

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF OLDHAM WOODS)	CASE NO.
SANITATION, INC. FOR RATE ADJUSTMENT)	2016-00131
FOR SMALL UTILITIES 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 April 15, 2016, 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 April 15, 2016 Order, Oldham Woods Sanitation, Inc. is required to file written comments regarding the findings of Commission Staff no later than July 25, 2016.



Aaron D. Greenwell
Acting Executive Director
Public Service Commission
P.O. Box 615
Frankfort, KY 40602

DATED JUL 07 2016

cc: Parties of Record

STAFF REPORT
ON
OLDHAM WOODS SANITATION, INC.
CASE NO. 2016-00131

Oldham Woods Sanitation, Inc. (“Oldham Woods”) provides wastewater service to approximately 126 customers residing in the Oldham Woods/Turtle Creek Subdivisions in Oldham County, Kentucky.¹ On March 28, 2016, Oldham Woods tendered an application to the Commission for an adjustment of sewer rates pursuant to 807 KAR 5:076. After Oldham Woods corrected filing deficiencies, its application was accepted for filing on April 11, 2016.

Oldham Woods based its application on the test year ended December 31, 2015. Oldham Woods calculated its requested revenue requirement using the operating ratio method as historically accepted by the Commission.² Pursuant to this method, the allowable revenue requirement is calculated by dividing pro forma operating expenses by 88 percent. Using operations reported for the test year, Oldham Woods determined

¹ *Annual Report of Oldham Woods Sanitation, Inc. to the Public Service Commission for the Calendar Year Ended December 31, 2015* at 9 and 25.

² An operating ratio measures the difference between operating revenues and operating expenses. It is defined by the following equation.

$$\text{Operating Ratio} = \frac{\text{Operation \& Maintenance Exp. + Depreciation + Taxes}}{\text{Gross Revenues}}$$

The Commission has found that the operating ratio is a reasonable and necessary alternative to the rate-of-return method for calculating the allowable Determination of Allowable Net Operating Income (“NOI”) for small sewer investor-owned utilities. Specifically, it has found that the rate-of-return method cannot be used because there is “no basis” upon which to determine a rate of return for these utilities, Administrative Case No. 95-236, *Application of Thelma Waste Control, Inc. for a Rate Adjustment Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC. Apr. 15, 1996) at 6. Further, it has found that the operating ratio method is appropriate when plant investment is low and operating expenses are high, Case No. 7982, *Notice of Application of Fern Lake Company* (Ky. PSC. Aug. 27, 1981) at 3.

that a revenue increase of \$12,211, or 22.39 percent, is warranted.³ Oldham Woods is seeking to increase its flat monthly wastewater service rate from \$36.07 to \$44.15, an increase of \$8.08, or 22.4 percent.

To determine the reasonableness of the requested rates, Commission Staff performed a limited financial review of Oldham Woods' test-year operations. 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 necessarily pursued or addressed.

Commission Staff's findings are summarized in this report. Mark Frost reviewed the calculation of Oldham Woods' Overall Revenue Requirements. Jason Green reviewed Oldham Woods' reported revenues and rate design.

Summary of Findings

Based on its review, Commission Staff determined that Oldham Woods' adjusted test-year operations support a monthly flat rate of \$40.61,⁴ an increase of \$4.54, or 12.59 percent, to its current rate of \$36.07. Commission Staff's calculations are shown and discussed in the remaining sections of this report.

³ Application at 15.

⁴ Revenue Requirement	\$ 61,407
Divided by: 12 Months	<u>12</u>
Monthly Revenue Requirement	5,117
Divided by: No. of Customers	<u>126</u>
Monthly Rate	<u>\$ 40.61</u>

Pro Forma Operating Statement

The Pro Forma Operating Statement for the test year ended December 31, 2015, as determined by Commission Staff, appears below:

