COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ALTERNATIVE RATE FILING ADJUSTMENT APPLICATION OF JOHNSON COUNTY GAS COMPANY	) CASE NO.) 2012-00140)

ORDER

This matter comes before the Commission by the April 11, 2012 application of Johnson County Gas Company ("Johnson County") requesting approval to increase its base rate revenues pursuant to 807 KAR 5:076, the regulation governing the Alternative Rate Filing ("ARF") procedure for small utilities. Pursuant to the ARF regulation, the application was based on Johnson County's most recent annual report covering the calendar year ended December 31, 2011.

Johnson County's application was deficient. On August 10 and 29, 2012, it filed supplemental information which cured its filing deficiencies and the application was accepted for filing as of the latter date. Johnson County responded to three requests for information from Commission Staff ("Staff"). There were two informal conferences which were attended by representatives of Johnson County and Staff. There are no intervenors in this matter. An evidentiary hearing was conducted on May 8, 2013. Johnson County has provided responses to information requests made at the hearing. The record is now complete and the matter is submitted for a decision.

BACKGROUND

The rates proposed by Johnson County in its application would produce base rate revenues of $154,255, or $47,344 above the revenues of $106,911 generated by its existing rates in 2011. This did not reconcile with the required revenue increase of $96,722 shown on ARF Form-1, Revenue Requirement Calculation in the application. In its December 5, 2012 response to the Staff's Second Request for Information ("Staff's Second Request"), Johnson County submitted a new rate proposal that differed from its original proposal.[1] With this response, Johnson County proposed rates that were designed to produce base rate revenues of $185,755. Johnson County's response also included a proposed surcharge of $3.0772 per Mcf, which was designed to produce $39,000 annually to pay creditors pursuant to its Reorganization Plan ("Plan").[2]

By Order dated March 13, 2013, the Commission found that Johnson County's December 5, 2013 rate proposal should be treated as a new application, with that date considered the filing date of its application. Pursuant to 807 KAR 5:076, that finding extended the six-month period for processing this case to June 5, 2013.[3]

TEST PERIOD

Johnson County proposed the 12–month period ending December 31, 2011 as the test period for determining the reasonableness of its proposed rate increase. The Commission finds that using the 12-month period ending December 31, 2011 as the test period in this proceeding is reasonable. In using a historic test period, the Commission has given full consideration to appropriate known and measurable changes, based on changes occurring both during and subsequent to the test period.

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[1] Response to Staff's Second Request dated November 7, 2012, Item 2.b.

[2] The response stated that per Johnson County's Reorganization Plan filed with the United States Bankruptcy Court, it needs to pay its creditors $39,000 annually for five years and that the surcharge was intended to produce this amount. Documents included with Johnson County's application indicate its plan was filed in the court's Eastern District of Kentucky, Pikeville Division.

[3] Pursuant to 807 KAR 5:076, Section 7, a utility applying for a rate adjustment under the ARF filing procedures may place its proposed rates into effect six months from the date of filing its application, subject to refund, upon providing the Commission written notice of its intent to place its rates into effect.

TEST-PERIOD REVENUES AND EXPENSES

For the test period, Johnson County reported operating revenues of $250,712, which consisted of $106,911 in revenues from base rates and miscellaneous charges plus $143,801 in gas cost recovery revenues. It reported operation and maintenance expenses during the test period of $187,549. With its proposed adjustments to the test year, based on its 2012 budget, which included expenses of $182,417, Johnson County requested an increase in rates that, as stated previously, would generate annual base rate revenues of approximately $185,755 and annual surcharge revenues of $39,000.

Johnson County reported sales of 16,316 Mcf for its 2011 test year. However, in its revised rate proposal of December 5, 2012, it calculated its proposed rates based on 12,674 Mcf, its sales for the 12 months ended September 30, 2012. Johnson County's proposed rates and requested revenue increase were based on a budget that included operating and maintenance expenses, but did not include depreciation expense or a determination of any mark-up or profit margin.[4]

ADJUSTMENTS TO TEST-YEAR REVENUES AND EXPENSES

We will approve a rate increase for Johnson County of $88,162 based on its operations for the test year, adjustments and expenses proposed by Johnson County which we accept, and adjustments made by the Commission as described below. These adjustments reflect standard ratemaking theories and the Commission's long-held ratemaking practices. The first issues we address are Johnson County's proposal to use sales volumes other than its test year sales volumes to calculate rates and the

[4] In its revised rate proposal of December 5, 2012, Johnson County proposed to reduce the management fee paid its president, Bud Rife, from $84,000 annually to $72,000, and to calculate its revenue requirement using a margin based on 9 percent of base rate revenues. In its response to Staff's Third Request, submitted January 28, 2013, Johnson County stated that it was restating the management fee at the original amount of $84,000. This effectively eliminated the margin it had derived, except for a difference of $3,338 between its proposed revenues and its proposed expenses.

surcharge it has proposed for the purpose of generating revenues to pay its creditors under its Plan.

