COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ELECTRONIC APPLICATION OF WATER	)	
SERVICE CORPORATION OF KENTUCKY FOR A	)	CASE NO.
GENERAL ADJUSTMENT IN EXISTING RATES	)	2018-00208

ORDER

On July 5, 2018, Water Service Corporation of Kentucky (Water Service Kentucky) filed its application for an adjustment of its rates. It was notified its application contained no deficiencies by letter on July 16, 2018. The Commission entered an order on July 19, 2018, suspending the effective date of proposed rates for approximately five months and establishing a schedule for the Commission's investigation. On July 25, 2018, the Attorney General filed a motion to intervene, and the Commission granted that motion by Order dated July 30, 2018. The city of Clinton filed a motion to intervene after the deadline for intervention on September 28, 2018, and the Commission denied its motion by Order of October 22, 2018. Water Service Kentucky is the only party to file testimony in this matter.

BACKGROUND

This matter was scheduled for hearing on November 7, 2018; however, the hearing was continued to December 19, 2018, at Water Service Kentucky's request and agreement not to implement its proposed rates subject to refund earlier than February 12, 2019, as otherwise permitted by KRS 278.190.

The evidentiary hearing was held on December 19, 2018, and testimony was presented on behalf of Water Service Kentucky by Robert Guttormsen, Perry Brown, Andrian Dmitrenko, Michael Miller, Constance Heppenstall, and Steven Lubertozzi.

Water Service Kentucky is a Kentucky corporation whose stock is wholly owned by Utilities, Inc., which is based in Northbrook, Illinois. Water Service Kentucky provides water service to approximately 6,000 connections in Middlesboro and 600 connections in Clinton, located in Bell and Hickman counties, respectively.[1] The proposed rates, which Water Service Kentucky based upon a historical test period of the 12 months ended December 31, 2017, would produce additional annual revenues of $852,743 or 35.29 percent, over pro forma test-year revenues from existing rates of $2,416,580.[2]

ANALYSIS AND DETERMINATION

Test Year

Water Service Kentucky proposes to use as its historical test year the 12-month period ending December 31, 2017, as adjusted for known and measurable changes. The Commission finds the use of this period reasonable.

Income Statement

For the test year, Water Service Kentucky reported actual operating revenue and expenses of $2,477,391 and $2,114,014, respectively.[3] Water Service Kentucky proposed several adjustments to revenues and expenses to reflect current and anticipated operating conditions, resulting in pro forma revenues of $2,479,383 and pro

[1] Application, Direct Testimony of Michael A. Miller Jr., at 4.

[2] Application, Exhibit 4, Schedule B, Combined Operations Test Year 12/31/2017 at 1.

[3] *Id.*

forma expenses of $2,568,215.[4] The Commission's review of Water Service Kentucky's pro forma adjustments is set forth below.

Deferred Maintenance.

Water Service Kentucky proposed to increase its test-year Maintenance and Repair expense by $68,823 for deferred maintenance projects and $2,122 for the balance relating to deferred assets. These adjustments result in an increase of $70,935 to a pro forma level of $198,869.[5] During the proceeding and in response to a post-hearing data request, Water Service Kentucky acknowledged that an annual level of amortization to recover inspection costs related to the Clinton-Grubbs Subdivision and ClintonWTP Clearwell tanks was already included in the test year, and accordingly withdrew its request for the pro forma recovery of $1,240 costs related to these assets.[6]

Additionally, Water Service Kentucky updated estimated UCMR4 testing costs and provided actual costs for the UCMR4 testing requirements of $11,625 or a three-year amortization of $3,875.[7] In its Application, Water Service Kentucky estimated these costs to be $16,900 or $5,633 based on a three-year amortization. This reduces this pro forma adjustment by $1,758.

Additional pro forma adjustments included two tank-painting projects for the Bean's Fork and Middlesboro Tanks for a total of $605,000, or a ten-year amortization of

[4] *Id.*

[5] Application, Exhibit 4, Schedule B, Combined Operations Test Year 12/31/2017 at 1.

[6] Water Service Kentucky Response to Commission Staff's Third Information Request, Item 11 and December 19, 2018, H.V.T at 04:51-05:28.

[7] Response to Commission Staff's Post Hearing Data Requests, Response_to_PSC_PHDR_1.3_ (UCMR4_Actual_Coss).

$61,110.[8] Water Service Kentucky claims that the two tank painting projects have been evaluated by an engineering firm and the recommendation was for the work to be performed in the next one to two years. Water Service Kentucky stated that the interior coating is failing and a delay in performing the necessary work may result in additional repair and replacement costs. Water Service Kentucky further stated that it anticipates increased costs if the projects are delayed for lack of funding. Water Service Kentucky also included $840 of other pro forma expenses related to the Bean's Fork Tank.

The Attorney General concluded that the costs claimed for the two painting projects are not sufficiently known and measurable, and are therefore speculative. The Attorney General further stated that the projects are anticipated to start over one year after the end of the test year and that is not guaranteed. Additionally, the Attorney General noted that Water Service Kentucky has not provided any bids and no first steps have been taken in the bidding process. In regard to the Bean's Fork Tank Inspection, Water Service Kentucky relied solely on an internal estimate on what the projects would cost. It is the Attorney General's position that both the Middlesboro tank painting projects and the Bean's Fork Tank inspection have not been sufficiently established in the record and therefore the expenses should be denied.[9]

The Commission finds that Water Service Kentucky's post-test-year adjustment to reflect costs related to anticipated Deferred Maintenance projects does not meet the ratemaking criteria of being known and measurable. However, since the UCMR4 testing

---

[8] Responses to Commission Staff's First Request for Information (Staff's First Request), Item 3, Staff DR_1.3_-_ Filing Template.xlsx, Tab KY Def ASSETS, Paint #1 - -1.2 million gallon storage tank and Paint #2 - -1.2 million gallon storage tank.

