

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF WESTERN LEWIS-)
RECTORVILLE WATER & GAS DISTRICT FOR) CASE NO.
RATE ADJUSTMENT FOR SMALL UTILITIES) 2014-00266
PURSUANT TO 807 KAR 5:076)

NOTICE OF FILING OF COMMISSION STAFF REPORT

Notice is hereby given that, in accordance with the Commission's Order of September 3, 2014, the attached report containing the findings of Commission Staff regarding the Applicant's proposed rate adjustment has been filed in the record of the above-styled proceeding. Pursuant to paragraphs 2 and 4 of the Commission's September 3, 2014 Order, Western Lewis-Rectorville Water and Gas District is required to file written comments regarding the findings of Commission Staff no later than November 21, 2014.



Jeff Derouen
Executive Director
Public Service Commission
P.O. Box 615
Frankfort, KY 40602

DATED NOV 07 2014

cc: Parties of Record

STAFF REPORT
ON
WESTERN LEWIS-RECTORVILLE WATER AND GAS DISTRICT

CASE NO. 2014-00266

Western Lewis-Rectorville Water and Gas District (“WLWD”) provides water service to approximately 2,255 customers residing in Lewis and Mason counties, Kentucky.¹ On July 25, 2014, WLWD tendered an application to the Commission pursuant to 807 KAR 5:076 requesting to adjust its water service rates.

The requested water service rates would increase the monthly cost of 5,000 gallons of water purchased through a 5/8-inch x 3/4-inch meter from \$34.75 to \$43.08, an increase of \$8.33, or 23.97 percent. WLWD stated that these rates would increase its annual revenues by \$177,026, or 23.96 percent. WLWD provided financial exhibits with its application in support of the requested increase that were based on the test year ended December 31, 2012.² These exhibits are shown below in condensed form.

¹ *Annual Report of Western Lewis-Rectorville Water and Gas District to the Public Service Commission for the Calendar Year Ended December 31, 2012* (“2012 Annual Report”) for the WLWD Water Division, at 5.

² By Commission Order dated August 7, 2014, WLWD was authorized to deviate from 807 KAR 5:076, Section 9, and, to use the calendar year ended December 31, 2012, as the test year in this proceeding.

Overall Revenue Requirement and Required Revenue Increase

Pro Forma Operating Expenses	782,145 ³
Plus: Average Annual Principal and Interest Payments on Current Debts	167,775
Additional Working Capital	<u>16,777</u>
Overall Revenue Requirement	966,697
Less: Other Operating Revenue	(37,296)
Interest Income	(547)
Non-Operating Revenue	<u>(12,859)</u>
Revenue Required From Rates	915,995
Less: Pro Forma Present Rate Service Revenues	<u>(738,969)</u>
Required Revenue Increase	<u>\$ 177,026</u>
Percent Increase	<u>23.96%</u>

Staff performed a limited financial review of WLWD's operations for the test year ended December 31, 2012, to determine the reasonableness of the requested water service rates. The scope of Staff's review was limited to determining whether operations reported for the test year were representative of normal operations. Known and measurable changes to test-year operations were identified and adjustments were made when their effects were deemed to be material. Insignificant or immaterial discrepancies were not pursued and were not addressed.

Staff's findings are summarized in this report. Ariel Turnbull reviewed the calculation of WLWD's Overall Revenue Requirement. Sam Reid reviewed revenues and rate design.

³ Pro Forma Operating Expenses represents the test-year Total Operating Expenses reflected in the Water Division's 2012 Annual Report, and a \$7,302 adjustment to purchased water requested by WLWD. For further discussion, see adjustment (G), page 10.

Summary of Findings

1) Overall Revenue Requirement and Required Revenue Increase. By applying the Debt Service Coverage (“DSC”) Method, as generally accepted by the Commission, Staff found WLWD’s Overall Revenue Requirement for the Water Division to be \$845,854 and that a revenue increase of \$106,885, or 14.46 percent, above pro forma present rate revenues is necessary to generate the Overall Revenue Requirement.

