COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

APPLICATION OF SUNSHINE SEWER) SYSTEMS, INC., FOR AN ADJUST-) MENT OF RATES PURSUANT TO) THE ALTERNATIVE PROCEDURE) FOR SMALL UTILITIES)	CASE NO. 8650

O R D E R

On September 20, 1982, Sunshine Sewer Systems, Inc., ("Sunshine") filed an application with the Commission to increase its sewer rates pursuant to 807 KAR 5:076. This regulation allows utilities with 400 or fewer customers or $200,000 or less gross annual revenues to use the alternative rate filing method in order to minimize the necessity for formal hearings, to reduce filing requirements and to shorten the time between the application and the Commission's final Order. This procedure minimizes rate case expenses to the utility and, therefore, results in lower rates to the ratepayers.

Sunshine requested rates which would produce an annual increase of $59,392. According to Sunshine's application, this increase is necessary due to the increased cost of operation and for repairs and improvements. In this Order the Commission has allowed rates to produce an increase of $14,994.

There were no intervenors in this matter. All information requested by the Commission has been submitted.

TEST PERIOD

For the purpose of determining the reasonableness of the proposed rates, the 12-month period ending December 31, 1981, has been accepted as the test period.

REVENUES AND EXPENSES

Sunshine proposed no specific adjustments to test period operations but made general statements in its application regarding increases in expenses. The Commission advises Sunshine that prior to filing future rate cases, it should familiarize itself with the Commission's policy concerning pro forma adjustments. In accordance with the Commission's rate-making policies, the following adjustments have been made to Sunshine's test period operations to reflect actual and anticipated operating conditions:

Management Fee

Sunshine's test period expenses included $3,000 of compensation for management services. All routine service operations are performed by Ray McDonald and Associates and all billing and collection is performed by the Louisville Water Company. Thus, Sunshine's management is limited to part-time administrative duties. Based on its experience with other similarly-operated sewer utilities, the Commission is of the opinion that $3,000 for management services is excessive and should be reduced to a reasonable level of $1,800.

Utilities Expense

During the test period, Sunshine reported $13,081 for fuel and purchased power expense. Based on the information provided by Sunshine, the Commission increased this expense by $1,531 to reflect the application of the current rates in effect for electric service from Louisville Gas and Electric to test period usage levels.

Moreover, Sunshine provided adequate information to verify an increase in its water costs. Thus, the Commission has increased this expense by $156.

Customer Records and Collection Expense

Sunshine reported that its customer collection expense from the Louisville Water Company for the test period was $4,891. The Commission increased this expense by $800 to reflect the increase in the current cost per bill from the Louisville Water Company.

Depreciation Expense

During the test period Sunshine reported depreciation expense of $8,975. It was disclosed that Sunshine's depreciation expense included depreciation on $430,705 (1) of plant financed by contributions in aid of construction from its ratepayers. It is the policy of the Commission to compute depreciation expense on the basis of the original cost of the plant, less contributions in aid of construction, as ratepayers should not be required to provide recovery on that portion of plant that has been provided free of cost. Therefore, the Commission has determined that Sunshine's

(1) Item 4, Information Request Response, October 29, 1982.

adjusted depreciation expense for rate-making purposes is $682.[2]

Other Expenses

Sunshine provided sufficient evidence to indicate that its sludge hauling, garbage removal, alarm system, chemical deodorant and insurance expenses had increased. Therefore, the Commission has increased test period operations by $481 to reflect increases in these expenses.