[9] Case No. 2018-00208, Attorney General's Post Hearing Brief, at 6–7 (filed Jan. 18, 2019).

has already been performed, the Commission is including the 3-year amortization of this project in Water Service Kentucky's pro forma maintenance expense. Removal of the inspection costs related to the Clinton-Grubbs Subdivision and ClintonWTP Clearwell tanks, over-estimated costs for the UCMR4 testing, tank projects, and other tank related expenses results in the Commission's net adjustment to deferred maintenance expense of ($64,948) for a pro forma expense level of $133,921.[10]

Transportation Expense.

In its application, Water Service Kentucky proposed to increase transportation expense by a net $2,332. This adjustment included a reduction of $864 because of purchasing a more fuel-efficient vehicle and an increase of $3,196 to account for anticipated rising fuel costs.

The Commission finds that Water Service Kentucky's post-test-year adjustment to reflect anticipated savings and increased costs related to anticipated transportation expenses does not meet the ratemaking criteria of being known and measurable. Therefore, the Commission has eliminated Water Service Kentucky's pro forma adjustment of $2,332 for a pro forma level of $28,507.

Operating Expense Charged to Plant.

Water Service Kentucky reported a test-year operating expense charged to plant of $(110,733) and proposed to remove $103,218 of the expense credit to eliminate capitalized time that it says is not associated with capital projects. Water Service

[10] $1,240 + $1,758 + $61,109 + $840 = $64,948.

Kentucky asserts that there is an incongruence of capitalizing salary expense and recovering those expenses over the useful lives of the assets being depreciated.[11]

The Commission finds that accounting instructions 19 and 33, of the Uniform System of Accounts (USoA), which states that costs such as employee wages, wage overhead charges, materials and supplies, transportation costs, etc., are costs that are required to be capitalized as Utility Plant in Service and depreciated over their estimated useful lives. As a result, the Commission finds that the $103,218 should be included in Operating Expense Charged to Plant.

Salaries and Wages.

Water Service Kentucky proposed to increase its test-year salaries and wages expense of $790,838 by $105,832 for a pro forma level of $896,670. This increase reflects Water Service Kentucky's allocation of new positions from Water Service Kentucky's cost center. In its post-hearing brief, Water Service Kentucky acknowledged that salary expense should be reduced due to the elimination of the Director of Capital Planning and Asset Management position, whose salary was allocated 13.55 percent to Water Service Kentucky.[12] As a result, the Commission removed payroll, health insurance, and 401k retirement expenses of $20,750 that were related to the eliminated position.

---

[11] Responses to Commission Staff's Third Request for Information (Staff's Third Request), Item 2.b.

[12] Brief of Water Service Corporation of Kentucky, at 8.

The Commission notes, that while they accept Water Service Kentucky's adjustment to Salaries and Wages, in future rate cases it will apply more scrutiny to any proposed increases to allocated wage expense.

Regulatory Commission Expense.

Water Service Kentucky estimated its rate case expense to be $218,625 and proposed to amortize this expense over a two and one-half period.[13] Water Service Kentucky's most recent update on January 11, 2019, indicated that its total rate case expense was $147,677.[14] The Commission finds this amount reasonable but finds that a three-year amortization period is more appropriate. Because Water Service Kentucky incurred fewer expenses than expected, a three-year amortization of these expenses will result in a decrease in its operating expenses of $38,224.

Depreciation.

Water Service Kentucky proposed to increase its test-year depreciation expense of $290,060 by $172,428 to a pro forma level of $462,488.[15] According to Water Service Kentucky, the proposed increase to depreciation expense is the result of a depreciation analysis that was performed on its behalf by John F. Guastella of Guastella Associates, LLC.[16] Water Service Kentucky claimed that the depreciation analysis is consistent with the stipulation entered into by Water Service Kentucky and the Attorney General in Case No.

---

[13] Application, Exhibit 4, w/p[d].

[14] Water Service Kentucky's Supplemental Response to PSC Order dated July 19, 2018.

[15] Responses to Commission Staff's First Request, Item 3, Staff DR_1.3_-_ Filing Template.xlsx, Tab Sch. B-I.S, Combined Operations, Test Year ended 12/31/17.

[16] Application, Paragraph No. 24.

2015-00382.[17] Water Service Kentucky asserts that the methodology used in the analysis is consistent with the National Association of Regulatory Utility Commissioners (NARUC) Study of Depreciation Practices for Small Water Utilities (NARUC Study).[18]

Rather than perform a traditional depreciation study that examines the utility's actual property schedules of plant additions and retirements to calculate either an actuarial or simulated plant balance method for determining average service lives, Mr. Guastella performed a comparative analysis to establish the appropriate average service lives and depreciation rates.[19] According to Mr. Guastella, the recommended average service lives are within the range of data he has compiled for various utilities and regulatory agencies around the country.[20] In support of this assertion, Mr. Guastella compiled the average service lives, net salvage values and depreciation rates of a proxy group consisting of eleven other water utilities in various states,[21] NARUC guideline depreciation rates, California Public Utilities Commission Standard Practice depreciation rates, and Florida Public Service Commission rules and regulations on depreciation rates,

---

[17] Case No. 2015-00382, *Application of Water Service Corporation of Kentucky for a General Adjustment in existing Rates* (2015 Stipulation)(Ky. PSC May 31, 2016).

