

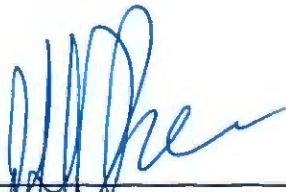
COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ALTERNATIVE RATE ADJUSTMENT FILING OF) CASE NO.
REID VILLAGE WATER DISTRICT) 2014-00379

NOTICE OF FILING OF COMMISSION STAFF REPORT

Notice is hereby given that, in accordance with the Commission's Order of December 12, 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 the Commission's December 12, 2014 Order, Reid Village Water District is required to file written comments regarding the findings of Commission Staff no later than March 6, 2015.



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

DATED FEB 20 2015

cc: Parties of Record

STAFF REPORT
ON
REID VILLAGE WATER DISTRICT
CASE NO. 2014-00379

Reid Village Water District ("Reid Village"), a water district organized pursuant to KRS Chapter 74, provides retail water service to approximately 1,130 customers that reside in the Kentucky counties of Clark and Montgomery.¹ On October 27, 2014, Reid Village tendered its application to the Commission requesting to increase its water service rates and certain nonrecurring charges. After Reid Village corrected a deficiency, its application was deemed filed on November 18, 2014.

The proposed water service rates as stated in the application would increase a monthly bill for 4,000 gallons of water purchased through a 5/8-inch x 3/4-inch meter from \$31.59 to \$42.36, an increase of \$10.77, or 34.1 percent. Reid Village stated that these rates would increase its annual revenues by \$147,680, or 34.11 percent.

Reid Village based its requested rates on the test year ended December 31, 2013. The financial exhibits shown in Reid Village's application that support the requested rates are summarized below in condensed form.

¹ *Annual Report of Reid Village Water District to the Public Service Commission for the Calendar Year Ended December 31, 2013 ("Annual Report")* at 12 and 53.

Pro Forma Operating Expenses	\$ 530,979
Plus: Average Annual Principal and Interest Payments on Current Debts	45,265
Additional Working Capital	<u>9,053</u>
Overall Revenue Requirement	585,297
Less: Other Operating Revenue	(4,159)
Interest Income	<u>(513)</u>
Revenue Required From Rates	580,625
Less: Pro Forma Present Rate Service Revenues	<u>(432,945)</u>
Required Revenue Increase	<u>\$ 147,680</u>
Percent Increase	<u>34.11%</u>

The table below details the increase to nonrecurring charges requested by Reid Village. As part of its application, Reid Village provided cost justification sheets for each of the requested charges.

	<u>Current</u>	<u>Proposed</u>	<u>\$ Increase</u>	<u>%</u>
Connect Fee	\$20.00	\$27.00	\$7.00	35
Reconnect Fee	25.00	35.00	10.00	40
Deposit	65.00	84.00	19.00	29

To determine the reasonableness of the proposed water service rates and nonrecurring charges, Staff performed a limited financial review of Reid Village's operations for the test year ended December 31, 2013. The scope of the 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 and immaterial discrepancies were not pursued or addressed.

Staff's findings are summarized in this report. David Foster reviewed the calculation of Reid Village's Overall Revenue Requirements. Eddie Beavers reviewed Reid Village's reported revenues, rate design, and nonrecurring charges.

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 Reid Village's overall revenue requirement to be \$559,604 and that a revenue increase of \$126,659, or 29.26 percent, over pro forma present rate revenues is necessary to generate the overall revenue requirement.

2. Water Service Rates. Reid Village proposes an across-the-board increase in general water sales rates of approximately 34 percent. The Commission has previously found that an across-the-board increase is an appropriate and equitable method of cost allocation in the absence of a cost-of-service study.

The rates set forth in Attachment A to this report are based upon the revenue requirement as calculated by the Commission Staff and will produce revenues of at least \$559,904 from water sales, resulting in an approximate 29.26 percent increase to current rates.