Sales Volumes

Johnson County's test year sales were 16,316 Mcf. It based its initial proposed rate increase on these sales volumes. However, as stated earlier, with the revised rate proposal in its response to Staff's Second Request, for the purpose of calculating its proposed rates Johnson County used 12,674 Mcf, its sales for the 12 months from October 1, 2011 through September 30, 2012.[5] In that same response, Johnson County stated that its reduction in sales volumes was primarily due to a much warmer 2011-2012 winter, compared to the 2010-2011 winter.[6] In response to Staff's Third Request for Information ("Staff's Third Request"), when asked about different Heating Degree Day ("HDD") levels for the two winters in question, as published statewide for Kentucky by the National Oceanographic and Atmospheric Administration ("NOAA"), Johnson County stated that "winters are typically milder in the mountains of Eastern Kentucky than in other parts of Kentucky, meaning that data for the entire state is not necessarily applicable to Johnson County's service territory."[7]

In response to Staff's Third Request, Johnson County stated that it was not aware of any reason why its sales would have declined as they did in the 12 months ended September 30, 2012 aside from the milder weather.[8] Johnson County affirmed

[5] Response to Staff's Second Request dated November 7, 2012, Item 2.b.

[6] While there are several published reports stating that 2012 is the warmest year on record for the United States since such records were first developed, Johnson County provided no evidence in support of this statement.

[7] Response to Staff's Third Request dated January 11, 2013, Item 1.b.2.

[8] Id. Item 1.b.1.

its belief that milder weather was the cause of the lower sales at the hearing;[9] however, at another point in the hearing, it indicated that customers' use of more efficient electric heat pumps as their primary heat source and their use of natural gas for back-up heating contributed to these lower sales volumes.[10]

Having considered Johnson County's proposal, we find that it should be denied. Its statement about milder winters in Eastern Kentucky was based solely on anecdotal evidence and carries no weight in this matter. The same applies to the claim that its customers are relying more on electric heat pumps as a primary heat source. The Commission recognizes that 2012 has been reported to be the warmest year on record; however, that distinction reflects only the results for a single year. It does not mean that all subsequent years will be as warm as 2012. As was brought out at the hearing, the sales volumes upon which Johnson County is requesting as the base for its rates does not approach its sales volumes in the test year or the four years immediately preceding the test year.[11] Furthermore, in rate cases of large gas utilities, the Commission typically accepts adjustments to sales volumes using "normal" temperatures/HDD based on data published by NOAA, which covers periods of 25 to 30 years.[12] There is no precedent in Kentucky for adjusting test year sales based on the result for a single winter or single calendar year. Accordingly, Johnson County's revenue and rates will be based on its actual test year sales of 16,316 Mcf.

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[9] Hearing Video at 11:23:53 to 11:24:15.

[10] Id., at 11:56:45 to 11:59:00.

[11] Id., at 11:52:09 to 11:56:45

[12] The Commission has accepted settlements in which the parties agreed to sales volumes that had been adjusted based on periods shorter than this.

Surcharge Proposal

In its December 5, 2012 data response Johnson County proposed a surcharge intended to produce $39,000 annually based on a rate of $3.0772 per Mcf.[13] This rate was derived based on the sales volumes of 12,764 Mcf for the 12 months ended September 30, 2012, which Johnson County also proposed for purpose of calculating its base rates. The amounts generated by the surcharge are, according to Johnson County, to be used to pay its creditors pursuant to its Plan. Exhibit 2 of the Plan, Johnson County's 2012 budget, shows that Johnson County is to pay its creditors $195,000 over a period of five years, resulting in an annual amount of $39,000.

The Commission will not approve a surcharge for the purpose of paying creditors pursuant to Johnson County's Plan. The costs which gave rise to the filing of Johnson County's Plan are recurring costs of operations, some of which were recoverable under its Gas Cost Adjustment mechanism, and some of which it could have recovered had it timely filed for a base rate increase.

In general, asking today's customers to pay amounts related to costs incurred prior to the filing of Johnson County's Plan will result in generational inequities in that some current customers likely were not customers when those costs were incurred. The ratemaking process is prospective in nature, except in the case of after-the-fact adjustments such as the Fuel Adjustment Clause applicable to our jurisdictional electric utilities. To allow the recovery Johnson County requests would constitute inappropriate retroactive ratemaking. For these reasons, we will deny the surcharge requested by Johnson County.

