COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

THE APPLICATION FOR RECON-SIDERATION OF EAST CLARK COUNTY WATER DISTRICT FOR AN ADJUSTMENT OF RATES PURSUANT TO THE ALTERNATIVE PROCEDURE FOR SMALL UTILITIES	)	CASE NO. 8644

O R D E R

On December 17, 1982, the Commission issued an Order in this case which denied a rate increase proposed by East Clark County Water District ("East Clark"). On January 5, 1983, East Clark filed an application for reconsideration of certain issues contained in the Order. On January 27, 1983, the Commission issued an Order granting reconsideration of the issues addressed by East Clark. Based on the information presented in the application for reconsideration and the subsequent filings by East Clark the Commission has determined that the following issues require adjustment and further commentary:

Bulk Water Sales

During the test period East Clark increased the rate charged for bulk water sales from $2.50 per 1,000 gallons to $3.50 per 1,000 gallons. The Commission made an adjustment to increase operating revenue based on the rate in effect at the end of the test period and the actual gallons sold during the test period. In the application for reconsideration East Clark maintained that a substantial amount of bulk sales during the test period can be attributed to purchases for construction purposes at the J.K. Smith Power Station. During the early part of 1982 the purchases for the power station were discontinued. East Clark requested that an adjustment be made to recognize a decline in bulk water sales.

Based on the evidence of record the Commission has determined that bulk water sales have significantly declined from the test period amount. The Commission's Order dated February 22, 1983, requested the number of gallons that were purchased for the power station during the test period. East Clark could not furnish this information because the bulk loading stations are coin operated and purchases by specific customers are not recorded. However, the Commission is of the opinion that an adjustment to recognize the decline in bulk water sales is appropriate in the instance. Based on the evidence of record, the 12-month period ending February 1983 should represent a reasonable level of sales without purchases for the power station. Therefore, by using the level of sales from this period the Commission has made an adjustment to reduce bulk sales by $15,130 below the amount allowed in the original Order. This adjustment results in total revenue of $25,421 from bulk sales.[1] Furthermore, the Commission has determined that an adjustment to reduce purchased water costs and operation labor should be made to reflect the decline in bulk water sales. Therefore, an adjustment has been made to reduce purchased water costs by $3,757 based on the allowed volume of 7,263,000 gallons at the purchased water cost of 86.9 cents per 1,000 gallons. The operation labor has been reduced by $952 to exclude the 20 percent of gross receipts retained by the bulk station operators based on the reduction in sales.

Damages Paid by Contractor

East Clark's test period operating statement included $2,000 in operating revenue for settlement of a claim with a contractor in connection with malfunctioning telemetering equipment. Initially, the record did not contain sufficient detail to identify the associated costs or the dates that the costs were incurred. Therefore, for rate-making purposes the amount was retained in operating revenue so that operating income would not be understated because of the inclusion of associated expenses in the test period operating statement. In the application for reconsideration East Clark requested

1 7,263,000 gallons x $3.50/1000 gallons = $25,421

that the $2,000 be removed from the test period operating statement because it is a non-recurring item.

The Commission concurs that the item in question is non-recurring. Furthermore, sufficient detail has now been supplied by East Clark to make the applicable adjustments to expenses associated with this item. Therefore, the Commission has made an adjustment to reduce operating revenue by $2,000. In addition, based on the additional information filed by East Clark, the Commission has determined that $767 was included in test period operating expenses in connection with this item and adjustments have been made to reduce the applicable expense accounts for purchased water, transportation, salaries, court costs and legal fees.

Insurance

Initially, East Clark submitted documents which gave the impression that an amount paid for an insurance policy covering a 3-year period had been deducted in total during the test period. The Commission pro-rated this expense over the periods which the policy covered. However, in the application for reconsideration East Clark stated that the cost of the policy had already been pro-rated in arriving at test period insurance expense and requested that the Commission reverse the adjustment made in the original Order.

East Clark has filed an analysis of the prepaid insurance account for the beginning and for the end of the test period. After reviewing the analysis the Commission has determined that East Clark did properly pro-rate the cost of the policy. Therefore, an adjustment has been made to reverse the reduction of $257 made to this account in the original Order. Furthermore, it has been determined that East Clark improperly reduced test period insurance expense by $21 in recognition of receipt of a credit associated with an insurance premium paid in a prior period. This item should have been included in adjustments to Retained Earnings (Account No. 439) since it relates to a prior period. These two adjustments result in total test period insurance expense of $1,305.

Depreciation

The Commission determined in the original Order that contributions in aid of construction represented approximately 64 percent of the total cost of utility plant in service. Depreciation expense was reduced by $11,959 for the test period to exclude depreciation on assets purchased with contributions in aid of construction. In the application for reconsideration East Clark objected to this adjustment and argued that current depreciation accounting does not ensure replacement of water systems at the original capital investment, the Commission's approach does not allow for the establishment of realistic rate schedules nor provide adequate funds for capital maintenance, and East Clark's method is in accordance with generally-accepted accounting standards and business practices.

