

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ELECTRONIC PROPOSED ADJUSTMENT OF)	
THE WHOLESALE WATER SERVICE RATES)	CASE NO.
OF THE CITY OF PIKEVILLE TO MOUNTAIN)	2019-00080
WATER DISTRICT)	

ORDER

By tariff filing submitted on February 21, 2019, the city of Pikeville (Pikeville) proposes to increase the wholesale water rates it charges to Mountain Water District (Mountain District). Pikeville currently charges Mountain District \$1.68 per 1,000 gallons for the first 28,000,000 gallons purchased and \$1.30 per 1,000 gallons for purchases above 28,000,000 gallons.¹ Pikeville proposes to increase its volumetric rate for all water purchased by Mountain District to \$2.30 per 1,000 gallons. Pikeville further proposes to assess a monthly surcharge to Mountain District over 36 months to recover any rate case expenses it incurs participating in and defending its proposed rates in this current proceeding.² The proposed tariff listed the Rate Case Expense Surcharge as \$2,500 per month. The table below is a comparison of Pikeville’s current and proposed volumetric wholesale rates for Mountain District.

			<u>Existing Rates</u>	<u>Proposed Rates</u>	<u>Increase</u>
First	28,000,000	Gallons	\$ 1.68 per 1,000 Gallons	\$ 2.30 per 1,000 Gallons	36.9%
Next	28,000,000	Gallons	\$ 1.30 per 1,000 Gallons	\$ 2.30 per 1,000 Gallons	76.9%

¹ Pikeville’s responses to June 10, 2019 Order, Item 1, Direct Testimony of Philip Elswick (Elswick Testimony), page 3.

² TFS 2019-00080, *Electronic Proposed Adjustment of the Wholesale Water Service Rates of the City of Pikeville to Mountain Water District* (filed Feb.21, 2019).

The Commission has jurisdiction over Pikeville's rates for wholesale water service to Mountain District pursuant to KRS 278.200 and the Supreme Court's decision in *Simpson County Water District v. City of Franklin*, 872 S.W.2d 460, 463 (Ky. 1994), in which the Court specifically stated that "where contracts have been executed between a utility and a city . . . KRS 278.200 is applicable and requires that by so contracting the City relinquishes the exemption and is rendered subject to the PSC rates and service regulation."³ Following the Court's decision in *Simpson County*, the Commission has allowed city-owned utilities to file rate adjustments by a tariff filing, and if a hearing is requested and the Commission suspends the proposed rate, the requirements and procedures set forth in KRS Chapter 278, and the Commission's regulations, apply equally to filings by a city-owned utility or a jurisdictional utility.⁴ The parties in this case present two issues to the Commission. The first issue is whether Pikeville's proposed rate increase is fair, just, and reasonable based upon the evidentiary record and the second issue is whether Pikeville's rate case expense and the proposed 36-month surcharge to recover that expense is fair, just, and reasonable based upon the evidentiary record.

³ *Simpson County Water District v. City of Franklin*, 872 S.W.2d 460, 463 (Ky. 1994).

⁴ *Id.*; *City of Danville v. Public Service Comm'n, et al.*, Civil Action No. 15-CI-00989, *Opinion and Order* (Franklin Circuit Court Division II, June 14, 1016).

BACKGROUND

Pikeville is a city of the third class⁵ that owns water treatment and distribution facilities that are operated as a department of the city, pursuant to KRS 96.320.⁶ Pikeville provides retail water service to 4,972 customers⁷ located in and near Pikeville, Kentucky. In addition to its retail water service, Pikeville provides wholesale water service to Mountain District and Southern Water and Sewer District (Southern District).⁸ The wholesale water rate that Pikeville charges to Mountain District was last adjusted in 2009.⁹

Mountain District is a water district organized pursuant to KRS Chapter 74 that owns and operates a water distribution system through which it provides water service to approximately 16,611 retail customers in Pike County, Kentucky.¹⁰ Mountain District's last general rate adjustment occurred in 2015.¹¹

⁵ KRS 81.010(3).

⁶ Pikeville's responses to the Commission's June 10, 2019 Order, Item 1, Direct Testimony of Philip Elswick (Elswick Testimony) page 2, Lines 6-7.

⁷ Pikeville's Responses to Commission Staff's Third Request for Information (Staff's Third Request), Item 14. 3,318 (Inside City Customers) + 1,654 (Outside City Customers) = 4,972 (Total Customers).

⁸ Pikeville's responses to the Commission's June 10, 2019 Order, Item 1, Elswick Testimony page 2, Lines 7-8.

⁹ *Id.* Lines 15-16.

¹⁰ *Annual Report of Mountain County Water District to the Public Service Commission for the Calendar Year Ended December 31, 2018* at 12 and 49.

¹¹ Case No. 2014-00342, *Application of Mountain Water District for an Adjustment of Water and Sewer Rates* (Ky. PSC Oct. 9, 2015).

PROCEDURAL

On February 21, 2019, pursuant to 807 KAR 5:011, Pikeville filed a revised tariff proposing to increase its existing rate for wholesale water service to Mountain District.¹² On March 4, 2019, Mountain District, through counsel, submitted a letter requesting that the Commission open a formal proceeding to investigate the reasonableness of the proposed rate, establish a procedural schedule, and ensure that the proposed rate is not placed into effect before the Commission conducts a hearing.¹³ By Order dated March 28, 2019, pursuant to KRS 278.190(2), the Commission determined that further proceedings were necessary and suspended the rates for five months, up to and including September 4, 2019. The Commission further granted Mountain District leave to intervene in this current proceeding.

On July 23, 2019, the Commission, on its own motion, scheduled an evidentiary hearing in this proceeding, to be held on August 22, 2019. In its July 24, 2019 Motion, Mountain District requested that the hearing be rescheduled due to a scheduling conflict on the part of one of its attorneys; the hearing was then rescheduled for September 11, 2019.

On September 3, 2019, Pikeville, pursuant to KRS 278.190(2) provided notice to the Commission of its intent to implement the proposed volumetric rate to Mountain District for water sold on or after September 5, 2019. The notice also stated that Pikeville would not implement the proposed rate case expense surcharge until the Commission's

¹² KRS 278.190(3) requires that the Commission render a final decision on Pikeville's proposed rate no later than ten months after the filing of the schedule. This ten-month period ends on December 20, 2019.

¹³ Protest Letter from Mountain District (filed March 4, 2019).

final order is issued. The Commission ordered Pikeville, pursuant to KRS 278.190(2), to maintain its records in a manner that would enable Pikeville, or any of its customers, or the Commission, to determine the amounts to be refunded and to whom due in the event a refund is ordered.

Following extensive discovery, the Commission held an evidentiary hearing on September 11, 2019, in Frankfort, Kentucky. Testimony was presented on behalf of Pikeville by Philip Elswick, Samuel Petty, Tonya Taylor, and Grondall Potter. Connie Allen, P.E., provided testimony on behalf of Mountain District. Both Pikeville and Mountain District submitted written briefs. This matter now stands submitted to the Commission for a decision.

TEST PERIOD

Pikeville proposes, and the Commission finds reasonable, the use of the 12-month period ending June 30, 2017 (Fiscal Year 2017) as the test period for determining the reasonableness of the proposed rate. The Commission's adjustments to Pikeville's test-year revenues and expenses are discussed below.

REVENUES AND EXPENSES

During Fiscal Year 2017, Pikeville reported operating revenues and operating expenses of \$2,452,736 and \$2,429,546, respectively.¹⁴ The Commission's review of Pikeville's test-year operating revenues and expenses are set forth below.¹⁵

¹⁴ Pikeville's responses to the Commission's June 10, 2019 Order, Item 10. Pikeville filed the excel spreadsheet for the Fiscal Year 2017 Trial Balance on September 10, 2019.

¹⁵ See Appendix A for the Pro Forma Income Statement.