[18] Application, Paragraph No. 24.

[19] *Id.*, Exhibit 5, Direct Testimony of John F. Guastella (Guastella Testimony) at 6.

[20] *Id.*, at 7.

[21] List of water utilities used in the analysis: Utilities & Industries Corp., Long Island Water Corporation, Elizabethtown Water Company, Citizens Water Company, Artesian Water Company, Illinois American Water Company, Middlesex Water Company, Citizens Water Company, the New Jersey American utilities, Pennichuck Water Company, Aqua Illinois, Inc. divisions known as Candlewick, Fairhaven Estates, Hawthorn Woods, Ivanhoe, Oak Run, Ravenna, University Park, Vermilion, Willowbrook, Elwood Green, Kankakee and Corporate.

and found that his results for Water Service Kentucky are within the ranges of these comparable studies.[22]

Due to the detailed information and expense required to perform a traditional depreciation study using generally accepted practices, no water utility operating under the Commission's jurisdiction, with the exception of Kentucky-American Water Company, has ever filed such a study for Commission review. The absence of such a study does not prevent Commission review of depreciation practices of those utilities. Historically, the Commission has relied on the NARUC Study, dated August 15, 1979, to judge the reasonableness of a utility's depreciation practices. The NARUC Study outlines expected life ranges for asset groups. An adjustment is made when the Commission finds that a utility is using a life that falls outside of this range and there is no persuasive evidence to support the out-of-range service life.

Based on a review of the depreciation analysis filed by Water Service Kentucky, the Commission finds that it suffers from the same deficiencies as the benchmarking analysis filed by Northern Kentucky Water District in Case No. 2006-00398.[23] Water Service Kentucky's analysis does not identify specific characteristics that Water Service Kentucky shares in common with the utilities in the proxy group; the analysis does not identify the specific methods of determining the service lives, salvage values, and depreciation rates for each member of the proxy group; and no utility in Kentucky was included in the proxy group. Appendix A of this Order contains a comparison of depreciable lives proposed in Water Service Kentucky's depreciation analysis to those of

---

[22] Application, Exhibit 5, Guastella Testimony at 7.

[23] Case No. 2006-00398, Application of Northern Kentucky Water District for Approval of Depreciation Study (Ky. PSC Nov. 21, 2007).

the NARUC Study, and the recommended lives assigned to certain asset groups in Water Service Kentucky's analysis fall outside the recommendations of the NARUC Study. For all of these reasons, the Commission finds that Water Service Kentucky's proposed depreciation analysis to be inappropriate and should be denied.

The Commission further finds that Water Service Kentucky's current depreciation rates warrant adjustment. To maintain a consistent application of depreciation practices for water utilities in which traditional depreciation studies are not performed, the Commission finds that Water Service should be allowed to adjust its current depreciation rates based on the average life range for each asset group found appropriate in the NARUC Study. Using the mid-point of the depreciable lives in the NARUC Study results in a pro forma depreciation expense of $443,320,[24] which is $19,167 below the depreciation expense proposed by Water Service Kentucky of $462,167.

<u>Tax Cuts and Jobs Act (TCJA)</u>.

The TCJA was signed into law on December 22, 2017, and all of its provisions became effective on January 1, 2018. One of the major provisions that affected the investor-owned utilities subject to Commission regulation was the reduction in the corporate federal income tax (FIT) rate from 35 percent to 21 percent. The Commission, on its own motion, initiated Case No. 2017-00481[25] to investigate the impact the FIT rate

---

[24] Responses to Staff's Second Request, Item 24.d.

[25] Case No. 2017-00481, *Electronic Investigation of the Impact of the Tax Cuts and Job Act on the Rates of Atmos Energy Corporation, Delta Natural Gas Company, Inc., Columbia Gas of Kentucky, Inc., Kentucky-American Water Company, and Water Service Corporation of Kentucky* (filed Jan. 26, 2018). Case No. 2017-00481 was subsequently separated into utility-specific investigations. By its January 26, 2018 Order, the Commission established Case No. 2018-00043, *Electronic Investigation of the Impact of the Tax Cuts and Job Act on the Rates of Water Service Corporation of Kentucky*. By Order dated August 30, 2019, the record from Case No. 2018-00043 was incorporated by reference into this proceeding. All issues raised in Case No. 2018-00043 shall be adjudicated in Case No. 2018-00208.

reduction would have on the rates of Water Service Kentucky and four other investor-owned utilities.

On January 26, 2018, Water Service Kentucky filed[26] the Direct Testimony of Steven Lubertozzi, in which Mr. Lubertozzi estimated that the impact the TCJA would have on its revenue requirement would be a reduction of $4,281. Mr. Lubertozzi explained that Water Service Kentucky's ratepayers are not entitled to a rate reduction because Water Service Kentucky is not achieving the revenue requirement that was authorized in its most recent rate case, Case No. 2015-00382, and the estimated revenue impact of $4,281 is *de minimus*.[27] Water Service Kentucky further explained that in Case No. 2015-00382, there was no determination as to the amount of corporate FIT expenses that were included in its authorized rates as it was the result of a settlement.[28] With no determination of the corporate FIT expense included in customer's rates, Water Service Kentucky argues that its ratepayers are not due a refund for the TCJA FIT rate reduction.[29]

According to the Attorney General, multiple other Kentucky utilities whose recent rate increases were the result of settlements agreements, agreed to return to the ratepayers the FIT savings resulting from their respective TCJA investigation case.[30] The Attorney General recommends the Commission employ the same income statement methodology proposed by Delta Natural Gas Company, Inc., and Columbia Gas of

---

[26] Water Service Kentucky filed the testimony in Case No. 2017-00481.

