COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF VALLEY, INC. FOR ALTERNATIVE RATE FILING ADJUSTMENT	) CASE NO.) 2011-00010

ORDER

On January 7, 2011, Valley Gas, Inc. ("Valley") tendered its application requesting the Commission approve a proposed increase in its base rates for providing natural gas service. Because of filing deficiencies, the Commission did not accept the application for filing until February 17, 2011.[1] Having performed a limited financial review of Valley's operations, Commission Staff has prepared the attached report that contains Commission Staff's findings and recommendations regarding the proposed base gas rates.

Finding that Valley should be afforded the opportunity to respond to Commission Staff's findings and recommendations, the Commission HEREBY ORDERS that:

1. All parties shall have 14 days from the date of this Order to file with the Commission written comments, if any, on the findings and recommendations contained

[1] In its application, Valley failed to comply with 807 KAR 5:076, to satisfactorily complete the application form. The Commission's Executive Director notified Valley of this failure by letter dated January 18, 2011. Valley made supplemental fillings on February 7, 2011 and February 17, 2011 to correct the filing deficiencies. On February 17, 2011, the Commission deemed Valley's application filed as of that date.

in the attached Commission Staff Report and to request a hearing or an informal conference with Commission Staff in this matter.

2. A party's failure to file with the Commission written objections to a finding or recommendation contained in the Commission Staff Report within 14 days of this Order shall be deemed as agreement with that finding or recommendation and a waiver of any right to object to that finding or recommendation.

3. Any party that requests a hearing in this matter shall specifically identify in its written request for hearing all objections to the findings and recommendations set forth in the Commission Staff Report and shall provide a brief summary of testimony that it expects to present at hearing.

4. If the Commission does not receive any written request for a hearing or for an informal conference with Commission Staff within 14 days of the date of this Order, this case shall stand submitted to the Commission for decision based upon the existing record.

By the Commission

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KENTUCKY PUBLIC
SERVICE COMMISSION

ATTEST:

Executive Director

STAFF REPORT

ON

VALLEY, INC.

CASE NO. 2011-00010

Pursuant to a request by Valley, Inc. ("Valley") for assistance with the preparation of a rate application, Commission Staff performed a limited financial review of Valley's test period operations, the calendar year ending December 31, 2008. The scope of Staff's review was limited to obtaining information as to whether the test period operating revenues and expenses were representative of normal operations. Insignificant or immaterial discrepancies were not pursued and are not addressed herein.

Mark Frost and Leah Faulkner of the Commission's Division of Financial Analysis performed the limited review. This report summarizes Staff's review and recommendations. Ms. Faulkner is responsible for the pro forma revenue adjustment, the adjustment to purchased gas, and the development of the base rates. Mr. Frost is responsible for the remaining pro forma expense adjustments and the revenue requirement determination.

Upon completion of its limited review, Valley was presented with a draft rate application containing Staff's findings and recommendations regarding Valley's operating revenues, operating expenses, revenue requirement, and base gas rates. Valley disagreed with Staff's recommendation regarding the fee that it paid to Kenneth Kasey, Valley's sole stockholder. For this reason, Valley revised Staff's proposed pro forma income statement. Appendix A to this report is Valley's proposed pro forma operating income statement. Appendix B to this report is Staff's pro forma operating income statement, and Appendix C contains an explanation of each pro forma adjustment accepted by Staff.

The Commission has historically used an operating ratio approach[2] to determine the revenue requirement for small, privately-owned utilities. This approach is used primarily when there is no basis for a rate-of-return determination or the cost of the utility has fully or largely been funded through the receipt of contributions. Staff finds that the operating ratio method should be used to determine Valley's revenue requirement. Staff further finds that an operating ratio of 88 percent will allow Valley sufficient revenues to cover its reasonable operating expenses and to provide for reasonable equity growth.

Using an 88 percent operating ratio, Valley determined that its pro forma operations support a revenue requirement from base gas rates of $236,153, which is $94,233 or 66.4 percent over Valley's normalized revenues from base gas rates of $141,920.[3] Staff's recommended pro forma operations and an operating ratio of 88 percent result in a revenue requirement from base gas rates of $165,078, an increase of $23,158 or 16.3 percent over Staff's normalized revenue from base gas rates of

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[2] Operating Ratio is defined as the ratio of expenses, including depreciation and taxes, to gross revenues.

$$\textit{Operating Ratio} = \frac{\textit{Operating Expenses + Depreciation + Taxes Other Than Income Taxes}}{\textit{Gross Revenues}}$$

[3] Application, Exhibit A, Determination of Revenue Requirement.

$141,920. Table 1 is a comparison of Valley's requested revenue requirement to the revenue requirement recommended by Staff.