UMG Reimbursements

In its audited trial balance for Fiscal Year 2017 general ledger, Pikeville reported gasoline and telephone expenses of \$144,174 and \$8,206, respectively.¹⁶ Pikeville also reported water special revenue of \$150,303,¹⁷ which represents reimbursements Pikeville received from UMG for the water department's fuel and phone use.¹⁸ Pikeville explains that:

The City is able to purchase fuel at a lower cost and bill to UMG, which puts [sic] burden back on UMG to operate in an efficient manner. The phone system is tied together with public works due to customer service, and UMG reimburses for phones allocated to them.¹⁹

The gasoline and telephone/public works expenses are being recovered by UMG through its annual management fee.²⁰ To simplify the revenue requirement calculation and to eliminate any possibility of double recovery of these expenses, the Commission is reducing operating revenues and expenses by \$150,303.²¹

Cost Allocations

In fiscal year 2006, when Pikeville acquired the assets formerly owned by the Sandy Valley Water District (Sandy Valley District) it separated its water department into

¹⁶ Pikeville's responses to the Commission's June 10, 2019 Order, Item 10.

¹⁷ *Id.*

¹⁸ Pikeville's responses to Staff's Second Request, Item 18.

¹⁹ Pikeville's responses to Commission Staff's Post Hearing Request (Staff's Post-Hearing Request), Item 1.

²⁰ *Id.*, Item 2.

²¹ Operating Expenses: \$(144,174) (Gasoline) + \$(6,129) (Telephone) = \$(150,303). The telephone expense was not adjusted down by the entire fiscal year amount of \$8,206 as the net difference between the revenue and expense adjustment should be zero.

service areas inside and outside the city limits and began to maintain separate general ledgers for each customer class.²² Pikeville's goal was to track expenses and revenues separately between the two customer classes in order to set separate rates.²³ Pikeville allocates the identified shared costs (variable and fixed) between the two customer classes based upon water consumption.²⁴ In Fiscal Year 2017, Pikeville allocated 77.13 percent of the shared cost to customers inside the city limits and 22.87 percent to the customers outside the city.²⁵ Pikeville designates its wholesale water customers as inside city customers.

This allocation was explained by Tonya Taylor, who testified that Pikeville allocates costs of its treatment plant (electricity, repairs, and UMG management fee) between its two customer classes using a customer consumption factor.²⁶ Ms. Taylor added that, in her opinion, allocating costs using the consumption factor should not result in volatile or unstable cost allocations between fiscal years and is the most practical allocation factor for Pikeville to use.²⁷ Ms. Taylor explained that Pikeville has not performed an analysis or study to support its use of consumption to allocate the shared costs between the inside city and outside city systems.²⁸

²² Pikeville's responses to Staff's Third Request, Item 10.

²³ *Id.*

²⁴ Pikeville's responses to the Commission's June 10, 2019 Order, Item 8.

²⁵ *Id.*

²⁶ September 11, 2019 Hearing Video Transcript (HVT) at 18.10.

²⁷ September 11, 2019 HVT at 18.55.

²⁸ September 11, 2019 HVT at 17.33.

Given the absence of a supporting study or analysis, the Commission finds that Pikeville’s fixed shared costs would not vary with the amount of water that Pikeville either produces or sells. In prior proceedings the Commission has found that a more equitable allocation method to use is a factor based on the number of customers that are served by each division (Customer Allocation Factor).²⁹ The Commission finds that Pikeville’s shared fixed costs should be reallocated using a five-year average Customer Allocation Factor.³⁰ The customer allocation factor for the outside-the-city system is 33.423 percent and the factor for the inside-the-city system is 66.577 percent, as calculated in the table below:

Fiscal Years	Customers				Total
	Outside	%	Inside	%	
2018	1,541	32.836%	3,152	67.164%	4,693
2017	1,653	33.253%	3,318	66.747%	4,971
2016	1,639	33.517%	3,251	66.483%	4,890
2015	1,696	33.718%	3,334	66.282%	5,030
2014	1,727	33.790%	3,384	66.210%	5,111
	<u>8,256</u>	<u>33.432%</u>	<u>16,439</u>	<u>66.568%</u>	<u>24,695</u>
		<u>33.423%</u>		<u>66.577%</u>	

Reallocating the shared fixed costs between the two customer classes results in a decrease of \$106,059 in operation and maintenance expense allocated to inside-the-

²⁹ See, e.g. Case No. 2012-00309, *Application of Southern Water and Sewer District for an Adjustment in Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC: Staff Report issued Feb. 15, 2013; Final Order issued July 12, 2013); Case No. 2013-00350, *Alternative Rate Adjustment Filing Garrison-Quincy-Ky-O-Heights Water District* (Ky. PSC: Staff Report issued Jan. 17, 2014; Final Order issued Feb 19, 2014); Case No. 2017-00074, *Application of Western Lewis Rectorville Water and Gas District for Rate Adjustment for Small Utilities Pursuant to 807 KAR 5:076* (Ky. PSC: Staff Report issued July 17, 2017; Final Order issued Oct. 18, 2017); Case No. 2017-00371, *Application of Symsonia Water and Sewer District for Rate Adjustment Pursuant to 807 KAR 5:076* (Ky. PSC: Staff Report issued Jan. 3, 2018; Final Order issued Mar. 30, 2018); and Case No. 2018-00117, *Application of Ledbetter Water District for an Alternative Rate Adjustment* (Ky. PSC: Staff Report issued July 16, 2018; Final Order issued Sep. 10, 2018).

³⁰ Pikeville’s responses to Staff’s Post-Hearing Request, Item 12.

city customers. A listing of the adjustments to reallocate each shared fixed cost is contained in the following table.

Account Title	Allocation Adjustment
Insurance	(11,663) ³¹
Public Works Water - UMG Mgt Fee	(49,416) ³²
UMG...Services	(39,598) ³³
Repairs/Maintenance	(3,254) ³⁴
Repairs and Maintenance Plant	(2,128) ³⁵

The only variable shared cost reported by Pikeville as a separate line item is electric expense.³⁶ Given that Pikeville would be unable to provide water service to the outside-the-city system without the pumping stations and the storage tanks located inside the city system, the Commission is allocating total test-year electric expense between the two customer classes using a five-year average of water produced and sold. Inside-the-city electric expense is being decreased by \$46,328, as calculated in the table following.

³¹ \$29,134 (Reported Inside City) + \$5,762 (Allocated Outside City) = \$34,896 x (33.423%) (Customer Allocation Factor –Outside City) = \$(11,663).

³² \$1,671,184 (UMG Mgt Fee Water Department) x 66.577% (Customer Allocation Factor – Inside City) = \$1,112,624 (Reallocated UMG Fee Inside City) - \$1,162,040 (Reported UMG Fee Inside City) = \$(49,416).

³³ \$141,565 (Reported UMG Services) - \$23,091 (Capital & Retail Cust. Costs) = \$118,474 x (33.423%) (Customer Allocation Factor –Outside City) = \$(39,598).

³⁴ \$139,077 (Reported Repairs/Maintenance) - \$129,342 (Nonrecurring & Capital Costs) = \$9,735 x (33.423%) (Customer Allocation Factor –Outside City) = \$(3,254).

³⁵ \$30,632 (Reported Repairs & Maintenance Plant) - \$24,264 (Nonrecurring Costs) = \$6,368 x (33.423%) (Customer Allocation Factor –Outside City) = \$(2,128).

³⁶ Chemical expense is also a variable cost, but it is embedded in the UMG Management Fee so an additional adjustment is unnecessary.

Reported Electric Inside City	\$ 299,596
Add: Electric Expense Allocated Outside City: Treatment Plant	<u>43,440</u>
Total Electric Expense	343,036
Divided by: Average Water Production	<u>1,221,449,560</u>
Electric Cost per Gallon	0.000281
Multiplied by: Average Inside Water Sales	<u>901,310,007</u>
Reallocated Inside City Electric Expense	253,268
Less: Reported Electric Expense	<u>(299,596)</u>
Pro Forma Adjustment	<u>\$ (46,328)</u>

Customer-Related Costs

In its rate study, Pikeville allocated its functional costs between the categories of administration, water treatment plant, and distribution.³⁷ Pikeville next divided the costs in each of the three categories into either fixed or variable costs.³⁸ The costs identified by Pikeville as fixed were not allocated or recovered in its proposed wholesale rate.³⁹

According to the American Water Works Association (AWWA) Manual of Water Practices, Principals of Water Rates, Fees, and Charges (AWWA M1 Manual):

Wholesale rates should be designed to recover costs of providing service based on usage, pattern of usage, and level of service of individual wholesale class members. Often in developing a rate design to recover the cost of providing wholesale service, customer-related costs are a small percentage of the total cost of service. Rather than use a wholesale service charge, some utilities recover customer related costs through the commodity, or volume charge.⁴⁰

³⁷ Pikeville's responses to the Commission's June 10, 2019 Order, Item 1, Elswick Testimony page 3, Lines 16-17.

