

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF SOUTH HOPKINS WATER)
DISTRICT FOR AN ALTERNATIVE RATE) CASE NO.
ADJUSTMENT) 2018-00387

NOTICE OF FILING OF COMMISSION STAFF REPORT

Notice is hereby given that, in accordance with the Commission's Order of December 19, 2018, the attached report containing the findings of Commission Staff (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 19, 2018 Order, South Hopkins Water District is required to file written comments regarding the findings of Staff no later than 14 days from the date of this report.



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

DATE MAR 05 2019

cc: Parties of Record

STAFF REPORT
ON
SOUTH HOPKINS WATER DISTRICT
CASE NO. 2018-00387

South Hopkins Water District (South Hopkins District) is a water utility district, organized pursuant to KRS Chapter 74, that owns and operates a water distribution system through which it provides retail water service to approximately 2,984 customers residing in Caldwell and Hopkins counties, Kentucky.¹ On November 21, 2018, South Hopkins District filed an application (Application) to the Commission requesting to increase its water service rates pursuant to 807 KAR 5:076. To ensure the orderly review of the Application, the Commission established a procedural schedule by Order dated December 19, 2018.

South Hopkins District based its requested rates on a historical test period that coincides with the 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, as required by 807 KAR 5:076, Section 9.

South Hopkins District provided exhibits in its Application demonstrating that a 7.53 percent increase was reasonable. The rates requested by South Hopkins District would increase the monthly bill of a customer using 3,000 gallons of water by \$1.82, from \$24.26 to \$26.08, or 7.50 percent. South Hopkins District presented financial exhibits in the

¹ *Annual Report of South Hopkins Water District to the Public Service Commission for the Calendar Year Ended December 31, 2017, (Annual Report)* at 12 and 50.

Application that demonstrated how it calculated the amount of increase it could have justified. The exhibits are summarized below in condensed form.

Pro Forma Operating Expenses	\$ 1,543,044
Plus: Average Annual Principal and Interest Payments	89,657
Additional Working Capital	<u>17,931</u>
Overall Revenue Requirement	1,650,632
Less: Other Operating Revenue	(64,838)
Interest Income	(1,968)
Existing Wholesale Sales Revenue	<u>(318,895)</u>
Revenue Required from Rates	1,264,931
Less: Pro Forma Present Rate Service Revenues	<u>(1,176,350)</u>
Required Revenue Increase	<u>\$ 88,581</u>
Percentage Increase	<u>7.53%</u>

To determine the reasonableness of the rates requested by South Hopkins District, Staff performed a limited financial review of South Hopkins 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. Ariel Miller reviewed the calculation of South Hopkins District’s Overall Revenue Requirement. Sam Reid reviewed South Hopkins District’s reported revenues and rate design.

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 that South Hopkins District's Overall Revenue Requirement is \$1,619,927 and that a \$60,153 revenue increase, or 5.12 percent, to pro forma present rate revenues is necessary to generate the Overall Revenue Requirement.

2. Water Service Rates. South Hopkins District's application proposes a 7.5 percent across-the-board increase to current retail rates. South Hopkins District did not propose an increase to its wholesale rates. South Hopkins District has not performed a cost-of-service study. 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. Staff finds that an across-the-board increase is the appropriate means to allocate the increased revenue requirement. The rates set forth in the Attachment to this report are based upon the revenue requirement as calculated by Commission Staff and will produce sufficient revenues from retail water sales to recover the \$1,234,225 determined by Staff, an approximate 5.12 percent increase.

Staff agrees with South Hopkins District that the contracted wholesale rate should not be adjusted in this proceeding and that only retail rates should be increased. South Hopkins District relies on the mechanism contained in the water purchase contracts with the wholesale customers to determine the annual wholesale rate.

The monthly service rates calculated by Staff are shown in the Attachment to this report. These rates will increase the monthly cost of 3,000 gallons of water purchased through a 5/8-inch x 3/4-inch meter from \$24.26 to \$25.52, an increase of \$1.26 or 5.19 percent.