[27] Direct Testimony of Steven Lubertozzi, Case No. 2017-00481 at 9.

[28] Responses to Staff's Third Request, Item 6.

[29] *Id.*

[30] Brief of the Attorney General at 9.

Kentucky, Inc., in their respective TCJA investigation cases and subsequently ordered in Duke Kentucky's tax case.[31] The Attorney General asserts that this methodology properly passed back to ratepayers the tax reductions without increasing shareholders actual earned returns and in the public interest.[32]

The December 27, 2017 Order opening the investigation of the impacts of the TCJA stated that utility rates must be set at a level to allow a utility to recover all its reasonable expenses, including taxes, and to provide an opportunity to earn a fair return on invested capital.[33] Similarly, in December 1986, the Commission established investigations for the investor-owned utilities to determine the effect the Tax Reform Act of 1986 (TRA of 1986) had on the rates of those utilities. In that case, the Commission explained that its objective was to recognize the impact of TRA of 1986 on the capital requirements of the investor-owned utilities but to leave their earnings positions as before the rate change.[34]

In Water Service Kentucky's last rate case, Case No. 2015-00352, Water Service Kentucky and the Attorney General were parties to the 2015 Stipulation. The 2015 Stipulation was considered a "black box" settlement because it identified Water Service Kentucky's revenue requirement but omitted any explanation of how the revenue requirement was calculated or why the requirement was reasonable.

---

[31] *Id.* at 9–10.

[32] *Id.* at 10.

[33] Case No. 2017-00481 at 2.

[34] Case No. 9788 (Ky. PSC June 11, 1988) at 11.

The Commission approved the 2015 Stipulation, finding that it was: the product of arms-length negotiations among knowledgeable, capable parties; was reasonable; and was in the public interest. The Commission approval was based solely on the reasonableness of the 2015 Stipulation and did not constitute a precedent on any individual issue, ratemaking theory, or adjustment. Therefore, the revenue requirement as set forth in the 2015 Stipulation was explicitly approved as being reasonable only for the purpose of reviewing the 2015 Stipulation in its entirety. The Commission finds that it is unreasonable for Water Service Kentucky to use the argument that it is unable to achieve its authorized revenue requirement as grounds to deny its ratepayers the benefit of the TCJA reduction in the corporate FIT rate.

Water Service Kentucky has presented no argument to persuade this Commission that the significant tax savings from the TCJA should be used to offset its inability to earn its claimed revenue requirement. This Commission further concludes that if Water Service Kentucky is not required to refund its FIT reduction to the ratepayers, then the result would be an improvement to Water Service Kentucky's stockholders earning position.

The Commission agrees with the Attorney General that the income statement methodology proposed by Delta Natural Gas Company, Inc., and Columbia Gas of Kentucky, Inc., in the corresponding investigations initiated to review the impacts of the TCJA, Case Nos. 2018-00040[35] and 2018-00041,[36] properly passed back to ratepayers

[35] Case No. 2018-00040, *Electronic Investigation of The Impact of the Tax Cuts and Job Act on the Rates of Delta Natural Gas Company, Inc.* (Ky. PSC Sep. 21, 2018).

[36] Case No. 2018-00041, *Electronic Investigation of The Impact of the Tax Cuts and Job Act on the Rates of Columbia Gas of Kentucky, Inc.* (Ky. PSC Oct. 26, 2018).

the tax reductions without increasing shareholders actual earned returns and thus was in the public interest. By using this methodology, the TCJA will have neither a positive nor a negative impact on Water Service Kentucky's actual earnings.

Applying the same income statement methodology for Water Service Kentucky and using the FIT rates of 35 percent and 21 percent, Water Service Kentucky's gross revenue conversion factor (GRCF),[37] and Water Service Kentucky's income statement for the calendar year ending December 31, 2017,[38] the Commission has determined that Water Service Kentucky's revenue requirement should be reduced by $48,606, as shown in the table below.

[37] Responses to the Commission Staff's First Request, Item 6.

[38] *Id.*, Item 1 at 2.

Line No.	Description	Calendar Year Ended Dec. 31, 2017			
		35% Fed Tax Rate		21% Fed Tax Rate	
		Rates	Amount	Rates	Amount
1.	Total Revenue		$ 2,477,391		$ 2,477,391
2.					
3.	Maintenance Expense		1,114,973		1,114,973
4.	General Expense		670,828		670,828
5.	Depreciation & Amortization		278,884		278,884
6.	Taxes Other Than Income		156,799		156,799
7.	Income from Management Services		(177,741)		(177,741)
8.	Interest Expense		156,983		156,983
9.					
10.	Expenses and Interest		2,200,725		2,200,725
11.					
12.	State and Federal Taxable Income		276,666		276,666
13.	Less: State Income Taxes	6%	(16,600)	5%	(13,833)
14.					
15.	Federal Taxable Income		260,066		262,833
16.	Federal Tax Rate	35%	(91,023)	21%	(55,195)
17.					
18.	Net Income		$ 169,043		$ 207,638
19.					
20.					
21.	Federal Taxes @21%		$ 55,195		
22.	Federal Taxes @35%		91,023		
23.					
24.	Current FIT Reduction		(35,828)		
25.	Gross-up Factor @21%		1.35666		
26.					
27.	Revenue Increase/(Decrease)		$ (48,606)		

