COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE CHARGING OF EXCESSIVE RATES OF FERN LAKE COMPANY	)))	CASE NO. 8276

O R D E R

PROCEDURAL BACKGROUND

On July 23, 1981, the Commission issued an Order instituting a show cause proceeding in the above-styled case ordering Fern Lake Company ("Fern Lake") to appear and give testimony, if any it could, why its rates should not be reduced. The Order was issued pursuant to a rate investigation in Case No. 7982, wherein the Commission, in an Order entered July 23, 1981, found that the revenues generated by Fern Lake's existing rates produced an operating ratio of 54.7 percent and that a fair, just and reasonable operating ratio for Fern Lake was 88 percent.

The matter was set for hearing on August 31, 1981, and again on September 21, 1981, with the Consumer Protection Division of the Attorney General's Office and Kentucky Water Service Company, Fern Lake's sole customer, being present and intervening in the proceedings.

Fern Lake presented three witnesses who gave testimony as to why Fern Lake's rates were not excessive. The witnesses were Messrs. Arthur E. Abshire, Ralph G. Nall and J. Burtram Soloman.

In addition to the testimony, exhibits and cross-examination presented in the instant case, the records in Fern Lake's most recent two rate cases (Cases Nos. 7292 and 7982) were made a part of the record in this proceeding. The entire matter is now submitted for final determination.

ANALYSIS AND DETERMINATION

Test Period

The test period adopted by the Commission in this case is the same as that adopted in Fern Lake's Case No. 7982, or the 12-month period ended July 31, 1980.

Valuation and Return

Fern Lake's testimony, as presented by its three witnesses, primarily involved the Commission's decision in Case No. 7982 to use the operating ratio method in the determination of Fern Lake's revenue requirements, and the Commission's decision in Case No. 7982 that a fair, just and reasonable operating ratio for Fern Lake is 88 percent. Although the testimony is interrelated and involves the witnesses' beliefs that the operating ratio method and the Commission's designated ratio of 88 percent are inadequate, the Commission will address each sub-issue directly.

Mr. Abshire, owner of Fern Lake, made statements concerning the fact that when he purchased Fern Lake in March 1977 he paid $775,000[1/] for the company's outstanding stock. Of this $775,000 he transferred out approximately $195,000 in non-utility property, leaving his investment in Fern Lake's utility operations at approximately $580,000.[2/]

When questioned by Fern Lake's counsel as to why the books reflected an investment of only $18,068, Mr. Abshire responded that this figure reflected the original company value of Fern Lake and that under tax laws he, as an individual, was not permitted to increase that value following his purchase of the stock and assets of the company.[3/]

The remainder of his testimony can be summarized by stating that he considered his investment in Fern Lake of $580,000 to be the appropriate rate base or valuation method for the Commission to employ in its determination of the revenue requirements of the company.

The Commission is of the opinion that regardless of whether the books of Fern Lake were or were not increased to reflect Mr. Abshire's additional investment in the utility plant, the original cost of this plant should be the controlling factor in a determination of valuation in the setting of fair,

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1/ Transcript of Evidence, August 31, 1981, page 15.

2/ Ibid.

3/ Paraphrased, Transcript of Evidence, August 31, 1981, page 16.

just and reasonable rates. Over the years this plant has been in service Kentucky Water Service Company and its ratepayers in the City of Middlesboro have paid a return on this plant investment and provided for the recovery of this investment in the form of depreciation expense. To require these ratepayers to pay a much higher return on the same plant where the only changed characteristic is that it is now owned by a different individual is in the Commission's opinion totally unjust, unreasonable and unfair and will not be permitted.

The second issue testified to by Fern Lake's witnesses, Mr. Nall, an investment counselor, and Mr. Soloman, a utility consultant, was the effect of the 88 percent operating ratio on the marketability of the industrial building revenue bonds in the amount of $1,700,000. The bonds, which are to be issued by the City of Middlesboro and the proceeds of which are to be loaned to Fern Lake to make remedial construction repairs to the dam, were authorized by the Commission in Case No. 7982 in an Order entered February 27, 1981. Fern Lake in its Notice in Case No. 7982 stated that the interest rate would not exceed 12 percent per annum and requested that the debt service costs be collected in a surcharge to Kentucky Water Service Company and be remitted to a trustee as specified in the bond indenture. The Commission's Order in that case approved the surcharge method of collection and established the interest rate ceiling at 12 percent as requested by Fern Lake.

Mr. Nall and Mr. Soloman argued in the instant case that a reduction in Fern Lake's revenues, resulting from the Commission's determination that an 88 percent operating ratio is fair, just and reasonable, would have and has had an adverse effect on the sale of the bonds as it increases the risk as perceived by potential bond investors.