Table 1: Determination of Revenue Requirement				
	Valley		Staff	
Pro Forma Operating Expenses	$	211,454	$	150,648
Divide by: Operating Ratio	÷	88%	÷	88%
Revenue to Cover Operating Ratio	$	240,289	$	171,191
Less: Operating Expenses	-	211,454	-	150,648
Net Operating Income	$	28,835	$	20,543
Multiplied by: Gross-up Factor	x	1.23839009	x	1.23839009
Net Operating Income Before Income Taxes	$	35,709	$	25,440
Add: Pro Forma Operating Expenses		211,454		150,648
Interest Expense	+	1,488	+	1,488
Total Revenue Requirement	$	248,651	$	177,576
Less: Other Operating Revenues	-	12,498	-	12,498
Revenue Requirement - Base Gas Rates	$	236,153	$	165,078
Less: Test-Period Revenue - Base Gas Rates	-	141,920	-	141,920
Requested Increase - Base Gas Rates	$	94,233	$	23,158
Percentage Increase		66.4%		16.3%

Staff's recommended revenue requirement from gas sales will allow Valley to cover its pro forma operating expenses, meet its debt service requirements, and provide for future equity growth. Because the rates proposed by Valley will produce annual revenues that are greater than the revenue requirement determined reasonable herein, Staff recommends that the Commission deny Valley's proposed rates. Staff developed its proposed base gas rates by applying the 16.3 percentage increase to operating revenues first to the existing customer charge and then rounding up to the nearest dollar, and then applying the remainder of the increase to volumetric rates. The rates contained in Appendix D will produce the revenue requirement determined reasonable of $165,078. Therefore, Staff recommends that the Commission accept those rates.

The gas cost rate in Appendix D is that approved by the Commission effective March 1, 2011.

Signatures

Mark C Frost

Prepared by: Mark C. Frost
Financial Analyst, Water and Sewer
Revenue Requirements Branch
Division of Financial Analysis

Leah Faulkner

Prepared by: Leah Faulkner
Rate Analyst, Electricity and Gas Rate
Design Branch
Division of Financial Analysis

APPENDIX A
STAFF REPORT, CASE NO. 2011-00010
VALLEY'S REQUESTED
PRO FORMA OPERATING STATEMENT

	2008	Pro Forma Adjustments	Pro Forma Operations
Operating Revenues:			
Total Gas Service Revenues	$ 518,814	$ (376,894)	$ 141,920
Forfeited Discounts	6,977	0	6,977
Miscellaneous Service Revenues	5,521	0	5,521
Total Gas Operating Revenues	$ 531,312	$ (376,894)	$ 154,418
Operating Expenses:			
Other Gas Supply Exp.			
Natural Gas City Gate Purchases	$ 382,538	$ (382,538)	$ 0
Gas Withdrawn from Storage – Cr.	(81,028)	81,028	0
Natural Gas City Gate Purchases	$ 301,510	$ (301,510)	$ 0
Distribution Expenses:			
Operation Supervision and Eng.	$ (42,758)	$ 42,758	$ 0
Mains & Service Exp.	32,229	0	32,229
Total Distribution Expenses	$ (10,529)	$ 42,758	$ 32,229
Customer Records and Collection:			
Uncollectible Accounts	$ 8,048	$ 0	$ 8,048
Administrative & General Exp:			
Administrative & General Salaries	$ 28,900	$ 0	$ 28,900
Office Supply & Exp.	19,933	0	19,933
Outside Services Employed	87,093	(15,594)	71,499
Property Insurance	14,334	0	14,334
Employee Pension & Benefits	9,720	8,886	18,606
Misc. General Exp.	711	0	711
Rents	3,225	2,775	6,000
Total Admin & Gen. Exp.	$ 163,916	$ (3,933)	$ 159,983
Total Gas Operation & Maint Exp.	$ 462,945	$ (305,443)	$ 200,260
Depreciation	4,432	0	4,432
Taxes Other Than Income Tax	38,958	(32,196)	6,762
Total Gas Operating Expenses	$ 506,335	$ (337,639)	$ 211,454
Net Operating Income	$ 24,977	$ (39,255)	$ (57,036)

