

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

THE RATE ADJUSTMENT)
APPLICATION OF MCKINNEY) CASE NO. 8577
WATER ASSOCIATION, INC.)

O R D E R

On July 30, 1982 McKinney Water Association, Inc., ("McKinney") filed an application with the Commission to increase its rates pursuant to 807 KAR 5:076, the alternative rate adjustment procedure for small utilities ("ARF"). The information supplied with the application reflected that the proposed rates would produce additional revenue of \$45,000 annually, an increase of 57 percent. However, based on the billing analysis filed as a part of this case the Commission has determined that the total increase in revenue requested herein is \$46,718 annually, an increase of 52 percent. Based on the determination herein, the revenue of McKinney will increase by \$9,477 annually, an increase of 10 percent.

A hearing was not requested in this matter, and in accordance with the provisions of the ARF no hearing was conducted. Therefore, the decision of the Commission is based on information contained in the application, written submissions, annual reports and other documents on file in the Commission offices.

COMMENTARY

McKinney is a nonprofit water distribution system organized and existing under the laws of the Commonwealth of Kentucky, and serves approximately 494 customers in Lincoln County.

TEST PERIOD

The Commission has adopted the 12-month period ending December 31, 1981, as the test period for determining the reasonableness of the proposed rates. In utilizing the historical test period, the Commission has given full consideration to known and measurable changes found reasonable.

REVENUES AND EXPENSES

The ARF was established to provide a simplified and less expensive method for small utilities to apply for rate increases with the Commission. Therefore, the financial data from the 1981 annual report is used as the basis for determining the revenue requirements. McKinney proposed no specific adjustments to the test period operating statement. The following adjustments have been made by the Commission, in accordance with its normal rate-making practices, to McKinney's test period operating statement to reflect actual and anticipated operating conditions:

Metered Sales To Customers

McKinney's 1981 annual report lists total revenue from sales of water in the amount of \$79,183. However, the billing analysis filed by McKinney for calendar year 1981 reflects annual revenues for this period of \$87,416. Therefore, the Commission

has determined that an adjustment should be made to increase operating revenue by \$8,233.

In Case No. 7311-1 McKinney was granted an increase in rates effective September 7, 1982, to flow through the increased cost of purchased water from the city of Stanford, effective August 1, 1982. To reflect this additional revenue based on the test year, operating revenue has been increased by \$2,672.

These two adjustments result in total pro forma operating revenue of \$90,588.

Purchased Water

The Commission has determined that McKinney's purchased water costs should be increased by \$2,825 to reflect the increased cost of purchased water from the City of Stanford, effective August 1, 1982.

McKinney's 1981 annual report shows that line loss for this period was 24 percent. The Commission has an established policy for ratemaking purposes of disallowing the cost associated with line loss in excess of 15 percent. McKinney has failed to present a reasonable explanation for the excess loss, and no indication has been given that action will be taken to reduce line losses in the future. Therefore, the Commission has determined that an adjustment of \$3,729 should be made to exclude the cost associated with the line loss in excess of 15 percent.

Operation Labor

The Commission has learned that McKinney is not following certain accounting principles as prescribed by the Uniform System

of Accounts for Class C Water Utilities. Labor costs that were attributed to extensions and improvements of the system have been incorrectly charged to expense during the test period. The Uniform System of Accounts, as adopted by this Commission, specifies that labor costs incurred as a result of extensions and improvements shall be capitalized and included in the asset account to which the costs are related. McKinney indicated in response to a request for information that \$4,100 was charged to operation labor during the test period which should have been capitalized. Therefore, the Commission has determined that operation labor should be reduced by \$4,100 to exclude this cost from operating expenses for rate-making purposes. An adjustment has been made to depreciation expense to provide for the annual depreciation expense associated with the capitalization of these assets.

Operation Supplies

In response to information request no. 2, McKinney stated that in 1980 materials totaling approximately \$8,000 were purchased in connection with a new water line constructed in that year. The materials were paid for in 1981 and charged to operation supplies. The Commission is of the opinion that this accounting practice is improper and does not conform to accounting principles prescribed by the Uniform System of Accounts for Class C Water Utilities. The costs incurred in 1980 should have been accrued as an account payable in 1980. In addition, the costs

should have been capitalized in 1980 and depreciated over their useful life since they were associated with new service. Therefore, based on Exhibit V from the response to information request no. 1 and the response to information request no. 2, the Commission has determined that operation supplies should be adjusted downward by \$8,755 for the test period to exclude the expenses which were accounted for improperly.

Depreciation

In response to an information request McKinney filed a depreciation schedule which revealed that depreciation expense had been charged on land during the test period. The Commission finds that an adjustment to reduce depreciation expense by \$46 for rate-making purposes is necessary to reflect proper depreciation accounting in accordance with generally accepted accounting principles. Moreover, McKinney should make the appropriate adjustments to its depreciation schedules to discontinue this practice for accounting purposes.

