

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF NORTH MCLEAN COUNTY)
WATER DISTRICT FOR ALTERNATIVE RATE) CASE NO.
ADJUSTMENT) 2018-00260

NOTICE OF FILING OF COMMISSION STAFF REPORT

Notice is hereby given that, in accordance with the Commission's Order of August 10, 2018, 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 August 10, 2018 Order, North McLean County Water District is required to file written comments regarding the findings of Commission Staff no later than 14 days from the date of this report.¹



Gwen R. Pinson
Executive Director
Public Service Commission
P.O. Box 615
Frankfort, KY 40602

DATED NOV 29 2018

cc: Parties of Record

¹ An amended procedural schedule was entered November 6, 2018, to extend the date for filing the Commission Staff Report from November 14, 2018, to November 30, 2018.

STAFF REPORT
ON
NORTH MCLEAN COUNTY WATER DISTRICT
CASE NO. 2018-00260

North McLean County Water District (North McLean District) is a water utility organized pursuant to KRS Chapter 74 that owns and operates a water distribution system through which it provides retail water service to approximately 1,304 customers that reside in McLean County, Kentucky.² On July 31, 2018, North McLean District tendered an application (Application) to the Commission requesting to increase its water service rates pursuant to 807 KAR 5:076. By letter dated August 7, 2018, the Commission notified North McLean District that its application was rejected as deficient. On August 10, 2018, North McLean District filed its responses to the filing deficiencies and its Application was accepted for filing on August 15, 2018. To ensure the orderly review of the Application, the Commission established a procedural schedule by Order dated August 31, 2018. Finding in its November 6, 2018 Order that Commission Staff (Staff) requires additional time to complete its report on North McLean District's application, the Commission, on its own motion, extended the date the Staff Report would be issued from November 14, 2018, to November 30, 2018.

To comply with the requirements of 807 KAR 5:076, Section 9, North McLean District based its requested rates on a historical test period that coincides with the

² *Annual Report of McLean County Water District to the Public Service Commission for the Calendar Year Ended December 31, 2017 (Annual Report)* at 12 and 48.

reporting period shown in its most recent Annual Report on file with the Commission at the time it filed the Application, the calendar year ended December 31, 2017.

Using its pro forma test-year operations, North McLean District determined that it could justify a revenue increase of \$123,640, or 19.57 percent, as shown in the table below.³ North McLean District also included a copy of the customer notice that detailed the impact of the proposed rates on an average residential customer using 6,767 gallons as an increase of \$8.23, from \$46.29 to \$54.52 or 19.6 percent. Upon Staff review, it was determined that the notice filed by North McLean District incorrectly calculated the increase in average customer bill. When recalculated by staff it was determined the rates requested by North McLean would increase the monthly bill of a typical residential customer⁴ by \$9.02, from \$46.00 to \$55.02, or 19.61 percent.

	North McLean District
Pro Forma Operating Expenses	\$ 738,836
Plus: Average Annual Debt Service	41,630
Overall Revenue Requirement	780,466
Less: Other Operating Revenue	(20,983)
Interest Income	(4,025)
Revenue Required from Rates	755,458
Less: Normalized Revenues from Water Sales	(631,818)
Required Revenue Increase/(Decrease)	\$ 123,640
Percentage Increase	19.57%

³ Application, Revenue Requirement Calculation-Debt Service Coverage Method.

⁴ As provided in North McLean District's customer notice, a typical residential customer purchases 6,767 gallons of water per month.

To determine the reasonableness of the rates requested by North McLean District, Staff performed a limited financial review of North McLean District's test-year operations. 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 and immaterial discrepancies were not necessarily pursued or addressed.

Staff's findings are summarized in this report. Travis Leach and David Foster reviewed the calculation of North McLean District's Overall Revenue Requirement. Jason Green reviewed North McLean's reported revenues and rate design.

SUMMARY OF FINDINGS

1. Overall Revenue Requirement and Required Revenue Increase. By applying the Operating Ratio Method, as generally accepted by the Commission, Staff found that North McLean District's Overall Revenue Requirement is \$838,372 and that an \$111,377 revenue increase, or 15.81 percent, to pro forma present rate revenues is necessary to generate the Overall Revenue Requirement.

