on proposed rates in the pending KU rate case, the actual adjustment was in flux until that case was decided.

Based on a proposed stipulated settlement in the KU rate case, the Attorney General/LFUCG proposed a $97,027 reduction to fuel and power expense.[91] Subsequently, Kentucky-American accepted the recommendation and reduced its fuel and power expense by $97,027 for a total purchased power expense of $4,373,843.

In his post-hearing brief, the Attorney General agreed with Kentucky-American's adjustment and recommended that the Commission accept it.[92] However, in its post-hearing brief, LFUCG argued that the final order in the KU rate case reduced KU's revenue requirement 4.233 percent lower than the proposed stipulation, and, therefore, Kentucky-American's purchased power expense should be lowered by 4.233 percent.[93]

The Commission finds that an adjustment is warranted but that it should be based upon the final rates approved by the Commission in the KU rate case, which reflects the

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[90] Application, Exhibit 37 Schedule C-1 page 2.

[91] Kollen Testimony at 30–31. Grossed-up expense.

[92] Attorney General Brief at 40.

[93] LFUCG Post-Hearing Brief (LFUCG Brief) (filed June 11, 2019) at 20.

actual rates that apply to Kentucky-American. As LFUCG discussed, the rates approved by the Commission are lower than the rates contained in the proposed stipulation. Based on the evidence in the record and the final Order issued in Case No. 2018-00294, the Commission finds that Kentucky-American's purchased power expense should be reduced by $100,320 for ratemaking purposes as calculated in the table below.

As Filed Power Expense Increase Related to Increase in KU Rates (Based on a 7.8% Increase in Rates)		$ 199,399
KU Original Overall Rate Increase Ask	$ 112.460	
Divided by: Granted Overall Increase	$ 55.880	
KU Rate Increase Settlement As Percentage of Request	49.7%	
Power Expense Related Granted Rate Increase		$ 99,079
Commission Adjustment		$ (100,320)

(2) Unaccounted-for Water Loss

Kentucky-American did not make an adjustment for its unaccounted-for water loss above 15 percent, as required by 807 KAR 5:066, Section 6(3), nor did Kentucky-American request a deviation from that regulation. Instead, Kentucky-American asserted that the Commission should approve Kentucky-American's proposed alternative unaccounted-for water loss of 20 percent because, according to Kentucky-American, it is taking reasonable, cost-effective steps to control unaccounted-for water.[94] Kentucky-American further asserted that it remained below the 15 percent threshold between 2009

[94] O'Neill Rebuttal Testimony at 16; Kentucky-American Brief at 43.

and 2015 and that its unaccounted-for water loss had only recently exceeded 15 percent.[95]

The Attorney General/LFUCG argued that because Kentucky-American did not propose an adjustment or propose an alternative method for measuring water loss in its initial application, its request should be denied.[96] The Attorney General/LFUCG further argued that Kentucky-American's unaccounted-for water has been steadily rising and support for this increase is lacking.[97]

Pursuant to 807 KAR 5:066, Section 6(3), Kentucky-American has the burden of proof to establish that an alternative threshold for unaccounted-for water loss is more reasonable than the regulatory standard of 15 percent. The Commission agrees with the Attorney General/LFUCG that Kentucky-American failed to meet its burden of proof, and therefore its proposed alternative 20 percent threshold is denied. In reviewing Kentucky-American's water-loss history it appears that unaccounted-for line loss has steadily increased and that the proposed alternate level is simply the current unaccounted-for water loss. Although Kentucky-American identifies cost-effective steps, it has recently taken to control unaccounted-for water, it has neither produced an analysis or study to quantify the impact these programs will have on water loss; nor has it presented a quantifiable plan as to how it will maintain its target water loss into the future.

Because the Commission denied the alternative threshold, we must make adjustments related to the unaccounted-for water loss above 15 percent. Limiting

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[95] O'Neill Rebuttal Testimony at 17; Kentucky-American Brief at 44.

[96] Attorney General Brief at 57; LFUCG Brief at 8–13.

[97] *Id.*

Kentucky-American's water loss to 15 percent results in a decrease to forecasted fuel and power expense of expense for the water division of $190,993. When combined with the reduction from the purchased power expense discussed above, the Commission's total reduction to the forecasted fuel and power expense is $291,313.

Chemical Expense

Kentucky-American included the chemical expense of $2,887,866 in forecasted operations.[98] Through discovery, the Attorney General/LFUCG found that Kentucky-American had overstated certain of its forecast chemical expenses due to calculation errors that double counted these expenses.[99] In its Base Period Update, Kentucky-American corrected the errors, resulting in a decrease to the forecasted chemical expense of $102,886.[100]

In addition to the reduction to account for Kentucky-American's calculation error, the Commission finds that it is reasonable to make an additional adjustment to remove chemical expense related to unaccounted-for water loss above the 15 percent regulatory threshold, discussed in the above section. Therefore, The Commission finds that the chemical expense should be reduced by $121,704[101] to eliminate the chemical cost incurred for line loss over 15 percent. The total Commission adjustment to the forecasted chemical expense is a reduction of $224,590.

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[98] Application, Exhibit 37 Schedule C-1 page 2 of 9.

[99] Kollen Testimony at 29

[100] Base Period Update, Exhibit 37 at 1.

[101] $2,887,866 (Kentucky-American's Forecast) - $102,866 (Error Correction) = $2,785,866 x (4.37)% (Line Loss in Excess of 15%) = ($121,704).

Uncollectible Expense

According to Kentucky-American, it developed its forecasted uncollectible percentage of revenue by utilizing historical uncollectible dollars to revenue ratio from 2015, 2016, and 2017.[102] By applying this percentage to pro forma revenue for the fully forecasted test period, Kentucky-American calculated its forecasted level of uncollectible expense to be $804,093.[103]

The Commission finds that it is reasonable to reduce the uncollectible expense due to the loss of revenue from the closure of the Trane plant, which was discussed above. Applying the uncollectible percentage to the approximately $8,000 in revenue to reflect the loss of Trane, the Commission finds that uncollectible expense should be reduced by $72.

Depreciation Expense

Kentucky-American includes a depreciation expense of $18,604,103 in its forecasted operations.[104] Based on the Commission's treatment of forecasted rate base with regard to slippage, an adjustment has been made to increase forecasted depreciation expense by $17,404.

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[102] Direct Testimony of James L. Pellock (Pellock Testimony) at page 16.

[103] *Id.*

[104] Application, Exhibit 37, Schedule C-1; Kentucky-American's Response to Commission Staff's First Request for Information (Staff's First Request), Item 3(a), W/P-4-1 and W/P-4-3. $18,316,098 (Depreciation) + $24,567 (Amortization UPAA) + $263,438 (Amortization) = $18,604,103.

General Tax Expense

Kentucky-American included a forecast of general tax expense of $57,814,766, which includes property taxes of $7,032,232, payroll taxes of $596,020, Commission assessment of $175,930, and taxes and licenses of $10,594.[105]

Based on our treatment of forecasted rate base with regard to slippage, the Commission finds that it is reasonable to reduce forecasted property tax expense by $3,379. The Commission further finds that it is reasonable to reduce the Commission assessment by $16 to reflect the $8,000 decrease in revenues from water sales resulting from the closure of the Trane plant. Finally, The Commission finds that it is reasonable to decrease payroll tax expense by $23,303 to reflect the reduction to incentive compensation as discussed below. The Commission's total adjustment to Kentucky-American's forecasted general tax expense is a reduction of $26,698.

Interest Synchronization Expense

Kentucky-American proposed a forecasted interest expense of $13,233,671 based on the forecasted capital structure, the weighted cost of debt and the weighted dividend rate on the preferred stock.[106] As shown in the table below, the Commission has recalculated this expense to be $13,315,311 based on the rate base and weighted cost rates found reasonable herein resulting in an adjustment of $75,940.

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

[106] Application, Exhibit 37, Schedule E-1.3.

	Weighted Cost of Debt	Rate Base	Interest Synchronization
Short-Term Debt	0.05%	443,843,707	$ 221,922
Long-Term Debt	2.91%	443,843,707	12,915,852
Preferred Dividend	0.04%	443,843,707	177,537
Interest Synchronization			$ 13,315,311

Deferred Income Tax Expense

In its application, Kentucky-American included a forecast of deferred income tax expense of $1,549,140.[107] In the Base Period Update, Kentucky-American decreased deferred income tax expense to $1,212,844, which represents a $385,857 expense for the stub period, a $109,930 expense for state excess ADIT, and a $717,057 expense for federal excess ADIT.[108]

The excess ADIT arose from the TCJA, which reduced the federal income tax rate from 35 percent to 21 percent effective January 1, 2018, and the reduction of the Kentucky income tax rate from 6 percent to 5 percent, also effective January 1, 2018. The reduction in the federal and state income tax rate resulted in excess ADIT balances that must be returned to the ratepayers. An additional issue is that federal excess ADIT is separated into two categories, protected and unprotected. The TCJA normalization rules only apply to protected ADIT, which is defined as public utility property subject to accelerated

[107] Application, Exhibit 37, Schedules C-2 and D-1.

[108] Base Period Update at 1; Kentucky-American's response to the Commission Staff's Post Hearing Request for Information, Item 8, Kentucky-American_R_PSCPHDR_NUM008_052419_Attachment.xlsx, Line 24, Column D. We note that there is a $3.00 difference in the amount of state excess ADIT between the Base Period Update and Kentucky-American's response to the Post-Hearing Request for Information.

depreciation under 26 U.S.C.A §§ 167 and 168.[109] The TCJA normalization rules require utilities to use the Average Rate Assumption Method (ARAM) or the Reverse South Georgia Method (RSGM) if the utility does not have sufficient financial records to comply with the requirements of the ARAM. Unlike the federal excess ADIT, the state excess ADIT is not deemed protected.

The issues to be decided regarding Kentucky-American's deferred state and federal income taxes are: (1) the amortization period for excess state and federal tax between January 1, 2018, and June 30, 2019 (stub period); (2) the amount of federal excess ADIT; (3) treatment of repair-related federal excess ADIT; (4) the amortization period for unprotected federal excess ADIT; and (5) the amortization period for the state excess ADIT.

First, regarding the amortization of excess state and federal ADIT deferring during in the stub period, Kentucky-American proposed to amortize over a three-year period beginning June 30, 2019.[110]

Second, as noted above, Kentucky-American provided an estimate of the aggregate of federal excess ADIT but was unable to separate it into protected and unprotected excess ADIT or amortize the excess ADIT to be returned to the customers because the estimates were uncertain and subject to revision.[111] Kentucky-American explained that, prior to the TCJA enactment, it was not required to use the ARAM and had to build a database in tax software, which included formatting and aligning vintage

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[109] Tax News Update, *Power and Utility concerns under the TCJA*, January 25, 2018, 2018-0186 https://taxnews.ey.com/news/2018-0186-power-and-utility-concerns-under-the-tcja.

[110] Wilde Rebuttal Testimony at 4; Kentucky-American Brief at 17.

[111] Direct Testimony of John R. Wilde (Wilde Direct Testimony) at 8.

records.[112] Kentucky-American further explained that the process would be completed by the first or second quarter of 2019.[113]

Third, Kentucky-American proposed that its repair-related federal excess ADIT be treated as protected, consistent with its consent agreement (Consent Agreement) with the Internal Revenue Service (IRS). The Consent Agreement between Kentucky-American and the IRS directs Kentucky-American to use normalization rules for repairs costs.[114] In other words, the Consent Agreement requires Kentucky-American to treat repair costs, which otherwise would be unprotected, as protected for ADIT purposes. Kentucky-American argued that if it returned the excess ADIT associated with its repair deductions more rapidly than the ARAM, then it would be a normalization violation and a violation of the Consent Agreement, which would subject Kentucky-American to a fine and retroactive loss of the use of accelerated depreciation.[115] Kentucky-American requested that the following categories of repair deductions be treated as protected: Fed-Repair M/L, which has a net total of $1,357,034; Fed-Repair 481(a), which has a net total of $2,827,732; and Fed-Tax Repairs, which has a net total of $3,095,042.[116]

Fourth, Kentucky-American requested approval to amortize the unprotected excess ADIT over a 20-year period.[117] Kentucky-American argued that a 20-year period

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[112] *Id.* at 12.

[113] *Id.* at 13.

[114] *Id.* at 10–11, and Exhibit JRW-2.

[115] Wilde Rebuttal Testimony at 18; Kentucky-American Brief at 20; Kentucky-American Reply Brief at 12–13.

[116] Wilde Rebuttal Testimony, Exhibit JRW-4R.

[117] Wilde Rebuttal Testimony at 11–12; Kentucky-American Brief at 21; Kentucky-American Reply Brief at 14.

was consistent with the life of the underlying assets, would minimize rate shock to customers, would reduce the impact on Kentucky-American's cost of capital from negative cash flow, and was consistent with unprotected excess ADIT amortization periods approved in other proceedings.[118]

Fifth, Kentucky-American requested to treat the state excess ADIT the same as federal excess ADIT.[119]

The Attorney General/LFUCG disagreed with Kentucky-American on the majority of the excess ADIT issues but did not address the amortization period for the stub period excess state and federal excess ADIT.