3. Nonrecurring Charges. Reid Village's application proposes to increase its nonrecurring charges. Reid Village proposes to increase its Connect Fee from \$20 to \$27, its Reconnect Fee from \$25 to \$35, and its Deposit from \$65 to \$84. To support the proposed increases in fees, Reid Village filed Cost Justification Sheets with the application. The Cost Justification Sheets list the expenses that are incurred to provide the associated service. Staff has reviewed the Cost Justification Sheets and believes

the proposed charges are cost-based. Staff has reviewed the proposed Deposit charge of \$84, which is based on an average customer usage for Reid Village's system of 4,000 gallons and calculated using the proposed rates in this proceeding. Staff has recalculated this charge using the Monthly Water Rates in Attachment A to be \$81.00 in accordance with 807 KAR 5:006, Section 8. Staff finds that the nonrecurring charges set forth in Attachment A of this report should be approved.

4. Depreciable Lives. In this report, Staff revised the depreciable lives assigned to some of Reid Village's assets for ratemaking purposes. The revised lives should be used for accounting purposes in all future reporting periods. They better match the life expectancy of Reid Village's assets and will better match expenses to the revenues generated by the water rates approved in this proceeding. No adjustment to accumulated depreciation or retained earnings should be made to account for the retroactive effect of this change in accounting estimate.

Pro Forma Operating Statement

Reid Village's Pro Forma Operating Statement for the test year ended December 31, 2013, as determined by Staff, appears below.

	Test Year	Adjustment (Ref.)	Pro Forma
Operating Revenues			
Sales of Water	\$ 423,646	\$ (12,452) (A)	
		21,751 (B)	\$ 432,945
Other Operating Revenue		12,452 (A)	
		1,345 (C)	13,797
Total Operating Revenues	423,646	23,096	446,742
Operating Expenses			
Operation and Maintenance Expenses			
Salaries and Wages - Employees	140,490	5,348 (D)	145,838
Salaries and Wages - Commissioners	3,500		3,500
Employee Pensions and Benefits	53,028	5,646 (E)	58,674
Purchased Water	156,043	21,310 (F)	177,353
Materials and Supplies	10,102		10,102
Contractual Services	1,510		1,510
Rental of Equipment	6,000		6,000
Transportation Expenses	11,454		11,454
Insurance	9,682	276 (G)	9,958
Miscellaneous Expense	42,042	690 (H)	
		0 (I)	42,732
Total Operation and Maintenance Expenses	433,851	33,270	467,121
Taxes Other Than Income	11,641		11,641
Depreciation	44,887	(4,053) (J)	40,834
Total Operating Expenses	490,379	29,217	519,596
Net Operating Income	(66,733)	(6,121)	(72,854)
Interest Income	513		513
Income Available to Service Debt	\$ (66,220)	\$ (6,121)	\$ (72,341)

(A) Water Sales Revenue – Reclassify Collection of Nonrecurring Charges.

During the test year, Reid Village realized revenues from nonrecurring charges in the

amount of \$12,452.² Reid Village improperly reported this revenue with Water Sales Revenues in its 2013 Annual Report. The Uniform System of Accounts (“USoA”) requires that this revenue be reported as Other Operating Revenue.³ Staff reclassified the nonrecurring charge revenue from Water Sales Revenue to Other Operating Revenue as required by the USoA.

(B) Water Sales Revenue – Purchased Water Adjustment. Reid Village purchases wholesale water from Mount Sterling Water and Sewer System (“Mount Sterling”). Effective August 12, 2014, Mount Sterling increased the wholesale rate charged to Reid Village from \$2.46 per thousand gallons to \$2.77 per thousand gallons. In Case No. 2014-00259, the Commission authorized Reid Village to adjust its retail water service rates to pass through this wholesale rate increase.⁴ Staff determined that

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Late Payment Penalties	\$ 8,576
Connection Fees	1,780
Reconnection Fees	1,806
Meter Reread Charges	40
Returned Check Charges	<u>250</u>
Total	<u>\$ 12,452</u>

³ USoA for Class A&B Water Districts and Associations, pages 92 and 93.