³⁸ *Id.*, Lines 17-18.

³⁹ *Id.*, Line 21.

⁴⁰ AWWA M1 Manual, page 236.

Following the directions of the AWWA M1 Manual, the Commission has identified the customer-related costs that should be allocated to the wholesale customers and is allocating 0.181 percent of those costs to the wholesale customers.⁴¹ The remaining customer-related costs should be totally recovered from the retail water customers. The Commission is allocating 0.181 percent of the customer-related costs as detailed in the table below, which is a list of the fixed (administrative) costs identified by Pikeville as being allocated to the wholesale rate and to the retail rates.

	Test-Year Amounts	Wholesale Allocations		Administrative Costs - Retail
		Factors	Amounts	
Other Water Revenues:				
Bad Debt Recovery	\$ (290)	0.000%	\$ -	\$ (290)
Water Tap Fee	(24,510)	0.000%	0	(24,510)
Water Penalty	(10,911)	0.000%	0	(10,911)
Operating Revenue	(35,711)		0	(35,711)
Operating Expenses:			0	
Bank Charges-Water Revenue	(3,890)	0.181%	7	(3,883)
Provision For Bad Debt	(1,158)	0.000%	0	(1,158)
Dues	(850)	0.181%	2	(848)
Freight/Postage	(1,349)	0.181%	2	(1,347)
Office Supplies	(2,489)	0.181%	5	(2,484)
Public Works Water - UMG MGT Fee	(58,102)	0.181%	105	(57,997)
Prof Service Other	(777)	0.181%	1	(776)
Ut Monthly Billing/Professional Services	(3,803)	0.181%	7	(3,796)
Rent-Easements	(376)	0.181%	1	(375)
Purchase Software	(1,845)	0.181%	3	(1,842)
Workers Comp	(286)	0.000%	0	(286)
Salaries & Wages	(21,294)	0.000%	0	(21,294)
Employee Benefit Insuranc	(7,567)	0.000%	0	(7,567)
Pension Matching	(8,719)	0.000%	0	(8,719)
Taxes Other Than IncomeTax:				
Payroll Tax	(1,629)	0.000%	0	(1,629)
Unemployment Tax	(127)	0.000%	0	(127)
Operating Expense	(114,261)		133	(114,128)
Net Operating Income	\$ 78,550		\$ (133)	\$ 78,417

⁴¹ $4,971$ (Pikeville Retail Customers Fiscal Year 2017) \div 9 (Wholesale Master Meters) = $4,980$ (Monthly Bills). 9 (Wholesale Master Meters) \div $4,980$ (Total Retail and Master Meters) = 0.181% .

UMG Management Fees

On July 1, 2007, Pikeville and UMG entered into an Agreement for Operations, Maintenance and Management Services (Management Agreement), wherein UMG agreed to manage and operate the following city departments: Streets; Parks; Landscape; Gas; Water; Garbage; and Wastewater.⁴² UMG's compensation under the Management Agreement for the first year, fiscal year ending June 30, 2008, was listed as \$4,026,174, with a maintenance and repair limit of \$494,904 for the water department.⁴³ However, in the first amendment to the Management Agreement, dated July 23, 2007, UMG's management fee for fiscal year 2007 was increased to \$4,399,474 and the maintenance and repair limit for the water department increased to \$546,904.⁴⁴ The reason given for the increases in the fiscal year 2007 UMG fees was Pikeville's acquisition of the Sandy Valley District's system located in Pike County and the acquisition of Mountain District's Mossy Bottom sewer system.⁴⁵

UMG and Pikeville agreed in the Fifth Amendment to the Management Agreement, dated February 14, 2010, that effective July 1, 2010, Pikeville would be directly responsible for paying all costs associated with maintenance and repairs, thereby reducing the annual UMG fee by the maintenance and repair limit.⁴⁶ This modification

⁴² Pikeville's responses to Commission Staff's Second Request for Information (Staff's Second Request), Items 20.a, Management Agreement and 20.b, Management Agreement Costs by Major Functions.

⁴³ *Id.*, Item 20.a, Management Agreement, page 11, paragraph 8.1.

⁴⁴ *Id.*, Amendment One to the Management Agreement.

⁴⁵ *Id.*

⁴⁶ *Id.*, Amendment Five to the Management Agreement.

reflected Pikeville's and UMG's intent to keep system maintenance and repair costs as low as possible by eliminating the 6 percent state sales tax paid on materials and supplies purchased by UMG to make the maintenance and repairs.⁴⁷

The total Management Fee Pikeville paid to UMG in Fiscal Year 2017 was \$4,341,794, of which \$1,671,185 was allocated to the water department.⁴⁸ In Fiscal Year 2017, Pikeville allocated \$1,162,040 of the annual UMG management fee and \$141,565 of the UMG repairs and maintenance costs to inside-the-city accounts.⁴⁹

According to Pikeville, there was a joint effort between UMG and Pikeville administrators to develop the departmental allocations when the UMG contractual management relationship was initiated.⁵⁰ Pikeville claims that the initial allocation to inside-city water has only been increased by the overall percentage increase and that the expense allocations to the inside-city water system has not increased for unrelated changes in the scope of UMG's work (i.e.; additional employees to clean litter along roads and city streets).⁵¹

Pikeville provided the following four explanations as to why the allocation of the UMG management fee to the inside-the-city water system is reasonable.

1. The Management Agreement between Pikeville and UMG is the result of an arms-length transaction between two independent parties. In prior decisions the

⁴⁷ *Id.*

⁴⁸ Pikeville's responses to Staff's Post-Hearing Request, Item 5.

⁴⁹ Post-Hearing Brief of Pikeville (Pikeville's Brief) page 6.

⁵⁰ Pikeville's Brief, Pages 6-7.

⁵¹ *Id.*, Page 7.

Commission has held that contracts negotiated at arms-length deserve a presumption of reasonableness. In Case No. 2002-00022,⁵² the Commission found that Pikeville's decision to contract for the operation and maintenance of its water system is a management decision that is presumed to be reasonable. The Commission further found that, "[t]he burden of overcoming the presumption of managerial good faith falls on the party challenging it."⁵³

2. UMG's calculation of the expenses it incurred in Fiscal Year 2017 to operate Pikeville's water department are remarkably close to the Management Fee that was allocated to Pikeville's water department. UMG's breakdown of expenses related to providing operational and management services to Pikeville's water department totaled \$1,670,884, while the management fee allocated to the water department was \$1,671,185. The difference between the expenses UMG actually incurred and the management fee allocation is \$301.⁵⁴

3. A comparison of Pikeville's water department expenses with the expenses identified in annual reports of twenty utilities regulated by the Commission demonstrates that Pikeville's expenses related to the services provided by UMG are reasonable. A comparison based on consumption reveals that only one out of the twenty regulated water utilities has a lower cost per thousand gallons.⁵⁵

⁵² Case No. 2002-00022, *Proposed Adjustment of Wholesale Water Service Rates of the City of Pikeville, Kentucky* (Ky. PSC Oct. 18, 2002).

⁵³ Pikeville's Brief, Page 7, quoting, Case No. 2002-00022, *Proposed Adjustment of Wholesale Water Service Rates of the City of Pikeville, Kentucky* (Ky. PSC Oct. 18, 2002) at 8

⁵⁴ *Id.* Pages 7-8.

⁵⁵ *Id.* Page 8.