2) Water Service Rates. WLWD’s application proposed an increase of approximately 24 percent across-the-board to the current water rates. WLWD has not performed a cost-of-service study to allocate the utility’s costs to varying customer classifications. The Commission has previously found that an across-the-board increase is an appropriate and equitable method to increase rates in the absence of a cost-of-service study. Given this precedent, Staff finds that an across-the-board increase is an appropriate means to allocate the increased revenue requirement.

The monthly rates established by Staff in this report are based upon this method. The utility’s Bulk Water Sales are sold through an automated vending machine that can be adjusted only by \$0.25 increments. Therefore, the Bulk Water Sales rate has been adjusted accordingly. The rates set forth in Attachment A will produce sufficient revenues from water sales to meet the revenue requirement as calculated by Staff.

3) Allocation and Assignment of Transactions Between Divisions. During the test year, WLWD did not make proper assignment and allocation of many transactions between its Water Division and Gas Division. As noted throughout the remainder of this report, correcting adjustments were made to test-year operations to properly assign or

allocate these transactions to the appropriate division. Staff recommends the Commission require WLWD to make the necessary revisions to its accounting procedures and internal controls so that proper assignment and allocation of revenues and expenses are recorded in its books of original entry in all future reporting periods.

4) Depreciation. At Attachment B of this report, Staff finds that the depreciable lives assigned to certain water assets should be changed for ratemaking purposes and that these lives should be used for accounting purposes in all future reporting periods. These recommended depreciable lives better match the life expectancy of WLWD's assets for the Water Division and will better match expenses to revenues. Staff further finds that no adjustment to accumulated depreciation and retained earnings should be made to account for the retroactive effect of this recommended change in accounting estimate.

Pro Forma Operating Statement

The known and measurable adjustments found appropriate by Staff are detailed in the Pro Forma Operating Statement shown below.

	Test Year	Adjustment	(Ref.)	Pro Forma
Operating Revenues				
Sales of Water	\$ 691,832	\$ 33,507	(A)	
		5,068	(B)	
		8,562	(C)	\$ 738,969
Other Operating Revenue	<u>37,296</u>	<u>1,378</u>	(D)	<u>38,674</u>
Total Operating Revenues	<u>729,128</u>	<u>48,515</u>		<u>777,643</u>
Operating Expenses				
Operation and Maintenance Expenses				
Salaries and Wages - Employees	190,968	(55,341)	(E)	135,627
Salaries and Wages - Commissioners	10,800	801	(E)	11,601
Employee Pensions and Benefits	68,350	(9,191)	(F)	59,159
Purchased Water	25,234	3,658	(G)	28,892
Purchased Power for Pumping	35,133	12,307	(H)	47,440
Purchased Power, Office	1,788	(348)	(I)	1,440
Chemicals	9,494	3,165	(J)	12,659
Materials and Supplies	70,238	9,665	(K)	79,903
Contractual Services	7,125	528	(L)	
		53,505	(M)	61,158
Rental of Equipment	1,720	573	(N)	2,293
Transportation Expenses	3,155			3,155
Insurance	31,083			31,083
Advertising Expenses	1,963	654	(O)	2,617
Regulatory Commission Expense	1,371			1,371
Misc. Expense	4,266	171	(P)	4,437
Total Operation and Maintenance Expenses	462,688	20,147		482,835
Taxes Other Than Income	15,560	(4,297)	(Q)	11,263
Depreciation	<u>296,595</u>	<u>(96,589)</u>	(R)	<u>200,006</u>
Total Operating Expenses	<u>774,843</u>	<u>(80,739)</u>		<u>694,104</u>
Net Operating Income	(45,715)	129,254		83,539
Interest Income	547			547
Non-Operating Revenue	<u>12,859</u>	<u>(2,500)</u>	(S)	<u>10,359</u>
Income Available to Service Debt	<u>\$ (32,309)</u>	<u>\$ 126,754</u>		<u>\$ 94,445</u>