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[13] Response to Staff's Second Request dated November 12, 2012, Item 2.c.

Management Fee

Johnson County is operated by Mr. Rife under the terms of a management agreement ("Agreement") executed by and between Mr. Rife and the utility. Mr. Rife's compensation under this Agreement is $7,000 per month or $84,000 annually. Per its response to a Staff Information Request,[14] Johnson County identified a number of tasks covered by Mr. Rife's management fee.[15] Those include management of the utility, meter reading, billing, and repairs and maintenance. Johnson County's response also stated that secretarial services are provided under the management fee at a lower cost than if these services were "charged directly to Johnson County...."[16]

We are not persuaded by Johnson County's arguments in favor of the Agreement as the means by which it receives the services required to operate. Its response to Staff's Information Request lists several functions for which Mr. Rife is responsible.[17] In addition to those listed previously, the response states that he oversees all legal proceedings, matters related to disconnecting customers for non-payment, bankruptcy filings, and collection actions. It states that he participates in locating gas leaks and delivering meters to a testing facility. Finally, the response states that other expenses included in the management fee which are paid directly by Johnson County's sister utility, B & H Gas Company ("B & H"), are banking, odorization, and valve maintenance.

The descriptions and explanations of some of the services allegedly covered by Mr. Rife's management fee are of concern to the Commission. One of these services is

[14] Response to Staff's Second Request dated November 12, 2012, Item 5.b.

[15] The request also referenced the other gas utility owned by Mr. Rife, B & H Gas Company.

[16] Response to Staff's Second Request dated November 12, 2012, Item 5.b.

[17] Id.

"repairs and maintenance." The response to Staff's Information Request states that repairs and maintenance are covered by the management fee.[18] However, the hearing testimony describes how the construction company owned by Mr. Rife, Bud Rife Construction Company, bills Johnson County for these services,[19] and Johnson County's income statements in the annual reports it files with the Commission include amounts for maintenance separate and apart from the expense reported in Account 923, Outside Services, which is the account in which the management fee is reported.

In addition to these concerns, we are also concerned that Johnson County has not adequately explained why the services it claims are covered by the management fee can be provided to B & H without the need for a comparable management fee. The only explanation offered, provided at the hearing, cited the fact that there are 50 miles of pipeline on the Johnson County system while the B & H system consists of only 11 miles of pipeline.[20] While that likely results in greater time required for meter reading, leak detection, disconnection of customers, and odorization by Johnson County than by B & H, and possibly a greater amount of maintenance expense,[21] there is little evidence, anecdotal or otherwise, to indicate that billing, overseeing legal proceedings, providing secretarial services, banking, or delivering meters to a testing facility is more expensive for a utility with 50 miles of pipeline than for a utility with 11 miles of pipeline.[22]

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[18] Response to Staff's Second Request dated November 12, 2012, Item 5.b.

[19] Hearing video at 10:16:58 to 10:17:40.

[20] Id., at 12:40:31 to 12:41:45

[21] The two utilities' annual reports for the test year and the four calendar years prior to the test year reflect a higher level of maintenance expenses reported by B & H in 2008, 2009, and the 2011 test year. Johnson County reported a higher level of maintenance expenses in 2007 and 2010.

[22] Johnson County and B & H have the same approximate number of customers.

Having concluded that here is inadequate support for allowing a management fee of $84,000 annually, we will include for ratemaking purposes an amount equal to what Mr. Rife received as a salary from B & H in 2011, $22,950, along with the cost of employee benefits, which at a benefits loading ratio of 1.6, equals $36,720. We will also include half the cost, both of wages and benefits, for one full-time secretarial employee, which equals $22,400.[23] Given the Commission's knowledge of similarly sized Kentucky utilities, some providing gas service and others providing water or waste water service, we find that a single adequately trained full-time secretarial employee should be able to perform the required tasks for both Johnson County and B & H. The resulting total is $59,120, which is the amount we will allow for ratemaking purposes in lieu of the management fee of $84,000.

Office Rent

Johnson County proposed annual expense for office rent of $12,000. According to Johnson County, this amount reflects its share of the rent expense for the building it shares with B & H.[24] Although Johnson County states that its monthly rent expense is $1,000, the lease between Johnson County and Mr. Rife, its president and owner of the building it leases, does not support this level of rent expense. The lease was provided in Johnson County's post-hearing data response, and reflects a monthly expense of $603.83. Based on Johnson County's response to our hearing request, we have reduced its annual rent expense by $4,754, from $12,000 to $7,246.