Mr. Soloman testified:

> Investors in utility bonds normally expect to be able to invest in bonds of a company which is able to consistently earn a coverage of at least 2.0 times. Coverage ratios below 2.0 times generally restrict the marketability of such bonds and increases the rate of interest required on those instruments. . . . Investors may not require a Fern Lake coverage ratio quite as high as 2.0 times to invest in its industrial revenue bonds, but the fact that those bonds remain unsold, even with a tax-free yield of 12 percent I believe is certainly an indication that investors do not have enough confidence in the financial wherewithal of Fern Lake to turn loose of their money for that rate of interest.[4/]

The emphasis of Mr. Nall's testimony with regard to the sale of the bonds was that investors are primarily interested in seeing that Fern Lake will survive as a going concern over the 20-year payback period of the bond issue. When cross-examined by Fern Lake's counsel regarding whether the ability to sell the bonds was tied directly to the financial stability of Fern Lake, Mr. Nall responded, "To say it's tied directly would be to ignore

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4/ Transcript of Evidence, September 21, 1981, pages 15 and 16.

the surcharge. However, it is tied to the ability of the Fern Lake Company to continue to supply its sole customer with water and, therefore, the health of the company, obviously, is a factor in the sale of the bonds."[5]

The Commission notes that Mr. Nall's correspondence with Fern Lake's counsel, entered in the record in Case No. 7982 on June 12, states that failure to sell the bonds at the 12 percent ceiling was due to the high interest rate levels demanded by purchasers of municipal bonds and to the reluctance of investors to purchase long-term debt securities at any yield due to a "wait-and-see attitude" among investors anticipating higher yields in the volatile market. It should also be noted that the 12 percent ceiling was originally proposed by Fern Lake and at no time since has Fern Lake petitioned the Commission to lift the restriction of the 12 percent interest rate in order to be able to sell the bonds.

The Commission is not persuaded by the arguments that the adoption of an 88 percent operating ratio will in any manner affect the salability of the bond issue. The surcharge method of servicing the debt through a trustee provides ample protection to potential bond holders in that the risk is virtually eliminated as Fern Lake has no opportunity to use the revenues obtained through the surcharge for any purpose but payment of debt service requirements.

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[5] Transcript of Evidence, August 31, 1981, page 51.

As to the argument that potential investors would question the ability of Fern Lake to continue as a going concern, the Commission finds that it is only reasonable to assume that the sole supplier of water to the City of Middlesboro would continue to operate indefinitely. However, in this regard, the Commission was persuaded by Mr. Abshire's and Mr. Nall's testimony concerning the impact of the lack of insurance coverage against natural calamities and the effect this might have on the marketability of the bonds. Interruption of service due to natural calamity against which there is no protection or insurance would likely have an adverse effect on the sale of the bonds and is, moreover, not in the public interest. Therefore, as will be reflected in a subsequent section of this Order, the Commission will provide revenues sufficient to cover insurance expense against natural disaster at $15,000[6/] per year, the higher estimate quoted to Mr. Abshire.

The final argument against the Commission's use of the operating ratio was advanced by Mr. Soloman in his testimony. Mr. Soloman correctly described that the operating ratio method is appropriately used in a company where the investment in property is smaller than the operating costs of the company. However, Mr. Soloman further testified that in his opinion the

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6/ Transcript of Evidence, August 31, 1981, page 35.

method is inappropriate to use for Fern Lake as "...Fern Lake's operating costs, excluding taxes, are approximately $40,000. And its invested capital is now over $580,200, and hopefully soon will be over two million dollars."[7/]

The Commission has already addressed Fern Lake's contention that the sale price of the stock of approximately $580,000 should be rejected in favor of the original cost of the utility property. Moreover, as to the additional investment in the remedial construction of the dam, the Commission has, as described above, provided adequate coverage through the surcharge method of collection which will be imposed at the time the bonds are sold. Thus, the Commission has not changed its position that the operating ratio method is an appropriate method to use in setting rates for Fern Lake to charge its customer, Kentucky Water Service Company, nor has the Commission been persuaded by any arguments advanced by Fern Lake's witnesses that an operating ratio of 88 percent is inadequate or that it would be less than fair to Fern Lake's ratepayer and stockholder. Therefore, the Commission will base Fern Lake's revenue requirements on an operating ratio of 88 percent.

Revenues and Expenses

The Order entered July 23, 1981, in Case No. 7982 made specific findings as to revenues and expenses found reasonable

7/ Transcript of Evidence, September 21, 1981, page 19.

on a pro forma basis for the test period ended July 31, 1980. Specifically the Commission accepted the majority of Fern Lake's proposed adjustments to its operating statement, with the following exceptions: interest and dividend income was increased by $720; rate case expenses were reduced by $4,750; taxes other than income taxes were increased by $3,000; and income taxes were adjusted to $11,018 to reflect the tax expense on adjusted taxable income. As the Order in Case No. 7982 fully explained each of these adjustments, the Commission, with the exception of rate case expenses, will not elaborate on these issues in this Order.