	Test Year Operations	Pro Forma Adjustments	Adj. Ref.	Pro Forma Operations
Operating Revenues				
Sewer Sales Revenue	\$ 53,095	\$ 1,443	(A)	\$ 54,538
Operating Expenses:				
Operation and Maintenance Expenses:				
Owner/Manager Fee		3,600	(B)	3,600
Collection System	27,324	435	(C)	
		(2,270)	(D)	25,489
Purchased Power	8,622			8,622
Chemicals	1,766			1,766
Agency Collection Fee	3,827	104	(E)	3,931
Miscellaneous General Expenses	3,205	(1,866)	(F)	1,339
Total Operation and Maintenance Exp.	44,744	3		44,747
Depreciation	7,951	(1,526)	(G)	6,425
Amortization		1,551	(H)	1,551
Taxes Other Than Income Tax	1,315			1,315
Total Operating Expenses	54,010	28		54,038
Net Operating Income	\$ (915)	\$ 1,415		\$ 500

(A) Sewer Service Revenue. Oldham Woods proposes to adjust its test-year revenue from sewer rates of \$53,095 by \$1,443 to a pro forma level of \$54,538. Oldham Woods proposes to normalize its revenues to reflect the end-of-year customer level of 126 and its current tariffed rate of \$36.07 per month.⁵ Commission Staff agrees with Oldham Woods' proposed adjustment and is increasing operating revenues by \$1,443.

⁵ 126 (Number of Customers) x \$36.07 (Current Tariffed Rate) x 12 (months) = \$54,538.

(B) Owner/Manager Fee. Patience Martin is the owner and president of Oldham Woods. Oldham Woods did not report compensating Ms. Martin for her owner/manager duties in the test year. In its application, Oldham Woods is proposing to increase test-year operating expenses by \$3,600 to provide rate recovery of an owner/manager fee at the level historically authorized by the Commission for small wastewater systems.

The Commission has historically allowed small, investor-owned sewer utilities, such as Oldham Woods, recovery of a \$3,600 owner/manager fee to be paid to the utility's owner for serving as its chief executive officer. In the cases of very small utilities, the fee is also considered compensation for providing additional services.⁶ Commission Staff finds that Oldham Woods' proposed owner/manager fee adjustment is consistent with prior Commission rulings and, therefore, is increasing test-year expenses by \$3,600.

(C) Routine Maintenance Fee. Camden Environmental Services ("Camden") provides the certified operator and handles the day-to-day operations of Oldham Woods wastewater treatment system. In the test year, Oldham Woods reported paying Camden \$5,505 for the routine maintenance service.

⁶ In Case No. 2007-00397, *Application of Woodland Estates Sewage System for an Adjustment of Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC Dec. 27, 2007), the Commission found that the \$3,600 owner-manager fee awarded to Woodland Estates Sewage System, which served 24 customers at the time its rate application was filed, was appropriate compensation for the owner serving as the utility's executive officer and for the owner's contribution to the utility of office space, office supplies, telephone service, billing and collection services, and bookkeeping services (Ky. PSC. Dec. 27, 2007). In Case No. 2005-00036, *Application of Lewis Sanitation Company, Inc. d/b/a Garden Heights Sewer System for Adjustment of Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC Apr. 14, 2005), the Commission found that the \$3,600 owner manager fee was appropriate compensation for only the owner's executive oversight of the utilities operations. In addition to the owner manager fee, the Commission allowed rate recovery for expenses that were incurred by the utility for bookkeeping services, office rent, office supplies, office utilities, and reimbursement to the owner for transportation expenses. Lewis Sanitation Company, Inc. served 108 customers at the time its rate application was filed.

In April 2015, Camden increased its routine maintenance fee from \$350 to \$495 per month, resulting in an increased annual fee of \$5,940.⁷ Oldham Woods proposes to increase its routine maintenance fee expense by \$435⁸ to reflect the current annual cost of its routine maintenance. After reviewing the test-year invoices, Commission Staff finds that Oldham Woods' proposed adjustment is reasonable and is increasing operating expenses by \$435.

(D) Nonrecurring Labor. Oldham Woods proposes a net decrease to its pro forma operating expenses of \$1,125 to remove nonrecurring labor costs of \$1,250 and to increase operating expenses by \$125 to reflect amortizing the nonrecurring labor over ten years. Oldham Woods was not able to explain how it calculated the nonrecurring labor costs, nor could Commission Staff locate the nonrecurring labor costs in the test-year invoices or in the operating expense schedule. Therefore, Commission Staff is recommending that Oldham Woods' proposed adjustments be denied.