APPENDIX B
STAFF REPORT, CASE NO. 2011-00010
STAFF'S RECOMMENDED
PRO FORMA OPERATING STATEMENT

	2008	Pro Forma Adjustments	Adj. Ref.	Pro Forma Operations
Operating Revenues:				
Total Gas Service Revenues	$ 518,814	$ (376,894)	(a)	$ 141,920
Other Operating Revenues:				
Forfeited Discounts	$ 6,977	$ 0		$ 6,977
Miscellaneous Service Revenues	5,521	0		5,521
Total Operating Revenues	$ 12,498	$ 0		$ 12,498
Total Gas Operating Revenues	$ 531,312	$ (376,894)		$ 154,418
Operating Expenses:				
Other Gas Supply Exp:				
Natural Gas City Gate Purchases	$ 382,538	$ (382,538)	(b)	$ 0
Gas Withdrawn from Storage - Cr.	(81,028)	81,028	(b)	0
Natural Gas City Gate Purchases	$ 301,510	$ (301,510)		$ 0
Distribution Expenses:				
Operation Supervision and Eng.	$ (42,758)	$ 42,758		$ 0
Mains & Service Exp.	32,229	0	(b)	32,229
Total Distribution Expenses	$ (10,529)	$ 42,758		$ 32,229
Customer Records and Collection:				
Uncollectible Accounts	$ 8,048	$ 0		$ 8,048
Administrative & General Exp:				
Administrative & Gen. Salaries	$ 28,900	$ 0		$ 28,900
Office Supply & Exp.	19,933	0		19,933
Outside Services Employed	87,093	(76,400)	(c)	10,693
Property Insurance	14,334	0		14,334
Employee Pension & Benefits	9,720	8,886	(d)	18,606
Misc. General Exp.	711	0		711
Rents	3,225	2,775	(e)	6,000
Total Admin & Gen. Exp.	$ 163,916	$ (64,739)		$ 99,177
Total Gas Op. & Maint Exp.	$ 462,945	$ (366,249)		$ 139,454
Depreciation	4,432	0		4,432
Taxes Other Than Income Tax	38,958	(32,196)	(f)	6,762
Total Gas Operating Expenses	$ 506,335	$ (398,445)		$ 150,648
Net Operating Income	$ 24,977	$ 21,551		$ 3,770

APPENDIX C
STAFF REPORT, CASE NO. 2011-00010
STAFF'S RECOMMENDED
PRO FORMA ADJUSTMENTS

a. Operating Revenue – Base Rate. Valley reported total test period operating revenues from gas sales of $518,814. However, included in this amount are purchased gas costs and gas transmission fees. These costs are recovered by Valley through its purchased gas adjustment and are excluded when determining base rate revenue.

In 2008, Valley reported gas sales of 39,456 Mcfs to 470 customers. By applying the gas sales to the current rate of $2.3819 per Mcf and the test period customer level to the monthly customer charge of $8.50, Staff calculates revenues from base gas rates of $141,920 as shown in Table 2.

Table 2: Normalized Operating Revenues		
Tariffed Customer Charge	$	8.50
Multiplied by: No. of Customers	x	470
Monthly Customer Charge Revenues	$	3,995
Multiplied by: 12 Months	x	12
Annual Customer Charge Revenues	$	47,940
Base Rate per MCF	$	2.3819
Multiplied by: Mcf Sales	x	39,456
Volumetric Rate Revenues	$	93,980
2008 Normalized base rate revenues	$	141,920

Staff recommends that the Commission decrease operating revenues from gas sales by $376,894 to eliminate the purchased gas costs and gas transmission fees.

b. Natural Gas Purchases and Transmission Fees. Valley reported net natural gas purchases and transmission fees of $259,111.[4] Given that the natural gas purchases and transmission fees are recovered through Valley's purchased gas adjustment, Staff proposes that operating expenses be reduced by $259,111 to exclude these costs from the determination of Valley's revenue requirement.

c. Outside Services Employed. Valley is proposing to reduce its outside services expense by $15,594 to reflect the $64,406 annual owner/manager fee paid to Mr. Kasey. To support its proposed owner/manager fee, Valley claims that the fee is intended to compensate Mr. Kasey for management services, office space rental, utilities, labor, and insurance.[5] According to Valley, the managerial services provided to Valley by Mr. Kasey are: (1) the payment of Valley's bills; (2) the preparation of correspondence for Valley; (3) the oversight of employees; (4) gas purchases; (5) attendance at meetings with various gas companies; and (6) involvement in all of the company decisions.[6] Valley claims that Mr. Kasey has been required to invest additional capital in order for Valley to remain current with its obligations.[7] Valley

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[4] $382,538 (Natural Gas City Gate Purchases) - $81,028 (Gas Withdrawn from Storage – Cr.) - $42,758 (Operation Supervision & Eng.) = $258,752.

[5] Id.

[6] Page 3 of the Application, Adjustment (b), Management Fee/Owner Manager Fee.

[7] Id.

argues that Mr. Kasey could sell his investment in Valley to a major company and re-invest the proceeds in a company that would produce a greater return on investment.[8]

The building and facilities used by Valley are owned and operated by Irvington Gas Company ("Irvington"), an affiliated company.[9] Irvington is an independent liquid propane distributor that was established in 1938.[10] Irvington also provides underground propane service to nine subdivisions through 70,000 feet of 2-inch mains.[11] In the test period, the only overhead expenses that Irvington allocated to Valley were the salaries for two employees and office rent.