Pro Forma Operating Statement

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

	Test Year	Adjustment	(Ref.)	Pro Forma
Operating Revenues				
Sales of Water	\$ 1,051,658	\$ 122,415	(A)	\$ 1,174,073
	318,895			318,895
Other Water Revenues	64,838			64,838
Total Operating Revenues	1,435,391	122,415		1,557,806
Operating Expenses				
Operation and Maintenance Expenses				
Salaries and Wages - Employees	298,515	(27,533)	(B)	270,982
Salaries and Wages - Commissioners	18,000			18,000
Employee Pensions and Benefits	219,980	(68,856)	(C)	
		(10,236)	(D)	140,888
Purchased Water	703,342	(18,920)	(E)	684,422
Purchased Power for Pumping	65,320	(1,757)	(E)	63,563
Chemicals	60	(2)	(E)	58
Materials and Supplies	51,537			51,537
Contractual Services	25,044			25,044
Transportation Expense	22,256			22,256
Insurance	42,398			42,398
Bad Debt Expense	9,862			9,862
Miscellaneous Expense	9,973			9,973
Total Operation and Maintenance Expenses	1,466,287	(127,304)		1,338,983
Taxes Other Than Income	28,214	(2,106)	(B)	26,108
Depreciation	91,163	56,085	(F)	147,248
Total Operating Expenses	1,585,664	(73,325)		1,512,339
Net Operating Income	(150,273)	195,740		45,467
Interest Income	1,968			1,968
Nonutility Income	-			-
Income Available to Service Debt	\$ (148,305)	\$ 195,740		\$ 47,435

(A) Billing Analysis Adjustment. South Hopkins District provided a billing analysis listing the water usage and \$1,176,350 in retail sales revenue for the 12-month test year in its application. The Application billing analysis reflected South Hopkins District's increased rates per Case No. 2017-00420 that went into effect on June 13,

2018.² Staff has reviewed the South Hopkins District's billing analysis provided in the Application and finds that an inadvertent error occurred in the calculation of revenue for the 5/8-inch x 3/4-inch meter customers. This resulted in an overstatement of pro forma present rate revenue in the amount of \$2,277. Therefore, the corrected retail water sales revenue is \$1,174,073. Staff finds that the billing analysis as corrected by Staff is an accurate representation of the normalized test-year revenue from water sales, and has increased test-year water sales revenue by \$122,415.

(B) Salaries and Wages - Employees. During the test year, South Hopkins District reported \$298,545 in wages paid to its employees. During and subsequent to the test year, South Hopkins District experienced multiple changes in staffing levels. As a result of the changes, South Hopkins District currently has eight full-time employees. Staff calculated pro forma wages based on hours worked for the test year at the current wage rates paid to South Hopkins District's employees. As shown below, this results in a decrease in pro forma salaries and wages of \$27,533.

² Case No. 2017-00420, *Application of South Hopkins Water District for an Alternative Rate Adjustment* (June 13, 2018).

	Current Pay Rate	Regular Hours	Overtime Hours (x1.5)	Pro Forma
Superintendent, Salaried	\$58,000/year			\$ 58,000
Office Manager, Salaried	\$37,000/year			37,000
Office Employee 1	10.70	2,080		22,256
Office Employee 2	11.95	2,080		24,856
Field Employee 1	11.20	2,080	66.00	24,405
Field Employee 2	13.20	2,080	13.50	27,723
Field Employee 3	16.45	2,080	71.50	35,980
Field Employee 4	18.70	2,080	66.50	40,761
Pro Forma Wages				270,982
Less: Test Year				<u>(298,515)</u>
Decrease				<u>\$ (27,533)</u>

To account for the decrease in pro forma wages, it was also necessary to calculate the decrease in payroll taxes. Accordingly, Staff decreased South Hopkins District's Taxes Other Than Income by \$2,106 to reflect these changes as shown in the calculation below.

Decrease to Pro Forma Wages	\$ (27,533)
Times: 7.65%	<u>7.65%</u>
Decrease to Payroll Taxes	<u>\$ (2,106)</u>

(C) Retirement Expense Pursuant to GASB 68. South Hopkins District provides pension benefits and post-retirement health care benefits to its employees by participating in the County Employee Retirement System (CERS). As a participating member, South Hopkins District is required to contribute a percentage of its employee wages to CERS.

In the fiscal year, beginning July 1, 2018, the CERS contribution rate was 21.48 percent.³ The CERS pension expense South Hopkins District reported in the test year conformed to the requirements of the Governmental Accounting Standards Board Statement No. 68 (GASB 68).