Regarding the amount of federal excess ADIT, the Attorney General/LFUCG argued that Kentucky-American should separate estimated excess ADIT into protected and unprotected amounts, calculate an amortization expense for the protected excess ADIT, and use a short amortization period for the unprotected excess ADIT.[120] The Attorney General/LFUCG argued that the differences between the temporary excess ADIT returned to customers and the actual amounts could be trued up through a TCJA rider in a separate proceeding, Case No. 2018-00042 once Kentucky-American determined the actual excess ADIT amounts.[121]

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[118] Wilde Rebuttal Testimony at 12; Kentucky-American Brief at 21–22; Kentucky-American Reply Brief at 14.

[119] Wilde Direct Testimony at 8.

[120] Kollen Testimony at 34–35.

[121] Case No. 2018-00042, *Electronic Investigation of the Impact of the Tax Cuts and Job Act on the Rates of Kentucky-American Water Company* (Ky. PSC Dec. 21, 2018). We note that Case No. 2018-00042 was consolidated into this proceeding and closed as a separate proceeding.

Regarding the repair-related federal excess ADIT, the Attorney General/LFUCG argued that Kentucky-American incorrectly characterized the repair-related excess ADIT as protected.[122] The Attorney General/LFUCG disagreed that the Consent Agreement was applicable to the repair-related excess ADIT in the categories of Fed-Repair M/L, Fed-Repair 481(a), and Fed-Tax Repairs.[123] The Attorney General/LFUCG argued that the Consent Agreement includes a provision that subsequent changes in the law that are inconsistent with the Consent Agreement will nullify the Consent Agreement, and that the TCJA was a change in the law that nullified the Consent Agreement.[124] Although the Attorney General/LFUCG disagreed that the Fed-Repair M/L category should be treated as protected, they explained that the amount is relatively minor, and thus did not dispute the characterization of that category as protected.[125] The Attorney General/LFUCG further explained that that the Fed-Repair 481(a) and Fed-Tax Repair categories were significant and should be treated as unprotected.[126]

Regarding the amortization period for the federal unprotected excess ADIT, the Attorney General/LFUCG recommended that it be amortized over a three-year period.[127] The Attorney General/LFUCG argued that extending the amortization period delays the return of excess ADIT to ratepayers, and therefore proposed a three-year period because

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[122] Kollen Testimony at 35–37; Attorney General Brief at 43–45.

[123] May 14, 2019 HVT at 11:22:57.

[124] Kollen Testimony at 36–37; Attorney General Brief at 43–44.

[125] May 14, 2019 HVT at 11:23:18.

[126] *Id.* at 11:28:15.

[127] Kollen Testimony at 39; Attorney General Post-Hearing Reply Brief at 41–43.

it matched the amortization period that Kentucky-American proposed for rate case expenses.[128]

Regarding the state excess ADIT, the Attorney General/LFUCG noted that the normalization requirement does not apply to the amortization of the state excess ADIT. The Attorney General/LFUCG proposed that the Commission approve a three-year amortization period, which would match their recommendation for unprotected federal excess ADIT.[129]

Beginning with the amortization period for the stub period, the Commission finds that it is reasonable for Kentucky-American to amortize the state and federal excess ADIT that was deferred during the stub period for the same length of time as the stub period, 18 months.

Regarding the amount of the excess federal ADIT, including the repair-related federal excess ADIT, we are not persuaded by the Attorney General/LFUCG's arguments. First, Case No. 2018-00042 was consolidated into this case and closed, so we must address the issue in the proceeding. Second, we disagree with the Attorney General/LFUCG's conclusions regarding the applicability of the Consent Agreement to the repair-related federal excess ADIT. In relevant part, the Consent Agreement stated:[130]

> If any item of property subject to the taxpayer's Form 3115 is public utility property within the meaning of § 168(i)(10) or former § 167(l)(3)(A):

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[128] *Id.*

[129] Kollen Testimony at 41.

[130] Wilde Direct Testimony, Exhibit JRW-2.

> (A) A normalization method of accounting (within the meaning of § 168(i)(9), former § 168(e)(3)(B), or former § 167(l)(3)(G), as applicable) must be used for such public utility property;
>
> (B) As of the beginning of the year of change, the taxpayer must adjust its deferred tax reserve account or similar reserve account in the taxpayer's regulatory books of account by the amount of the deferral of federal income tax liability associated with the § 481(a) adjustment applicable to such public utility property[.]

The Commission disagrees that the Consent Agreement is no longer applicable because the TCJA required a change in the law. When the Consent Agreement referred to a "normalization method of accounting" as defined in Section 168(i)(9), it was referring to 26 U.S.C.A. § 168(i)(9), which defines a normalization method of accounting in the tax code. Important here, the TCJA did not amend the definition of a normalization method of accounting in the tax code. In fact, despite several amendments to 26 U.S.C.A. § 168 since Kentucky-American entered into the Consent Agreement in 2010, the codified language defining a "normalization method of accounting" in Section 169(i)(9) has not been changed.

The TCJA did add to the definition of a normalization method of accounting as used in 26 U.S.C.A § 168 by including a "note," stating:

> A normalization method of accounting shall not be treated as being used with respect to any public utility property for purposes of section 167 or 168 of the Internal Revenue Code of 1986 if the taxpayer, in computing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, reduces the excess tax reserve more rapidly or to a greater extent than such reserve would be reduced under the average rate assumption method [ARAM].

This note, which has the force of law, essentially creates the requirement at issue in this case: that a utility use ARAM to reduce excess ADIT created by the reduced tax

rate and arising from certain book-tax timing differences for public utility property. However, there is no indication that this "change" modified the requirement in the Consent Agreement that Kentucky-American use a normalization method of accounting for public utility property. The Commission notes that the 1986 Tax Act contained a nearly identical note for excess ADIT generated by the reduction in tax rates.

Absent a direct conflict between the Consent Agreement and the change in the law, of which there is none here, the Commission is unpersuaded that Kentucky-American does not remain subject to the Consent Agreement. In fact, the Consent Agreement appears to have been written in a manner that accounts for potential changes in the definition of a "normalization method of accounting" without affecting the requirement that Kentucky-American use that method.

As noted above, the Consent Agreement states in relevant part that a "normalization method of accounting (within the meaning of § 168(i)(9) . . .)" must be used for public utility property. Section 168(i)(9)(A) first defines a "normalization method of accounting" by stating what a utility must do to use a normalization method of accounting. Section 168(i)(9)(B) then defines a normalization method of accounting by identifying things that are prohibited and, if done, will require the IRS to find that a utility is not using a normalization method of accounting. The TCJA simply adds to that definition, with language similar to 1986 Tax Act, by stating that "[a] normalization method of accounting shall not be treated as being used with respect to any public utility property for purposes of section 167 or 168" if the ARAM is not used to reflect the amortization of excess ADIT.

These requirements do not conflict and may all be applied pursuant to their plain language. Reading them together, they indicate that Kentucky-American must, among other things, apply the ARAM (or the RSGM if they cannot apply the ARAM) when determining the extent to which the excess ADIT arising from repair costs for public utility property subject to the 2010 Consent Agreement may be amortized to reduce rates.

Regarding the amortization period for unprotected federal excess ADIT, we are not persuaded that Kentucky-American's request to use a 20-year amortization period is reasonable. The Commission agrees with the Attorney General, who noted in his brief that the Commission has not granted a 20-year amortization period for the unprotected federal excess ADIT resulting from the TCJA and that the facts of this proceeding more closely match the case where we approved a 10-year amortization period.[131] However, we do not find the 3-year amortization period proposed by the Attorney General/LFUCG to be reasonable. The Commission finds that a 10-year amortization is reasonable because it will balance the impact to cash flow and will provide ratepayers the full benefit of the reduction in the federal corporate income tax in a timely manner.

Similarly, the Commission finds it reasonable to apply an amortization period of 10 years for the state excess ADIT. The Attorney General/LFUCG are correct that the normalization requirement does not apply to state excess ADIT, and therefore the Commission further finds it reasonable to apply the 10-year amortization period to the entirely of Kentucky-American's state excess ADIT.

The Commission must adjust Kentucky-American's deferred income tax expense for slippage and the deferred maintenance increase, along with the TCJA impact from the

[131] Attorney General Brief at 41–43.

stub period, and the state and federal excess ADIT. Based on the evidence of record and as discussed above, the Commission finds that it is reasonable to decrease Kentucky-American's deferred income tax expense by $1,226,898, for ratemaking purposes.[132]

Middletown Employee Allocation Expense

In its Base Period Update, Kentucky-American reduced labor costs by $27,538 to reduce the allocation of the city of North Middletown's employee from a 100 percent allocation to the water division to a 60 percent allocation. Based upon the Commission's findings regarding the North Middletown acquisition, which are discussed below, the Commission finds that the allocation revision is reasonable and therefore should be accepted.

Employee Vacancies/Labor Expenses

In the application, Kentucky-American identified the appropriate staffing level as 152 full-time positions, which is an increase of 9 new employees and 5 temporary employees.[133] Kentucky-American stated that the increase in staffing level is needed in order to establish and sustain a more cost-effective level of service, and that the proposed staffing level is consistent with meeting regulatory requirements, tariff requirements, industry standards, service requests, and customer needs.[134]

The Attorney General/LFUCG questioned this increase to the full-time employee estimate and noted that historically Kentucky-American has had fewer actual full-time

[132] State $(160,979) + Federal $(680,062) + Stub $(385,857).

[133] Rogers Direct Testimony at 19.

[134] *Id.* at 19–20.

employees than it has forecasted.[135] The Attorney General/LFUCG asserted that the impact of fewer forecasted employees would reduce revenue requirement by $492,027.[136]

Kentucky-American countered that, with the use of a forecasted test period, two methods are available to address employee vacancies. First, assume no vacancies and reduce overtime, temporary and contractor expenses accordingly. Second, assume a vacancy rate and include increased expenses for overtime, temporary, and contractor expenses to complete the work.[137] Kentucky-American employed the first option in developing its forecasted labor expense.[138] Kentucky-American argued that the Attorney General/LFUCG incorrectly used only a portion of the second methodology because there is no corresponding adjustment for increased overtime, temporary, or contract labor costs that would be necessary at the proposed full-time employee level.[139]

In his post-hearing brief, the Attorney General argued that Kentucky-American will not achieve the 152 forecasted full-time employee count by July 1, 2019, and that as of May 15, 2019, the full-time employee count was 138.[140] For this reason, the Attorney General asserted that the Commission should accept the Attorney General/LFUCG's

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[135] Kollen Testimony at 22; Attorney General Brief at 31.

[136] Kollen Testimony at 23. Grossed-up expense.

[137] Rebuttal Testimony of James S. Pellock (Pellock Rebuttal Testimony) at 2; Kentucky-American Brief at 37–38.

[138] Pellock Rebuttal Testimony at 2; Kentucky-American Brief at 38.

[139] *Id.*

[140] Attorney General Brief at 32.

proposed adjustment as a more accurate barometer of Kentucky-American's expenses.[141]

We are not persuaded by the Attorney General/LFUCG's arguments. They are similar to arguments from the Attorney General that we have rejected in prior Kentucky-American rate proceedings in which we noted that the Attorney General considered only the impact of employee vacancies on Kentucky-American's labor forecast and did not consider the impact of the vacancies on Kentucky-American's overtime and temporary/contract forecasts.[142] We continue to adhere to this position. If vacant employee positions exist, work will either be shifted to other employees and thus result in an increase in overtime costs, or Kentucky-American will hire additional temporary/contract labor. Kentucky-American has shown that its forecasts for overtime and temporary/contract labor have been reduced from an average of 27,500 hours to 16,034 hours to reflect the full employee complement proposed.[143] The Attorney General/LFUCG has not considered that the decreased direct labor costs from vacant employee positions will be offset by increases in overtime or temporary labor costs.[144] However, the overall impact of these vacancies on Kentucky-American's operating expenses and ultimately its revenue requirement is unknown. Based on the evidence of record and the reasons discussed above, the Commission finds that the Attorney

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[141] *Id.* at 32.

[142] Case No. 2004-00103, *Adjustment of the Rates of Kentucky-American Water* Company (Ky. PSC Feb. 28, 2005) Order at 44. *See* Case No. 95-554, *Application of Kentucky-American Water Company to Increase Its Rates* (Ky. PSC Sept. 11, 1996); Case No. 2010-00036, *Application of Kentucky-American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year* (Ky. PSC Dec. 14, 2010).

[143] Pellock Rebuttal Testimony at 3.

[144] *Id.* at 2.

General/LFUCG's proposed adjustment to labor expense for employee vacancies should be denied.

Support Services Expense

In its forecasted Service Company costs, Kentucky-American included business development costs of $93,013 and external affairs and public policy costs of $262,641 that the Service Company had allocated to Kentucky-American.[145] Of these amounts, the Commission has deducted $9,184 and $23,166 to reflect the elimination of costs related to the Annual Performance Plan (APP) and Long-Term Performance Plan (LTPP), respectively, which is discussed below.

The Commission previously placed Kentucky-American on notice that business development expenses allocated to the utility from the Service Company would be considered reasonable and appropriate for rate recovery only in those instances in which the utility was able to "appropriately document and separate forecasted management fees between those that are directly assignable and those that are allocated."[146]

In this proceeding, Kentucky-American was unable to provide the Commission with a detailed listing and description of business development costs or external affairs and public policy costs included in forecasted management fees that would support allowing recovery for those costs. As with the Commission's previous decisions concerning business development costs, it is the Commission's belief that external affairs and public

[145] Kentucky-American's Response to Staff's Second Request, Item 70.