⁴ Case No. 2014-00259, *Purchased Water Adjustment Filing of Reid Village Water District* (Ky. PSC Aug. 12, 2014).

the rates authorized in Case No. 2014-00259 will generate annual revenues of \$432,945, requiring an increase to Water Sales Revenues of \$21,751.⁵

(C) Other Operating Revenue. As previously discussed in this report, Staff found that Reid Village’s request to increase its connection fee and reconnection fee should be approved. If approved, the new fees will increase test-year revenues by \$1,345.⁶ Accordingly, Staff increased test-year revenues by this amount. This adjustment is not appropriate if the Commission does not authorize the increase to the connection and reconnection fees.

(D) Salaries and Wages – Employees. Reid Village has four full-time employees and one part-time employee. It reported \$140,490 for test-year Salaries and Wages – Employees expense. It proposed to increase this amount by \$5,348 to account for employee wage rates that became effective on January 1, 2014, as approved by Reid Village’s Board of Commissioners on December 30, 2013. Staff reviewed the calculation of Reid Village’s proposed adjustment and finds that it

⁵

Pro Forma Present Rate Revenue as Stated in Billing Summary	\$ 432,945
Less: Test-Year Water Sales Revenue as Adjusted by Staff to remove Other Operating Revenue (\$423,646 - \$12,452)	<u>(411,194)</u>
Purchased Water Adjustment	<u>\$ 21,751</u>

⁶

	Test-Year Revenue	Times: Percentage Increase to Fee	Increase in Revenue
Connection Fee	\$ 1,780	35%	\$ 623
Reconnection Fee	<u>1,806</u>	40%	<u>722</u>
Total	<u>\$ 3,586</u>		<u>\$ 1,345</u>

represents, in all material respects, the impact that the 2014 wage rates will have on test-year expenses. Accordingly, Staff increased test-year Salaries and Wages expense by \$5,348.

(E) Employee Pensions and Benefits. Reid Village provides health insurance coverage to full-time employees, for which it reported \$53,028 during the test year. It proposed to increase this amount by \$5,646 to account for the increased costs to its policy premium subsequent to the test year.⁷ After reviewing documentation supporting Reid Village's proposed adjustment, Staff finds that the adjustment is appropriate and increased test-year Employee Pensions and Benefits expense by \$5,646.

(F) Changes to Wholesale Purchase Water Rates. As previously discussed at Item (B), Reid Village purchases wholesale water from Mt. Sterling. Effective August 12, 2014, Mount Sterling increased its wholesale rate from \$2.46 per thousand gallons to \$2.77 per thousand gallons. Reid Village proposed to increase test-year expenses by \$27,876 to account for the increased wholesale rate. It calculated the adjustment by applying the new wholesale water rate to water it purchased during the 12 months ending May 31, 2014 – a total of 66,396,790 gallons.

Reid Village's adjustment is not accurate because it is not based on test-year water purchases. It inappropriately mismatches pro forma water sales, which are based on water sales for the calendar year ended December 31, 2013, with water purchases for a different 12-month period. As shown below, Staff found that the proper increase to test-year purchased water expense is \$21,310, which is determined by applying the new wholesale water rate to Reid Village's test-year water purchases of 64,026,216 gallons.

⁷ In its application, Reid Village included this adjustment in Misc. Expenses.

	Test-Year Gallons Purchased	Current Rate Per Thousand Gallons	Pro Forma
Mount Sterling	64,026,216	\$ 2.77	\$ 177,353
Less: Test Year			<u>(156,043)</u>
Increase			<u>\$ 21,310</u>

(G) General Liability Insurance. Reid Village increased test-year general liability insurance expense by \$276 to account for an increase to its insurance policy premium.^B Staff finds that this adjustment, while having no material effect on Reid Village's Overall Revenue Requirement, is known and measurable and is, therefore, acceptable.

(H) Miscellaneous Expense – Tank Inspection Fees. Reid Village contracts with Utility Service Co. Inc. ("Utility Service") to perform annual inspections, cleaning, and repairs on all tanks. The annual test-year expense was \$4,604. Subsequent to the test year, Utility Service increased its annual fee by \$690. Reid Village requested to increase test-year expenses by this amount. Staff accepted Reid Village's adjustment.