2. Water Service Rates. In the Application, North McLean District proposed to increase all of its monthly water service rates evenly across the board by approximately 19.57 percent. The Commission has previously found that the allocation of a revenue increase evenly across the board to a utility's current rate design is an appropriate and equitable method of cost allocation in the absence of a cost-of-service study. Finding no evidence of a cost-of-service study having been performed in this case, Staff followed the method proposed by North McLean District and allocated the \$111,377 revenue increase

Staff found warranted evenly across the board to North McLean District's current monthly water service rates. Shown in the Attachment to this report are the monthly water service rates as calculated by Staff. These rates would increase a typical residential customer's monthly bill from \$46.00 to \$53.29, an increase of \$7.29, or approximately 15.85 percent.

PRO FORMA OPERATING STATEMENT

North McLean District's Pro Forma Operating Statement for the test year ended December 31, 2017, as determined by Staff, appears below.

[REMAINDER OF PAGE INTENTIONALLY LEFT BLANK]

Staff's Pro Forma Income Statement

	2017 Annual Report	Pro Forma Adjustments	Adj. Ref.	Pro Forma Operations
Operating Revenues:				
Metered Water Sales	\$ 634,744	83,236	(A)	\$ 704,507
		(13,473)	(A)	
Misc Service Revenues	20,983			20,983
Total Operating Revenues	655,727	69,763		725,490
Operating Expenses:				
Operation & Maintenance:				
Salaries & Wages - Employees	197,015	(10,735)	(B)	186,280
Salaries & Wages - Commissioners	15,600			15,600
Purchased Water	340,812	(35,612)	(C)	305,200
Purchased Power	6,367			6,367
Materials and Supplies	33,324			33,324
Contractual Services - Acct	6,060			6,060
Contractual Services - Water Testing	3,789			3,789
Contractual Services - Other	22,081			22,081
Rents	2,040			2,040
Transportation	13,795			13,795
Insurance - Worker's Com	3,756			3,756
Insurance - Other	8,741			8,741
Advertising	884			884
Miscellaneous	1,361			1,361
Total Operation & Maintenance	655,625	(46,347)		609,278
Depreciation	66,085	757	(D)	66,842
Taxes Other Than Income	18,130	(2,829)	(E)	15,301
Utility Operating Expenses	739,840	(2,072)		737,768
Net Utility Operating Income	\$ (84,113)	\$ 71,835		\$ (12,278)

(A) Billing Analysis Adjustment. North McLean District provided a billing analysis that based the water usage and water sales revenue for the entire 12-month test year with its Application. Staff reviewed North McLean District's billing analysis provided in the Application and finds that the water sales revenues determined by the billing

analysis of \$604,254 for all customers is not an accurate representation of normalized test-year revenue from water sales. Staff found errors in the gallons reported in the usage blocks of North McLean District's billing analysis provided in its application and on November 13, 2018, North McLean District filed a corrected billing analysis.⁵ An adjustment of \$83,236 was made to test-year revenues to reflect the increase in water rates that were approved in Commission Case No. 2017-00253. North McLean District also filed a summary of adjustments for leaks and misread meters that were made during the test period on November 13, 2018.⁶ An additional adjustment of (\$13,473) was made to test-year revenues to reflect these billing adjustments.

(B) Employee Benefits. In the test year, North McLean District reported \$19,680, in its Salaries and Wages – Employees account, for reimbursements made to employees in order to allow them to purchase single coverage health insurance. In the test year, two of the four employees of North McLean District stopped receiving reimbursement for their health insurance as a result of joining plans provided by their spouses, leaving two employees receiving reimbursements. The reimbursement is capped at \$420.83 on the employee with the highest premium with one employee at that cap and the other being reimbursed for lower premiums at a level of \$324.56. As shown below, Staff annualized the most recent reimbursement received by each full-time employee at the time of Staff's review. Although North McLean District is providing 100 percent reimbursement for single coverage health insurance, it does not contribute to an

⁵ North McLean County Water District Supplemental Information, Rate Analysis.

⁶ North McLean County Water District Supplemental Information, Customer Activity Report.

employee retirement or pension plan. Consequently, Staff determined that the total compensation package was reasonable.