4. Pikeville performed an expense per customer comparison using four other utilities that produce nearly all of their own water and have more than 40 percent of water consumption to wholesale customers. Pikeville's comparison revealed that Pikeville's UMG expenses fell within the middle of the comparative utilities' expenses and that Pikeville's expense for each of the three factors used was below the median cost per customer of each of the four utilities.⁵⁶

Pikeville concluded that there is no valid reason for the Commission to deviate from its long-standing policy that arms-length transactions are presumed to be reasonable.⁵⁷ In the absence of a presumption of reasonableness, Pikeville argues that it has provided quantifiable data to show that the expense allocation of the UMG management fee to the water department is reasonable.⁵⁸

Mountain District argues that Pikeville has not presented any evidence to show that its UMG contract was either bid or cost-effective.⁵⁹ Mountain District notes that Pikeville was unable to produce any memoranda, correspondence, or other documents showing that Pikeville had analyzed, reviewed, or discussed its contract negotiations with UMG.⁶⁰ This failure, according to Mountain District, places the burden upon the Commission and Mountain District to show that the presumptively reasonable UMG management fees are unreasonable - a difficult if not impossible proposition.⁶¹

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ Post-Hearing Brief of Mountain District (Mountain District's Brief) page 21.

⁶⁰ *Id.*

⁶¹ *Id.* at 22.

Mountain District explains that in Pikeville's comparative analysis, it simply listed the revenues and expenses of several regulated water systems, without providing evidence showing the correlation or the relevance to the UMG expenses allocated to Pikeville's water division.⁶² Mountain District notes that even the information that has been provided for the UMG operational expenses is unaudited.⁶³ According to Mountain District, the evidence shows that UMG simply bills Pikeville and that Pikeville unquestionably accepts any increase to the UMG annual management fee that is due to either increases in the Consumer Price Index or operational changes.⁶⁴ Mountain District stated that Pikeville did not present any evidence supporting the methodology that is used to allocate the UMG management fee to each of Pikeville's city departments.⁶⁵ According to Mountain District, Pikeville's defense is that it requested evidence to support the allocations from UMG, but UMG had not provided the requested information to Pikeville.⁶⁶

Mountain District contends that the UMG management fee cannot be verified at any level and that verification becomes moot and the Commission's oversight is relegated to a determination of the reasonableness of the total level of operating expense, but not the level of any specific expense category.⁶⁷ While this arrangement would simplify the

⁶² *Id.* at 23.

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.* at 24.

utility's filing requirements, Mountain District claims that it would stifle the Commission's traditional review of known and measurable revenues and expenses.⁶⁸

In Pikeville's last fully-litigated rate case⁶⁹ before the Commission, Mountain District raised the same objections to Pikeville's management contract with Professional Services Group (PSG) as it has raised in this current proceeding with the UMG Management Agreement.⁷⁰ In that proceeding the Commission rejected Mountain District's objections finding that:

Hindsight cannot be used in evaluating the prudence of management's actions. Management must be judged on what was known or should have been known at the time of its decision. The burden of overcoming the presumption of managerial good faith falls on the party challenging it. Once this burden is met, however, management must demonstrate that its actions were reasonable and prudent.⁷¹

The Commission also found no merit to Mountain District's contention that the lack of individual cost components for each management service provided to Pikeville from PSG rendered the lump sum management fee unreasonable or unfit for rate recovery. In

⁶⁸ *Id.*

⁶⁹ Case No. 2002-00022, *Proposed Adjustment of Wholesale Water Service Rates of the City of Pikeville, Kentucky* (Ky. PSC Oct. 18, 2002).

⁷⁰ *Id.* at 8-9. First, Mountain District contends that Pikeville has failed to demonstrate that its decision to enter a management services contract with PSG or that the provisions of that contract with PSG are reasonable. Second, Mountain District contends that Pikeville has not identified the individual components of the contract or presented any evidentiary support of the actual costs of the services that PSG provides. Finally, Mountain District contends that, by contracting for the management services, Pikeville seeks to circumvent the regulatory review of its operations by presenting the Commission with a *fait accompli*.

⁷¹ Case No. 2002-00022, *Proposed Adjustment of Wholesale Water Service Rates of the City of Pikeville, Kentucky* (Ky. PSC Oct. 18, 2002) at 9. (Internal citations omitted.)

its decision the Commission noted that Pikeville's payments are the result of an arms-length transaction and that they were documented by separate invoices.

Pikeville's contractual arrangement with UMG, in which the annual management fee is not broken down into its separate cost components is not uncommon. In Case No. 2017-00338, the Commission found that the annual management fee U. S. 60 Water District of Shelby and Franklin Counties paid to North Shelby Water Company was reasonable.⁷² In Case No. 2018-00429 the Commission found reasonable the \$890,730 annual management fee Graves County Water District paid to Mayfield Electric and Water Systems pursuant to an operational agreement.⁷³ In both cases the managing company did not provide the Commission or its Staff a breakdown of the contract fee into its individual cost components.

The Commission finds little merit in the arguments presented by Mountain District, and accordingly, finds that the present management services agreement between UMG and Pikeville to be reasonable.

In fiscal year ending June 30, 1997, Pikeville paid to PSG an annual fee of \$1,242,026 for the management of its water department. The management fee that Pikeville paid to UMG in the test year is \$1,671,185. In the 20 years since Case No. 2002-00022, Pikeville's management fee has increased by \$429,159, for an average

⁷² Case No. 2017-00388, *Electronic Application of U.S. 60 Water District of Shelby and Franklin Counties for an Alternative Rate Adjustment* (Ky. PSC Staff Report issued Feb. 8, 2018; Final Order issued Mar. 21, 2018) Staff's finding page 7 of its report; The Commission ordered that: The findings contained in the Staff Report are adopted and incorporated by reference into this Order as if fully set out herein.

⁷³ Case No. 2018-00429, *Application of Graves County Water District for an Alternative Rate Adjustment* (Ky. PSC Staff Report issued June 10, 2019; Final Order issued Aug. 30, 2019) Staff's finding page 10 of its report; The Commission ordered that: The findings contained in the Staff Report are adopted and incorporated by reference into this Order as if fully set out herein.

annual increase of \$21,458, or 1.73 percent per year. For comparison the average Consumer Price Index (CPI) for the same period of 1997 through 2017 is 2.15 percent,⁷⁴ as calculated below. Based on the CPI comparison, the Commission has determined that the total allocation of UMG management fee to the water department is reasonable.

Year	CPI
1997	2.30%
1998	1.60%
1999	2.20%
2000	3.40%
2001	2.80%
2002	1.60%
2003	2.30%
2004	2.70%
2005	3.40%
2006	3.20%
2007	2.80%
2008	3.80%
2009	-0.40%
2010	1.60%
2011	3.20%
2012	2.10%
2013	1.50%
2014	1.60%
2015	0.10%
2016	1.30%
2017	2.10%
Average CPI	2.15%

UMG Services

In its Fiscal Year 2017 Trial Balance, Pikeville reported a UMG service expense of \$141, 565, which represents reimbursements Pikeville made to UMG for maintenance supplies.⁷⁵ Upon its review of the general ledger, the Commission notes that Pikeville recorded as an expense \$23,091 of capital expenditures that would be used solely to

⁷⁴ <https://www.statista.com/statistics/191077/inflation-rate-in-the-usa-since-1990>.

⁷⁵ Pikeville's responses to the Commission's June 10, 2019 Order, Item 10.

provide service to its retail customers. Accordingly, UMG service expense is being reduced by \$23,091 to eliminate the capital expenditures that should not be recovered from the wholesale water customers with no corresponding adjustment to depreciation.

Repairs and Maintenance

In its Fiscal Year 2017 Trial Balance, Pikeville reported a repair and maintenance plant expense of \$139,077.⁷⁶ For ratemaking purposes, costs classified as nonrecurring are removed from a utility's operating expenses and are amortized over their estimated useful life. We find that repairs and maintenance expense should be decreased by \$99,506⁷⁷ to eliminate for ratemaking purposes the costs that the Commission classifies as nonrecurring. Operating expenses are being increased by \$4,417⁷⁸ to reflect amortizing the nonrecurring costs over 15-years and allocating 33.423 percent of the amortization expense to the outside city water system.