The depreciation schedule submitted by McKinney further reflected that depreciation expense for the test period was based on the total utility plant in service of \$717,337. It is the policy of the Commission to compute depreciation expense for rate-making purposes on the basis of the original cost of the plant in service less contributions in aid of construction. The Commission has determined that contributions in aid of construction represent approximately 49 percent of the total cost of utility plant in service. Therefore, depreciation expense has been

reduced by \$8,769 for the test period to exclude depreciation on assets purchased with contributions in aid of construction.

Pursuant to the adjustments concerning operation labor and operation supplies the Commission has determined that an allowance should be made for depreciation on those items which should have been capitalized. As a result, test period depreciation expense has been increased by \$322 to allow for depreciation on those capital items.

The net effect of these adjustments on annual depreciation expense results in pro forma depreciation expense of \$9,486.

Interest Income

The record indicates that McKinney has used a substantial portion of its temporary cash investments in order to meet current principal and interest payments on its long-term debt obligations. The Commission is of the opinion that this reduction in funds available for investment will result in a decrease in annual interest income. Therefore, interest income for the test period has been reduced by \$1,711 to reflect the decrease in interest income. The remaining interest income of \$437 is based on the level of temporary cash investments at the end of 1981 and at a projected 7 percent yield.

Interest Expense

Interest expense has been reduced by \$390 to reflect the annual interest expense on long-term debt outstanding at the end of the test period.

After consideration of the aforementioned adjustments the Commission finds that McKinney's test period operations are as follows:

	<u>Actual Test Period</u>	<u>Pro forma Adjustments</u>	<u>Adjusted Test Year</u>
Operating Revenue	\$ 79,683	\$ 10,905	\$ 90,588
Operating Expenses	<u>95,200</u>	<u>(22,252)</u>	<u>72,948</u>
Operating Income	<u>\$ (15,517)</u>	<u>\$ 33,157</u>	<u>\$ 17,640</u>
Interest on Long-term Debt	18,954	(390)	18,564
Interest Income	<u>2,148</u>	<u>(1,711)</u>	<u>437</u>
Net Income	<u><u>\$ (32,323)</u></u>	<u><u>\$ 31,836</u></u>	<u><u>\$ (487)</u></u>

REVENUE REQUIREMENTS

McKinney's annual debt service requirement based on the documents filed with this case is \$22,962. The adjusted test period operating statement reflects a net loss of \$487 which provides inadequate coverage on McKinney's debt service. The Commission is of the opinion that the adjusted operating income is inadequate and will adversely affect the financial condition of McKinney. To improve McKinney's debt service coverage ratio to a reasonable level of 1.2, additional revenues of \$9,477 are required. Based on adjusted test period results, total operating revenues of \$100,065 will produce net operating income of \$27,117 which, after considering other income of \$437, will be sufficient to allow McKinney to pay its operating expenses and meet its debt service requirements.

The Commission has made adjustments to reflect a normal level of revenue and expense for rate-making purposes. Some of

the adjustments were necessary because McKinney failed to follow accounting practices prescribed by the Uniform System of Accounts for Class C Water Utilities as adopted by this Commission. Rate proceedings filed under ARF require that the utility maintain adequate financial records and that the annual reports be accurate. Therefore, in the future McKinney should be aware of this requirement and maintain accurate and complete records in order to comply with the regulations established by this Commission.

SUMMARY

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

1) The rates in Appendix A are fair, just and reasonable rates for McKinney in that they will produce annual operating revenues of approximately \$100,065 and should be approved. These revenues will be sufficient to meet McKinney's operating expenses found reasonable for rate-making purposes, service its debt, and provide a reasonable surplus.

2) The rates proposed by McKinney would produce revenue in excess of that found reasonable herein and should be denied.

3) The record herein demonstrates that McKinney's 1981 annual report contains deficiencies that should be corrected to be in conformity with Commission regulations.

IT IS THEREFORE ORDERED that the rates in Appendix A be and they hereby are approved for service rendered by McKinney on and after the date of this Order.

IT IS FURTHER ORDERED that the rates proposed by McKinney be and they hereby are denied.

IT IS FURTHER ORDERED that within 30 days from the date of this Order McKinney shall file with this Commission its revised tariff sheets setting out the rates approved herein.

IT IS FURTHER ORDERED that McKinney shall revise its 1981 annual report in conformity with accounting practices as prescribed by the Uniform System of Accounts for Class C Water Utilities as adopted by this Commission.

Done at Frankfort, Kentucky, this 10th day of December, 1982.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Secretary

APPENDIX A

APPENDIX TO AN ORDER OF THE PUBLIC SERVICE
COMMISSION IN CASE NO. 8577 DATED December
10, 1982.

The following rates are prescribed for the customers of McKinney Water Association. 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 effective date of this Order.

GALLONAGE BLOCK

RATE

First 1,000 gallons	\$9.80 minimum
Next 2,000 gallons	2.90 per 1,000 gallons
Next 7,000 gallons	2.35 per 1,000 gallons
Over 10,000 gallons	1.80 per 1,000 gallons