(A) Water Sales Revenue. WLWD reported test-year water sales revenue in the amount of \$691,832 using a cash basis of accounting pursuant to which revenues are recorded when received. The Uniform System of Accounts (“USoA”) does not allow the use of cash based accounting. It requires that all transactions be accounted for

using an accrual basis⁴ where revenues are reported when earned rather than when received. During the test year, WLWD billed revenue from water sales totaling \$724,306. This amount represents, in all material respects, WLWD’s earned revenue for the test year. Following the requirements of the USoA, Staff increased test-year water sales revenue by \$33,507 to \$724,306 to convert Western-Lewis’s reported revenues from a cash basis of accounting to an accrual basis.

(B) Purchased Water Adjustment. In its application, WLWD requested to increase test-year purchased water by \$7,302. WLWD purchases wholesale water from Maysville Utility Commission (“Maysville”). Subsequent to the test year, Maysville increased the wholesale rate charged to WLWD. Pursuant to the Order of the Commission dated April 25, 2013, in Case Number 2013-00131,⁵ WLWD received a purchased water adjustment in the amount of \$.05 per thousand gallons for water service rendered on or after April 1, 2013. Staff increased test-year revenues in the amount of \$5,068 to account for this adjustment in rates.⁶

(C) Billing Analysis Adjustment. WLWD provided a billing analysis summary with its application that calculated normalized water sales revenue of \$738,969 for all

⁴ USoA for Water Districts and Associations, at 36.

⁵ Case No. 2013-00131, *Purchased Water Adjustment Filing of Western Lewis-Rectorville Water and Gas District*, (Ky. PSC Apr. 25, 2013).

⁶

Test-Year Gallons Sold (000's Omitted)	101,363
Times: Increase Per Thousand Gallons	<u>\$ 0.05</u>
Increase in Revenue	<u><u>5,068</u></u>

customers. After making the adjustments identified in (A) and (B) above, a further adjustment of \$8,562 was made to reflect Water Sales Revenue of \$738,969.

(D) Other Operating Revenue – Late Fees. During the test year, WLWD reported the collection of late charges based on an allocation of 75 percent to the Water Division and 25 percent to the Gas Division. WLWD was unable to provide data to support actual collections between the divisions. Staff agrees that late charges should be allocated between the divisions, but disagrees with the allocation factor used. Staff believes that the customer number allocation factor⁷ better represents the actual collection of late charges for each division. As shown below, Staff increased test-year Water Division late-payment penalties by \$1,378.

	Late Payment Penalties	Allocated To 80.56% Water	19.44% Gas
Pro Forma Allocation	\$ 24,787	\$ 19,968	\$ 4,819
Less: Reported Amount		<u>(18,590)</u>	<u>(6,197)</u>
Total Adjustment		<u>\$ 1,378</u>	<u>\$ (1,378)</u>

(E) Salaries and Wages. During the test year, WLWD reported \$258,224 for total test-year wages; \$190,968 was reported by the Water Division, and \$67,256 was reported by the Gas Division. As discussed in detail below, Staff decreased test-year

⁷ The customer number allocation factor used throughout this report was calculated using actual customer data for the year ended December 31, 2012. This was computed as follows:

Number of Gas Customers	544	19.44%
Number of Water Customers	<u>2,255</u>	<u>80.56%</u>
Total Customers	<u>2,799</u>	<u>100.00%</u>

Water Division wages by \$55,341 to account for a reduction to WLWD's workforce and to properly allocate wages between the Water Division and Gas Division.

Subsequent to the test year, WLWD replaced two employees with contracted services. Staff determined pro forma salaries for the remaining employees to be \$168,355 based on 2014 wage rates as shown below. An adjustment to account for contracted services is shown in Reference Item (M).

	Annual Salary
Office Employees	
Office Manager	\$ 32,136
Office Employee #1	27,810
Office Employee #2	24,461
Field Employees	
Plant Operator	32,136
Maintenance Employee #1	28,933
Maintenance Employee #2	<u>22,880</u>
 Pro Forma Employee Wages	 <u><u>\$ 168,355</u></u>

Staff then allocated \$135,627 of the pro forma wages to the Water Division based on the customer number allocation factor. This allocation results in a reduction to the Water Division's test-year salaries of \$55,341 as calculated below.