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

policy costs enhance shareholder value but do not benefit ratepayers, and therefore should not be costs borne by ratepayers.

In light of its failure to identify or describe the business development as well as external affairs and public policy services that the Service Company provides, the Commission finds that Kentucky-American has failed to meet its burden to demonstrate the reasonableness of the costs. Therefore, we will reduce forecasted service company costs by $323,304.[147]

Incentive Compensation Expense

In its forecasted labor expense, Kentucky-American included $1,273,663[148] for its APP and $496,223[149] for its LTPP, which are performance pay incentive compensation plans for Kentucky-American employees and Service Company employees. One hundred percent of the funding measures for the APP are based on earnings per share (EPS), which means that no APP payments are made if EPS targets have not been met.[150] Once the funding measures have been met, the APP performance measures are weighted based on 50 percent financial measures and 50 percent non-financial operational measures, which include safety, drinking water quality, and customer

[147] Business & Development $(83,829) + External Affairs & Public Policy $(239,475).

[148] Kentucky-American's Response to the Attorney General's First Request for Information (Attorney General's First Request), Item 22.

[149] *Id.*

[150] Kentucky-American response to Staff's Second Request, Item 31.

satisfaction goals.[151] Under the LTPP, 100 percent of the performance measures are based on earnings measures that consist of EPS and relative total shareholder return.[152]

The Attorney General/LFUCG recommended that the Commission exclude the entirety of APP and LTPP incentive compensation expense from rate recovery. As support for the recommendation, the Attorney General/LFUCG explained that 100 percent of Kentucky-American's performance measures for the APP and LTPP are tied to financial measures, which the Commission has historically disallowed. The Attorney General/LFUCG argued that incentive compensation tied to financial measures incentivize achievement of shareholder goals for maximizing return on their investment, rather than ratepayer goals of improved service and safety, and reduced rates. The Attorney General/LFUCG argued that ratepayers should not pay for expenses that primarily benefit shareholders. Additionally, the Attorney General/LFUCG argued that incentive compensation tied to financial measures incentivizes Kentucky-American to request greater and more frequent rate increases in order to improve EPS and total shareholder return, which creates a conflict between achieving lower rates for customers or achieving greater financial performance for shareholders. The Attorney General/LFUCG recommended that Kentucky-American's revenue requirement be reduced by $1,927,000, consisting of a reduction of $1,770,000 in incentive compensation expense, and the related reduction of $135,000 in payroll tax expense and $22,000 in

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[151] *Id.*

[152] Kentucky-American response to Staff's First Request, Item 33.

bad debt and Commission assessment expenses related to the incentive compensation plans.[153]

In response, Kentucky-American asserted that because 50 percent of the APP is weighted on operational measures and 50 percent on financial measures, if the Commission were to deny recovery of incentive compensation expense related to financial measures, Kentucky-American should be allowed to recover in rates at least 50 percent of its APP expense related to non-financial measures.[154]

The Commission agrees in part and disagrees in part with the Attorney General/LFUCG. The Commission has consistently disallowed recovery of the cost of employee incentive compensation plans that are tied to financial measures because such plans benefit shareholders while ratepayers receive little benefit.[155] However, the Commission has also held that the amount removed for ratemaking purposes should be based on the performance measures and not the funding measures.[156] This distinction is important because, while 100 percent of Kentucky-American's LTPP performance measures are tied to earnings measures, the APP performance measures are based 50 percent on financial measures and 50 percent on non-financial measures. The Attorney General/LFUCG's recommendation is inconsistent with Commission precedent in regards

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[153] Kollen Testimony at 27.

[154] Rebuttal Testimony of Kurt M. Kogler at 7–8.

[155] *See* Case No. 2014-00396, *Application of Kentucky Power Company for: (1) A General Adjustment of its Rates for Electric Service; (2) An Order Approving its 2014 Environmental Compliance Plan; (3) An Order Approving its Tariffs and Riders; and (4) An Order Granting All Other Required Approvals and Relief* (Ky. PSC June 22, 2015).

[156] *Id.* at 25–26.

to the APP because the Attorney General/LFUCG's recommendation is based on the percentage of funding measures and not performance measures.

The Commission finds that it is reasonable to remove 50 percent, or $636,832, of the $1,273,663 cost for the APP that is tied to financial measures, and 100 percent, or $496,746 of the cost for the LTPP that is tied to financial measures for ratemaking purposes.[157]

401(k) Contribution Expense

Kentucky American included $38,433 for its employees and $31,550 allocated from the service company in retirement plan expense related to matching contributions made to employees' 401(k) retirement plans who are also participants in a defined benefit pension retirement plan.[158]

The Attorney General recommended reducing Kentucky-American's retirement plan expense by $70,000 based on recent decisions in which the Commission denied recovery of retirement expenses in which a utility made contributions to both a defined benefit pension plan and a 401(k) plan.[159]

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[157] Support Services

APP	$696,641	50 percent	$348,321
LTPP	$480,641	100 percent	$480,641
	TOTAL		$828,962
Kentucky-American			
APP	$577,022	50 percent	$288,511
LTPP	$ 16,105	100 percent	$ 16,105
	TOTAL		$304,616

[158] Kentucky-American Response to Attorney General's First request, Item 10.

[159] Kollen Testimony at 28–29.

Kentucky-American asserted that the Commission addressed this issue in Case No. 2017-00321,[160] and rejected a disallowance of such a retirement plan expense because the utility provided evidence of the steps it undertook to manage retirement benefits.[161] Kentucky-American contended that it has taken similar significant steps to manage and offering a lump-sum distribution to no longer active but vested plan participants in lieu of receiving their retirement annuity under the defined benefit plan to reduce Kentucky-American's plan expenses and risk.[162] Kentucky-American also asserted that it has taken additional steps to reduce employee benefit costs beyond retirement benefits.[163]

Kentucky-American misreads the Commission's finding in Case No. 2017-00321. The Commission clearly stated that we will make adjustments to retirement plan expenses for duplicative retirement plans, such as when defined benefit plans are not locked and frozen, and participants continue to earn benefits under a defined benefit plan and a defined contribution plan.[164] When a defined benefit plan is frozen, participants stop earning benefits from the date the plan is frozen. When a defined benefit plan is locked, then eligibility for the plan is closed. When a defined benefit plan is locked, but

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[160] Case No. 2017-00321, *Electronic Application of Duke Energy Kentucky, Inc. for: 1) An Adjustment of the Electric Rates; 2) Approval of an Environmental Compliance Plan and Surcharge Mechanism; 3) Approval of New Tariffs; 4) Approval of Accounting Practices to Establish Regulatory Assets and Liabilities; and 5) All Other Required Approvals and Relief* (Ky. PSC Apr. 13, 2018) at *22-23.*

[161] Rebuttal Testimony of Kurt M. Kogler (Kogler Rebuttal Testimony) at 2–3.

[162] Kentucky-American Brief at 39.

[163] *Id.* at 39–41.

[164] Vice Chair Cicero's Comments, Kentucky Chamber Energy Management Conference (Jan. 18, 2018), https://psc.ky.gov/agencies/psc/speeches/cicero/VC_Cicero_KYChamber_Energy_Conference_1-18-18.pdf.

not frozen, then those employees who participated in the now-closed plan continue to accrue benefits. Managing duplicative retirement plans to lessen costs is not the equivalent of locking and freezing a plan to avoid duplicative benefits.

Here, Kentucky-American locked the defined benefit plan as of January 1, 2006. However, the locked defined benefit plan was frozen for a small group of employees consisting of union employees hired between January 1, 2001, and December 31, 2005.[165] Union employees hired before January 1, 2001, and non-union employees hired before January 1, 2006, continue to accrue benefits under the defined benefit plan because it was locked but not frozen for these employees.[166]

We conclude that Kentucky-American's retirement plan expenses for matching 401(k) contributions are reasonable only for union employees hired between January 1, 2001, and December 31, 2005, whose defined benefit plan was locked and frozen, and thus are not duplicative. The retirement plan expenses for matching 401(k) contributions for union employees hired prior to January 1, 2001, and for non-union employees hired before January 1, 2006, should be disallowed because the defined benefit plan for these employees was locked, but not frozen, and thus are duplicative, with these employees accruing retirement benefits from both plans. Permitting utility employees to participate in multiple pension plans simultaneously while many ratepayers have no pension plan at all, is not fair, just, or reasonable.

For the reasons set forth above, the Commission finds that the retirement contribution expense should be reduced by $65,058 to reflect 401(k) matching

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[165] Kentucky-American response to Staff's Post-Hearing Request, Item 10.

[166] *Id.*

contributions made by Kentucky-American to union employees hired prior to January 1, 2001, and to non-union employee hired prior to January 1, 2006, who are also eligible for the defined benefit program.[167]

Deferred Maintenance Expense

The Commission made an adjustment for the operations and maintenance (O&M) impact of the amortization for the Base Period Update for deferred maintenance of $107,578.

Rate Case Expense Amortization

Kentucky-American's forecasted rate case expense of $1,230,559 included $312,141 for internal labor services.[168]

The Attorney General/LFUCG recommended that the internal labor costs be excluded from the rate case expense for the following reasons: (1) the significant increase in estimated expenses compared to Kentucky-American's prior rate case; (2) a comparison of the size of the rate case cost estimate to the size of the requested increase; and (3) internal labor costs are generally not requested by other utilities in rate case expense recovery because the costs are not incremental.[169] The Attorney General/LFUCG recommended reducing forecasted rate case costs by $312,000 to remove internal labor support services expense.[170]

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[167] Support Services $(26,625) + Kentucky-American $(38,433)

[168] Application, Exhibit 37, Schedule F-6.

[169] Kollen Testimony at 42.

[170] *Id.* at 43.

Kentucky-American countered that higher rate case cost than past cases is not a sufficient basis to disallow recovery of prudently incurred cost.[171] Kentucky-American explained that the internal labor costs resulted from compensation and Service Company cost studies that Kentucky-American commissioned to support its position and to provide the Commission with a complete record.[172] In addition, Kentucky American asserted that the Attorney General/LFUCG has not shown that there is a correlation between the requested revenue increase and the estimated cost to submit a rate case application.[173]

In additional support of the internal labor costs, Kentucky-American explained that it uses the resources of the Service Company to support the preparation, filing, and litigation of a rate case as an alternative to Kentucky-American staffing and maintaining its own in-house expertise for the full scope of rate case filings 100 percent of the time.[174] According to Kentucky-American, the cost of providing these services is directly charged to Kentucky-American and not otherwise included in the allocated Service Company costs recovered as an expense in Kentucky-American's revenue requirement, therefore, these costs are incremental.[175]

In his post-hearing brief, the Attorney General reiterated the increased costs since the last rate case, noting that it is a 39.25 percent increase.[176] The Attorney General

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[171] Pellock Rebuttal Testimony at 3.

[172] *Id.* at 4.

[173] *Id.* at 5.

[174] *Id.*

[175] *Id.*

[176] Attorney General Brief at 45.

maintained that the additional studies commissioned by Kentucky-American were not required or requested by the Commission.[177]

In its post-hearing brief, LFUCG argued that only actual, reasonable rate case expenses should be recovered in rates.[178] LFUCG recommended that the Commission disallow the legal fees and internal labor costs, asserting that Kentucky-American failed to provide sufficient support for the fees.[179]

In response to LFUCG's arguments, Kentucky-American filed unredacted time entries for its legal fees, arguing that LFUCG failed to raise this issue prior to raising it in its post-hearing brief.[180]

Based on the evidence of the case, the Commission finds that Kentucky-American demonstrated that the allocated Service Company costs are reduced by all forecasted directly billed costs (rate case costs for all subsidiaries) and, therefore, there is no double recovery. In fact, Kentucky-American's allocation of Service Company costs is reduced by the hours directly billed.[181] Kentucky-American has also shown that the cost of using the Service Company is a financially sound decision as expenses are directly charged to Kentucky-American and are treated as incremental. Accordingly, the Commission finds that the Attorney General/LFUCG's proposed adjustment to rate case amortization be denied. However, the Commission's review of the unredacted invoices for legal services

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[177] *Id.* at 45–46.

[178] LFUCG Brief at 20.

[179] *Id.* at 22.

[180] Kentucky-American Reply Brief at 20–21.

[181] *See* Kentucky-American Brief at 43.

as filed by Kentucky-American on June 14, 2019, reveal a number of charges totaling $40,950 for consulting fees charged by Edward J. Grubb. Kentucky-American's data responses provide no details regarding this consultant, such as the work he performed, the number of hours he worked, or his hourly rate. Consequently, the rate case expenses should be reduced by $40,950 to reflect the exclusion of these unsupported fees. Based upon the updated estimated rate case costs of $1,296,794, the Commission increased Kentucky-American's revenue requirement by $22,079 based on a three-year amortization.