The Commission will follow the same methodology in terms of rate design as it did in Case Nos. 2018-00040 and 2018-00041 and include a separate line item surcredt on the monthly bills. This surcredit will be effective from February 12, 2019 – February 11, 2020, and will return to customers the TCJA revenue impact from the effective date of the TCJA through the date of this Order, or $54,199.[39] Based upon the test year's total annual sales of 408,717,112 gallons, the surcredit will be $0.13 per 1,000 gallons sold.[40]

[39]
(1) Annual revenue reduction for Jan 1 – Dec 31, 2018 $48,606
(2) Revenue reduction for Jan 1 – Feb 11, 2019 $ 5,593 (line 1 ÷ 365 * 42)
(3) Total Refund for Jan 1, 2018 – Feb 11, 2019 $54,199 (line 1 + line 2)

[40]
(1) Total Refund for Jan 1, 2018 – Feb 11, 2019 $54,199
(2) Test Year Annual Sales 407,717,112 gallons
(3) Surcredit $0.133 / 1000 gallons (line 1 ÷ line 2)

Accumulated Deferred Income Taxes.

According to Water Service Kentucky, its deferred tax assets and liabilities have not been included in the calculation of its authorized revenue requirement. Water Service Kentucky argues that its customers cannot receive a benefit of the regulatory liability if the ADIT that generated the regulatory liability was not included in rates. The Attorney General's position is that the Commission should similarly require Water Service Kentucky to refund the savings from both the FIT reduction and excess ADIT to its ratepayers.

The Commission has historically calculated Water Service Kentucky's revenue requirement using the operating ratio method. Deferred income taxes have not been included in the prior year's calculations. Accordingly, the Commission agrees with Water Service Kentucky and denies the Attorney General's proposed adjustment for ADIT.

Income Tax Expense

Based upon its pro forma operating revenues and expenses, Water Service Kentucky originally calculated a negative pro forma income tax expense of $83,129, a decrease of $153,400 to the test-year reported level of $70,272. Using the pro forma operating revenues and expenses determined reasonable herein, the Commission arrives at its pro forma income tax expense of $(27,457), an increase of $55,678 above Water Service Kentucky's pro forma level. The table below is the Commission's calculation of pro forma income tax expense:

Operating Revenue		$	2,479,383
Add:			
Income from Management Services			177,741
Less:			
Operating Expenses (Net Income Tax Exp.)			(2,595,222)
Interest Expense			(171,951)
Taxable Income			(110,050)
Pro Forma State Income Tax	5%		(5,502)
Federal Taxable Income			(104,548)
Pro Forma Federal Income Tax	21%		(21,955)
Net Income		$	(126,503)
Total Pro Forma Income Tax Expense		$	(27,457)

Summary of Adjustments to Operating Expense and Revenue

The chart in Appendix B, attached to this Order, shows the effect of the Commission's adjustments along with the proposed and accepted adjustments of Water Service Kentucky:

OPERATING RATIO

Water Service Kentucky is proposing to use an 88.00 percent operating ratio to calculate its requested revenue requirement. In Case No. 2008-00563[41] the Commission found that the use of an operating ratio is preferred to the return-on-equity approach for a utility of Water Service Kentucky's size. The Commission explained that it has historically used an operating ratio approach for privately owned utilities when no basis exists for a rate-of-return determination or the cost of the utility has fully or largely been funded through contributions. For these reasons, the Commission used the operating

[41] Case No. 2008-00563, *Application of Water Service Corporation of Kentucky for an Adjustment of Rates,* Final Order (Ky. PSC Nov. 9, 2009) at 23–24

ratio method to calculate Water Service Kentucky's revenue requirement in Case No. 2010-00476,[42] again finding that an 88.00 percent operating ratio would allow Water Service Kentucky sufficient revenues to cover its reasonable operating expenses and to provide for reasonable equity growth. Therefore, this Commission concurs with Water Service Kentucky's proposed to use an 88.00 percent operating ratio to calculate its requested revenue requirement.

AUTHORIZED INCREASE

The Commission finds that Water Service Kentucky's net operating income for ratemaking purposes is $103,985. We further find that this level of net operating income and an 88.00 percent operating ratio require an increase in present rate revenues of $535,327, as shown below.

Line No.	Description		Amount
1.	Total Operating Expenses	$	2,375,398
2.	Less: Federal & State Income Taxes		27,457
3.			
4.	Operating Expenses Net of Income Taxes	$	2,402,855
5.	Divide by: Operating Ratio		88%
6.			
7.	Revenue to Cover Operating Ratio	$	2,730,517
8.	Less: Operating Expenses Net of Income Taxes	$	(2,402,855)
9.			
10.	Net Operating Income After Income Taxes	$	327,662
11.	Less: Pro Forma Net Income		66,941
12.			
13.	Net Operating Income Adjustment	$	394,603
14.	Multiplied by Gross-up Factor		1.356621985
15.			
16.	Revenue Requirement	$	535,327
17.			
18.	Percentage Increase/Decrease		22.15%

[42] Case No. 2010-00476, *Water Service of Kentucky,* Final Order (Ky. PSC Nov. 23, 2011) at 18.