Pikeville also recorded as an expense \$29,836 of capital expenditures (i.e.; meters, meter vaults, etc.) that were used solely to provide service to its retail customers. Accordingly, repairs and maintenance expense is being reduced by \$29,836 to eliminate the capital expenditures that should not be recovered from the wholesale water customers, with no corresponding adjustment to depreciation. The total reduction to repairs and maintenance expense found reasonable in this discussion is \$129,342.⁷⁹

⁷⁶ Pikeville's responses to the Commission's June 10, 2019 Order, Item 10.

⁷⁷ \$11,006 (Telemetry Repairs at Toller Tank) + \$88,500 (Rehabilitation of Bob Atmos Storage Tank) = \$99,506.

⁷⁸ \$99,506 (Telemetry Repairs and Water Tank Rehabilitation) ÷ 15 (Years) = \$6,634 x 33.423% (Outside City Allocation Factor) = \$2,217. \$6,634 (Total Amortization) - \$2,217 (Outside System Allocation) = \$4,417.

⁷⁹ \$99,506 (Telemetry Repairs and Water Tank Rehabilitation) + \$29,836 (Capital Expenditures) = \$129,342.

Repairs and Maintenance Plant

In its Fiscal Year 2017 Trial Balance, Pikeville reported a repair and maintenance plant expense of \$30,632.⁸⁰ In its review of the general ledger, Commission Staff discovered that Pikeville had expensed the repair of a high service pump that cost \$24,264. We find that repairs and maintenance plant expense should be decreased by \$24,264 to eliminate the repair cost that the Commission classifies as nonrecurring for ratemaking purposes. Operating expenses are being increased by \$1,077⁸¹ to reflect amortizing the nonrecurring cost over 15-years and allocating 33.423 percent of the amortization expense to the outside city water system.

Combining the amortization of the nonrecurring costs results in a pro forma adjustment of \$8,252. Reallocating based upon the outside city allocation factor results in a pro forma adjustment of \$5,494.⁸²

Depreciation

Pikeville reported test-year depreciation expense of \$414,518.⁸³ To evaluate the reasonableness of the depreciation practices of small water utilities, the Commission has historically relied upon the report published in 1979 by the National Association of Regulatory Utility Commissioners (NARUC) titled Depreciation Practices for Small Water Utilities (NARUC Study). When no evidence exists to support a specific life that is inside

⁸⁰ Pikeville's responses to the Commission's June 10, 2019 Order, Item 10.

⁸¹ $\$24,264$ (High Service Pump Repair) \div 15 (Years) = $\$1,618$ x 33.423% (Outside City Allocation Factor) = $\$541$. $\$1,618$ (Total Amortization) - $\$541$ (Outside System Allocation) = $\$1,077$.

⁸² $\$4,417$ (Telemetry Repairs & Water Tank Rehabilitation) + $\$1,077$ (High Service Pump Repair) = $\$5,494$.

⁸³ *Id.*

or outside of the NARUC ranges, the Commission has historically used the mid-point of the NARUC ranges to depreciate utility plant.

Pikeville has not presented any supporting analysis or study to show that its depreciation lives are appropriate.⁸⁴ The Commission finds that Pikeville's test-year depreciation expense should be decreased by \$5,093⁸⁵ to reflect depreciating all of Pikeville's utility plant, including post-test-year plant, over the NARUC depreciation lives.

In its responses to Commission Staff's interrogatories, Pikeville did not specify that any of its inside-the-city water system plant depreciation was allocated to the outside-the-city system.⁸⁶ Upon review of Pikeville's depreciation schedules for both the inside-the-city and outside-the-city systems, the Commission confirmed that Pikeville did not allocate depreciation expenses between the two systems. Mr. Petty explained that in his review of the depreciation schedules for the inside-the-city and outside-the-city systems he was unable to identify detailed plant descriptions or the location of each plant item.⁸⁷ Furthermore, without the inside-the-city infrastructure (i.e.; treatment plant, transmission and distribution mains, pumping equipment, storage tanks, etc.) Pikeville would be unable to provide adequate service to its outside-the-city system. The Commission is decreasing depreciation expense by \$136,842⁸⁸ to reflect allocating 33.423 percent of the inside-the-city system depreciation expense to the outside-the-city water system.

⁸⁴ Pikeville's responses to Staff's Third Request, Item 9.

⁸⁵ Pikeville's responses to Staff's Second Request, Item 19.a.

⁸⁶ Pikeville's responses to the Commission's June 10, 2019 Order, Item 8.

⁸⁷ VHT at 3:19:01-3:22:18.

⁸⁸ $\$414,518 - \$5,093 = \$409,425$ (Pro Forma Depreciation) \times 33.423% (Outside City Allocation Factor) = \$136,842.

Summary Impact of Adjustments

After considering the test-year operating revenues and expenses, including appropriate adjustments found reasonable herein, the Commission has determined that the financial results of Pikeville's pro forma test-year operations would be as follows:⁸⁹

	Fiscal Year Ending 06/30/17	Pro Forma Adjustments	Pro Forma Operations
Operating Revenues	\$ 2,452,736	\$ (186,014)	\$ 2,266,722
Operating Expenses	2,429,546	(729,956)	1,699,590
Non Utility Operating Income	<u>\$ 23,190</u>	<u>\$ 543,942</u>	<u>\$ 567,132</u>

REVENUE REQUIREMENT

The Commission has historically applied a DSC method to calculate the Overall Revenue Requirement of water districts, water associations, and municipal-owned water utilities. This method allows for recovery of 1) cash-related pro forma operating expenses; 2) recovery of depreciation expense, a non-cash item, to provide working capital; 3) the average annual principal and interest payments on all long-term debts, and 4) working capital that is in addition to depreciation expense.

The Commission's calculation of the Revenue Requirement to be allocated between Pikeville and the wholesale customers is shown in the table below.

⁸⁹ See Appendix A for a detailed summary of this table.

Operation & Maintenance	\$ 1,421,513
Depreciation	272,583
Amortization	<u>5,494</u>
Pro Forma Operating Expenses	1,699,590
Plus: Average Annual Debt Principal and Interest Payments	116,499
Debt Coverage Requirement	<u>23,300</u>
Total Revenue Requirement	1,839,389
Less: Other Operating Revenue	<u>(60,384)</u>
Revenue Required from Rates	<u>\$ 1,779,005</u>

Average Annual Principal and Interest Payments. In calculating its revenue requirement, Pikeville used the Fiscal Year 2017 debt service of \$205,351 and calculated a debt service coverage of \$48,814.⁹⁰ At the close of Fiscal Year 2017, Pikeville reported the following three outstanding debt issuances: (1) General Obligation Series 2012C Bonds (Series 2012C Bonds); (2) United States Department of Agriculture (USDA) Series 2016A Bonds (Series 2016A Bonds); and (3) General Obligation Series 2017 Bonds (Series 2017 Bonds).⁹¹

Series 2012C Bonds. Pikeville explained that the purpose of this debt issuance was to refinance a debt that was issued in 2004, which was issued to refinance a debt that was originally issued in 1985.⁹² According to Pikeville, the following description was given for the purpose of the 1985 bond ordinance:

Whereas the portion of the system constituting the present water treatment plant facilities and appurtenances is inadequate to service the present and future needs; in order to aid in financing the construction and installation of major improvements and additions to such water treatment plant facilities and appurtenances; and proceeds thereof to be

⁹⁰ Pikeville's responses to Staff's Second Request, Item 16.c.

⁹¹ Pikeville's responses to the Commission's June 10, 2019 Order, Item 5.c.

⁹² Pikeville's responses to Staff's Third Request, Item 4.

applied to the construction and installation of certain waterworks improvements and additions.⁹³

Given the original purpose of the 1985 debt issuance, the Commission finds that 66.577 percent of the debt service for the Series 2012C Bonds should be assigned to the inside-the-city water system. The following schedule is the comparison of the three-year average debt service calculation for the total and allocated debt service for the Series 2012C Bonds.