Other

Due to the Commission approved slippage adjustment, the Commission made a reconciling adjustment for other table income. The net impact of these adjustments is a reduction in the revenue requirement of $470,157.[182]

Income Tax Expense

Kentucky-American included a forecast of current income tax expense of $4,271,756, which includes state income tax of $738,871 and federal income tax of $3,532,885.[183]

The Commission finds that it is reasonable to make an adjustment to Kentucky-American's state income tax expense of $112,608 for an adjusted current state income tax expense amount of $851,479. The Commission further finds an adjustment to Kentucky-American's federal income tax expense of $449,302 to an adjusted level of

[182] See Appendix A.

[183] Application, Exhibit 37, Schedule C-1.

$3,982,187 is reasonable. The calculations of the Commission's adjustments to current state and federal income taxes is contained in Appendix A which is attached hereto.

Chemical Complex Expense

In its post-hearing reply brief, LFUCG raised, for the first time, an argument that expenses related to the construction of a chemical complex at one of Kentucky-American's treatment stations should be disallowed because Kentucky-American did not request a Certificate of Public Convenience and Necessity (CPCN) prior to constructing the facility.[184] LFUCG asserted that, because Kentucky-American did not request a CPCN, the Commission has not determined the reasonableness of the expense, and therefore it should be disallowed.

The Commission notes that the Attorney General and LFUCG submitted data requests to Kentucky-American regarding the chemical complex but offered no evidence or testimony regarding the ratemaking treatment of the chemical complex. The Commission's findings must be supported by sufficient evidence. Here, with no evidentiary support in the record regarding the proposed adjustment, the Commission is without any basis, much less sufficient evidence, to justify an adjustment, and therefore we deny LFUCG's proposed adjustment to remove expenses related to constructing the chemical complex.

To the extent that LFUCG based its argument on our findings in Case No. 2018-00281, LFUCG misreads those findings.[185] We did not apply a 2 percent bright-line test

[184] LFUCG Brief at 17–19.

[185] Case No. 2018-00281, *Electronic Application of Atmos Energy Corporation for an Adjustment of Rates* (Ky. PSC May 7, 2019).

in that Order to determine whether a utility should apply for a CPCN. We explained that the utility in that case alleged that its estimated project cost was less than 2 percent of net utility plant, and thus did not request a CPCN. As we pointed out in that case, the estimated cost for the proposed construction was over 2 percent of net utility plant, and thus, the utility's alleged reason for not requesting a CPCN was not supported by the facts. While we have, on occasion, considered the percentage of the utility's net utility plant in CPCN determinations, each determination is fact specific, takes into account all of the facts, and does not rely on a single bright-line test.

RATE OF RETURN

Capital Structure

Kentucky-American's proposed capital structure based on the projected 13-month average balances for the forecasted test period and the costs assigned to each capital component is shown in the table below.[186]

Class of Capital	Application 13-Month Avg Net Caryng Amount	Ratios	Job Develop Credit	Adjusted Capitalization	Requested Returns
Short-Term Debt	$ 6,777,501	1.519%	$ 3,110	$ 6,780,611	3.2740%
Long-Term Debt	220,061,621	49.324%	100,990	220,162,611	5.9000%
Preferred Stock	2,243,433	0.503%	1,030	2,244,463	8.5100%
Common Equity	217,071,552	48.654%	99,618	217,171,170	10.8000%
Total Capitalization	$ 446,154,107	100.000%	$ 204,748	$ 446,358,855	
JDITC		$ 204,748			

When submitting its Base Period Updates Kentucky-American proposed the following revisions to its forecasted capital structure to reflect (1) an update to the short-

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

term debt balance to reflect the North Middletown acquisition that closed in April 2019 as opposed to February 2019; (2) an increase in the equity infusion from $6,000,000 to $9,300,000; (3) a reduction in the long-term interest rate for the $16,000,000 issuance from 4.55 percent to 4.16 percent; and (4) a reduction in the cost of short-term debt from 3.274 percent to 2.585 percent.[187] Kentucky-American's revised forecasted capital structure and assigned cost rates are shown in the table below.

Class of Capital	Update 13-Month Avg Net Caryng Amount	Ratios	Job Develop Credit	Adjusted Capitalization	Updated Requested Returns
Short-Term Debt	$ 10,308,270	2.274%	$ 4,656	$ 10,312,926	2.5850%
Long-Term Debt	220,061,621	48.546%	99,397	220,161,018	5.8700%
Preferred Stock	2,246,465	0.496%	1,016	2,247,481	8.5100%
Common Equity	220,689,002	48.684%	99,680	220,788,682	10.8000%
Total Capitalization	$ 453,305,358	100.000%	$ 204,749	$ 453,510,107	
JDITC		$ 204,748			

The Attorney General/LFUCG objected to Kentucky-American's proposed cost of short-term debt, arguing that the forecasted cost is overstated and inconsistent with present rates.[188] The Attorney General/LFUCG asserted that the forecast assumes an increase in short-term rates throughout the test year and that such an assumption cannot be determined with any level of certainty. The Attorney General/LFUCG recommended a short-term cost rate of 2.68 percent, the present one-month LIBOR rate of 2.49 percent plus 0.19 percent credit spread.[189] Regarding long-term interest rates, the Attorney

[187] Scott W. Rungren Rebuttal Testimony (Rungren Rebuttal Testimony) at 3–6. In addition, a correction to the base period balance of preferred stock was updated in the filing.

[188] Kollen Testimony at 46. One-month LIBOR rate as of March 11, 2019.

[189] *Id.* at 46–47.

General/LFUCG argued that the long-term debt rate proposed by Kentucky-American for its May 2019 financing is overstated and recommended a cost rate of 4.22 percent for the debt issuance based on the present 3.10 percent yield on the 30-year Treasury debt plus a credit spread of 1.12 percent.[190]

Kentucky-American responded stating that it has revised its short-term interest rate forecast downward based on more current LIBOR rate projections in its Base Period Update filing.[191] Regarding the long-debt rate for the May 2019 issuances, Kentucky-American also updated this interest rate projection to 4.16 percent in its Base Period Update filing.[192] The Attorney General agreed with these revised cost rates.[193]

Upon review of the record, the Commission finds that Kentucky-American's revised capital structure accurately projects the test-year capitalization requirements with the exception of short-term debt. The Commission is reducing short-term debt by $2,023,097 to reflect the construction slippage approved herein. The Commission's forecasted capital structure and assigned cost rates are shown in the table below.

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[190] *Id.* at 48.

[191] Rungren Rebuttal Testimony at 7; Kentucky-American Brief at 45.

[192] Rungren Rebuttal Testimony at 8; Kentucky-American Brief at 45.

[193] Attorney General Brief at 28.

Class of Capital	Commission 13-Month Avg Net Caryng Amount	Ratios	Job Develop Credit	Adjusted Capitalization	Authorized Returns
Short-Term Debt	$ 8,285,173	1.836%	$ 3,759	$ 8,288,932	2.4320%
Long-Term Debt	220,061,621	48.764%	99,843	220,161,464	5.8600%
Preferred Stock	2,246,465	0.498%	1,020	2,247,485	8.5100%
Common Equity	220,689,002	48.903%	100,128	220,789,130	9.7000%
Total Capitalization	$ 451,282,261	100.001%	$ 204,750	$ 451,487,011	
JDITC		$ 204,748			

Return on Equity

Kentucky-American developed its proposed ROE using versions of the constant growth discounted cash flow (DCF) model and the forward-looking capital asset pricing model (CAPM). The modeling includes two proxy groups, a Water Proxy Group, composed of water utilities only, and a Combined Utility Proxy Group,[194] composed of water and natural gas distribution utilities. Both proxy group model results include and exclude American Water. Kentucky American also considered Value Line's projected ROEs. The results ranged from 8.00 percent to.13.03 percent.[195] Based upon these models, Kentucky-American proposed an ROE range of 10.00 percent to 10.80 percent, with a recommended ROE of 10.80 percent.[196]

Kentucky-American stated that its recommendation takes into consideration business and financial risk factors of Kentucky-American, including its capital expenditure

[194] Kentucky-American included the Combined Utility Proxy Group due to the small size of the Water Utility Group, which included only five companies.

[195] Bulkley Direct Testimony, AEB-1 – AEB-5 and AEB-9 – AEB-10.

[196] *Id.* at 8.

requirements and adjustment mechanisms, as compared with the Combined Utility Proxy Group.[197] Kentucky-American supported a forward-looking estimate and, as such, relied on forward-looking inputs and assumptions, and expectations for higher interest rates.[198]

The Attorney General/LFUCG urged the Commission to reject Kentucky-American's proposed 10.80 percent ROE, asserting that it grossly overstated a fair rate of return.[199] The Attorney General/LFUCG provided an ROE analysis that employed the DCF and two CAPMs but based their recommendation on the results of the DCF model.[200] The Attorney General/LFUCG's DCF model results indicated equity cost rates ranging from 7.92 percent to 10.95 percent for the Water Proxy Group, and from 8.38 percent to 11.49 percent for the Combined Utility Proxy group. Based on the DCF model results, the Attorney General/LFUCG proposed a range of 9.02 percent to 9.27 percent, with a recommended ROE of 9.15 percent.[201]

For the DCF model, the Attorney General/LFUCG employed the same two proxy groups as Kentucky-American and the average and medium value for the expected growth rates.[202] The Attorney General/LFUCG noted that the median DCF results for the Combined Utility Proxy Group were within the allowed ROEs for American Water subsidiaries, which average 9.66 percent, yet Kentucky-American excluded these median

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[197] *Id.* at 4–5, 8.

[198] *Id.* at 8–9.

[199] Direct Testimony and Exhibits of Richard A. Baudino (Baudino Testimony) at 3.

[200] *Id.*

[201] *Id.* at 33–36.

[202] *Id.* at 23.

values in favor of the high range values.[203] The Attorney General/LFUCG argued that Kentucky-American's DCF model results were asymmetric and biased because Kentucky-American excluded only the low-end DCF results, and did not examine and exclude excessively high DCF estimates.[204] The Attorney General/LFUCG further argued that the Commission should not consider Kentucky-American's projected stock price DCF results when determining the ROE because investors cannot purchase the proxy company stock at this projected price and because the use of these projected prices is speculative and inaccurate.[205] The Attorney General/LFUCG advised the Commission to reject the Value Line projected Water Proxy Group ROEs because recently allowed ROEs for American Water's subsidiaries and DCF estimates using current stock prices are much lower.[206] Finally, the Attorney General/LFUCG recommended that the Commission apply Kentucky-American's DCF model results in totality for guidance in determining a fair ROE.[207]

For the CAPM analysis, the Attorney General/LFUCG presented models based on the expected return for the stock market and on a risk premium using historical market returns.[208] The CAPM analysis also used the average yields on 30-year and 5-year Treasuries from September 2018 through February 2019.[209] The results of the Attorney

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[203] *Id.* at 38, 40, and Table 4 at 39.

[204] *Id.* at 44.

[205] *Id.* at 46.

[206] *Id.* at 46.

[207] *Id.* at 40.

[208] *Id.* at 3 and Table 3 at 35.

[209] *Id.* at 34.

General/LFUCG's CAPM analysis ranged from 6.74 percent to 9.35 percent.[210] However, the Attorney General/LFUCG argued that the CAPM analysis should be rejected outright because the results were exceedingly high and, even at the lower end of the range, the CAPM analysis far exceeds recently allowed returns that average 9.66 percent for operating companies within American Water.[211]

The Attorney General/LFUCG asserted that, instead of forward-looking assumptions used by Kentucky-American, the Commission should rely on current interest rates and data in determining a fair ROE.[212] The Attorney General/LFUCG emphasized that, given the recent hold in increases in federal funds rates, the current interest rates are indicative of investor expectations and are efficient.[213] The Attorney General/LFUCG maintained that with low inflation, slowing growth, and tightening financial conditions, the case for increased interest rates in 2019 has weakened considerably.[214]

Similarly, the Attorney General/LFUCG asserted that it was inappropriate to use forecasted or projected bond yields, because bond yield forecasts are speculative, while current rates are tangible and verifiable.[215] For this reason, the Attorney General/LFUCG rejected Kentucky-American's use of forecasted 30-year Treasury bond yields and recommended using shorter-term Treasury yields, arguing that shorter securities have

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[210] *Id.* at 35, Table.

[211] *Id.* at 38.

[212] *Id.* at 40–41.

[213] *Id.* at 10.

[214] *Id.* at 9.

[215] *Id.* at 47.

less risk and are, therefore, more indicative of the risk-free rate.[216] Further, the Attorney General/LFUCG claimed that the market return estimate of 15.19 percent is extraordinarily high when compared to historical norms, as well as in comparison to the Attorney General/LFUCG's models, and therefore should be given little weight in this proceeding.[217]

The Attorney General/LFUCG also disagreed with Kentucky-American's assertion that risks arising from the use of a future test year, revenue decoupling, the impact of the proposed QIP, and its capital expenditure program should be taken into account when determining the ROE.[218] First, regarding the future test year, the Attorney General/LFUCG disputed Kentucky-American's assertion that it has a comparable risk to the proxy groups if rates are set using a future test year.[219] The Attorney General/LFUCG countered that Kentucky-American actually has less risk because 58 percent of the operating subsidiaries of the Water Proxy Group and 50 percent of the operating subsidiaries of the Combined Utility Proxy Group use future test years.[220] Second, the Attorney General/LFUCG argued that Kentucky-American did not request a decoupling mechanism and questioned the appropriateness of awarding Kentucky-American a higher ROE due to a factor that is not applicable.[221] Third, the Attorney General/LFUCG

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[216] *Id.* at 48.