Upon review of the test-year invoices, Commission Staff discovered that Oldham Woods had incorrectly expensed the cost of a disinfection system of \$2,270. The disinfection system is considered a capital expenditure that should be depreciated, rather than recorded as an expense. Commission Staff is reducing Oldham Woods' operating expenses by \$2,270. The depreciation of the disinfection system is contained in section H of this report.

⁷ \$495 (Increased Monthly Fee) x 12 (Months) = \$5,940.

⁸ \$5,940 (Current Annual Routine Maintenance Fee) - \$5,505 (Test-Year Routing Maintenance Fee) = \$435.

(E) Agency Collection Fee. Oldham Woods reported a test-year agency collection fee expense of \$3,827. The Oldham County Water District provides the customer billing and collection service to Oldham Woods for a flat fee of \$2.60 per customer. Using the end-of-year customer level of 126 and the \$2.60 billing and collection fee, Commission Staff calculates a pro forma agency collection fee expense of \$3,931, an increase of \$104 above the reported test-year expense. Accordingly, Commission Staff is increasing the agency collection expense by \$104.

(F) Accounting Fee. In the test year Oldham Woods recorded a payment of \$2,457 to its Certified Public Accountant ("CPA") for the filing of federal income tax returns for prior years. Also in 2016, Oldham Woods' CPA increased the fee he charges to file the Annual Report with the Commission from \$200 to \$300. Oldham Woods proposed to reduce its accounting fee by \$1,157 to eliminate the fees for the prior year's tax returns and to include the 2016 fee increase.

Upon its review of the invoice from Lindemeyer CPA, LLC, Oldham Woods' CPA, the Commission Staff noted that the \$2,457 fee was for the filing of the corporate income tax returns for the years 2010 through 2014. Dividing the \$2,457 income tax filing fee by five years results in an annual cost of \$491, \$1,966 below the amount recorded in the test year. Accordingly, Commission Staff is reducing the accounting fee expense by \$1,866 to reflect the elimination of the cost to prepare four years of Oldham Woods' corporate tax returns and to include the 2016 fee increase.

(G) Amortization. In 2016 Oldham Woods renewed its Kentucky Pollution Discharge Elimination System ("KPDES") permit at a cost of \$2,200. The KPDES permit expires five years from its origination date. Oldham Woods is requesting to amortize its

KPDES permit over its five-year life, resulting in an annual amortization of \$440. Commission Staff finds that Oldham Woods' proposed adjustment is reasonable and has increased operating expenses by \$440.

Oldham Woods also requests recovery of \$900 to account for the three-year amortization of the \$2,700 rate case expense it incurred to prepare, file, and adjudicate the application filed in this proceeding. Commission Staff agrees that recovery of amortization of this rate case expense is appropriate, but disagrees with the use of a three-year amortization period.

The rate case consulting fees are considered to be an intangible regulatory asset. Generally, when there is no evidence to support an alternative amortization period, the Commission amortizes an intangible regulatory asset or liability identified in a rate proceeding over the anticipated life of the utility rates approved in that proceeding. It is Commission Staff's opinion that the rates approved in this proceeding will likely become obsolete after five years, due to changes that will occur to Oldham Woods' cost of service during that time. This opinion is supported by the fact that it has been six years since Oldham Woods' last filed a rate case in 2010.⁹ Accordingly, absent a more reasonable amortization period, Commission Staff is amortizing rate case expense over five years, resulting in a \$540 increase to test-year operating expenses.

Lastly, subsequent to the test year, Oldham Woods made repairs to its lagoon and to its lagoon aerators at a total cost of \$7,408. Oldham Woods requested that these repairs be treated as a regulatory asset in this proceeding and that they be

⁹ Case No. 2010-00432, *Alternative Rate Filing of Oldham Woods Sanitation, Inc.* (Ky. PSC Sept. 1, 2011).

amortized over five years. Commission Staff agrees that the amortization of the post-test-year repairs is appropriate in this proceeding, with the exception of the \$1,700 lagoon bank repair. The bank repair was supported by a quote and had not been completed at the time the application was filed. Because this expenditure does not meet the ratemaking criteria of being known or measurable, Commission Staff is not including it in its post-test-year amortization adjustment.

Commission Staff also disagrees with Oldham Woods' proposed five-year amortization period. Given the nature of the repairs, Commission Staff believes that a ten-year amortization more closely matches the expected lives of the repairs. Accordingly, amortization expense is being increased by \$571.