Expense	Total Salary	Allocated to	
		80.56% Water	19.44% Gas
Employee Wages	\$ 168,355	\$ 135,627	\$ 32,728
Less: Test Year		<u>(190,968)</u>	<u>(67,256)</u>
Adjustment		<u><u>\$ (55,341)</u></u>	<u><u>\$ (34,528)</u></u>

WLWD also allocated a portion of Commissioners' Salaries to the Gas Division. Staff agrees that this expense should be allocated between the divisions, but disagrees with WLWD's method of allocation. Based on the customer number allocation factor, Staff increased the Water Division's Commissioners' Salaries by \$801 as calculated below.

Expense	Total Salary	Allocated to	
		80.56% Water	19.44% Gas
Commissioner's Salaries	\$ 14,400	\$ 11,601	\$ 2,799
Less: Test Year		<u>(10,800)</u>	<u>(3,600)</u>
Adjustment		<u>\$ 801</u>	<u>\$ (801)</u>

(F) Employee Pensions and Benefits. Staff calculated pro forma health insurance expense and retirement expense to be \$43,686⁸ and \$29,748,⁹ respectively, using the 2014 rates for these items. As shown in the following table, the pro forma

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2014 Health Insurance Premiums	\$ 3,641
Times: 12 months	<u>12</u>
Pro Forma Health Insurance Premiums	<u>\$ 43,686</u>

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Pro Forma Employee Wages	\$ 168,355
Times: 2014 Retirement Rate	<u>17.67%</u>
Pro Forma Retirement Expense	<u>\$ 29,748</u>

amount was allocated based on the customer number allocation factor, resulting in a test-year decrease of \$9,191 to the Water Division.¹⁰

		Allocated to	
	Pro Forma	80.56% Water	19.44% Gas
Health Insurance	\$ 43,686	\$ 35,194	\$ 8,493
Retirement	29,748	23,965	5,783
		<hr/>	
Allocated Expenses	73,435	59,159	14,276
Less: Test Year		(68,350)	(22,783)
		<hr/>	
Adjustment		\$ (9,191)	\$ (8,507)
		<hr/> <hr/>	

(G) Increase to Wholesale Water Rate. WLWD purchases wholesale water from Maysville. Subsequent to the test year, Maysville increased the wholesale rate charged to WLWD. Maysville's current rate is \$2.3414 per thousand gallons. Staff increased WLWD's test-year purchased water expense by \$3,658 to account for the current rate in pro forma operations.¹¹

(H) Purchased Power for Pumping. During the test year, WLWD allocated \$12,307 of the purchased power for pumping to the Gas Division. Since this expense

¹⁰ The overall amount of these expenses is less in 2014 than in the test year due to the loss of the two employees identified in Reference Item (E), Salaries and Wages.

Test-Year Gallons Purchased (000's Omitted)	11,970
New Wholesale Rate Per Thousand Gallons	<u>\$ 2.3414</u>
Purchased Water at Wholesale Rate	28,027
Less: Test Year	<u>(24,369)</u>
Increase	<u><u>\$ 3,658</u></u>

should be reported entirely by the Water Division, Staff added this amount back to the test-year expenses.

(I) Purchased Power, Office. WLWD incurred \$1,788 for test-year office power that was reported entirely by the Water Division. The test-year amount should be allocated between the divisions using the customer number allocation factor. Accordingly, Staff removed \$348 from the Water Division as calculated below.

	Total Expensed In Test Year	Allocated to	
		80.56% Water	19.44% Gas
Office Electric	\$ 1,788	\$ 1,440	\$ 348
Less: Test Year Expensed		(1,788)	
Adjustment		\$ (348)	\$ 348

(J) Chemicals. During the test year, WLWD reported \$9,494 for Chemicals in its Water Division 2012 Annual Report. In addition, the Gas Division incorrectly included \$3,165 for water chemicals in Miscellaneous General Expenses.¹² Chemicals that were used by WLWD in the test year were used in the operation of the water utility only and, therefore, should be reported as a Water Division expense. Staff increased the Water Division's test-year chemicals expense by \$3,165 to correct the accounting error.