Current Reimbursement for Full-time Employees Times: 12 Months	\$ 745 <u>12</u>
Annualized Reimbursements	8,945
Less: Test Year	<u>(19,680)</u>
Decrease	<u><u>(10,735)</u></u>

(C) Change of Water Supplier. North McLean District purchases water from three different suppliers: city of Calhoun (Calhoun); West Daviess County Water District (West Daviess District); and Ohio County Water District (Ohio District). North McLean purchased the bulk of its water from Calhoun. In the test year, North McLean District's major supplier, Calhoun discontinued producing and selling water. For this reason, North McLean District began purchasing water from a new supplier, McLean County Regional Water Commission (McLean County). Pursuant to the contract, the purchased water rate from McLean County is \$2.68 per 1,000 gallons. Staff has adjusted Purchased Water Expense to account for the decrease in purchased water cost as a result of the change in supplier as shown below.

[REMAINDER OF PAGE INTENTIONALLY LEFT BLANK]

North McLean Regional District

Gallons Billed/1000	108,764
Times: Purchased Water Rate	\$ <u>2.68</u>
Purchased Water Cost at New Rate	<u>291,488</u>

West Daviess District

Gallons Billed/1000	5,564
Times: Purchased Water Rate	\$ <u>2.41</u>
Pro Forma Purchased Water Cost	<u>13,409</u>

Ohio District

Gallons Billed/1000	138
Times: Purchased Water Rate	\$ <u>2.20</u>
Pro Forma Purchased Water Cost	<u>303</u>
Total	<u>305,200</u>
Less: Test Year	(340,812)
Adjustment	<u><u>(35,612)</u></u>

(D) Depreciation. The Commission has historically relied upon the report published in 1979 by the National Association of Regulatory Utility Commissioners (NARUC) titled Depreciation Practices for Small Water Utilities (NARUC Study). When no evidence exists to support a specific life that is inside or outside the NARUC ranges, the Commission has historically used the mid-point of the NARUC ranges to depreciate the utility plant. In following with the Commission's historical practice of using the mid-point of the NARUC ranges to calculate depreciation, Staff finds that North McLean District's test-year depreciation expense of \$66,085 should be increased by \$757 to

reflect the following the changes in depreciable lives across multiple assets, summarized below:

Asset Account	Current:		Life	Pro Forma:	
	Original Cost	Depreciation Expense		Depreciation Expense	Difference
Electric Pumping Equipment	\$ 90,780	\$ 2,269	37.5	\$ 2,421	\$ 152
Hydrants	32,872	657	50	657	0
Meter Installation	33,124	828	45	736	(92)
Meters	243,139	11,048	38	6,484	(4,564)
Misc Equipment	12,372	462	18	707	245
Office Equipment	6,162	454	23	274	(180)
Power Operated Equipment	10,676	631	13	854	223
Structures and Improvements	166,876	4,605	38	4,450	(155)
Tanks	222,287	5,740	45	4,940	(800)
Tools/Shop/Garage Equipment	1,862	152	18	106	(46)
Transmission Mains	2,326,685	36,199	62.5	37,227	1,028
Transportation Equipment	48,825	2,029	7	6,975	4,946
				Pro Forma Adjustment	<u>\$ 757</u>

(E) FICA. As discussed in Item (B), Staff reduced North McLean District's Salaries and Wages – Employees account by \$10,735. Staff also found that North McLean District's reported Taxes Other Than Income expense did not accurately reflect the correct level of FICA taxes. In addition, Staff has adjusted FICA to reflect Pro Forma Salaries and Wages recommended herein. As calculated below, Staff determined that test-year FICA taxes should be reduced by \$2,145 to reflect pro forma Salaries and Wages – Employees expense.

Test Year Wages	\$186,280
Annualized Reimbursements	(8,945)
Times: 7.65 Percent FICA Rate	<u>7.65%</u>
Total Pro Forma Payroll Taxes	13,566
Less: Test Year Payroll Taxes	<u>(16,396)</u>
Payroll Tax Adjustment	<u>\$ (2,829)</u>

OVERALL REVENUE REQUIREMENT AND REQUIRED REVENUE INCREASE

By applying the operating ratio method, Staff determined North McLean District's overall revenue requirement to be \$841,236.