(I) Postage. Reid Village reported test-year postage expense in the amount of \$4,178 to account 675, Miscellaneous Expense. It proposed to increase this amount by \$764. It calculated the adjustment by annualizing the difference between the first six months of postage expense reported for the test year and the postage expense

^B Application.

reported for the first six months of 2014.⁹ It did not provide an explanation for the method used to calculate the adjustment, nor did it identify the reason for the increase.

During its review, Staff found that postage expense for 2014 totaled \$4,363, only \$185 more than the amount reported for the test year. This annual increase to postage expense is not material to Reid Village's operations. Staff did not make an adjustment to test-year postage expense.

(J) Depreciation. Reid Village reported \$44,887 for test-year depreciation expense. It calculated the expense using the whole-life, straight-line method pursuant to which an asset's depreciable basis is divided by its estimated useful life. The lives assigned to each asset were reviewed by the Commission's Division of Engineering. A summary of Staff's review is found at Attachment B of this report. Staff adjusted the test-year expense to account for the effects of the changes to the depreciable lives recommended in Attachment B.

Also, during the test year, Reid Village purchased a backhoe for \$40,800 to replace an existing backhoe that was removed from service and sold. Reid Village reported a \$3,750 gain on the sale of the old backhoe using account 414, Gains

⁹ Application, ARF Form 1 – Attachment SAO-W, Page 3 of 3.

First Six Months of 2014	\$	2,360
Less: First Six Months of Test Year		<u>(1,978)</u>
Increase to Six Month Expense		382
Times: 2		<u>2</u>
Annualized Increase	\$	<u>764</u>

(Losses) from the Disposition of Utility Property.¹⁰ Reid Village's accounting for the gain is in violation of the USoA and deprives ratepayers of the benefits of the gain. Staff proposes to remove the gain from account 414 and use it to reduce the depreciable basis of the new backhoe.¹¹ As explained below, while this method represents a departure from the accounting principles of regulated utilities, it flows through to ratepayers the benefits of the gain over the depreciable life of the new backhoe and is consistent with prior Commission rulings.

The USoA adopted by the Commission governs the accounting for Reid Village's retirement of depreciable assets. It states, in part, that "at the time of retirement of depreciable utility plant in service, this account shall be charged with the book cost of the property retired plus the cost of removal, and shall be credited with the salvage value and any other amounts recovered, such as insurance."¹²

Under the accounting treatment prescribed by the USoA, gains and losses on the disposition of a depreciable asset are embedded in the accumulated depreciation account. Their effects are recognized in the determination of depreciation rates when the remaining-life method of depreciation is used. Gains have the effect of decreasing the composite rate while losses increase the rate; however, gains and losses have no

¹⁰ Reid Village's 2013 Annual Report, page 24.

¹¹

Original Cost of New Backhoe	\$	40,800
Less: Gain on Sale of Asset		<u>(3,750)</u>
Depreciable Basis	\$	<u>37,050</u>

¹² USoA for Class A/B Water Districts and Associations at 42.

impact in the determination of depreciation rates when the whole-life method is used to calculate depreciation. When using the whole life method, gains and losses remain embedded in the accumulated depreciation account, with no impact on depreciation rates absent an accounting treatment alternative to that required by the USoA.

The Commission has historically allowed small utilities, such as Reid Village, that do not maintain property records using the type of sophisticated computer software program necessary to accurately and reliably calculate remaining life depreciation rates and do not have the financial resources to commission a remaining-life depreciation study, to calculate depreciation using the whole-life method. In this proceeding, Reid Village has proposed the whole-life method. Staff agrees that this method is appropriate and should be accepted by the Commission, but, with its use, the gain on the disposition of a depreciable asset will be carried forward in Reid Village's property records indefinitely, absent an accounting method that is alternative to that required by the USoA.

Staff's proposed alternative recognizes the gain on the disposition of the retired asset over the life of the replacement asset. The effect of this method is the same as other alternative methods of accounting that have been authorized by the Commission for other utilities when the whole-life method is used to calculate depreciation.