(K) Materials and Supplies. During the test year, WLWD reported \$112,209 for materials and supplies and office expenses. This amount was allocated between the Water Division and the Gas Division in the accounts listed below.

¹² Annual Report of Western Lewis-Rectorville Water and Gas District to the Public Service Commission for the Calendar Year Ended December 31, 2012 for WLWD Gas Division at page 31.

Materials and Supplies (Water)	\$ 70,238
Transportation Expenses (Water)	3,155
Office Supplies (Gas)	10,623
Maintenance of Other Equipment (Gas)	<u>28,193</u>
Total Expenses From Annual Report	<u>\$ 112,209</u>

As a part of its review, Staff used WLWD's general ledger to determine which expenses were directly assignable to the Water Division, which expenses were directly assignable to the Gas Division, and which expenses were shared between the divisions.

The shared expenses between the divisions are listed below.

Materials and Supplies	\$ 4,029
Maintenance Fuel	13,740
Mileage	4,423
Automobile Expense	4,209
Office Expense	8,295
Office Supplies	2,413
Postage and Delivery	9,883
Deposit Interest	37
Bank Service Charges	603
Dues and Subscriptions	489
Returned Checks	1,068
Repairs: Computer Repairs	85
Credit Refund	385
Program Expense: Office	<u>3,673</u>
Shared Expenses	<u>\$ 53,332</u>

Staff determined that, using the customer number allocation factor, \$42,964 of the shared expenses should be allocated to the Water Division as calculated below.

		Allocated to	
	Total	80.56% Water	19.44% Gas
Shared Expenses	\$ 53,332	\$ 42,964	\$ 10,368

The following expenses were determined to be only for the Water Division:

Materials and Supplies: Water	\$ 20,669
Continued Education	2,204
Program Expense	568
Maintenance Water	15,920
Maintenance of Meters	<u>733</u>
Total Water Only Expenses	<u>\$ 40,094</u>

The total of the expenses that are either directly assignable or allocated to the Water Division is \$83,058, which results in a total adjustment of \$9,665 as calculated below.

Allocated Expenses	\$ 42,964
Water Only Expenses	<u>40,094</u>
Pro Forma Water Related Expenses	83,058
Less: Reported Water Expenses	<u>(73,393)</u>
Adjustment	<u>\$ 9,665</u>

(L) Contractual Services - Accounting. WLWD's Water Division reported \$7,125 in Contractual Services related to Accounting during the test year. An additional \$2,375 was reported under Outside Services Employed for the Gas Division. Staff agrees that the cost for accounting services should be allocated between the divisions, but does not agree with the allocation factor used. Staff used the customer number

allocation factor in the table below and adjusted Contractual Services by \$528 accordingly.

Expense	Total Expensed In Test Year	Allocated to	
		80.56% Water	19.44% Gas
Professional Fees: Accounting	\$ 9,500	\$ 7,653	\$ 1,847
Less: Allocated Test Year Expense		<u>(7,125)</u>	<u>(2,375)</u>
Adjustment		<u>\$ 528</u>	<u>\$ (528)</u>

(M) Contractual Services. Subsequent to the test year, WLWD began using outside contractors to read meters. The cost of this service is based on the number of stops that the meter readers make, at \$1 per stop. Staff calculated the pro forma meter reading cost for the test year to be \$31,416.¹³

Also, subsequent to the test year, WLWD hired a new general manager and reported the related cost as contract labor. No payroll taxes, benefits, or retirement are paid for any contract labor position. The amount of this expense is \$35,000 per year.