As shown below, Commission Staff calculated total pro forma amortization expense to be \$1,551.

Regulatory Asset - Amortization	Cost	Life	Annual Amortization Expense
Rate Case Consultant	\$ 2,700	5	\$ 540
KPDES Permit Fee	2,200	5	440
Post Test Year Repairs	5,707	10	571
Pro Forma Amortization Expense			\$ 1,551

(H) Depreciation. Oldham Woods reported \$7,951 for test-year depreciation expense. In calendar year 2012, Oldham Woods depreciated the cost of its gravel access road of \$5,560 over five years and in 2014 depreciated its gravel access road repairs of \$6,000 over ten years. Historically, the Commission has relied on Table 44, Average Service Lifetimes, Major Systems Components, Wastewater Systems, of the O&M Guide for the Support of Rural Water-Wastewater Systems by Commissions on

Rural Water, Chicago, Illinois, 1974, pages 246–247, to determine the reasonableness of the depreciation lives used by wastewater utilities. However, there is no account classification in this analysis for a gravel access road.

Because there would be no differences between the depreciation lives of a gravel access road installed by a wastewater utility versus a water utility, Commission Staff will use the National Association of Regulatory Utility Commissioners Study of Depreciation Practices for Small Water Utilities (“NARUC Study”) dated August 15, 1979, to judge the reasonableness of the lives Oldham Woods used to calculate depreciation for its gravel access road. The NARUC Study structures and improvements category shows a depreciation life range of 35 years to 40 years. Depreciating the gravel roads over 35 years results in an annual expense of \$422, which is \$1,753 below the test-year depreciation reported for these repairs.

Depreciating the disinfection system that was removed from operating expenses over ten years results in an increase to depreciation expense of \$227. Commission Staff’s net decrease to depreciation expense is \$1,526 as shown below:

	<u>Original Cost</u>	<u>Depreciation Life</u>	<u>Depreciation</u>
Access Road,	\$ 14,775	35	\$ 422
Less: Test-Year Depreciation			<u>(2,175)</u>
Access Road Adjustment			(1,753)
Disinfection System	2,270	10	<u>227</u>
Net Depreciation Adjustment			<u>\$ (1,526)</u>

Determination of Allowable Net Operating Income ("NOI")

Using the operating ratio method, Commission Staff calculated Oldham Woods' allowable NOI to be \$7,369 as shown below.

Operating Expenses	\$ 54,038
Divide by: Operating Ratio	<u>88%</u>
Operating Revenue	61,407
Less: Operating Expenses	<u>(54,038)</u>
Allowable NOI	<u><u>\$ 7,369</u></u>

Calculation of Overall Revenue Requirement
and Required Revenue Increase

To recover all pro forma operating expenses and to generate the allowable NOI, Oldham Woods requires an overall revenue requirement of \$61,407. As shown below, a \$6,869 revenue increase, or 12.595 percent, is necessary to produce the overall revenue requirement.

Operating Expenses	\$ 54,038
Allowable NOI	<u>7,369</u>
Revenue Requirement	61,407
Less: Pro Forma Present Rate Revenue	<u>(54,538)</u>
Required Revenue Increase	<u>\$ 6,869</u>
Percentage	<u><u>12.595%</u></u>

Rate Calculated by Commission Staff

Oldham Woods' current rate design is a flat monthly rate. The current monthly rate is \$36.07 for a single-family residential customer. Oldham Woods proposes to continue the current rate design and to recover the requested revenue requirement by

increasing the amount of the flat monthly rate. Commission Staff agrees with Oldham Woods' rate design. Using Commission Staff's revenue requirement of \$61,407, Commission Staff determines the flat monthly rate to be \$40.61, as shown in the Attachment to this report.¹⁰

Signatures:



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



Prepared by: Jason Green
Rate Analyst, Water and Sewer
Rate Design Branch
Division of Financial Analysis

¹⁰ \$61,407 (Revenue Requirement) ÷ 12 (Months) ÷ 126 (Customers) = \$40.61.

ATTACHMENT
STAFF REPORT, CASE NO. 2016-00131
RATE CALCULATED BY COMMISSION STAFF

Monthly Sewer Rate

\$40.61 per residential equivalent

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