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[23] This is based on the $14.00 hourly rate for the secretary employed by B & H and also reflects a 1.6 benefits load ratio. This ratio was derived based on annual wages of $28,000 using the $14.00 rate and recognizing Johnson County's statement that, including all benefits, etc. for the secretarial services included in Mr. Rife's management fee, the cost to Johnson County would be $45,000 annually.

[24] Both Johnson County and B & H are solely owned by Mr. Rife, who is the president of both companies. Mr. Rife is also owner of the building for which Johnson County is charged rent expense.

Repairs and Maintenance Expense

Johnson County proposed $23,176 for repairs and maintenance expense, which, according to its testimony, reflects its average annual expense in recent years.[25] There are six maintenance expense accounts included in the system of accounts for small gas utilities.[26] A review of those accounts in Johnson County's 2011 annual report shows that its test year repairs and maintenance expense was $17,555. A review of those accounts in Johnson County's annual reports for the years 2007 through 2010 shows annual amounts ranging from a low of $1,424 in 2008 to a high of $21,288 in 2009. The average for those four years was $11,778, approximately half the amount proposed by Johnson County and nearly $6,000 less than the actual test year amount reported in its 2011 annual report. Based on these levels, we will limit Johnson County's repairs and maintenance expense to its actual test year expense of $17,555.

Health Insurance Expense

Johnson County proposed to include $12,553 for health insurance expense in its 2012 expense budget as an item to recover through rates. When questioned about this expense, given that it has no employees, Johnson County indicated that the insurance was solely for Mr. Rife.

As noted at the hearing and explained in data responses, Mr. Rife is not an employee of Johnson County. The operation of the utility is the responsibility of Mr. Rife

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[25] Hearing video at 10:17:05 to 10:17:30.

[26] Those accounts are (1) Account 863, Maintenance of Mains – Transmission; (2) Account 885, Maintenance Supervising and Engineering – Distribution; (3) Account 887, Maintenance of Mains – Distribution; (4) Account 892, Maintenance of Services; (5) Account 893 – Maintenance of Meters and House Regulators; and (6) Account 894 – Maintenance of Other Equipment – Distribution.

under the terms of a management agreement between Mr. Rife and Johnson County.[27] It establishes that Mr. Rife is to be paid $7,000 monthly as compensation under the agreement. It makes no mention of other compensation in the form of health insurance coverage, life insurance, or any other of what might be considered "employee benefits."

While there is no evidence in the record to indicate whether there might be other individuals interested in operating Johnson County under a similar agreement, it is obvious that the agreement between Johnson County and Mr. Rife is not an arms-length agreement. Were Johnson County operated under an arms-length agreement by an individual with no financial interest in the utility or in entities that conduct business with Johnson County,[28] there is little reason to expect that the individual would receive health insurance from Johnson County. Given the facts at hand, and that there is no obligation for Johnson County to provide health insurance to a non-employee, we will eliminate the full amount of $12,553 budgeted by Johnson County.

United States Trustee Fees and Legal & Disbursing Agent Fees

Johnson County's 2012 budget included $3,900 in U.S. Trustee Fees and $1,200 in Legal and Disbursing Agent Fees, which are in conjunction with the plan filed in the U.S. Bankruptcy Court. As discussed more thoroughly in the portion of this Order addressing Johnson County's proposed surcharge, it is the Commission's finding that recovery from ratepayers of amounts included in Johnson County's Plan for costs incurred prior to the test year would constitute inappropriate retroactive ratemaking and should not be permitted. Accordingly, we also find that recovery from ratepayers of fees incurred in conjunction with the bankruptcy filing and Plan is inappropriate and should

[27] The management agreement, the same as various other Johnson County agreements, shows Mr. Rife as the signee on behalf of Johnson County as well as the signee for himself.

[28] Mr. Rife owns Bud Rife Construction Company, which provides services to Johnson County.

not be permitted. Therefore, the full amount, $5,100, budgeted for these fees has been eliminated from the expenses recoverable for ratemaking purposes.

Miscellaneous Expenses

Johnson County's 2012 operating expense budget included $600 identified as "Miscellaneous." The budget approach presented by Johnson County in this case is, in some ways, comparable to the use of a forecasted test period, which is permitted under the Commission's statutes. Under such an approach, budgeted, or forecasted, expense items must be identified as having a specific purpose. Budgeted expenses labeled "Miscellaneous" do not identify a purpose and, therefore, cannot be considered by the Commission to represent a known and measurable expense. Accordingly, we have eliminated for ratemaking purposes the full amount, $600, budgeted by Johnson County for miscellaneous expenses.