PRICING AND TARIFF ISSUES

Cost of Service Study / Rate Design

For general water service, Water Service Kentucky currently charges a monthly service charge and two differing volumetric rate structures for its two service areas of Clinton and Middlesboro. The service charge is based in part on the customer's meter size and is intended to recover the cost of customer facilities such as meters and services, the cost of customer accounting, including billing and collecting and meter reading, as well as other fixed costs, including but not limited to, distribution mains by which each customer is served.

In its application, Water Service Kentucky proposed to unify its rates between the two service areas. In her testimony at the hearing, Ms. Heppenstall claimed several benefits of consolidating the rates between the two service areas. These benefits include a single tariff with unified rates, improved customer service allowing customers of the two service areas to distinguish the rates they are charged regardless of the service area and the convenience to its own customer service representatives in helping its customers with issues regarding their bill. Ms. Heppenstall continued stating that she performed a cost-of-service allocation study (COSS) with no delineation between the costs of the Clinton and Middlesboro service areas. Ms. Heppenstall stated that she believed that the two service areas were not that dissimilar to one another and that water supplied by the same company should be charged at the same rate. Ms. Heppenstall added that the rates of the two service areas were brought closer together during Water Service Kentucky's previous rate case before the Commission.[43]

[43] December 19, 2018, H.V.T. at 10:00:12.

Water Service Kentucky included with its application a COSS that uses the base-extra capacity method.[44] This methodology is widely recognized within the water industry as an acceptable methodology for allocating costs.[45] This Commission has previously accepted the use of this for cost allocation and development of water service rates. No party has objected to the calculations in the COSS.

In developing its proposed rates, Water Service Kentucky chose not to implement the filed COSS's results. According to the filed study, Water Service Kentucky should assess a monthly service charge up to $9.53 per month for 5/8-inch meters; however, Water Service Kentucky proposes a monthly service charge of $12.50. Water Service chose $12.50, as this amount will allow Water Service Kentucky to continue recovering approximately 35 percent of its Overall Revenue Requirement through its fixed service charge. In its response to Commission Staff, Water Service stated that the COSS's customer costs calculation of $9.53 only recovers costs directly related to meters, services, customer billing, and unrecovered public fire and that the calculation does not include additional Company costs, which are considered to be fixed costs.[46]

In its responses to Commission Staff's post-hearing request for information, Water Service Kentucky provided a revised COSS, which updated the calculation of the customer charge to include all of the fixed costs into its monthly service charge. Such a calculation is designed to determine the minimum distribution costs needed to serve all

---

[44] Application, Exhibit CEH-1.

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

[46] Water Service Kentucky's Responses to Commission Staff's Third Request for Information, Item 16(a).

of Water Service Kentucky's customers. Having reviewed Water Service Kentucky's revised COSS, the Commission finds it to be acceptable for use as a guide in allocating the revenue increase granted herein. The revised monthly service charge calculation is $13.29, which is more than the $12.50 proposed by Water Service Kentucky.[47] While the proposed monthly service charge does not completely recover customer costs, the Commission approves the proposed increase as it recovers a greater percentage of customer costs than the present customer charge and moves the utility closer to completely cost-based rates.

The Commission has used Water Service Kentucky's COSS as a guide to develop the rates and charges set forth in Appendix C to this Order. We followed Water Service Kentucky's proposed calculation of the monthly service charges and are set to allocate 35 percent of the Overall Revenue Requirement as determined by Staff. The volumetric charges were then calculated in order to move the revenues generated towards the indicated cost of service.

Ambleside Private Fire Surcharge

Water Service Kentucky proposed a monthly surcharge rate for the customers residing in Ambleside Subdivision located in Middlesboro, Kentucky, for the operation and maintenance of the hydrants located within the subdivision. Water Service Kentucky claimed that the hydrants built in the subdivision have not been receiving payment from the subdivision's developer, Ambleside, LLC, since 2008. Through discovery, the Commission found that Water Service Kentucky failed to appropriately collect payments for the hydrants from Ambleside, LLC, did not address the hydrants in a prior rate case,

[47] Water Service Kentucky's Responses to Commission Staff's Post-Hearing Request for Information, Item 4(b) and Exhibit 4(b).

and instead decided to accrue a bad debt expense for the hydrants that resulted in subsidization by all other customers. As noted in PSC Staff Opinion 2010-016,[48] Commission regulations permit Water Service Kentucky to discontinue water service for any failure to pay outstanding fees for private hydrant services pursuant to 807 KAR 5:006, Section 14(f). Water Service Kentucky elected to continue service to the hydrants as stopping service was seen as a potential fire hazard and to continue billing Ambleside, LLC, for the cost of the hydrants.[49]

The Commission agrees with Water Service Kentucky's proposal of a surcharge to customers of Ambleside subdivision that include the operation and maintenance costs associated with the Ambleside private fire hydrants. In determining the monthly surcharge, the monthly private hydrant rate was multiplied by the number of hydrants in the subdivision, and then divided by the total amount of customers within Ambleside resulting in a $3.33 monthly charge. The Commission notes that "per hydrant" should be removed from the Ambleside Private Fire Surcharge rate listed in Water Service Kentucky's proposed tariff sheet and replaced with "per customer," as this is a monthly rate per customer located within the subdivision. Water Service Kentucky should provide notice of the Ambleside Private Fire Surcharge to the residents of Ambleside subdivision in accordance with the notice requirements of 807 KAR 5:011, Section 8, and KRS 278.180. Water Service Kentucky should include the explanation for the surcharge in the notice that it is required to continue operation and maintenance of the hydrants.