[217] *Id.* at 49.

[218] Bulkley Direct Testimony at 70–75.

[219] Bulkley Direct Testimony at 75.

[220] Baudino at 42.

[221] *Id.*

claimed that Kentucky-American has not suffered any adverse financial consequences from not having a QIP because it earned robust returns without a QIP, and, due to the use of a future test year, will recover infrastructure investments through June 30, 2020.[222] Finally, with respect to Kentucky-American's capital expenditure program, the Attorney General/LFUCG asserted that it is Kentucky-American's responsibly to prudently manage its expenditures and timing of its rate cases to ensure a balance of expenses and a competitive return on its investments.[223]

In response, Kentucky-American argued that the Attorney General/LFUCG's recommended ROE of 9.15 percent abandons standards for financial integrity, capital attraction, and comparable returns.[224] Kentucky-American asserted that a 9.15 percent ROE fails to offer equity investors a return that is comparable to alternative investments with similar risk, may not allow Kentucky-American the opportunity to raise equity capital, and falls outside the range of authorized ROE from 2012–2018, which averaged 9.68 percent.[225] Kentucky-American claimed that a 9.15 percent ROE combined with Kentucky-American's equity ratio of 48.65 percent resulted in a weighted equity ratio (WROE) of 4.45 percent, which is well below the average equity rate established for the operating subsidiaries of American Water and would impact American Water's allocation of discretionary capital.[226] Kentucky-American further claimed that a WROE of 4.45

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[222] *Id.*

[223] *Id.* at 42–43.

[224] Bulkley Rebuttal Testimony at 2 and 7.

[225] *Id.* at 2, 8–10, and Figure 1 at 12.

[226] *Id.* at 8.

percent would be well below the industry average of 4.88 percent and could be viewed as a credit negative by the rating agencies.[227]

Kentucky-American noted that Attorney General/LFUCG's recommended ROE is on the low end of their analytical results, which ranged from 8.38 percent to 11.49 percent for the Combined Utility Proxy group.[228] Kentucky-American argued that, in the current low interest rate environment, DCF models have been consistently underestimating and recommended that other ROE models be recognized.[229] Kentucky-American further argued that the Attorney General/LFUCG failed to consider the risk related to the TCJA for utilities and Moody's recent downgrade of American Water over concerns about increased leverage and cash flow leakage resulting from tax reform.[230]

Kentucky-American disagreed with the Attorney General/LFUCG's arguments regarding interest rate forecasts, noting that while the Federal Reserve recently indicated that it will be patient in determining future adjustments, other economic officials see higher rates as appropriate later this year.[231] Kentucky-American contended that, even with a wait-and-see policy, the lagged effect of past increases in the federal funds rate suggests a continued increase over the near-term yield on long-term government bonds.[232]

Kentucky-American questioned the Attorney General/LFUCG's DCF analysis; specifically, the reliance on projected dividend growth rates as investment analysts

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[227] *Id.* at 13–14 and Figure 2 at 15.

[228] *Id.* at 3.

[229] *Id.* at 3 and 14.

[230] Bulkley Rebuttal at 5 and 14–16.

[231] *Id.* at 17.
[232] *Id.* at 18.

predominantly report earnings per share growth projections. Kentucky-American maintained that using median as opposed to mean results is appropriate because outliers on both the high and low end have a lesser impact on the median as on the mean.[233] Upon revising the Attorney General's models, Kentucky-American not only determined that the DCF results increase from 9.15 percent to 9.55 percent, but also emphasized that the DCF results should be considered in conjunction with other ROE models.[234]

Regarding the Attorney General/LFUCG's CAPM analysis, Kentucky-American argued that the model results of 6.74 percent to 8.05 percent using the historical market risk premium are too low and are inconsistent with required returns because they are well below the average authorized ROE for water utilities of 9.48 percent for 2017–2018.[235] Kentucky-American contended that the Attorney General/LFUCG agreed that the results are too low because they rejected these results in favor of the DCF results.[236] Kentucky-American underscored the need to use forward-looking inputs in the CAPM for both the market risk premium and the risk-free rate.[237] Additionally, Kentucky-American noted the Attorney General/LFUCG's reliance on Value Line's annual return projections of 3 to 5 years are inconsistent with their opinion that the Commission should not consider Value Line's projected returns.[238] Kentucky-American updated the Attorney General/LFUCG's

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[233] *Id.* at 29–30.

[234] *Id.* at 35–36 and 38.

[235] *Id.* at 39.

[236] *Id.* at 40.

[237] *Id.*

[238] *Id.* at 47–48.

models using only Value Line's median growth rates and the Attorney General/LFUCG's risk-free rate and estimated an ROE of 9.98 percent.[239]

Kentucky-American presented additional ROE analyses, including Value Line's ROE projections for 10.50 percent in 2019 and a Risk Premium Analysis estimate of 9.80 percent at the Attorney General/LFUCG's risk-free rate.[240] Kentucky-American asserted that averaging and equally weighing the updated results to the Attorney General/LFUCG's DCF and CAPM models, as well as including the expected earnings and risk premium methodologies, results in an ROE in the range of 9.96 percent to 10.29 percent.[241]

Kentucky-American concluded that its proposed cost of equity is reasonable and should be approved.[242] Kentucky-American asserted that its proposed ROE is supported by multiple analytical techniques, adjusted for incremental costs and risks, and relies on market-based data to quantify investor expectations. Kentucky-American cautioned against accepting the Attorney General/LFUCG's lower ROE recommendation, emphasizing that utility regulators recognized that the DCF model is producing low return estimates and, as a result, utility regulators have considered the results of other equity models in addition to the DCF model.[243]

In his post-hearing reply brief, the Attorney General emphasized the need to balance the rates so that they are non-confiscatory, argued that Kentucky-American's

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[239] *Id.* at 49 and 53, Figure 7.

[240] *Id.* at 56 and 61.

[241] *Id.* at 62, Figure 8.

[242] Kentucky-American Brief at 46.

[243] *Id.* at 46, 50. LFUCG filed a post-hearing reply brief, but did not specifically discuss Kentucky-American's proposed ROE.

proposed ROE tests the upper bounds in ROE determination, and is 30 basis points higher than the highest authorized water ROE since 2012.[244] The Attorney General claimed that Kentucky-American's WROE argument is novel and goes beyond the ordinary consideration of financial risk.[245]

In evaluating the ROE for Kentucky-American, the Commission must evaluate and review each model and all parties' positions, and balance the financial integrity of the utility with the interests of the consumer and the statutory obligation that rates be fair, just, and reasonable. Kentucky-American supported a forward-looking model with forecasted interest rates, whereas the Attorney General claimed that current rates are more appropriate. This Commission previously held that forecasted interest rates are not reliable and that the best estimates are produced using the most current interest rates.[246] Rates have been forecasted to increase for several years, and, at one point, forecasted to increase two times in 2019.[247] However, the Federal Reserve Board changed its stance, decided to adopt a wait and see approach, and revised policies that were set just a short time prior.[248] Therefore, the Commission continues to view forecasted interest rates as unreliable and frequently inaccurate and supports models that utilize current interest rates and data.

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[244] Attorney General Brief at 12–13.

[245] *Id.* at 30.

[246] *See* Case No. 2018-00281, *Electronic Application of Atmos Energy Corporation for an Adjustment of Rates* (Ky. PSC May 7, 2019) at 43.

[247] *See* https://www.bbc.com/news/business-47644267

[248] *Id.*

The Commission is not persuaded by Kentucky-American's argument that a 10.80 percent ROE is reasonable because it addresses the unique business and financial risks arising from capital investments, impacts of the TCJA and the QIP, and the lack of a revenue decoupling mechanism. Many of these risks are mitigated through the use of a forecasted test year and the QIP, which is approved in this Order. Both mechanisms lower regulatory lag and allow for a timelier recovery of capital investments.[249] The Commission agrees with the Attorney General/LFUCG that additional adjustments for risk arising from the impact of the TCJA are unwarranted because Kentucky-American does not have credit ratings of its own, but falls under the umbrella of American Water's credit ratings and because American Water's credit ratings fall within the range of credit ratings for the Combined Proxy Group.[250] The Commission is also unpersuaded by Kentucky-American's WROE argument. The approved ROE and Kentucky-American's equity ratio result in a WROE of 4.744 percent that is within the range of American Water subsidiaries, which range from 3.44 percent to 6.29 percent and should not significantly affect credit agency evaluations.[251]

Kentucky-American's proposed ROE of 10.80 percent is above both the industry average of 9.68 percent and American Water's average of 9.66 percent. Additionally, it is far greater than recent returns awarded by this Commission and not in line with the Commission's objective to balance the needs of the utility and the customer. Conversely, the Commission believes that the Attorney General/LFUCG's recommended 9.15 percent

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[249] Bulkley Direct Testimony at 70–76. Even though Kentucky-American did not propose a decoupling mechanism, it justified a higher ROE as compensation for the higher risk.

[250] Baudino Testimony at 43.

[251] Kentucky-American's Response to Staff's Post Hearing Request, Item 22.

ROE is not compatible with the industry average and would not allow for the appropriate level of industry investment even when coupled with a timelier recovery of capital investment.

For the reasons set forth above, the Commission awards Kentucky-American an ROE of 9.70 percent. This award appropriately balances the needs of Kentucky-American and its customers, is within the range of recent awards to comparable companies,[252] and is compatible, if not slightly larger than, the industry average and American Water average. Furthermore, this award is within the mean and median results of Kentucky-American's DCF models and supports the revised DCF and CAPM of the Attorney General as presented by Kentucky-American and within the range of the DCF models presented by the Attorney General.[253] The impact on the revenue recruitment is a decrease of $3,347,811.

Weighted Cost of Capital

Applying the cost rates of 2.43 percent for short-term debt, 5.86 percent for long-term debt, 0.040 for preferred stock, and 9.70 percent for common equity to the Commission's capital structure percentages consisting of 1.84 percent, 48.76 percent, 0.50 percent, and 48.90 percent, respectively, produces an overall cost of capital of 7.69 percent.

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[252] *See* Case No. 2018-00281, *Electronic Application of Atmos Energy Corporation for an Adjustment of Rates* (Ky. PSC May 7, 2019); Case No. 2018-00261 *Electronic Application of Duke Energy Kentucky, Inc. for Authority to 1) Adjust Natural Gas Rates 2) Approval of a Decoupling Mechanism 3) Approval of New Tariffs 4) and for All Other Required Approvals, Waivers, and Relief* (Ky. PSC Mar 27, 2019); and Case No. 2018-00295, *Electronic Application of Louisville Gas and Electric Company for an Adjustment of Its Electric and Gas Rates* (Ky. PSC Apr. 30, 2019).

[253] The Commission agrees with the Attorney General that Kentucky-American's proposed CAPM market return estimate of 15.19 percent is excessive and used Kentucky-American's revised CAPM models.

Authorized Increase

The Commission finds that Kentucky-American's net operating income for rate-making purposes is $ 34,116,970. We further find that this level of net operating income requires an increase in forecasted present rate revenues of $13,399,178. A schedule with the revenue requirement impact of each of the Commission's adjustments is contained in Appendix A.[254]

Net Investment Rate Base	$ 443,653,707
Multiplied by: Rate of Return	7.6900%
Operating Income Requirement	34,116,970
Less: Operating Income - Present Rates	24,172,918
Operating Income Deficiency	9,944,052
Multiplied by: Revenue Conversion Factor	1.3475
Increase in Revenue Requirement	13,399,178
Increase in Revenue Requirement - Water Sales	13,399,178
Forecasted Operating Revenues - Water Sales	85,473,766
Total Revenue Water Sales - Required Rates	$ 98,872,944
Percentage Increase	15.676%

COST-OF-SERVICE STUDY/RATE DESIGN

Kentucky-American filed a cost-of-service study (COSS) using the base-extra capacity method.[255] This methodology is widely recognized within the water industry as an acceptable methodology for allocating costs.[256] This Commission has previously

[254] There is $9 immaterial difference between Appendix A and the increase in the revenue requirement calculated here.

[255] Application, Exhibit 36.

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

accepted the use of this methodology for cost allocation and development of water service rates.[257] The Commission finds the COSS to be acceptable for use as a guide in allocating the revenue increase granted herein.

Rate Design

For general water service, Kentucky-American currently charges a monthly service charge and a flat volumetric fee. Kentucky-American separates the service charges by meter size, and between residential users, and all other customers. Kentucky-American proposed to unify the monthly service charge to all classes of customers by meter size. The service charge is intended to recover the cost of customer facilities such as meters and services, and the cost of customer accounting, including billing and collecting and meter reading.[258] The volumetric fee is intended to recover the cost of producing, transporting, and distributing the water.[259]

In developing its proposed rates, Kentucky-American used the COSS as the basis to move the customer charge towards the true cost to serve.[260] As seen in the table below, the COSS supports the proposed rates.

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[257] *See, e.g.* Case No. 2002-00040, *An Investigation Into Butler County Water System, Inc.'s Rate Schedule for Services with Private Fire Protection Facilities* (Ky. PSC Mar. 29, 2005) at 12 ("While several different methods of allocating costs exist, the base-extra capacity method is one of the most widely used methods of allocating costs. It recognizes that the cost of serving customers depends not only on the total volume of water used but also on the rate of use. We have used this methodology in several rate proceedings and have found it an effective methodology.").