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Meter Reading Cost (per stop)	\$ 1
Times: Number of Stops	<u>2,618</u>
Monthly Meter Reading Cost	2,618
Times: 12 Months	<u>12</u>
Total Meter Reading Cost	<u>\$ 31,416</u>

Both of these contract labor expenses must be allocated between the divisions. Staff used the customer number allocation factor for this purpose. As shown below, Staff assigned \$53,505 of the total cost to the Water Division.

Expense	Pro Forma	Allocated to	
		80.56% Water	19.44% Gas
Meter Reading Cost	\$ 31,416	\$ 25,309	\$ 4,920
General Manager	35,000	28,196	5,481
Adjustment		<u>\$ 53,505</u>	<u>\$ 10,401</u>

(N) Rental of Equipment. During the test year, WLWD reported a total of \$2,293 for expenses related to rental of equipment. WLWD allocated \$573 of this expense to the Gas Division. This expense represents costs that were all associated with maintenance of the Water Division. Accordingly, Staff increased the Water Division’s rental of equipment expense for the test year by \$573.

(O) Advertising Expense. During the test year, WLWD’s Water Division incurred \$2,617 for advertising expenses related to water testing. WLWD erroneously allocated \$654 of this expense to the Gas Division. As this is strictly a water expense, Staff adjusted the Water Division’s advertising expense by increasing it \$654 to correct this error.

(P) Miscellaneous Expense. WLWD incurred \$5,508 in expenses related to telephone service for the district. WLWD allocated \$4,266 to the Water Division, and \$1,242 to the Gas Division. Staff agrees that an allocation should be made between the divisions, but disagrees with the allocated amounts. Staff used the customer number

allocation factor calculated previously in this report, resulting in an adjustment of \$171 to increase the expense of the Water Division.

Expense	Total Expensed In Test Year	80.56% Water	Allocated to 19.44% Gas
Telephone	\$ 5,508	\$ 4,437	\$ 1,071
Less: Test Year Expense		<u>(4,266)</u>	<u>(1,242)</u>
		<u>\$ 171</u>	<u>\$ (171)</u>

(Q) Taxes Other Than Income. Below, Staff calculated the Water Division’s pro forma payroll taxes by multiplying the total taxable wages by the payroll tax rate. Staff decreased payroll tax expense by \$4,297 as calculated below.

Pro Forma Employee Wages	\$ 135,627
Commissioner's Salaries	<u>11,601</u>
Total Wages Subject to Payroll Taxes	147,228
Times: Tax Rate	<u>7.65%</u>
Payroll Tax Expense	11,263
Less: Test Year Expense	<u>(15,560)</u>
Adjustment	<u>\$ (4,297)</u>

(R) Depreciation. WLWD reported \$295,595 for test-year Water Division depreciation expense. This amount was calculated by dividing the plant’s original cost by its estimated useful life. A summary of Staff’s review of the estimated useful lives is found at Attachment B of this report. To account for the effects of the changes to the

lives recommended in Attachment B, Staff decreased depreciation by \$96,589, as shown below.¹⁴

Asset	Original Cost	Western Lewis	Staff	Pro Forma
Structures and Improvements:				
New Building, Office Building	\$ 343,647	30	37.5	\$ 9,164
Transmission and Distribution Mains	8,781,819	40	62.5	140,509
Transportation Equipment	20,113	5	7	2,873
Meter Installations	181,383	10	45	<u>4,031</u>
Pro Forma				156,577
Less: Test-Year Depreciation on Assets Listed in the Adjustment				<u>(253,166)</u>
Adjustment				<u>\$ (96,589)</u>

(S) Non-Operating Revenue – Sewer Billing Service. During the test year, WLWD provided contracted billing and collection services to the Sanitation District No. 1 of Lewis County. Pursuant to the contract, WLWD bills and collects the volumetric sewer rates that are in effect for Lewis County. It remits the total amount collected to Lewis County less its billing fee of \$2.25 per sewer bill that was issued. WLWD assigned all of this revenue to the Water Division. The benefits of this should be shared with the Gas Division. Staff used the customer number allocation factor calculated previously in this report to assign some of the revenue to the Gas Division. Staff's calculation, as shown below, results in a decrease to Non-Operating Revenue of \$2,500.