<u>General Water Rates</u>

---

[48] PSC Staff Opinion No. 2010-00016, (July 19, 210)

[49] December 19, 2018 H.V.T. at 10:52:35 – 10:52:50

The rates and charges contained in Appendix C to this Order produce the required revenue requirement based upon Water Service Kentucky's normalized sales. For a residential customer residing in the Middlesboro service area who uses an average of 3,696 gallons per month, the following table illustrates the monthly bill impact:

	Current	Feb. 12, 2019 - Feb. 12, 2020	Feb. 12, 2020
Customer Charge	$10.00	$11.45	$11.45
Volumetric Charge	$15.00	$18.66	$18.66
TJCA		$(0.49)	-
Total	$25.00	$29.62	$30.11
Difference		$ 4.62	$ 0.49
% Difference		18.48%	1.65%

For a residential customer residing in the Clinton service area who uses an average of 3,089 gallons per month, the following table illustrates the monthly bill impact:

	Current	Feb. 12, 2019 - Feb. 12, 2020	Feb. 12, 2020
Customer Charge	$10.00	$11.45	$11.45
Volumetric Charge	$13.47	$15.60	$15.60
TJCA		$(0.41)	-
Total	$23.47	$26.64	$27.05
Difference		$ 3.17	$ 0.41
% Difference		13.51%	1.54%

NONCOMPLIANCE

In Case No. 2017-00481, the Commission Ordered Water Service Kentucky and the four other investor-owned utilities to commence recording deferred liabilities on their respective books to reflect the reduction in the federal corporate tax rate from 35 percent to 21 percent. In the Order initiating Case No. 2018-00043, the Commission Ordered that Water Service Kentucky shall continue to record deferred liabilities on its books, as previously Ordered in Case No. 2017-00481, to reflect the reduction in the federal corporate tax rate to 21 percent.

The reason Water Service Kentucky gave for not recording the FIT deferred liability, as required by this Commission, was its inability to achieve the revenue requirement that it stated it was authorized in its most recent rate case, Case No. 2015-00352. Water Service Kentucky's inability to earn a specific return, or Operating Ratio, is not an adequate reason for ignoring a Commission Order. This current failure to follow a Commission directive is inexcusable. If Water Service Kentucky believes it has justifiable reasons for not following Commission Orders, then it could have filed a formal motion asking the Commission to revise the Order rather than just not comply. Water Service Kentucky is placed on notice that future noncompliance with Commission Orders will not be tolerated and could subject it to administrative sanctions.[50]

SUMMARY

The Commission, after consideration of the evidence of record and being otherwise sufficiently advised, finds that:

1. The 12-month period ending June 30, 2017, should be used as the test year to determine the reasonableness of Water Service Kentucky's current and proposed rates.

2. Based upon pro forma test-year operations, Water Service Kentucky's pro forma total operating expenses, after adjusting for known and measurable changes, are $2,375,398.

[50] See KRS 278.990.

3. The use of an operating ratio is the most appropriate means to determine Water Service Kentucky's total revenue requirement.

4. An operating ratio of 88 percent will permit Water Service Kentucky to meet its reasonable operating expenses and provide a fair and reasonable return and should be used to determine Water Service Kentucky's total revenue requirements.

5. Applying an operating ratio of 88 percent to Water Service Kentucky's pro forma total operating expenses of $2,375,398 and adjusting for the effects of state and federal income taxes produces a total revenue requirement from water sales of $2,730,517, or $535,327 more than the annual revenue from water sales that Water Service Kentucky's current rates produce.

6. The rates proposed by Water Service Kentucky would produce revenue in excess of that found to be reasonable herein and should be denied.

7. The rates set forth in Appendix B to this Order are the fair, just, and reasonable rates for Water Service Kentucky to charge for service rendered on and after the date of this Order and should be approved

IT IS THEREFORE ORDERED that:

1. Water Service Kentucky's application for an adjustment of its rates is denied as proposed.

2. The rates and charges set forth in Appendix C of this Order are approved for the water service that Water Service Kentucky renders on and after the date of this Order.

3. Within 20 days of the date of entry of this Order, Water Service Kentucky shall file with the Commission, using the Commission's electronic Tariff Filing System,

revised tariff sheets setting out the rate approved herein and reflecting that it was approved pursuant to this Order.

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

[REMAINDER OF PAGE INTENTIONALLY LEFT BLANK]

By the Commission

ENTERED

FEB 11 2019

KENTUCKY PUBLIC SERVICE COMMISSION

ATTEST:

Gwen R. Pinson

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2018-00208 DATED FEB 1 1 2019

	Service Lives			
	NARUC Guide			WSCK's
Account Description	Range			Deprec. Study
Organization				25
Franchises & Consents				25
Land and Land Rights				
Structures and Improvements	35	-	40	30
Collecting & Impounding Res.	50	-	75	70
Lake, River and Other Intakes	35	-	45	75
Wells and Springs	25	-	35	60
Mains - Supply and T&D	50	-	75	90
Power Generating Equipment	25	-	25	30
Source of Supply & Pumping Equip.	20	-	20	40
Electric Pumping Equip.	20	-	20	40
Water Treatment Equipment	20	-	35	35
Other Plant & Misc. Equipment	30	-	40	18
Dist. Reservoirs & Standpipes	30	-	60	60
Services	30	-	50	60
Meters	35	-	45	15
Meter Installations	40	-	50	45
Hydrants	40	-	60	43
Backflow Prevention Devices	35	-	45	45
Other Plant & Misc. Equipment	30	-	40	30
Office Furniture	20	-	25	20
MainFrame Computers	20	-	25	8
MainFrame Software	20	-	25	8
Personal Computers	20	-	25	8
PC Software	20	-	25	5
Other Allocated Computer System Costs	20	-	25	8
Other Allocated Micro System Costs	20	-	25	3
Transportation Equipment	7	-	7	7
Stores Equipment	20	-	20	30
Tools, Shop and Garage Equip.	15	-	20	15
Laboratory Equipment	15	-	20	20
Power Equipment	10	-	15	10
Communication Equipment	10	-	10	8
Miscellaneous Equipment	30	-	40	18
Other Tangible Plant	30	-	40	30