To account for the effects of Staff's findings, test-year Depreciation Expense was decreased by \$4,053 as calculated below:

Asset Classification	Depreciable Depreciable			Pro Forma Test Year	Adjustment
	Basis	Life			
2000 Chevy	\$ 7,500	7	\$ 1,071	1,500	\$ (429)
2011 Chevy Colorado	12,940	7	1,849	2,588	(739)
Trailers	5,450	17.5	311	860	(549)
Kubota	37,050	12.5	2,964	4,760	(1,796)
Air Compressor	4,500	12.5	360	900	(540)
Decrease					<u>\$ (4,053)</u>

Overall Revenue Requirement and Required Revenue Increase

The Commission has historically applied a DSC method to calculate the Overall Revenue Requirement of water districts and water associations. This method allows for recovery of: 1) cash related pro forma operating expenses; 2) depreciation expense, a non-cash item, to provide working capital;¹³ 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 Reid Village's and Staff's calculations of Reid Village's Overall Revenue Requirement and Required Revenue Increase using the DSC method is shown below.

¹³ 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 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).

	Reid Village	Staff
Pro Forma Operating Expenses	\$ 530,979	\$ 519,596
Plus: Average Annual Principal and Interest Payments on Current Debts Additional Working Capital	45,265 <u>9,053</u>	45,265 <u>9,053</u>
Overall Revenue Requirement	585,297	573,914
Less: Other Operating Revenue Interest Income	(4,159) <u>(513)</u>	(13,797) <u>(513)</u>
Revenue Required From Rates	580,625	559,604
Less: Pro Forma Present Rate Service Revenues	<u>(432,945)</u>	<u>(432,945)</u>
Required Revenue Increase	<u>\$ 147,680</u>	<u>\$ 126,659</u>
Percent Increase	<u>34.11%</u>	<u>29.26%</u>

(1) Average Annual Principal and Interest Payments. Reid Village has two outstanding bond series payable to the United States Department of Agriculture Rural Development. In its Application, Reid Village requested recovery of the three-year average principal and interest payments due in 2014, 2015, and 2016. Staff agrees that the \$45,265 requested by Reid Village represents, in all material respects, the average annual debt payments that will be made in each year that the water rates approved by the Commission in this proceeding will be in effect.

(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 a district's lenders that are above its average annual debt payments. In this case, Staff agrees with the amount requested by Reid Village as calculated below.

Average Annual Principal and Interest	45,265
Times: DSC Coverage Ratio	<u>120%</u>
Total Net Revenues Required	54,318
Less: Average Annual Principal and Interest Payments	<u>(45,265)</u>
Additional Working Capital	<u>\$ 9,053</u>

Signatures



Prepared by: David P. Foster
 Financial Analyst, Water and Sewer
 Revenue Requirements Branch
 Division of Financial Analysis



Prepared by: Eddie Beavers
 Water and Sewer Rate Design Branch
 Division of Financial Analysis

ATTACHMENT A
STAFF REPORT, CASE NO. 2014-00379
RATES CALCULATED BY STAFF

Monthly Water Rates

First	2,000	gallons	\$24.91	Minimum bill
Next	1,000	gallons	8.26	per 1,000 gallons
Next	2,000	gallons	7.67	per 1,000 gallons
Next	5,000	gallons	7.06	per 1,000 gallons
Over	10,000	gallons	6.44	per 1,000 gallons

Non-Recurring Charges

Connect Fee	\$27.00
Reconnect Fee	35.00
Deposit Fee	81.00

ATTACHMENT B
 STAFF REPORT, CASE NO. 2014-00379
 REID VILLAGE WATER DISTRICT
 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
2000 Chevy and 2011 Chevy Colorado/Transportation equipment	5	7	7
Trailer and enclosed trailer/Tools, Shop and Garage Equipment	5	17.5	15-20
Kubota Excavator and Air Compressor with tamp/Power Operated Equipment	5	12.5	10-15

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 January 7, 2015



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