Year	Total Debt Service	Inside City Allocation
2019	\$ 151,962	\$ 101,172
2020	\$ 149,162	\$ 99,308
2021	\$ 151,131	\$ 100,618
3-Year Avg.	\$ 150,752	\$ 100,366

Series 2016A Bonds. According to Pikeville, the proceeds of the Series 2016A Bonds was used to construct water and sewer services to the Kentucky Enterprise Industrial Park.⁹⁴ Pikeville states that the total cost of the Marion's Branch Water Sewer Project was \$4,743,496, of which \$3,813,633, or 80 percent, was for the water department and the remaining \$929,863, or 20 percent, was sewer-related. In their responses to Post-Hearing Requests for Information, Pikeville provided the engineering report for the Kentucky Enterprise Industrial Park project (Engineering Report)⁹⁵ and Mountain District provided a copy of Resolution 15-05-007, Authorization to Approve

⁹³ *Id.*

⁹⁴ Pikeville's responses to the Commission's June 10, 2019 Order, Item 5.c.

⁹⁵ Pikeville's responses to Staff's Post-Hearing Request, Item 10.

Letter of Support for the Marions Branch Water Line Extension Project (Mountain District Resolution).⁹⁶

Upon review of the Engineering Report and the Mountain District Resolution, the Commission determines, as shown in the calculation in Appendix B, that only 16.833 percent of the Series 2016A Bonds debt service should be included in the revenue requirement calculation. The following schedule is the comparison of the three-year average debt service calculation for the total and allocated debt service for the Series 2016A Bonds.

Year	Total Debt Service	Allocation
2019	\$ 95,270	\$ 16,084
2020	\$ 95,565	\$ 16,134
2021	\$ 95,834	\$ 16,180
3-Year Avg.	\$ 95,556	\$ 16,133

Series 2017 Bonds. Pikeville states that it used the proceeds of the Series 2017 Bonds to purchase and install radio read meters throughout the water system, to fund improvements at the athletic field, and to fund a wastewater treatment plant upgrade.⁹⁷ Given the stated purpose of the Series 2017 Bonds the Commission finds that the debt service for this issuance should not be included in its determination of Pikeville’s revenue requirement.

Three-Year Average Debt Service. The schedule below is the calculation of the three-year average debt service the Commission used in its revenue requirement determination.

⁹⁶ Mountain District’s responses to Pikeville’s Post Hearing Request.

⁹⁷ Pikeville's responses to the Commission’s June 10, 2019 Order, Item 5.c.

<u>Year</u>	<u>Series 2012C</u>	<u>Series 2016A</u>	<u>Series 2017</u>	<u>Total</u>
2019	\$ 101,172	\$ 16,084	\$ -	\$ 117,256
2020	\$ 99,308	\$ 16,134	\$ -	\$ 115,442
2021	\$ 100,618	\$ 16,180	\$ -	\$ 116,798
3-Year Average	\$ 100,366	\$ 16,133	\$ -	\$ 116,499

Rate Study

Pikeville had a two-step rate design, consisting of volumetric rates of \$1.68 per 1,000 gallons for the first 28,000,000 gallons purchased and \$1.30 per 1,000 gallons for purchases above 28,000,000 gallons.⁹⁸ Pikeville's proposal is to increase its volumetric rate for all water purchased by Mountain District to \$2.30 per 1,000 gallons. Pikeville's rate study follows the methodology discussed in the AWWA M54 Manual, *Developing Rates for Small Systems* (AWWA M54 Manual), but its requested revenue requirement is based on the DSC method.⁹⁹

According to Pikeville the AWWA M1 Manual describes the methodology that a water utility should follow to perform a Cost-of-Service Study (COSS) and also lists the customer demand data that is necessary to accurately calculate the cost of providing service to the different customer classifications.¹⁰⁰ Pikeville claims that it does not have the individual customer peak-day or peak-hour demands as required by the AWWA M1

⁹⁸ Pikeville's responses to the Commission's June 10, 2019 Order, Item 1, Elswick Testimony, Page 3.

⁹⁹ *Id.*, Pages 2-3.

¹⁰⁰ Pikeville's Brief, page 10.

Manual.¹⁰¹ Therefore, Pikeville performed a rate study following the AWWA M54 Manual, a methodology that does not require data on peak consumption.¹⁰²

Pikeville hired Samuel R. “Buddy” Petty, President of RateStudies, LLC. to prepare a comprehensive rate study.¹⁰³ According to Pikeville, Mr. Petty engaged staff from Pikeville and UMG to determine the most appropriate allocation factors for various expense categories using a collaborative process.¹⁰⁴ At the hearing Mr. Petty acknowledged that he did not obtain any records from Pikeville that would allow him to determine the appropriate allocation factors for the various expenses.¹⁰⁵ Pikeville claims that this lack of documentation does not impact the accuracy of the work that was originally performed and that the accuracy of most of the assignments can be determined at face value.¹⁰⁶

Pikeville argues that ultimately, Mr. Petty’s rate analysis is the only one presented in this case and although Pikeville was unable to produce peak-hour and peak-day demand information to produce a study based on AWWA’s M1 Manual, Mr. Petty was able to process the information that he was given and prepare – in his expert opinion – reasonable and reliable allocation factors.¹⁰⁷

¹⁰¹ *Id.*, pages 10-11.

¹⁰² Pikeville’s responses to the Commission’s June 10, 2019 Order, Item 1, Direct Testimony of Samuel R. Petty (Petty Testimony), page 2

¹⁰³ *Id.*, pages 1-2.

¹⁰⁴ Pikeville’s Brief, page 11.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*, Page 12.

According to Mountain District, the burden is upon the applicant utility to show that a proposed increase in a rate or charge is just and reasonable.¹⁰⁸ Mountain District asserts that Pikeville's application fails to comply with the Commission's "known and measurable" ratemaking standard and that the data relied on by Pikeville is not verifiable or accurate.¹⁰⁹ Mountain District contends that it is up to Pikeville to justify its allocations and that it is not the responsibility of the Commission or Mountain District to formulate an allocation method.¹¹⁰ Mountain District agrees with Vice Chairman Cicero's statement at the hearing, "the burden is on Pikeville and without verification of the methodology, there is no way to allocate costs among the classes of users."¹¹¹

Mountain District points to the Commission's decision in Case No. 1990-00019, wherein the Commission made the following finding when rejecting Hardin County Water District No. 1's (Hardin County District No. 1) COSS:¹¹²

The Commission finds the record to be devoid of any evidence to support the reliability of this study. Its sponsor was unable to explain why various inputs or allocation factors were used. He was unfamiliar with accepted authorities on rate design and the basic principles to develop a cost-of-service study. He did not collect the data used for the study nor was he able to explain how it was collected.

None of Hardin District No. 1's other witnesses, furthermore, could explain the source of the data used in the cost-of-service study or why the Water District had ordered the

¹⁰⁸ Mountain District Brief page 6.

¹⁰⁹ *Id.* at 6-7.

¹¹⁰ *Id.* at 7.

¹¹¹ *Id.*, HTV 11:14:48.

¹¹² Mountain District Brief at 8, *quoting*, Case No. 1990-00019, *Petition of Hardin County Water District No. 1*, (PSC Ky. Feb. 21, 1991) ay 3.

study's preparer to use certain inputs and cost allocation factors.

Utility rates should not be based on a hunch and a prayer. The proponent of rates should be able to explain how its rate proposal was derived. Hardin District No. 1 cannot. Unable to assess the accuracy or reliability of the cost-of-service study, the Commission has no choice but to disregard it.¹¹³

In Hardin District's next rate case, the Commission was unable to verify the accurateness of Hardin District's COSS because Hardin District was unable to produce its accounting workpapers that supported its allocations. The Commission found that an accurate COSS cannot be prepared when the utility cannot determine the components of an expense category.