In Case No. 7982, the Commission reduced Fern Lake's estimated rate case expenses by $4,750. The Commission has re-evaluated this allowance in light of the additional requirements pursuant to this show cause proceeding and while still of the opinion that the estimated expenses are on the high side of a reasonable amount for the nature and complexity of Case No. 7982, is of the opinion that the added requirements of this case will substantially increase Fern Lake's rate case expenses. The Commission is further of the opinion that in order to permit Fern Lake the opportunity to earn the return found fair, just and reasonable herein, the allowance for rate case expenses of $4,750 disallowed in Case No. 7982 should be reinstated.

As stated previously, it was disclosed in the hearing of August 31, 1981, that Fern Lake did not have insurance protection against natural calamities beyond the construction period of the repairs to the dam. The Commission has, therefore, made an adjustment to Fern Lake's operating expenses to allow $15,000 per year to insure the dam against disaster.

Income taxes have been adjusted to $6,444[8/] to reflect the tax expense applicable to adjusted taxable income.

Therefore, the Commission finds that Fern Lake's operating statement, as set out in its Order of July 23, 1981, should be adjusted as follows:

	Per Case No. 7982[9/]	Adjustments	Adjusted
Revenues	$89,622	$ -0-	$ 89,622
Expenses	49,019	15,176	64,195
	$40,603	$(15,176)	$ 25,427

Revenue Requirements

The revenues generated by the existing rates produce an operating ratio, following adjustments, of 71.6 percent. The Commission is of the opinion that a fair, just and reasonable operating ratio is 88 percent in that it will allow Fern Lake to meet its reasonable operating expenses, service its debt and provide a reasonable return to Fern Lake's owner. Therefore, the Commission finds that Fern Lake's present rates produce revenues in excess of those found reasonable and should be reduced by $21,756 to produce annual operating revenues on a test period basis of $67,866. Income taxes have been adjusted to $1,972 to reflect the tax expense applicable to adjusted taxable income following the reduction in annual operating revenue.

8/ $31,871 (taxable income) x 23.2% (composite federal and state corporate tax rate) - $950 = $6,444.

9/ Order in Case No. 7982, entered July 23, 1981, page 7.

FINDINGS AND ORDER

The Commission, after reviewing all the evidence of record and being advised, is of the opinion and finds that:

(1) The rates approved in Case No. 7982 produce revenues in excess of the revenues found reasonable herein and should be reduced upon application of KRS 278.030.

(2) The rates in Appendix A, attached hereto and made a part hereof, are the fair, just and reasonable rates for Fern Lake to charge its customer in rendering wholesale water service.

(3) All findings and orders as set out in Case No. 7982 not specifically changed herein should remain in force and effect.

IT IS THEREFORE ORDERED that the rates prescribed in Appendix A, attached hereto, are hereby fixed as the fair, just and reasonable rates to be charged by Fern Lake Company on and after the date of this Order.

IT IS FURTHER ORDERED that the rates approved in Case No. 7982 produce revenues in excess of those found reasonable herein and are hereby reduced upon application of KRS 278.030.

IT IS FURTHER ORDERED that Fern Lake shall file with this Commission, within 30 days after the date of this Order, its tariff sheets setting forth the rates approved herein.

IT IS FURTHER ORDERED that all findings and orders as set out in Case No. 7982 not specifically changed herein shall remain in force and effect.

Done at Frankfort, Kentucky, this 9th day of December, 1981.

PUBLIC SERVICE COMMISSION

Marlin M. Volz

Chairman

Did Not Participate

Vice Chairman

[Signature]

Commissioner

ATTEST:

Secretary

APPENDIX A

APPENDIX TO AN ORDER OF THE PUBLIC SERVICE COMMISSION IN CASE NO 8276 DATED DECEMBER 9, 1981

The following rates are prescribed for the customers in the area served by the Fern Lake Company. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of the Commission prior to the date of this Order.

Usage		Monthly Rate
First	41,667,000 Gallons	$5,325.00 (Minimum Bill*)
Each Additional	1,000 Gallons	0.14 per 1,000 Gallons

* An additional surcharge not to exceed $18,535 per month shall be added to the minimum bill, for the purpose of servicing a 20-year loan from the City of Middlesboro, Kentucky, in the amount of $1,700,000, at an interest rate not to exceed 12%. This surcharge shall be computed monthly and automatically discontinues when the loan is amortized.