¹⁴ The cost of mechanical meters is reported in the same account group as their installation costs. The total combined cost of the group is \$181,383. Although the cost of meters cannot be accurately identified and separated, the majority of the cost of the account group is attributable to installations. This is evidenced by comparing the cost of a mechanical meter to the cost of installing a meter. The majority of WLWD's meters are 5/8-inch meters. The current average combined cost of a meter and meter installation is assumed to be equal to the current tap fee charged for a 5/8-inch connection, \$1,125. Of this amount, the current cost of the mechanical meter is roughly \$48. The installation is then assumed to represent approximately \$1,077, or over 95.7 percent of the combined cost.

	Total Received In Test Year	Allocated to 80.56% Water	19.44% Gas
Sewer Billing Service	\$ 12,859	\$ 10,359	\$ 2,500
Less: Test Year		(12,859)	
Adjustment		<u>\$ (2,500)</u>	<u>\$ 2,500</u>

Overall Revenue Requirement and Required Revenue Increase

Staff applied the DSC method as generally accepted by the Commission to calculate WLWD's Overall Revenue Requirement for the Water Division. 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;¹⁵ 3) the average annual principal and interest payments on all long-term debts, and 4) working capital that is in addition to depreciation expense.

A comparison of WLWD's and Staff's calculation of their Overall Revenue Requirement and Required Revenue Increase for the Water Division is shown below.

¹⁵ The Kentucky Supreme Court has held that the Commission must permit a water district to recover its depreciation expense through its rates for service to provide internal funds to be used for renewing and replacing assets. *See Public Serv. Comm'n of Kentucky v. Dewitt Water Dist.*, 720 S.W.2d 725, 728 (Ky.1986). Although a water district's lenders require that a small portion of the depreciation funds be deposited annually into a debt reserve/depreciation fund until the account's balance accumulates to a required threshold, neither the Commission nor the Court requires that revenues collected for depreciation be accounted for separately from the water district's general funds or that depreciation funds be used only for asset renewal and replacement. The Commission has recognized that the working capital provided through recovery of depreciation expense may be used for purposes other than renewal and replacement of assets. *See 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 Dec. 21, 2012).

	Western Lewis	Staff
Pro Forma Operation and Maintenance Expense	\$ 469,990	\$ 482,835
Pro Forma Taxes Other Than Income	15,560	11,263
Pro Forma Depreciation	296,595	200,006
	<hr/>	<hr/>
Pro Forma Operating Expenses	782,145	694,104
Plus: Average Annual Principal and Interest Payments on Current Debts	167,775	167,775
Additional Working Capital	16,777	33,555
	<hr/>	<hr/>
Overall Revenue Requirement	966,697	895,434
Less: Other Operating Revenue	(37,296)	(38,674)
Interest Income	(547)	(547)
Non-Operating Revenue	(12,859)	(10,359)
	<hr/>	<hr/>
Revenue Required From Rates	915,995	845,854
Less: Pro Forma Present Rate Service Revenues	(738,969)	(738,969)
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Required Revenue Increase	\$ 177,026	\$ 106,885
Percent Increase	23.96%	14.46%
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(1) Average Principal and Interest Payments. WLWD currently has outstanding bonds payable to RD. In its Application, WLWD requested recovery of the three-year average principal and interest payments due in 2013, 2014, and 2015 on all bonds that were used to finance the cost of water system improvement projects. Staff agrees that the \$167,775 requested by WLWD represents, in all material respects, the average annual debt payments that will be made on the Water Division's long-term debts in each year that the water rates approved by the Commission in the proceeding will be in effect, beginning in 2015.