In Case No. 2002-00022, Pikeville presented a COSS that it described as a fully allocated COSS, which was loosely based on the generally recognized commodity-demand method.¹¹⁴ In that proceeding the Commission found numerous flaws with Pikeville's proposed COSS and little evidence in the record to support the majority of Pikeville's under lying assumptions.¹¹⁵ For these reasons the Commission ultimately rejected Pikeville's proposed COSS and accepted Mountain District's modified inch mile method.¹¹⁶

¹¹³ See Case No. 90-019, *In the Matter of the Petition of the Hardin County Water District No.1 for a Certificate of Convenience and Necessity; Approval of Financing of the Construction and the Issuance of Bonds; and the Approval of Rates to be Charged its Retail and Wholesale Customers* (Ky. PSC Feb. 21, 1991) at 20-21.

¹¹⁴ See Case No. 2002-00022, *Proposed Adjustment of Wholesale Water Service Rates of the City of Pikeville, Kentucky* (Ky. PSC Oct. 18, 2002) at 31.

¹¹⁵ *Id.* at 31-36.

¹¹⁶ *Id.* at 36.

When responding to interrogatories concerning the calculations of the COSS allocation percentages, Pikeville explained that the allocations were the product of a collaborative effort between Mr. Petty and the following Pikeville representatives: Grondall Potter, Philp Elswick, Tonya Taylor, Brad Slone, Donnie Slone, Robbie Bentley, and Rebecca Hamilton (COSS Team).¹¹⁷ According to Mr. Petty this collaborative effort involved the COSS Team discussing each individual item (expense) that was listed on a spreadsheet and agreeing as a group as to how each cost would ultimately be allocated in the COSS. The COSS Team did not memorialize the discussions or maintain records to support the calculation of each expense allocation.

Mr. Petty agreed that the expense allocations used in his rate study cannot be objectively quantified or proven. The rate study allocations were developed by using the system knowledge and experience of each COSS Team member rather than documented empirical data. Pikeville's position that the accuracy of most of the assignments can be determined at face value fails to comply with the Commission's long-held ratemaking standard of known and measurable.

The Commission reaffirms its position in Case No. 90-019, that utility rates should not be based on a hunch and a prayer, which Pikeville is attempting to accomplish with its proposed rate study. Given the lack of supporting evidence, the Commission finds that Pikeville has failed to meet its burden of proof that its rate study produces a fair, just, and reasonable wholesale water rate, and therefore, Pikeville's proposed rate study should be rejected.

¹¹⁷ Pikeville's responses to Mountain District's First Request for Information, Item 10.

In the absence of an accepted rate study, the Commission is allocating a portion of the revenue requirement calculated herein using the ratio of wholesale water sales in gallons to total system sales in gallons for Fiscal Year 2017. In calculating a fair, just, and reasonable wholesale rate, the Commission finds that Pikeville should charge the same wholesale rate to both of its wholesale customers, Mountain District and Southern District. Accordingly, 68.7 percent or \$1,806,074 of the revenue requirement is being allocated to the wholesale customers, resulting in a wholesale rate of \$1.97 per 1,000 gallons, as calculated below:

Wholesale Water Sales - Gallons	619,140,000
Divide by: Total Inside Water Sales	<u>900,812,417</u>
% of Wholesale water Sales	68.7%
Multiplied by: Revenue Requirement	<u>1,779,005</u>
Allocated Revenue Requirement to Wholesale Rate	1,222,176
Divided by: Wholesale Water Sales	<u>619,140.000</u>
Wholesale Water Rate per 1,000 Gallons	<u>\$ 1.97</u>

Rate Case Expenses

A utility may properly recover reasonable rate case expenses as a cost of doing business.¹¹⁸ The Commission has generally permitted rate recovery of a reasonable level of rate case expenses but has disallowed such expenses when a utility has failed to provide adequate documentary evidence of the incurrence of the expense.¹¹⁹ The Commission has also disallowed such expenses as unreasonable when related to a

¹¹⁸ See *Driscoll v. Edison Light & Power Co.*, 307 U.S. 104, 120 (1939).

¹¹⁹ Case No. 2008-00250, *Proposed Adjustment of the Wholesale Water Service Rates of Frankfort Electric and Water Plant Board* (Ky. PSC Apr. 6, 2009).

poorly or improperly prepared rate application¹²⁰ and in cases where the utility failed to justify the high level of expenses for relatively simple alternative rate filings.¹²¹

In its February 21, 2019 tariff filing, Pikeville proposed a rate case expense surcharge mechanism. The filing proposed to assess a surcharge over 36 months to recover any rate case expenses it may incur to participate in and defend its proposed rates. In the tariff filing, Pikeville used rate case expenses totaling \$115,200¹²² as demonstrative of its proposed methodology.

In Case No. 2009-00373, *Proposed Adjustment of the Wholesale Service Rates of Hopkinsville Water Environment Authority*, the Commission analyzed whether the special counsel fees were part of reasonable rate case expenses and capped the rate case expense.¹²³ The Commission evaluates the prudence of rate case expense on a case-by-case basis.¹²⁴ In the Hopkinsville case, the Commission allocated the cost of performing a COSS because it related to all the customers and reduced the special counsel fees that were related to the COSS because it was performed after the application and not used to develop the proposed rates at issue. The high level of rate case expense compared to the complexity of the issues, and the level of rate case expenses for similar

¹²⁰ Case No. 8783, *Application of Third Street Sanitation, Inc. for an Adjustment of Rates Pursuant to the Alternative Procedural for Small Utilities* (Ky. PSC Nov. 14, 1983).

¹²¹ Case No. 9127, *Application of Sargent and Sturgeon Builders, Inc., Gardenside Subdivision Sewer Division, for a Rate Adjustment Pursuant to the Alternative Rate Filing for Small Utilities* (Ky. PSC Mar. 25, 1985).

¹²² \$3,200 (Monthly Surcharge) x 36-Months = \$115,200.

¹²³ Case No.2009-00373, *Proposed Adjustment of the Wholesale service Rates of Hopkinsville Water Environment Authority* (Ky. PSC July 2, 2010).

¹²⁴ *Id.* at 5–6.

cases, were factors the Commission reviewed in finding that Hopkinsville's expense related to special counsel fees should be limited to \$50,000.¹²⁵

Pikeville provided copies of invoices showing that actual costs incurred in conjunction with this rate case was \$85,814, plus an additional estimated \$3,675 for additional legal work to be performed through the final order in this case, for a grand total of \$89,489.¹²⁶

Pikeville hired Mr. Petty to prepare a comprehensive rate study in order to establish a wholesale rate for Mountain District. The Commission discovered the following deficiencies in Mr. Petty's rate study: (1) the failure to retain written records to record the COSS Team discussions or to support the calculation of the expense allocations that the COSS Team developed; (2) the expense allocations used in his rate study cannot be objectively quantified or proven; and (3) the rate study fails to comply with the Commission's long-held ratemaking standard of known and measurable. For these reasons the Commission finds that the cost of the rate analysis should not be recovered by Pikeville through the rate case surcharge.

Pikeville has proposed to assess a surcharge over 36 months to recover any rate case expenses it may incur to participate in and defend its proposed rates. However, when there is no evidence to support an alternative amortization period, the Commission amortizes an intangible regulatory asset or liability identified in a rate proceeding over the

¹²⁵ *Id.* at 9–13.

¹²⁶ Pikeville's September 20, 2019, supplemental responses to Staff's Second Request, Item 34. \$, page 13. \$64,394 (Attorney Fees) + \$25,095 (Consulting Fees) \$89,448.

anticipated life of the utility rates approved in that proceeding.¹²⁷ The life is generally based on the frequency of the utility's historic rate filings. Pikeville last increased Mountain District's wholesale rate in 2009, making the frequency of wholesale rate increase ten years. This evidence suggests that a ten-year amortization period may be appropriate; however, it is the Commission's opinion that the rates approved in this proceeding will become obsolete after five years due to changes that will likely occur to Pikeville's cost of providing wholesale water service. Accordingly, absent a more reasonable amortization period, the Commission is allowing Pikeville to recover its allowable rate case expense of \$64,394 over 60-months. The 60-month surcharge that Pikeville is authorized to charge Mountain District and Southern District is \$537 per month.¹²⁸

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

1. The rates proposed by Pikeville would produce revenues in excess of the revenues found reasonable herein and should be denied.
2. Pikeville should be permitted to recover \$64,394 for rate case expenses related to legal fees.
3. The rates set forth in the Appendix C to this Order are fair, just, and reasonable and should be approved for the provision of wholesale water service to Pikeville for services rendered on and after September 5, 2019.