REVENUE REQUIREMENT DETERMINATION

As stated earlier in this Order, Johnson County's proposed revenue increase did not include the recovery of depreciation expense. As revised in its response to Staff's Third Information Request, its proposed increase reflected a net margin of $3,338, which was not based on a specific formula or methodology. The revenue requirement we establish in the matter will include Johnson County's test year depreciation expense of $37,981. Consistent with our typical ratemaking treatment for small investor-owned utilities, we will use an operating ratio of 88 percent, including a provision for income tax expense, to calculate a margin above the allowed level of expenses. Based on those expense levels proposed by Johnson County that we accept, and the adjustments we have made to those expenses, Johnson County's adjusted test year operating results are as follows:

	Actual Test Year	Adjustments To Test Year	Adjusted Test Year
Operating Revenues	$ 250,712	$ (143,801)	$ 106,911
Operating Expenses	$ 327,354	$ (198,445)	$ 128,909
Operating Income	$ (76,642)	$ 54,644	$ (21,998)
Depreciation Expense	$ 37,981	$ -0-	$ 37,981
Net Income	$(114,623)	$ 54,644	$ (59,979)

Total expenses for the adjusted test year, including depreciation, are $166,890. Applying an operating ratio of 88 percent produces a revenue requirement of $189,648, resulting in $22,758 in net income. Pre-tax net income of $28,183 is required to provide for the related income tax expense of $5,425.[29] The sum of $189,648 and $5,425 is $195,073, which is Johnson County's revenue requirement and the level of base rate revenues being authorized by this Order.

OTHER ISSUES

Rate Design

In its December 5, 2012 data response, Johnson County proposed to combine its rate design for its residential and commercial classes and establish a monthly customer charge and a volumetric rate for all Mcf sold.[30] Johnson County proposed a monthly customer charge of $15 for all customers. We find that the proposed rate design and customer charges are reasonable, and are similar to recent rate designs and customer charges approved for other small gas utilities to provide stability to revenue collection, especially during summer months when low sales volumes are experienced. The Commission also finds, based on the revenue increase and test year sales volumes found reasonable herein, that the volumetric base rate proposed by Johnson County

[29] Net income of $22,758 X 'Tax Gross-up Factor' of 1.23839 = $28,183.

[30] Response to Staff's Second Request dated November 12, 2012, Item 2.b.

should be denied. Based on the revenues projected to be collected by the $15 monthly customer charge, the required volumetric rate is $8.60 per Mcf. We find this reasonable to be charged for service rendered on and after the date of this Order.

Requirements of Johnson County's Plan

Johnson County is required to pay $39,000 annually under its Plan. While the Commission denied Johnson County's request to establish a surcharge for the purpose of generating this level of revenues, it should be noted that $37,981 in depreciation, a non-cash expense, is included in the revenue requirement found reasonable herein. In addition, net income (margin) of $22,758 is provided for under the operating ratio of 88 percent permitted in this manner. Together, these exceed $60,000, an amount which is $21,000 greater than the annual amount required under Johnson County's Plan.

FINDINGS

The Commission, based on the evidence of record and being otherwise sufficiently advised, finds that:

1. The base rates and surcharge proposed by Johnson County should be denied.

2. The rate design proposed by Johnson County is reasonable and should be approved.

3. The rates in the appendix attached hereto are reasonable for Johnson County and should be approved for service rendered on and after the date of this Order.

IT IS THEREFORE ORDRED that:

1. The base rates and surcharge proposed by Johnson County are denied.

2. The rate design proposed by Johnson County is approved.

3. The rates in the appendix to this Order are approved for service rendered by Johnson County on and after the date of this Order.

4. Within 20 days of the date of this Order, Johnson County shall file with this Commission, using the Commission's Electronic Tariff Filing System, new tariffs setting forth the rates approved herein with the date of this Order as their effective date and that they were authorized by this Order.

By the Commission

ENTERED

JUN 18 2013

KENTUCKY PUBLIC SERVICE COMMISSION

ATTEST:

Executive Director

APPENDIX

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2012-00140 DATED JUN 18 2013

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

RATES:

Residential and Commercial

Monthly	Base Rate	Gas Cost Recovery Rate	Total Rate
Customer Charge	$15.00		$15.00
All Mcf	$ 8.60	$6.4140[31]	$15.0140

[31] Gas Cost Recovery Rate approved effective January 30, 2013 in Case No. 2012-00140, Notice of Purchased Gas Adjustment Filing of Johnson County Gas (Ky. PSC Jan. 30, 2013).

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