In its decision in Case No. 2007-00436, the Commission stated that "the reasonableness of the [owner-manager] fee will depend on the circumstances of the particular utility, to include its owner's responsibilities and duties and the size and complexity of the sewer utility's operations."[12] It further stated that, as payment of an owner-manage fee is not an arms-length transaction, the utility must demonstrate by substantial evidence that the fee is reasonable.

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[8] Id.

[9] Letter dated February 1, 2006 from Irvington to Beth O'Donnell, the Commission's Executive Director.

[10] Id.

[11] Letter dated November 20, 2008 from Irvington to Stephanie Stumbo, the Commission's Executive Director.

[12] Case No. 2007-00436, Application of Farmdale Development Corporation for an Adjustment in Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities, at 6 (Ky. PSC Jul. 30, 2008).

Valley has not demonstrated that, given its operations, the fee being paid to Mr. Kasey is reasonable. In this proceeding, Valley was unable to document either the time Mr. Kasey spends per month performing his management tasks or the office overhead expenses that were incurred by Irvington. Furthermore, Staff has included an allocation of office rent and employee health insurance in Valley's pro forma operating expenses. Upon its review of the management duties provided by Mr. Kasey, Staff has determined that they do not differ significantly from those of other similarly sized utilities to require greater administrative oversight and a larger administrative salary.

Staff notes that, in most recent proceedings involving similarly sized utilities, the Commission has found $3,600 to be a reasonable level of expense for the owner/manager fee. In the absence of any factor that distinguishes Valley's operations from those entities or the duties that Valley's owner performs from those of other utility owners, it recommends that the Commission use the same level of expense in this case, resulting in a recommended decrease of $76,400 to outside services employed expense for a pro forma level of $10,643.[13]

d. Employee Pension and Benefits. Valley accepted Staff's recommendation to increase operating expenses by $8,886 to reflect the allocation of employee health and life insurance premiums from Irvington. In the test period, Irvington allocated 44 percent of the salaries paid to Kevin Kasey and Kerry Kasey to Valley. Staff requested and received documentation showing that Irvington is paying $1,683 per month to provide health and life insurance coverage to these two employees. Given the salary

[13] This account includes payments to attorneys and computer consultants.

allocation of 44 percent, Staff is of the opinion that 44 percent of all employee benefits should be allocated to Valley. Table 3 is the calculation of the health and life insurance allocation from Irvington.

Table 3: Health and Life Insurance Allocation		
Monthly Health and Life Insurance Premium	$	1,683
Multiplied by: 12 Months	x	12
Annual Employee Health and Life Insurance	$	20,196
Multiplied by: Salary Allocation Percentage	x	44%
Allocated Emp. Health and Life Insurance Premium	$	8,886

e. Office Rent. Valley accepted Staff's recommendation to increase test-period office rent expense by $2,775. Valley informed Staff that it pays Irvington an annual office rent of $6,000, but incorrectly reported $3,225 as office rent expense in its 2008 annual report. After visiting the office and touring all of the facilities operated by Irvington, Staff believes that a $6,000 annual office rent is reasonable. Accordingly Staff recommends accepting Valley's proposal to increase office rent expense by $2,775.

f. Taxes Other than Income Taxes. Valley accepted Staff's recommendation to reduce taxes other than income tax expense by $32,196. Because Valley is acting as an agent of the taxing authorities to collect and remit sales/utility tax, these taxes should not be reported by Valley as either operating revenue or operating expense. Given that Valley's normalized operating revenues do not reflect the collection of the sales/utility tax, taxes other than income tax should be reduced by $31,870 to remove these taxes from operating expenses. Table 4 shows that taxes other than income tax expense should be reduced by an additional $318 to reflect the correct payroll tax allocation from Irvington.

Table 4: Payroll Taxes										
		Payroll		State Unemp.		Federal Unemp.		FICA		Totals
Kevin Kasey	$	26,400	$	56	$	80	$	2,020	$	2,156
Kerry Kasey	+	26,400	+	56	+	80	+	2,020	+	2,156
Pro Forma Totals	$	52,800	$	112	$	160	$	4,040	$	4,312
Less: Reported Payroll Tax									-	4,630
Pro Forma Adjustment									$	(318)

APPENDIX D
STAFF REPORT, CASE NO. 2011-00010
STAFF'S RECOMMENDED
RATES AND CHARGES

BASE GAS RATES

RATE CLASSIFICATION	BASE RATE
Customer Charge	$ 10.00
Per MCF Charge	$ 2.7544

GAS COST

Per Mcf	$ 5.8813

Kerry R Kasey
Secretary
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