A comparison of North McLean's and Staff's calculations of the Overall Revenue Requirement and Required Revenue Increase is shown below. In North McLean District's previous rate case,⁷ the Debt Service Coverage (DSC) method was used to calculate North McLean District's Revenue Requirement. Upon inspection, Staff determined that the United States Department of Agriculture acting through Rural Development (RD) bonds present in North McLean District's previous rate adjustment case⁸ had been retired using certificates of deposit and a local bank loan with a two-year term. The Commission has historically used the DSC methodology to determine the revenue requirement for water districts and water associations. This approach is used primarily because a bond ordinance or loan agreement requires the water district or association to maintain a predetermined DSC level. Staff, however, does not recommend the use of this methodology in this case because North McLean District's two-year term loan does not have a DSC requirement.

The operating ratio methodology⁹ is used when there is no basis for a rate-of-return determination, the cost of the utility has fully or largely been funded through contributions,

⁷ Case No. 2017-00253, *Application of North Mclean County Water District for Alternative Rate Adjustment* (Ky. PSC Jan. 5, 2018)

⁸ *Id.*

⁹ Operating Ratio is defined as the ratio of expenses, including depreciation and taxes, to gross revenues. It is illustrated by the following equation:

$$\text{Operating Ratio} = \frac{\text{Operating Expenses} + \text{Depreciation} + \text{Taxes}}{\text{Gross Revenues}}$$

or there is little or no outstanding long-term debt. Commission Staff is of the opinion that an operating ratio of 88 percent will allow North McLean District sufficient revenues to cover its reasonable operating expenses, and provide for reasonable equity growth. Therefore, Staff finds the Operating Ratio Method is more appropriate as the district's only outstanding long-term debt will be paid off within two years.


However, Staff notes that if North McLean District intends to roll the two-year term note over, up to the allowable six years,¹⁰ that the current rate of repayment will not be sufficient to fully pay off the note and that the district will need to seek approval of the Commission in order to roll the note over past the six-year limit.

[REMAINDER OF PAGE INTENTIONALLY LEFT BLANK]

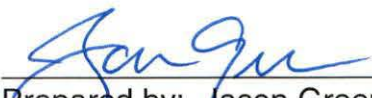
¹⁰ KRS 278.300(8). This section does not apply to notes issued by a utility, for proper purposes and not in violation of law, that are payable at periods of not more than two (2) years from the date thereof, or to like notes, payable at a period of not more than two (2) years from date thereof, that are issued to pay or refund in whole or in part any such notes, or to renewals of such notes from time to time, not exceeding in the aggregate six (6) years from the date of the issue of the original notes so renewed or refunded.

	North McLean District
	<u> </u>
Pro Forma Operating Expenses	\$ 738,836
Plus: Average Annual Debt Service	41,630
Overall Revenue Requirement	780,466
Less: Other Operating Revenue	(20,983)
Interest Income	<u>(4,025)</u>
Revenue Required from Rates	755,458
Less: Normalized Revenues from Water Sales	<u>(631,818)</u>
Required Revenue Increase/(Decrease)	<u>\$ 123,640</u>
Percentage Increase	<u>19.57%</u>
	<u>Staff</u>
Operating Expenses	\$ 737,768
Divided by: Operating Ratio	88%
Overall Revenue Requirement	<u>838,372</u>
Add: Interest Expense	2,520
Less: Other Operating Revenue	(20,983)
Interest Income	<u>(4,025)</u>
Revenue Requirement - Water Rates	815,884
Less: Normalized Revenue from Water Service	<u>(704,507)</u>
Required Revenue Increase	<u>\$ 111,377</u>
Percentage Increase	<u>15.81%</u>

Signatures



Prepared by: Travis Leach
Water and Sewer Branch
Division of Financial Analysis



Prepared by: Jason Green
Water and Sewer Branch
Division of Financial Analysis

ATTACHMENT

ATTACHMENT TO A STAFF REPORT OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 2018-00260 DATED **NOV 29 2018**

Monthly Water Rates

First	2,000	Gallons	\$19.54	Minimum bill
Next	8,000	Gallons	7.08	per 1,000 Gallons
Next	30,000	Gallons	6.42	per 1,000 Gallons
Over	40,000	Gallons	5.78	per 1,000 Gallons

*North McLean County Water District
217 Hill Street
P. O. Box 68
Livermore, KY 42352

*Tiffany Sallee
North McLean County Water District
217 Hill Street
P. O. Box 68
Livermore, KY 42352