[258] Direct Testimony of Constance E. Heppenstall (Heppenstall Direct Testimony) at 9.

[259] *Id.* at 9.

[260] *Id.* at 8.

Meter Size	Current Customer Charge Residential	Current Customer Charge All Other Customers	Proposed Customer Charge All Customers	COSS Customer Charge All Customers
5/8"	$12.49	$13.63	$15.00	$19.67
3/4"	18.74	20.46	22.40	29.51
1"	31.23	34.07	37.30	49.18
1-1/2"	62.45	68.17	74.70	98.35
2"	99.92	109.04	119.50	157.36
3"	187.35	204.47	224.00	314.72
4"	312.25	340.77	373.40	491.75
6"	624.50	681.50	746.70	983.50
8"	999.20	1,090.40	1,194.70	1,573.60

The Attorney General is against a higher customer charge and argued that a higher charge will impair the ability of Kentucky-American customers to conserve through reduced water usage and thus hinder their ability to lower bill costs.[261] The Attorney General stated his concern over Kentucky-American testimony that stated a guideline in the rate design was to increase customer charges to allow for a greater recovery of customer costs including ready-to-serve costs.[262] The Attorney General requested that the Commission consider a more measured approach concerning the customer charge increase and, should the Commission increase the monthly service charge, consider this reduction in volumetric risk when determining Kentucky-American's ROE.[263]

The Commission notes that the Attorney General offered no evidence or testimony regarding an increase in the customer charge. The Commission's findings must be supported by sufficient evidence, and therefore the Commission finds that the proposed customer charges are within the cost to serve. Thus, the proposed customer charges

[261] Attorney General Brief at 47.

[262] *Id.*

[263] *Id.* at 48.

should be approved, with the difference between the proposed and awarded revenue requirement applied to the volumetric charge. As a result, the average bill for a residential customer using 3,869 gallons per month will increase by $5.21, from $32.06 to $37.27, or 16.25 percent.

Rate Unification

Kentucky-American recently acquired two utilities: Eastern Rockcastle Water Association (Eastern Rockcastle) and North Middletown. Since their acquisition, Kentucky-American has maintained the service rates charged to those customers at the time they were acquired. Kentucky-American proposed that the customers in Eastern Rockcastle and North Middletown be charged the same rates as those charged to the rest of Kentucky-American's customers.

In opposition to the proposed unification of rates, the Attorney General argued that since Kentucky-American did not direct their COSS expert, Ms. Constance Heppenstall, to consider a separate cost of service for the acquired systems, there is no justification for a unified tariff.[264] The Attorney General stated that such actions fail to follow the Commission's previous orders, which directed Kentucky-American to perform a separate COSS when acquiring other water systems.[265]

LFUCG also opposed this proposed unification of the rates.[266] Specifically, LFUCG argued that Kentucky-American fails to adhere to a previous Commission

[264] Attorney General Brief at 46.

[265] *Id.* at 46.

[266] LFUCG Brief at 28.

directive in Case No. 2012-00520[267] in which the Commission stated that the consolidation of an acquired system's rates with Kentucky-American's rates should not be presumed.[268]

In support of the consolidation, Kentucky-American asserted that the decrease to the acquired utilities' rates will have a minimal effect on other customers. LFUCG stated that this impact is misleading as Kentucky-American is basing it on the deficiency between the present rate revenue to the proposed revenue and does not include the full cost to serve these new acquisitions.[269] LFUCG acknowledged that the impact on other customers is relatively small due to the scale of the systems, but stated that as more acquisitions occur the cost can grow exponentially resulting in a large impact to legacy customers.[270] In place of the unification of rates, LFUCG proposed to increase present rates based on a uniform percentage within each customer class and allow Kentucky-American, in its next base rate case, to present better information supporting the unification of rates.[271]

In Case No. 2005-00206, Kentucky-American acquired the city of Owenton's water and wastewater-related assets.[272] In that Order, we stated that "the Commission places

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[267] Case No. 2012-00520, *Application of Kentucky-American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year*, (Ky. PSC Oct. 25, 2013).

[268] LFUCG Brief at 28.

[269] *Id.* at 29.

[270] *Id.* at 30.

[271] *Id.* at 31

[272] Case No. 2005-00206, *The Verified Joint Application of the City of Owenton and Kentucky-American Water Company for Approval of the Transfer of Ownership of the Assets of the City of Owenton to Kentucky-American Water Company,* (Ky. PSC July 25, 2005).

KAWC on notice that KAWC's next application for a general rate adjustment should contain a proposal for a single rate schedule applicable to all KAWC customers."[273] In Kentucky-American's following rate case, Case No. 2007-00143, a single tariff rate structure was proposed and approved.[274] Further, in the final Order for Case No. 2012-00520, the Commission not only stated that rate unification should not be presumed, but also stated that such language was added merely to affirm the position and found that the unified rate structure should remain in place stating that "[T]he Commission has consistently supported the concept of a unified rate structure to encourage consolidation of water systems and to improve the quality of water service in the Commonwealth. Reversal of this policy would discourage further water system consolidation."[275]

Consistent with Commission precedent and based on the evidence in this case, the Commission now reaffirms those findings and, therefore, further finds that the proposed unified tariff is reasonable and should be approved.

Tap Fees

Kentucky-American proposed to decrease its tap fees based upon a three-year average of the actual cost of meter installation. Kentucky-American explained that the decrease is due to lower material costs as Kentucky-American transitions to polyethylene service lines rather than copper tubing.[276]

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[273] *Id.* at 6.

[274] Case No. 2007-00143, *Adjustment of Rates of Kentucky-American Water Company* (Ky. PSC Nov. 29, 2007).

[275] Case No. 2012-00520, *Application of Kentucky-American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year*, (Ky. PSC Oct. 25, 2013) at 70.

[276] O'Neill Direct Testimony at 47.

The Commission finds that the proposed tap fees will yield enough revenue to pay the expenses incurred in rendering the service and, therefore, are reasonable and should be approved.

Weather Normalization

Kentucky-American requested to adjust the normalized usage for residential and commercial customers. To develop its requested adjustment Kentucky-American analyzed weather data, time progression, customer usage patterns, and other predictor variables to develop a normalized usage for the forecasted test year.[277]

The Commission accepts the Weather Normalization as proposed by Kentucky-American for residential and commercial customers.

INFRASTRUCTURE REPLACEMENT TARIFF

Kentucky-American's Proposed QIP

Kentucky-American proposed to establish a tariff rate adjustment mechanism, the QIP tariff, to make capital improvements to replace its aging water system infrastructure. Kentucky-American's existing distribution system contains approximately 2,038 miles of water main,[278] including:

- 85 miles, or 4 percent, of lined and unlined cast iron and asbestos cement mains installed between 1885 and 1950;
- 515 miles, or 25 percent, of lined and unlined cast iron, galvanized steel, asbestos cement pipe, PVC pipe, ductile iron pipe, and other mains installed between 1950 and 1970;
- 1,356 miles, or 67 percent, of asbestos cement pipe, ductile iron pipe, galvanized steel, lined and unlined cast iron, PVC pipe and other mains installed between 1970 and 2010; and

[277] Schwarzell Direct Testimony at 10.

[278] O'Neill Direct Testimony at 24 and Exhibit 2 at 3–4.

- 82 miles, or 4 percent, of ductile iron and PVC pipe mains installed since 2010.

Although Kentucky-American accelerated the replacement of aging infrastructure in the last few years, its infrastructure is deteriorating at a faster rate than the current replacement rate. Kentucky-American projected that, at the current replacement rate, it will take 57.4 years to replace the rest of the cast iron main in the distribution system and approximately 377 years to replace the entire main in the system.[279] Because the infrastructure has a life expectancy of 60 to 100 years, Kentucky-American must further accelerate the rate of replacement of aging distribution and water treatment infrastructure to keep pace with the useful life of the assets in order to maintain safe and reliable water service. If the QIP is approved, Kentucky-American committed to investing between $6,000,000 and $10,000,000 in annual incremental capital spending.[280]

Kentucky-American asserted that the QIP would have substantial financial benefits for customers. Kentucky-American explained that alternative regulatory mechanisms, such as the QIP, provide financial benefits to customers by reducing regulatory costs, increasing rates on a more gradual basis than a general rate case, and providing regulatory certainty that attracts debt and equity capital at reasonable costs, all of which lower the rate impact on customers. Additionally, Kentucky-American claimed that the QIP would result in lower costs to customers over time as compared with the costs from deferred replacement because unscheduled pipe replacements are approximately ten

[279] O'Neill Direct Testimony at 28.

[280] O'Neill Testimony at 36; May 13, 2019 H.V.T. at 9:24:15.

times more expensive than scheduled pipe replacements.[281] Last, Kentucky-American provided evidence that other American Water subsidiaries filed less frequent rate cases after the implementation of a similar infrastructure replacement mechanism, which results in savings to ratepayers from avoided rate case expenses.[282]

Kentucky-American also asserted that the QIP would allow it to timely recover the fixed costs of infrastructure replacement, which provides an incentive for increased capital investment in replacing infrastructure, which, in turn, ensures safe, adequate, and reliable water service. Kentucky-American argued that it experiences an adverse revenue impact from regulatory lag because it carries the significant investment expense without an opportunity to recover costs until the next rate case. According to Kentucky-American, the QIP would mitigate the adverse revenue impact of regulatory lag by allowing Kentucky-American to recover its investment costs on a more current basis than under traditional ratemaking. Kentucky-American explained that, while Kentucky-American and its parent, American Water, always strive to provide safe, adequate, and reliable service, American Water competes with other companies for capital, and Kentucky-American competes with other American Water subsidiaries for investment funding. Kentucky-American claimed that the QIP would result in more predictable cost recovery, which would attract investors and the capital necessary for infrastructure replacement, both for American Water as it competes for capital in the marketplace and for Kentucky-American as it competes for discretionary funds within American Water.

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[281] O'Neill Direct Testimony at 32; Kentucky-American response to Staff's Second Request, Item 50; Kentucky-American Brief at 7–8.

[282] Kentucky-American's response to Staff's Second Request, Item 57; Kentucky-American Brief at 8.

Kentucky-American stated that the only plant eligible for the QIP would be existing distribution and water treatment infrastructure that was non-revenue producing and non-expense reducing.[283] Kentucky-American said that it would prioritize the replacement of cast iron and galvanized steel mains, which represent 15 percent of the distribution system but account for 64.2 percent of main breaks per year.[284]

Kentucky-American proposed that the QIP surcharge be established with an annual filing based on the forecasted test-period expense with an annual reconciliation of projected costs and actual costs. Under Kentucky-American's proposed plan, the first QIP test period would be July 2020 through June 2021, which are the 12 months following the forecasted test year in this case. Kentucky-American would make its first annual QIP filing, with a detailed schedule of qualifying projects, no later than April 2, 2020, which is 90 days before the start of the first test period. Kentucky-American provided a proposed schedule for processing annual QIP filings within the 90-day review period that included a timeline for requests to intervene, discovery, intervenor testimony, and a hearing. Kentucky-American further proposed that the annual balancing adjustment be filed at least 90 days before the end of each 12-month QIP period to true up projected costs and revenues with actual costs and revenues. The balancing adjustment filing also had a proposed timeline for intervention, discovery, intervenor testimony, and a hearing.

In calculating the QIP surcharge, Kentucky-American proposed that the total revenue requirement equal the pre-tax return for qualified additions and removal

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[283] Application, Exhibit 2 at 50; Schwarzell Direct Testimony at 31; Schwarzell Rebuttal Testimony at 21. Non-revenue producing and non-expense reducing plant is plant that is not constructed for the purpose of serving new customers.

[284] O'Neill Direct Testimony at 33, and Exhibit 2 at 18.

expenditures plus the depreciation and property tax for the proposed projects in the forecasted test year.[285] Kentucky-American suggested that the QIP surcharge be calculated as a percentage that would apply to all water charges, excluding other surcharges or add-on taxes; be displayed as a separate line item on customer bills; and be applied to all retail customer classes.[286] The QIP would be reset to zero as of the effective date of rates approved in each base rate case.[287]

Attorney General/LFUCG Position

The Attorney General/LFUCG recommended that the QIP be denied, or, in the event that the Commission approved the QIP, limited to a pilot program with defined constraints. The Attorney General/LFUCG addressed the QIP mechanism within the context of regulatory principles but declined to address the reasonableness or prudence of the proposed QIP.[288]

As a basis for the recommendation to deny the QIP, the Attorney General/LFUCG raised four arguments. First, they claimed that Kentucky-American failed to demonstrate a financial or infrastructure need for the QIP because Kentucky-American earned a "robust" ROE in 2017 and 2018 while investing in its system and providing reliable service and because Kentucky-American failed to demonstrate an increase in main breaks and leaks due to aging infrastructure.[289] The Attorney General/LFUCG argued that Kentucky-

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[285] Application, Exhibit 2 at 51; Schwarzell Direct Testimony at 32.

[286] Application, Exhibit 2 at 51; Schwarzell Direct Testimony at 32–33.

[287] Schwarzell Direct Testimony at 33.

[288] Baudino Testimony at 49.