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2018-00208 DATED FEB 1 1 2019

	Water Service Kentucky Pro Forma Operations	Commission Pro Forma Adjustments	Commission Pro Forma Operations
Operating Revenues:			
Service Revenues - Water	$ 2,416,580	$ -	$ 2,416,580
Miscellaneous Revenues	62,803	0	62,803
Total Operating Revenues	2,479,383	0	2,479,383
Operating Expenses:			
Maintenance Expenses:			
Salaries and Wages	745,934	0	745,934
Purchase Water/Sewer	123,204	0	123,204
Purchased Power	101,367	0	101,367
Maintenance and Repair	198,869	(64,948)	133,921
Maintenance Testing	43,482	0	43,482
Chemicals	108,012	0	108,012
Transportation	30,839	(2,332)	28,507
Operating Exp. Charged to Plant	(7,515)	(103,218)	(110,733)
Outside Services - Other	39,770	0	39,770
General Expenses:			
Salaries and Wages	150,736	(20,750)	129,986
Office Supplies & Other Office Exp.	62,407	0	62,407
Regulatory Commission Exp.	87,450	(38,224)	49,226
Pension & Other Benefits	238,521	0	238,521
Rent	28,396	0	28,396
Operating Leases	48,332	0	48,332
Insurance	75,288	0	75,288
Office Utilities	50,304	0	50,304
Uncollectible Accounts	39,304	0	39,304
Miscellaneous	33,060	0	33,060
Total Maintenance & GeneralExpenses	2,197,759	(229,472)	1,968,288
Depreciation	462,488	(19,167)	443,320
Taxes Other Than Income	183,615	0	183,615
Expense Reduction Related to Clinton Sewer Operations	(177,741)	0	(177,741)
Income Taxes - Federal	(83,135)	55,678	(27,457)
Amortization of CIAC	(14,627)	0	(14,627)
Total Operating Expenses	2,568,359	(192,961)	2,375,398
Net Operating Income	(88,976)	192,961	103,985
Other:			
Interest During Construction	(1,025)	0	(1,025)
Interest on Debt	171,951	0	171,951
Net Income	$ (259,902)	$ 192,961	$ (66,941)

APPENDIX C

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2018-00208 DATED FEB 11 2019

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

Service Charge Rates
For All Service Areas

Meter Size		
5/8-Inch	$ 11.45	per month
3/4-Inch	11.45	per month
1-Inch	28.63	per month
1 1/2-Inch	57.25	per month
2-Inch	91.60	per month
3-Inch	171.75	per month
4-Inch	286.25	per month
6-Inch	572.50	per month

Volumetric Rates

Middlesboro Service Area		
First 100,000 Gallons	$ 5.050	per 1,000 Gallons
Over 100,000 Gallons	$ 3.450	per 1,000 Gallons

Clinton Service Area		
First 100,000 Gallons	$ 5.050	per 1,000 Gallons
Over 100,000 Gallons	$ 3.450	per 1,000 Gallons

Monthly Fire Protection Charges
For All Service Areas

Fire Protection Charges		
Municipally Owned Hydrants	$ 7.40	per hydrant
Private Hydrants or Sprinkler Systems	33.50	per hydrant or sprinkler
Ambleside Private Fire Surcharge*	3.33	per customer

TCJA Surcredit

February 12, 2019 – February 11, 2020	$ (0.133)	per 1,000 Gallons

* Surcharge is only applicable to those customers residing in the Ambleside subdivision in Middlesboro, KY

*James W Gardner
Sturgill, Turner, Barker & Moloney, PLLC
333 West Vine Street
Suite 1400
Lexington, KENTUCKY 40507

*M. Todd Osterloh
Sturgill, Turner, Barker & Moloney, PLLC
333 West Vine Street
Suite 1400
Lexington, KENTUCKY 40507

*Justin M. McNeil
Office of the Attorney General Office of Rate
700 Capitol Avenue
Suite 20
Frankfort, KENTUCKY 40601-8204

*Kent Chandler
Assistant Attorney General
Office of the Attorney General Office of Rate
700 Capitol Avenue
Suite 20
Frankfort, KENTUCKY 40601-8204

*Lawrence W Cook
Assistant Attorney General
Office of the Attorney General Office of Rate
700 Capitol Avenue
Suite 20
Frankfort, KENTUCKY 40601-8204

*Mary Myers
Sturgill, Turner, Barker & Moloney, PLLC
333 West Vine Street
Suite 1400
Lexington, KENTUCKY 40507

*Rebecca W Goodman
Assistant Attorney General
Office of the Attorney General Office of Rate
700 Capitol Avenue
Suite 20
Frankfort, KENTUCKY 40601-8204

*Water Service Corporation of Kentucky
2335 Sanders Road
Northbrook, IL 60062-6196