In Case No. 2016-00163,⁴ Commission Staff discussed in great detail the reporting requirements of GASB 68 and how those requirements would affect a utility’s income statement and balance sheet. In that proceeding, Commission Staff found that the annual pension expense should be equal to the amount of a district’s contributions to CERS, which “historically have been fairly constant.” Staff determined that South Hopkins District’s pro forma CERS contributions would total \$58,207 as calculated below, based on the pro forma Salaries and Wages Expense adjustment as discussed in Item (B) above.

Pro Forma Salaries and Wages	\$ 270,982
Times: 21.48 Percent Contribution Rate	<u>21.48%</u>
Pro Forma Contributions	58,207
Less: Test Year	<u>(127,063)</u>
Decrease	<u>\$ (68,856)</u>

This results in a decrease of \$68,856 to pro forma operations, which Staff adjusted accordingly.

³ <https://kyret.ky.gov/Employers/Pages/Contribution-Rates.aspx>

⁴ Case No. 2016-00163, *Alternative Rate Adjustment Filing of Marion County Water District* (Ky. PSC Aug. 11, 2016) Staff Report on Marion County Water District at 10–27.

(D) Employee Pensions and Benefits. South Hopkins District currently pays 100 percent of monthly health and dental insurance premiums for its eligible full-time employees. Staff notes that in recent Orders, the Commission has made ratemaking adjustments to reduce the cost of employee benefit packages paid by some utilities when certain aspects of those benefits packages were found to be unreasonable based on a review of total salaries and fringe benefits. The Commission is placing greater emphasis on evaluating employees' total compensation packages, including both salary and benefits programs for market and geographic competitiveness, and to ensure the development of a fair, just, and reasonable rate. It has found in most cases 100 percent of employer-funded health care does not meet those criteria. Factoring in for the preceding, Staff determined the net adjustment to South Hopkins District's test-year employee pensions and benefits expense based on its current monthly premiums and the national average employee contribution rate for health insurance⁵ and dental insurance,⁶ which results in a decrease of \$10,236 as shown in the calculation below.

⁵ Bureau of Labor Statistics, Healthcare Benefits, March 2018, Table 10, private industry workers. (<https://www.bls.gov/ncs/ebs/benefits/2018/ownership/private/table10a.pdf>)

⁶ Willis Benefits Benchmarking Survey, 2015 (https://www.willis.com/documents/publications/Services/Employee_Benefits/Willis_Survey_011216_R1.pdf)

Type of Premium	Current Monthly Premium	Times: Average Employee Contribution Rate	Monthly Premium Adjustment	Pro Forma Monthly Premium
Single Health Coverage	\$ 5,681	21%	\$ (1,193)	\$ 4,488
Dependent Health Coverage	1,582	33%	(522)	1,060
Dental Insurance	283	60%	(170)	113
Life Insurance	52			52
Vision Insurance	147			147
Total Pro Forma Monthly Premium				5,860
Times: 12 Months				<u>12</u>
Total Annual Pro Forma Premium				70,320
Less: Test Year				<u>(80,556)</u>
Decrease				<u><u>\$ (10,236)</u></u>

(E) Expenses Attributable to Water Loss. Pursuant to 807 KAR 5:066, Section (6)3, South Hopkins District's water loss is limited to 15 percent for ratemaking purposes unless it can demonstrate that an alternative level is reasonable. South Hopkins District reported test-year water loss at 17.69 percent,⁷ or 2.69 percent above the amount allowed and did not attempt to demonstrate that the amount of the excess water loss is reasonable. To comply with the regulation, Staff removed the expenses incurred during the test year to purchase, pump, and treat the lost water that was in excess of the allowable amount. Staff's calculation is shown below.

⁷ Annual Report at 58.

	Test Year	Times: Excess Water Loss Percentage	Decrease
Purchased Water	\$703,342	-2.69%	\$(18,920)
Purchased Power	65,320	-2.69%	(1,757)
Chemicals	60	-2.69%	(2)

(F) Depreciation. In its Application, South Hopkins District proposed to increase its test-year depreciation expense of \$91,163 by \$56,085.⁸ This adjustment was the result of South Hopkins District's proposal to adjust the lives assigned to certain assets that were outside of the life ranges in accordance with the National Association of Regulatory Utility Commissioners' (NARUC) publication titled Depreciation Practices for Small Utilities (NARUC Study), and to include a depreciation expense for a Kentucky Infrastructure Authority (KIA) project that was completed in 2018.