[289] *Id.* at 52; LFUCG Brief at 5–8; Attorney General Brief at 48–54.

American will make the necessary infrastructure investments and that American Water will provide the necessary investment funds with or without the QIP.[290] Second, the Attorney General/LFUCG asserted that the categories of plant subject to the QIP were overly broad as compared to similar requests filed in Kentucky-American's previous rate cases.[291] Third, they declared that the proposed 90-day review period was too brief to allow for sufficient review by the Commission and intervening parties, and therefore allowed Kentucky-American to pass through capital costs without sufficient regulatory scrutiny to ensure that the capital costs were prudently incurred.[292] Fourth, they maintained that the QIP would not provide adequate procedural processes to protect customers from unreasonable costs and unnecessary rate increases because it was an automatic adjustment.[293]

The Attorney General/LFUCG recommended that, if the Commission approved the QIP, certain limitations be imposed, including: (1) the QIP be a two-year pilot to allow the Commission and intervenors to evaluate the feasibility of the QIP; (2) the eligible plant be limited to non-revenue producing distribution mains that replace existing mains to accelerate the replacement rate and limit annual rate increases; (3) that an annual and cumulative cap be imposed to protect ratepayers from excessive future rates; (4) that the ROE for the QIP be reduced by one percent from the ROE authorized in this case to mitigate rate impact on customers and balance the interests of shareholders and

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[290] LFUCG Brief at 4–5; Attorney General Brief at 49–51, 55.

[291] Baudino Testimony at 54–55; Attorney General Brief at 55.

[292] Baudino Testimony at 55–56.

[293] *Id.* at 56–57.

ratepayers; (5) that Kentucky-American be required to file a base rate case within two years of implementing the QIP in order to evaluate cost recovery under the QIP; (6) the use of a historical, rather than a forecasted cost basis, which would remove the need for an annual reconciliation of projected and actual costs; and (7) that the Commission allow for sufficient time for Commission Staff and intervenors to review costs, engage in discovery, and file testimony.[294]

Kentucky-American Response to Attorney General/LFUCG

In response, Kentucky-American argued that the Attorney General/LFUCG failed to provide any evidence that contradicted the financial and infrastructure need for the QIP, the reasonableness of the proposed categories of eligible plant, and the reasonableness of the proposed 90-day period to provide adequate opportunity to review the QIP filing. Kentucky-American reiterated that, while it accelerated the replacement rate and reduced the period to replace all of its mains from 500 years to 377 years, the current replacement rate is not sustainable without more timely cost recovery through the QIP.[295] Kentucky-American argued that, without the QIP, it would have to file a new rate case as soon as the prior rate case was decided in order to mitigate the regulatory lag for capital improvements associated with accelerated infrastructure replacement.

Kentucky-American also disputed the Attorney General/LFUCG's proposed modifications to the QIP, arguing that the Attorney General/LFUCG's recommendations were counterproductive, unnecessary, and artificial limitations not supported by evidence. Kentucky-American countered that aging infrastructure replacement programs have been

[294] Baudino at 57–61; Attorney General Brief at 55–56.

[295] Kentucky-American Brief at 11.

successfully implemented in other jurisdictions and have been recognized as a best practice by the National Association of Regulatory Utility Commissioners (NARUC).[296]

Analysis and Findings

It is well established that KRS 278.030 and KRS 278.040 expressly grant the Commission plenary ratemaking authority to regulate and investigate utilities and to establish fair, just, and reasonable rates.[297] In the absence of any statute that requires a particular procedure to determine whether rates are fair, just, and reasonable, the Commission has the authority to consider and decide ratemaking issues such as the infrastructure replacement surcharge proposed by Kentucky-American.[298]

As documented in the case record, aging water system infrastructure is a national issue, with an estimated 1,000,000 miles of pipe nearing the end of its useful life at an estimated replacement cost between $335 billion to $1 trillion over the next 25 years.[299] This Commission is cognizant of the need to prudently and timely replace aging infrastructure in order to provide safe, adequate, and reliable water to customers.

Before we address the Attorney General/LFUCG recommendations, we again note that they expressly stated that the recommendations were developed in the context of regulatory principles, and that they declined to address the reasonableness or prudence of the proposed QIP.[300]

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[296] Kentucky-American Brief at 16.

[297] *Public Serv. Comm'n v. Commonwealth ex. Rel. Jack Conway*, 324 S.W.3d 373, 383 (Ky. 2010).

[298] *Id.*

[299] Direct Testimony of Nick O. Rowe (Rowe Direct Testimony), Exhibit NOR-1; Kentucky-American Response to Staff's Second Request, Item 47 at 53.

[300] Baudino Testimony at 49.

Regarding the Attorney General/LFUCG's recommendation to deny the QIP, the Commission finds the Attorney General/LFUCG's arguments unpersuasive. First, despite the Attorney General/LFUCG's assertions to the contrary, the case record contains substantial evidence regarding the need for the QIP. The Attorney General/LFUCG's argument that the status quo is acceptable ignores the hard fact that, if Kentucky-American continues with the current replacement rate and investment level, it would take 377 years for Kentucky-American to replace infrastructure with 60 to 100 years of remaining useful life. Unlike infrastructure investment that extends service to new customers, and thus produces new revenue, investment in existing infrastructure nearing the end of its useful life is inherently a non-revenue producing investment, with the costs borne by the existing customer base. Another hard fact is that there will be a significant increase in capital costs to replace aging infrastructure, with a subsequent rate increase to recover those capital costs. The Commission must balance Kentucky-American's need to make a prudent infrastructure replacement investment to ensure that ratepayers receive safe, adequate, and reliable water, and the mandate that rates be fair, just, and reasonable. The Commission finds it reasonable to approve an alternative cost recovery based on smaller, more gradual rate increases. The alternative is to wait until Kentucky-American files its next general rate case, with the result that customers experience rate shock from large increases due to rate recovery for several years of capital investment to replace aging infrastructure.

Second, the Attorney General/LFUCG failed to provide evidence in support of their allegation that the plant Kentucky-American proposed to include in the QIP is overly broad. Further, the Attorney General/LFUCG's assertion that the Commission should

deny the QIP based on differing criteria in this case and previous requests for an infrastructure replacement tariff mechanism ignores that this is a factual determination that we make on a case-by-case basis.

Third, the Commission finds that a 90-day period is sufficient to review the annual filings. We established a 75-day period for our pilot program for processing electric distribution cooperatives general rate adjustments.[301] KRS 278.190 establishes a six-month suspension for a general rate case based on a forecasted test year. Here, the limited scope of the QIP annual filing should allow for thorough review and evaluation within three months. However, we reserve the right to extend the 90-day review upon good cause. In addition, certain periodic information related to construction under the QIP will be required to promote efficient processing of future filings.

Regarding the Attorney General/LFUCG's recommendations for certain limitations, if the Commission approves the QIP, the Attorney General/LFUCG offered conclusions without evidentiary support for their recommendations. The Attorney General/LFUCG stated that, unless the QIP is limited to a two-year pilot, the Commission effectively approves a rate mechanism with "essentially no cut-off to its operation."[302] However, the same statutory authority that permits the Commission to authorize a QIP also grants us the authority to terminate or limit the QIP. For example, as the Attorney General/LFUCG correctly noted, the Commission placed limits on a gas utility whose forecasted estimates for pipeline replacement were demonstrated to be unreliable.[303] Here, the Attorney

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[301] Case No. 2018-00407, *A Review of the Rate Case Procedure for Electric Distribution Cooperatives* (Ky. PSC Mar. 26, 2019).

[302] Baudino Testimony at 59 and 61.

[303] Case No. 2017-00349, *Electronic Application of Atmos Energy Corporation for an Adjustment of Rates and Tariff Modifications* (Ky. PSC May 28, 2010).

General/LFUCG offered no evidence that the list of projects that Kentucky-American expects to include in the first five years of the QIP is unreliable. Similarly, the Attorney General/LFUCG offered no evidence that annual and cumulative caps were necessary to protect ratepayers from excessive rates or that the ROE should be reduced in order to protect ratepayers' interests. Such a claim implies that the Commission is unable to carry out its statutory duty, which is refuted by the Attorney General/LFUCG's own example of the Commission acting to protect ratepayers that is cited above. Further, the Attorney General/LFUCG offered no evidence that the use of a historical test year would result in a more accurate review of costs than a forecasted year. We note that, as Kentucky-American pointed out, forecasted test years are authorized for gas pipeline replacement tariff mechanisms.

For the reasons discussed above, the Commission finds that Kentucky-American established the need for an infrastructure replacement tariff, and therefore we find it reasonable to authorize the QIP. The Commission directs Kentucky-American to keep track of any O&M savings that result from the QIP investment projects and report these savings in their next base rate case. Additionally, the Commission finds that the following language should be revised in the proposed tariff form as follows:

Remove:

> The monthly QIP Rider charges for all respective water service classifications will be calculated as a percentage and applied to all water charges excluding any other surcharge or add-on taxes.

To:

> The monthly QIP Rider charges for all respective water service classifications will be calculated as a percentage and applied to all water charges including meter fees, volumetric water sales, fire service fees, and

public and private hydrant fees from the Company's most recent base rate case but excluding any other surcharge or add-on taxes.

Kentucky-American should file its first annual QIP filing no later than April 2, 2020, for the first QIP forecasted test period, which should be July 2020 through June 2021. The filing process, information, and deadlines for the QIP are set forth in Appendix B to this Order and should follow Kentucky-American's proposed regulatory process as filed in response to Commission Staff's Post Hearing Request for Information, Item 20. Kentucky-American should include the QIP as a separate line item on its bill. Further, when Kentucky-American makes its annual filing, it should serve the Attorney General with a complete copy.

OTHER ISSUES

North Middletown

Kentucky-American proposed a utility plant acquisition adjustment of $229,290,[304] amortized over ten-years at $24,567 per year, to recover in rates Kentucky-American's purchase of North Middletown's water system assets.[305] Kentucky-American requested that the $1,175,509 purchase price for North Middletown's water assets be recognized as the ratemaking rate base, rather than the $929,841 net book value.[306] Kentucky-American asserted that it was reasonable to base cost recovery on the purchase price

[304] Base Period Update, Exhibit 37, Schedule B-1, page 2 of 2; Kentucky-American Brief at 59. Kentucky-American requested an adjustment of $225,195 in the Application, but filed revised total in the Base Period Update.

[305] Application at paragraph 20; Schwarzell Direct Testimony at page 29, lines 3–6; Base Period Update, Exhibit 37, Schedule D-2. Because North Middletown is a municipal water system and the requirement under KRS 278.020 that the Commission approve acquisitions applies only to utilities, Commission approval is not required for Kentucky-American's purchase of North Middletown's assets.

[306] Application, Exhibit 36, Schedule B-2.4; Schwarzell Direct Testimony at 29–30.

whether the Commission applied the five-step Delta Test, which was first developed and applied by the Commission in Case No. 9059,[307] or under the fair market value approach.[308] Kentucky-American provided evidence that the North Middletown acquisition satisfied the Delta Test criteria because: (1) the purchase was an arms-length transaction, initiated by North Middletown's invitation to bid that was published in a local, general interest newspaper, and with a purchase price that was negotiated without conflict by a willing seller and willing buyer; (2) Existing single tariff customers' bills will be unaffected because the purchase price is funded by the system's present rate revenue, minus a $16,000 deficiency, thus the transaction will not adversely impact the overall rates for new and existing customers; (3) the transaction will achieve operation economies; (4) non-utility property is not part of the transaction, thus the criteria that there be a clear segregation of utility and non-utility purchased property is moot; and (5) the purchase will result in overall benefits in the financial and service aspect of North Middletown's operations by leveraging Kentucky-American's existing financial opportunities and service operations.[309] Kentucky-American further asserted that, while the transaction satisfied each of the elements of the Delta Test, using a fair market value approach would encourage future consolidation and regionalization, which was consistent with the Kentucky Legislature's policy that regionalization and consolidation of water and wastewater systems should be encouraged.[310]

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[307] Case No. 9059, *An Adjustment of Rates of Delta Natural Gas Company, Inc.* (Ky. PSC Sept. 11, 1985).

[308] Schwarzell Direct Testimony at 29–30; Kentucky-American's Response to Staff's Second Request, Items 72 and 74.

[309] Kentucky-American Response to Staff's Second Request, Item 72.

[310] Schwarzell Direct Testimony at 30.

Despite being on notice of this issue,[311] neither the Attorney General nor LFUCG presented testimony or filed any evidence into the record regarding the valuation of the North Middletown transaction for ratemaking purposes. Despite this failure to provide evidence for the Commission to weigh and evaluate, both the Attorney General and LFUCG recommended in their post-hearing briefs that the Commission reject Kentucky-American's request to apply the fair market value to the North Middletown asset purchase.[312] LFUCG further recommended that the Commission reject the adjustment entirely, arguing that Kentucky-American failed to satisfy the Delta Test.[313] The Commission's findings must be supported by sufficient evidence. Here, with no evidentiary support in the record from the Attorney General or LFUCG for their respective positions, the Commission is without any basis, much less sufficient evidence, to evaluate Attorney General's or LFUCG's arguments.