The Commission has a well-established policy of disallowing depreciation in connection with facilities funded with contributions in aid of construction. This is a rate-making policy of a majority of regulatory commissions throughout the country. The Commission considers depreciation to be an assignment of the cost of an asset over the periods which will be benefited. Water districts generally have substantial contributions in aid of construction because they are non-profit and an extension of county government. Moreover, private investors generally are not interested in providing financing to public water utilities. Therefore, water districts must rely on government-related debt instruments, grants, and tap-on fees to fund capital expenditures. Generally, it is the latter two sources which constitute contributions in aid of construction. East Clark obtained funds from both of these sources for construction of its utility plant in service.

East Clark has expressed concern that the practice of excluding depreciation of assets purchased with contributed capital does not provide the proper level of funds through rates for future capital expenditures. The Commission, as stated previously, recognizes depreciation as a cost-assignment method and does not imply that it serves as a source of funds for future capital expansion and improvements or for replacements of existing facilities. In water district cases the Commission generally uses the debt service coverage ratio method to establish revenue requirements.[2] This method is used because water districts generally do not require a rate of return to investors but rather a fixed debt service requirement is necessary to satisfy mortgage obligations. In East Clark's case and in many other water district cases the ratio of 1.2 has been allowed. The Commission has found that the revenue generated by this ratio, along with other income, is sufficient to allow the utility to pay its operating expenses, meet its debt service requirements, and maintain an adequate reserve for expansion and improvements. If adverse conditions or unusual circumstances exist which would cause this method to place an undue burden on the cash flow of the utility the Commission considers the cash needs on a case-by-case basis. However, the burden is upon the utility to present evidence that such conditions and circumstances exist to substantiate the need for additional cash funds. Upon a determination that such

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[2] $$\text{Debt Service Coverage Ratio} = \frac{\text{Operating Income}}{\text{Average principal and interest payments}}$$

funds are needed the Commission may approve rates to provide these funds or the utility may be required to provide funds for these needs through other sources such as financing.

If depreciation were allowed on total plant in service in determining the revenue requirements the ratepayers would be paying for the assigned cost of assets which were provided to the utility at no cost. With regard to contributions in the form of the tap-on fees, the customers theoretically would be paying the cost of using an asset which they provided cost-free to the utility. This inequity is magnified even further when depreciation is allowed on subsequent capital acquisitions and the ratepayers are required to pay assigned costs associated with service to other present and future ratepayers. Therefore, depreciation on assets purchased with contributions in aid of construction should be disallowed, otherwise inequities to the ratepayers and excessive rate schedules would exist.

In summary, the Commission points out that the adjustment for depreciation associated with contributions in aid of construction is made for "rate-making purposes." In the case of most water districts, revenue requirements are determined by the debt service coverage ratio method. The Commission has determined that in East Clark's case no information has been presented to indicate that adverse conditions or unusual circumstances exist which would warrant a change in this approach. Therefore, the Commission affirms its original Order on this issue.

After review and analysis of the application for reconsideration the Commission finds that East Clark's adjusted test period operations should be restated as follows:

	Adjusted Test Year	Adjustments on Reconsideration	Restated Adjusted Test Year
Operating Revenue	$102,004	$(17,130)	$84,874
Operating Expenses	70,717	(5,198)	65,519
Operating Income	$ 31,287	$(11,932)	$19,355
Interest on Long-Term Debt	15,800	-0-	15,800
Interest Income	1,267	-0-	1,267
Net Income	$ 16,754	$(11,932)	$ 4,822

REVENUE REQUIREMENTS

In recognition of the items which have been adjusted herein the Commission has determined that East Clark is entitled to increase its rates to produce total annual revenues of $86,896 which will require an increase in revenues of $2,022.

RATE DESIGN

In its application for reconsideration East Clark requested that the Commission reconsider its proposal to change its rate design.

East Clark proposed to change its minimum usage of 2,000 gallons to a minimum of 1,000 gallons. This proposed change in rate design would decrease the bills of customers who use 1,000 gallons or less. East Clark stated that this change in rate design will benefit customers of lower income or those on a fixed income represented in this usage bracket.

After reviewing the proposed change in rate design the Commission found that customers who use 2,000 gallons would receive a greater percentage increase than if the rate design were not changed. The Commission is of the opinion that customers who use 2,000 gallons would not benefit from the proposed change in rate design and that it would be unfair for these customers to partially subsidize customers who use 1,000 gallons or less. Therefore, the Commission has determined that the present rate structure of East Clark is fair, just and reasonable and after reconsideration has determined that the proposed change in rate structure is not justified in this case.

SUMMARY

The Commission, having considered the application for reconsideration, is of the opinion and finds that:

(1) East Clark should be allowed to adjust its rates in recognition of those items which have been adjusted herein.

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

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

IT IS FURTHER ORDERED that the provisions of the Commission's Order of December 17, 1982, which have not been modified herein shall remain in full force and effect.

Done at Frankfort, Kentucky, this 27th day of April, 1983.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ATTEST:

Secretary

APPENDIX A

APPENDIX TO AN ORDER OF THE PUBLIC SERVICE COMMISSION IN CASE NO. 8644 DATED APRIL 27, 1983

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

RATES: Monthly

First	2,000 gallons	$8.60 (Minimum Bill)
Next	2,000 gallons	3.65 per 1,000 gallons
Next	3,000 gallons	3.15 per 1,000 gallons
Next	3,000 gallons	2.55 per 1,000 gallons
Over	10,000 gallons	1.90 per 1,000 gallons