To evaluate the reasonableness of the depreciation practices of small water utilities, the Commission has historically relied upon the NARUC Study. South Hopkins District proposed to adjust the lives of assets that were outside of the NARUC ranges to the mid-point of the depreciable life ranges. In this proceeding, Staff found no evidence to support depreciable lives that vary significantly from the mid-point of the NARUC ranges, and after further review of South Hopkins District's plant ledger, Staff agrees with South Hopkins District's increase to depreciation expense of \$56,085.

⁸ Application, Attachment 4a.

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) recovery of depreciation expense, a non-cash item, to provide working capital;⁹ (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 South Hopkins District's and Staff's calculations of the Overall Revenue Requirement and Required Revenue Increase using the DSC method is shown below.

⁹ 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).

	South Hopkins District	Staff	
Pro Forma Operating Expenses	\$ 1,543,044	\$ 1,512,339	
Plus: Average Annual Principal and Interest Payments	89,657	89,657	(1)
Additional Working Capital	17,931	17,931	(2)
	<hr/>	<hr/>	
Overall Revenue Requirement	1,650,632	1,619,927	
Less: Other Operating Revenue	(64,838)	(64,838)	
Interest Income	(1,968)	(1,968)	
Existing Wholesale Sales Revenue	(318,895)	(318,895)	
	<hr/>	<hr/>	
Revenue Required from Rates	1,264,931	1,234,226	
Less: Pro Forma Present Rate Service Revenues	(1,176,350)	(1,174,073)	
	<hr/>	<hr/>	
Required Revenue Increase	\$ 88,581	\$ 60,153	
Percentage Increase	<u>7.53%</u>	<u>5.12%</u>	

(1) Average Annual Principal and Interest Payments. At the time of filing, South Hopkins District had two outstanding bonds payable to the United States Department of Agriculture Rural Development (RD) and one note payable to KIA. In its Application, South Hopkins District requested recovery of the average annual principal and interest payments on this indebtedness based on a three-year average of the annual principal and interest payments for the years 2019 through 2021. Staff agrees with South Hopkins District's calculation of its average annual principal and interest payments and has included its recovery in the revenue requirement.

(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. South Hopkins District requested recovery of an allowance for working

capital that is equal to 120 percent of its average annual debt payments for its two bonds payable to RD, and current note payable to KIA.

RD requires that South Hopkins District charge rates that produce net revenues that are at least 120 percent of its average annual debt payments. Following the Commission's historic practice, Staff agrees with South Hopkins District's calculation of additional working capital and has included it in the revenue requirement.

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Signatures



Prepared by: Ariel Miller
Revenue Requirements Branch
Division of Financial Analysis



Prepared by: Sam Reid
Rate Design Branch
Division of Financial Analysis

ATTACHMENT

ATTACHMENT TO A STAFF REPORT OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 2018-00387 DATED **MAR 05 2019**

Staff Calculated Monthly Water Rates

5/8 x 3/4- Inch Meter

First	1,000	Gallons	\$ 12.36	Minimum bill
Next	9,000	Gallons	6.58	per 1,000 Gallons
Next	10,000	Gallons	6.12	per 1,000 Gallons
Next	30,000	Gallons	5.66	per 1,000 Gallons
All Over	50,000	Gallons	4.79	per 1,000 Gallons

1-Inch Meter

First	10,000	Gallons	\$ 71.58	Minimum bill
Next	10,000	Gallons	6.12	per 1,000 Gallons
Next	30,000	Gallons	5.66	per 1,000 Gallons
All Over	50,000	Gallons	4.79	per 1,000 Gallons

2-Inch Meter

First	20,000	Gallons	\$ 132.78	Minimum bill
Next	30,000	Gallons	5.66	per 1,000 Gallons
All Over	50,000	Gallons	4.79	per 1,000 Gallons

3-Inch Meter

First	50,000	Gallons	\$ 302.58	Minimum bill
All Over	50,000	Gallons	4.79	per 1,000 Gallons

*South Hopkins Water District
129 South Main Street
P. O. Box 487
Dawson Springs, KY 42408

*Jon Blalock
South Hopkins Water District
129 South Main Street
P. O. Box 487
Dawson Springs, KY 42408