The Commission has previously held that if a utility demonstrates that the acquisition of plant at a cost above book value is in the public interest, then the utility should be allowed to recover its investment.[314] The Commission developed the Delta Test as factors to evaluate whether a utility plant acquisition at a cost above book value is in the public interest. Here, Kentucky-American provided sufficient evidence that each

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[311] We expressly reject the Attorney General's argument raised in his post-hearing reply brief that Kentucky-American raised the argument that both methodologies are reasonable as "unsupported proposals in rebuttal testimony." *See* Attorney General Brief at 61. The record expressly demonstrates that Kentucky-American raised this argument in direct testimony and responded to data requests from Staff regarding this assertion.

[312] Attorney General Brief at 61–62; LFUCG Brief at 24–28.

[313] LFUCG Brief at 25.

[314] Case No. 9059, *An Adjustment of Rates of Delta Natural Gas Company, Inc.* (Ky. PSC Sept. 11, 1985) at 3.

of the five elements of the Delta Test are satisfied. Of particular note, the treatment of the North Middletown asset purchase price does not have a material impact on Kentucky-American's rates. As Kentucky-American explained, the purchase price and the cost of operating the North Middletown system are funded by present rate revenue, with the exception of a $16,000 deficit. Truing up the deficiency would result in a 5.5 percent rate increase to North Middletown customers, if treated as a standalone rate, or, if included in a unified tariff, would impact existing customers by less than one penny per month, and would result in a rate decrease to North Middletown's customers.[315] For the above reasons, the Commission finds that using the purchase price for ratemaking purposes is reasonable. The Commission further finds that, based upon the reasonableness of the purchase price, the amount of the adjustment proposed by Kentucky-American and the ten-year amortization period are reasonable, and should be approved. Finally, the Commission finds that, because we base our decision on Kentucky-American satisfying the Delta Test, the issue of whether to apply the fair market value is moot.

Low-Income Programs

At the Commission's request, Kentucky-American presented a witness at the hearing to discuss programs that assist low-income customers. Kentucky-American provides bill payment assistance to its residential customers through its H2O – Help to Others Program (H2O). Established 19 years ago, H2O is funded by a $62,500 annual commitment from Kentucky-American shareholders and voluntary contributions from customers.[316] Kentucky-American made an additional $5,000 contribution in the program

[315] Kentucky-American Response to Staff's Second Request, Item 72.

[316] May 13, 2019 HVT at 6:11:40.

year ended in September 2018 to replenish funds that were depleted prior to the close of the program year.[317]

The funds are available on a first-come, first-served basis.[318] Eligible customers can receive financial assistance in the form of a bill credit; the maximum amount of financial assistance is $125, and customers can receive H2O assistance only once per year.[319] For the program year ending in September 2018, H2O provided bill payment assistance for 706 eligible customers with an average grant of $114.[320] Kentucky-American publicizes the H2O program through bill inserts and local media, outreach to local officials, public speaking, and on its website.[321] Kentucky-American customer service representatives also make referrals to the H2O program.[322]

H2O is administered by the Dollar Energy Fund (Dollar Energy), a national non-profit organization that acts as the primary agent for gathering, processing, and approving applications, and manages and trains the community agencies that conduct the intake process for H2O applications.[323] Dollar Energy receives an 8.75 percent operating fee; community agencies receive $5.00 for each application that they process.[324] Prior to

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[317] *Id.* at 6:27:36.

[318] *Id.* at 6:21:10.

[319] *Id.* at 6:16:47.

[320] Kentucky-American's Response to Staff's Post-Hearing Request, Item 13; May 13, 2019 HVT at 6:28:50.

[321] May 13, 2019 HVT at 6:26:50.

[322] *Id.* at 6:26:31.

[323] Kentucky-American's Response to Staff's Post-Hearing Request, Item 14; May 13, 2019 HVT at 6:12:54 and 6:16:17.

[324] Kentucky-American's Response to Staff's Post-Hearing Request, Item 14.

2014, another Lexington, Kentucky-based non-profit agency administered the H2O program for an operating fee up to 15 percent.[325]

The Commission commends Kentucky-American for its H2O program, especially for providing an additional $5,000 when program funds were depleted.

SUMMARY

After consideration of the evidence of records and being otherwise sufficiently advised, the Commission finds that:

1. The rates set forth in Appendix C to this Order are fair, just, and reasonable rates for Kentucky-American to charge for service rendered on and after June 28, 2019.

2. The rate of return granted in this Order is fair, just, and reasonable, and will provide sufficient revenue for Kentucky-American to meet its financial obligations with a reasonable amount remaining for equity growth.

3. The rates proposed by Kentucky-American would produce revenue in excess of that found reasonable and should be denied.

4. Kentucky-American is authorized to establish a QIP Rider, as modified in this Order, with its first application filed on or before April 2, 2020, for the first QIP forecasted test period, which should be July 2020 through June 2021. The filing process, information, and deadlines for the QIP are set forth in Appendix B to this Order.

IT IS THEREFORE ORDERED that:

1. The rates and charges proposed by Kentucky-American are denied.

2. The rates and charges, as set forth in Appendix C to this Order are approved.

[325] May 13, 2019 HVT at 6:25:20.

3. The rates and charges for Kentucky-American, as set forth in Appendix C to this Order, are the fair, just, and reasonable rates for Kentucky-American, and these rates are approved for service rendered on and after June 28, 2019.

4. The QIP Rider requested by Kentucky-American, as modified in this Order, is granted.

5. Kentucky-American shall file its initial QIP Rider application on or before April 2, 2020, for the first QIP forecasted test period of July 2020 through June 2021.

6. Kentucky-American shall comply with the QIP filing process, information, and deadlines set forth in Appendix B to this Order

7. Any documents filed pursuant to ordering paragraph 6 shall reference this case number and be filed in the post-case file.

8. Within 20 days of the date of this Order, Kentucky-American shall, using the Commission's electronic Tariff Filing System, file its revised tariffs setting out the rates authorized in this Order and the revised QIP Rider and reflecting that they were approved pursuant to this Order.

9. This case is now closed and removed from the Commission's docket.

By the Commission

ENTERED
JUN 27 2019
KENTUCKY PUBLIC
SERVICE COMMISSION

ATTEST:

For Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2018-00358 DATED JUN 27 2019

Line No.	Description	Rate Base & Income Statement Adj.	Income Taxes (Current & Deferred) State 5%	Income Taxes (Current & Deferred) Federal 21%	Operating Income 8.25%	Impact on Revenue Req. 1.3475
1	Income Taxes; Rate Base; & Revenue Req. - App.		503,710	$ 2,140,415	$ 36,392,595	19,865,195
2	Effect of Rate Change					
3	Commission Weighted Cost-of-Capital	7.690%				
4	Less: KAWC Weighted Cost-of-Capital	8.250%				
5	Weighted Cost-of-Cap. Difference	-0.560%				
6	Multiplied by: KAWC Rate Base - Application	443,653,707			(2,484,461)	(3,347,811)
7						
8	Rate Base Adjustments:					
9	Utility Plant at Original Cost	(1,016,441)			(83,856)	(112,996)
10	Accumulated Depreciation	(19,206)			(1,584)	(2,134)
11	Construction Work In Progress	(203,005)			(16,748)	(22,568)
12	Working Capital Allowance	(201,000)			(16,583)	(22,346)
13	CIAC	1,108,255			91,431	123,203
14	Customer Advances	1,042,381			85,996	115,880
15	Deferred Income Taxes	234,092			19,313	26,024
16	Deferred Maintenance	1,586,270			130,867	176,343
17						
18	Required Net Operating Income				$ 34,116,970	
19						
20	Net Operating Income - KAWC Application				$ 21,650,007	
21	Operating Revenue Adjustments:					
22	Trane	(7,845)	(392)	(1,565)	(5,888)	7,934
23	AFUDC	(79,324)	(3,966)	(15,825)	(59,533)	80,221
24	Operation & Maintenance Adjustments:					
25	Fuel & Power - KU	(100,320)	5,016	20,014	75,290	(101,453)
26	Fuel & Power - Unaccounted for Water	(190,993)	9,550	38,103	143,340	(193,151)
27	Chemicals - Error Correction	(102,886)	5,144	20,526	77,216	(104,049)
28	Chemicals - Unaccounted for Water	(121,704)	6,085	24,280	91,339	(123,079)
29	Salaries & Wages - Incentive	(304,616)	15,231	60,771	228,614	(308,057)
30	Salaries & Wages - North Middletown Allocation	(27,538)	1,377	5,494	20,667	(27,849)
31	Support Services - Incentive	(828,962)	41,448	165,378	622,136	(838,328)
32	Support Services - Business Development	(83,829)	4,191	16,724	62,914	(84,777)
33	Support Services - External Affairs & Pub. Policy	(239,475)	11,974	47,775	179,726	(242,181)
34	Support Services - 401(k)	(26,625)	1,331	5,312	19,982	(26,926)
35	Pensions - 401(k)	(38,433)	1,922	7,667	28,844	(38,867)
36	Regulatory Expense	22,079	(1,104)	(4,405)	(16,570)	22,328
37	Uncollectable	(72)	4	14	54	(73)
38	Maintenance Supplies & Services	107,578	(5,379)	(21,462)	(80,737)	108,793
39	Depreciation/Amortization Adjustments:					
40	Depreciation - Slippage	17,404	(870)	(3,472)	(13,062)	17,601
41	Taxes Other Than Income Adjustments:					
43	Payroll, Property, and FICA Taxes	(26,698)	1,335	5,326	20,037	(27,000)
44	Temporary Reconciling ADJ. For Taxable Income:					
45	Interest Synchronization	75,940	(3,797)	(15,150)	18,947	(25,531)
46	Book Depreciation - Slippage	(31,738)	1,587	6,332	(7,919)	10,671
47	Tax Depreciation - Slippage	(52,650)	2,633	10,504	(13,137)	17,702
48	Taxable Customer Advances & CIAC - Slippage	(743,127)	37,156	148,254	(185,410)	249,840
49	Reflect Repairs Deduction - Slippage	356,000	(17,800)	(71,022)	88,822	(119,688)
50	Reverse Book Cost of Removal - Slippage	1,358	(68)	(271)	339	(457)
51	Deferred Income Taxes:					
52	State Def. Income Tax Adj	(160,979)	(160,979)		160,979	(216,919)
53	Federal Def. Income Tax Adj	(680,062)		(680,062)	680,062	(916,384)
54	EADIT Stub Period - State & Federal	(385,857)		(385,857)	385,857	(519,942)
55						
56	Income Tax; Net Operating Income; & Inc. Order		$ 455,339	$ 1,523,798	$ 24,172,916	$ 13,399,169
57						
58	Commission's Increase to Forecasted Current Income Taxes		112,608	449,302		
59	Reported Current Income Taxes		$ 738,871	3,532,885		
60						
61	Commission Adjusted Current Income Taxes		$ 851,479	$ 3,982,187		

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2018-00358 DATED JUN 27 2019

QIP RIDER
PERIODIC REPORTING AND ANNUAL FILING FORMATS

This Appendix includes the filing formats Kentucky-American shall prepare when submitting its application for the annual adjustment to the QIP Rider. Kentucky-American shall not modify any filing format without the prior written consent of the Commission Staff.

In order for the Commission to properly monitor the capital improvements to Kentucky-American's distribution system, Kentucky-American will need to provide the following information:

1. A list of the names and addresses of the contractors utilized for QIP projects.

2. A copy of the bid document signed with each contractor showing a description and scope of the work, construction specifications, and construction management.

3. Construction schedule for each job.

4. Reasonable size maps for each location.

5. Copies of updated welding certification for each welder kept on site for inspection by the Commission's investigator.

6. Annual progress report for work completed, the amount of progress payment and the costs of removal of the old pipes.

7. All identifying information noted by Kentucky-American in this preceding.

Items 1 through 3 are to be filed as contracts are issued. Items 4 and 6 are to be filed at the beginning of each project. Documents filed pursuant to Items 1 through 6 shall be filed in the post-case file for this proceeding. Item 7 will be filed along with Kentucky-American's application for the annual adjustment of the QIP Rider. Kentucky-American may request a conference with the Commission if clarifications are needed concerning Items 1 through 7.

APPENDIX C

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2018-00358 DATED JUN 27 2019

The following rates and charges are prescribed for the customers in the area served by Kentucky-American Water Company. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under the authority of this Commission prior to the effective date of this Order.

MONTHLY SERVICE CHARGE RATES

Meter Size		
5/8"	$	15.00
3/4"	$	22.40
1"	$	37.30
1 ½"	$	74.70
2"	$	119.50
3"	$	224.00
4"	$	373.40
6"	$	746.70
8"	$	1,194.70

MONTHLY RATES PER 1,000 GALLONS

Service Type		
Residential	$	5.7570
Commercial	$	5.2066
Industrial	$	4.3050
Other Public Authority	$	4.7960
Sales for Resale	$	4.2360

MONTHLY FIRE PROTECTION RATES

Line Size		
2"	$	8.76
4"	$	35.28
6"	$	79.37
8"	$	141.09
10"	$	220.51
12"	$	330.03
14"	$	317.98
16"	$	564.63
Private Hydrant	$	76.57
Public Hydrant	$	48.70

TAPPING FEES

Size of Meter Connected		
5/8-Inch	$	1,223.00
1-Inch	$	2,174.00
2-Inch	$	4,002.00
Larger than 2-Inch		Actual Cost

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