¹²⁷ Case No. 2013-00314, *Alternative Rate Adjustment Filing of Par-Tee LLC Db a Perry Park Resort Sewer Utility* (Ky. PSC Staff Report issued Dec. 6, 2013; Final Order issued Feb. 19, 2014) Staff's finding pages 13-14 of its report; The Commission ordered that: The findings contained in the Staff Report are adopted and incorporated by reference into this Order as if fully set out herein.

¹²⁸ \$64,394 (Attorney Fees) ÷ 60 (Months) = \$1,073 ÷ 2 (Wholesale Customers) = \$537 (Monthly Rate Case Expense Surcharge).

4. Pikeville District should be authorized to assess a monthly surcharge of \$537 each to Mountain District and Southern District for a period of 60 months to recover \$64,394 for rate case expenses.

5. Within 30 days of the date of this Order, Pikeville should file with the Commission a report on the amount of excess revenues collected from September 5, 2019, through the date of this Order and a plan for refunding these revenues. This report shall include interest for the period the excess revenues were collected at the average of the Three-Month Commercial Paper Rate as reported in the Federal Reserve Bulletin and the Federal Reserve Statistical Release. Pikeville shall include in its report its plan to refund the excess revenues collected and the associated interest within 60 days of the date of this order, as required by KRS 278.190(4).

6. Pikeville should file a revised tariff setting out these rates as approved and remove language pertaining to the possibility of a refund if a lower rate is determined from its tariff.

IT IS THEREFORE ORDERED that:

1. The wholesale rates proposed by Pikeville are denied.

2. The rates and charges found reasonable herein and set forth in Appendix C to this Order are approved for the provision of wholesale water service rendered by Pikeville to Mountain District and Southern District on and after September 5, 2019.

3. Within 30 days of the date of this Order, Pikeville shall file with the Commission a report on the amount of excess revenues collected from September 5, 2019, through the date of this Order and a plan for refunding these revenues. This report shall include interest for the period the excess revenues were collected at the average of

the Three-Month Commercial Paper Rate as reported in the Federal Reserve Bulletin and the Federal Reserve Statistical Release. Pikeville shall include in its report its plan to refund the excess revenues collected and the associated interest within 60 days of the date of this order, as required by KRS 278.190(4).

4. Within 20 days of the date of this Order, Pikeville shall file with this Commission, using the Commission's electronic Tariff Filing System, revised tariff sheets setting out the rates approved herein and reflecting that they were approved pursuant to this Order.

5. Any documents filed pursuant to ordering paragraph No. 3 and 4 of this Order shall reference the case number of this matter and shall be retained in the utility's general correspondence files.

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

By the Commission

ENTERED
DEC 19 2019
KENTUCKY PUBLIC
SERVICE COMMISSION

ATTEST:


Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2019-00080 DATED **DEC 19 2019**

Pro Forma Income Statement

	Fiscal Year Ending 06/30/17	Pro Forma Adjustments	Administrative Rev/Exp	Reallocations	Pro Forma Operations
Operating Revenues:					
Revenues from Water Sales:					
Residential Water City	\$ 509,291				\$ 509,291
Commercial Water City	253,583				253,583
Public Authority Wt City	321,007				321,007
Multiple Family City Residential	95,725				95,725
Multiple Family Commercial	28,658				28,658
W/Wholesale District/Rev	998,074				998,074
	<u>2,206,338</u>	<u>0</u>			<u>2,206,338</u>
Metered Water Sales:					
Other Water Revenues:					
Bad Debt Recovery	290		(290)		0
Water Tap Fee	24,510		(24,510)		0
Water Penalty	10,911		(10,911)		0
Water Special Revenue	150,303	(150,303)			0
Special Revenue	47,927				47,927
Water S C	12,457				12,457
	<u>246,398</u>	<u>(150,303)</u>	<u>(35,711)</u>	<u>0</u>	<u>60,384</u>
Total Other Water Revenues					
	<u>246,398</u>	<u>(150,303)</u>	<u>(35,711)</u>	<u>0</u>	<u>60,384</u>
Total Operating Revenues	<u>2,452,736</u>	<u>(150,303)</u>	<u>(35,711)</u>	<u>0</u>	<u>2,266,722</u>
Operating Expenses:					
Operation & Maintenance Expense					
Gasoline	144,174	(144,174)			0
Bank Charges-Water Revenue	3,890		(3,883)		7
Provision For Bad Debt	1,158		(1,158)		0
Dues	850		(848)		2
Freight/Postage	1,349		(1,347)		2
Insurance	29,134			(11,663)	17,471
Office Supplies	2,489		(2,484)		5
Public Works Water - UMG MGT Fee	1,162,040		(57,997)	(49,416)	1,054,627
Prof Service Other	777		(776)		1
Ut Monthly Billing/Professional Services	3,803		(3,796)		7
Umg...Services	141,565	(23,091)		(39,598)	78,876
Rent-Easements	376		(375)		1
Purchase Software	1,845		(1,842)		3
Repairs/Maintenance	139,077	(129,342)		(3,254)	6,481
Repairs And Maintenance Plant	30,632	(24,264)		(2,128)	4,240
Telephone/Public Works	8,206	(6,129)			2,077
Electric	299,596			(46,328)	253,268
City Utilities	4,445				4,445
Workers Comp	286		(286)		0
Salaries & Wages	21,294		(21,294)		0
Employee Benefit Insurance	7,567		(7,567)		0
Pension Matching	8,719		(8,719)		0
	<u>2,013,272</u>	<u>(327,000)</u>	<u>(112,372)</u>	<u>(152,387)</u>	<u>1,421,513</u>
Operation & Maintenance Expense					
Depreciation	414,518	(5,093)		(136,842)	272,583
Amortization		8,252		(2,758)	5,494
Taxes other than Income:					
Payroll Tax	1,629		(1,629)		0
Unemployment Tax	127		(127)		0
	<u>2,429,546</u>	<u>(323,841)</u>	<u>(114,128)</u>	<u>(291,987)</u>	<u>1,699,590</u>
Utility Operating Expenses					
	<u>2,429,546</u>	<u>(323,841)</u>	<u>(114,128)</u>	<u>(291,987)</u>	<u>1,699,590</u>
Net Utility Operating Income	<u>\$ 23,190</u>	<u>\$ 173,538</u>	<u>\$ 78,417</u>	<u>\$ 291,987</u>	<u>\$ 567,132</u>

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
 COMMISSION IN CASE NO. 2019-00080 DATED **DEC 19 2019**

Allocation of 2016A Bonds

	Project Cost	Overhead Allocations		Cost Breakdown
		Factors	\$	
General	83,830	4.001%	22,995	106,825
Water Line	718,200	34.277%	196,997	915,197
Valves and Fittings	232,000	11.073%	63,639	295,639
Storage Tank	861,250	41.104%	236,232	1,097,482
Pump Station	200,000	9.545%	54,857	254,857
	2,095,280			
Overhead	574,720	100.000%	574,720	
Project Total	2,670,000			2,670,000
Storage Tank				1,097,482
Pump Station				254,857
Total				1,352,339
Multiplied by: 1/3 MWD Allocation				33.333%
Construction Cost Allocated to MWD				450,780
Percentage of Loan - Wholesale	\$	450,780 / \$	2,670,000 =	16.883%

APPENDIX C

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 2019-00080 DATED **DEC 19 2019**

The following rates and charges are prescribed for the customers in the area served by the City of Pikeville. 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.

Wholesale Water Rates
Mountain Water District and
Southern Water and Sewer District

Volume Charge per 1,000 Gallons	\$ 1.97
Rate Case Expense Surcharge for 60 Months	\$537 Per Month

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