(2) Additional Working Capital. The DSC method, as historically applied by the Commission, includes an allowance for additional working capital that is equal to the minimum net revenues required by WLWD’s lenders that are above its average annual debt payments. In addition to depreciation expense, WLWD requested recovery of an allowance for working capital that is equal to 10 percent of its average annual RD bond payments. Historically, the Commission allows a water district recovery of additional working capital that is equal to the minimum net revenues required by the district’s lenders that are above the district’s average annual debt payments. In this case, RD requires that WLWD charge rates that produce net revenues that are at least 120 percent of its average annual bond payments. Following the Commission’s historic practice, Staff calculated WLWD’s allowance for additional working capital to be \$33,555, as shown below.¹⁶ Staff included this amount in the calculation of WLWD’s Overall Revenue Requirement for the Water Division.

¹⁶ Inclusion of the additional working capital in WLWD’s revenue requirement is not necessary for it to earn revenues that meet the minimum DSC ratio required by its lenders. As depreciation is a noncash item, it is excluded from the ratio calculation, which is actually a measure of cash flow. As shown below, WLWD’s minimum DSC ratio is met with or without the inclusion of additional working capital.

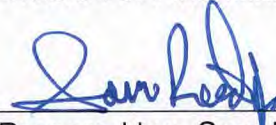
	With Additional Working Capital	Without Additional Working Capital
Overall Revenue Requirement	\$ 895,434	\$ 861,879
Less: Cash Related Expenses, includes Operation and Maintenance and Taxes	(494,098)	(494,098)
Net Revenues	401,336	367,781
Divide by: Average Annual Payments	167,775	167,775
DSC Ratio	239%	219%

	Water Division
Average Annual Principal and Interest Times: DSC Coverage Ratio	167,775 <u>120%</u>
Total Net Revenues Required	201,330
Less: Average Annual Principal and Interest Payments	<u>(167,775)</u>
Additional Working Capital	<u>\$ 33,555</u>

Signatures



Prepared by: Ariel Turnbull
Financial Analyst, Water and Sewer
Revenue Requirements Branch
Division of Financial Analysis



Prepared by: Sam Reid
Manager of Water
and Sewer Rate Design Branch
Division of Financial Analysis

ATTACHMENT A
STAFF REPORT, CASE NO. 2014-00266
RATES CALCULATED BY STAFF

Monthly Water Rates

First	1,000	gallons	\$ 16.65	Minimum bill
Next	4,000	gallons	5.80	per 1,000 gallons
All Over	5,000	gallons	4.36	per 1,000 gallons
Bulk Water Sales			3.00	per 1,000 gallons

ATTACHMENT B
 STAFF REPORT, CASE NO. 2014-00266
 ENGINEERING DIVISION'S
 ANALYSIS OF ASSET SERVICE LIVES

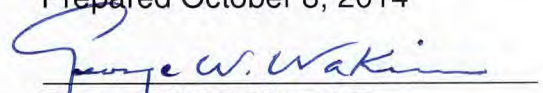
Historically, the Commission has relied on the National Association of Regulatory Utility Commissioners Study of Depreciation Practices for Small Water Utilities ("NARUC Study"), dated August 15, 1979, to evaluate the reasonableness of a utility's depreciation practices. This study outlines expected service life ranges for various asset groups designed, installed, and maintained in accordance with good water works practices. Typically, an adjustment is made when the Commission finds that a utility is proposing to use a service life that falls outside of this range, while service lives falling within these ranges are generally accepted.

In the following table, Engineering staff has identified the account classifications for which the utility's current service lives are not consistent with the service lives contained in the NARUC Study. The table shows the utility's current and Engineering staff's recommended reasonable and appropriate service lives based on a review of information contained in the record of this case.

Asset Classification	Current	Staff Recommended	NARUC Study
Structures and Improvements: New Building, Office Building	30	37.5	35-40
Transmission and Distribution Mains	40	62.5	50-75
Transportation equipment	5	7	7
Meter Installations	10-20	45	40-50

Absent any specific and verifiable evidence supporting alternative service lives, Engineering Staff finds that service lives based on the NARUC Study, as shown in the above table, should be considered reasonable and appropriate.

Prepared October 8, 2014



 George W. Wakim, P.E.
 Manager, Water and Sewer Branch

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