Thus, Sunshine's adjusted operations at the end of the test period are as follows:

	Actual	Adjustments	Adjusted
Operating Revenues	$95,045	$ -0-	$ 95,045
Operating Expenses	90,314	(4,160)	86,154
Net Operating Income	$ 4,731	$ 4,160	$ 8,891
Interest Expense	18,719	-0-	18,719
Interest and Dividend Income	12,115	$ -0-	12,115
Net Income (Loss)	$(1,873)	$ 4,160	$ 2,287

REVENUE REQUIREMENTS

Sunshine had adjusted test period out-of-pocket expenditures of $116,154[3] including annual debt service payments of $30,000. Because its cash flow was $107,842,[4] Sunshine was not able to

(2) Calculation:

Utility Plant in Service	$466,247
Contributions in Aid of Construction	(430,705)
Non-contributed Plant in Service	$ 35,542*

*Non-contributed property of $35,542 X composite depreciation rate of 1.92 percent = $682 adjusted depreciation expense.

(3) $86,154 (Adjusted Operating Expenses) + [$2,500 X 12 (Monthly Loan Payments)] = $116,154.

(4) $95,045 (Sewer Service Revenue) + $12,115 (Interest and Dividend Income) + $682 (Adjusted Depreciation Expense) = $107,842.

meet all of its financial obligations. Sunshine currently has outstanding debt of $172,330 to the Stock Yards Bank of Louisville, Kentucky. This loan was initially for 5 years at an 11 percent interest rate. However, it was disclosed that the loan will be extended for an additional 5 years.(5)

Mr. Ray McDonald, the majority stockholder, assumed control of Sunshine in 1980. At that time, Sunshine was encumbered with numerous debts, and its operations were not in compliance with local sanitary codes. Mr. McDonald co-signed for and financed Sunshine's outstanding obligations on reasonable terms. The proceeds were used to pay loans, taxes and liens incurred prior to 1980 and to make improvements to the system to meet the sanitary codes and the requirements of this Commission. The Commission commends Mr. McDonald's efforts to rectify prior management inadequacies.

Under strict rate-making policy, principal on debt should be repaid out of depreciation and income. Moreover, in sewer utilities whose plant is predominantly funded by contributions, the Commission generally uses the operating ratio method to determine revenue requirements. The operating ratio method is an appropriate valuation in instances in which equity and debt investments do not represent a significant portion of a utility's plant in service. Thus, the utility's ability to meet its out-of-pocket current operating expenses is its primary risk of doing business.

However, in this case, because Sunshine's plant is almost fully contributed, little depreciation is allowed and because of

(5) Letter from Stock Yards Bank, February 4, 1983.

inadequate management practices prior to 1980, Sunshine has significant debt outstanding to the Stock Yards Bank. Again, under strict rate-making policy, the Commission would not recognize all of this debt in the rate-making process because it resulted from improper management practices and should be paid by the owners of the utility. However, because Sunshine's new manager is responsive to the needs of the utility and its ratepayers and has made significant efforts to improve Sunshine's finances and operations, the Commission is of the opinion that the debt service requirements in the outstanding loan should be considered in Sunshine's revenue requirements.

Because of the significant debt investment to be considered in the determination of the revenue requirement, the operation ratio method is inappropriate as it does not provide sufficient income to meet Sunshine's principal repayments. Thus, the Commission finds that the debt service coverage method ("DSC") is the appropriate method to use in determining Sunshine's revenue requirement.

In addition to income from sewer rates, Sunshine had other investment income of $12,115, which the Commission considers a part of utility revenue for rate-making purposes. Sunshine's debt service is approximately $30,000. Sunshine's DSC on adjusted net operating income of $8,891 is .30X, which the Commission finds to be unfair, unjust and unreasonable. The Commission is of the opinion that a fair, just and reasonable DSC is 1.2X in that this coverage will provide revenues sufficient for Sunshine to pay its operating expenses, service its debt and provide a reasonable return to its equity stockholders.

To achieve the DSC found fair, just and reasonable, the Commission has determined that Sunshine is entitled to increase its rates to produce an increase in annual revenues of $14,994,(6) which includes state, federal and Jefferson County income taxes of $3,510.(7)

OTHER ISSUES

Future Repairs

Sunshine wishes to make certain major repairs to its system in the near future. Sunshine provided a list of these expenditures totalling approximately $106,500. While the Commission recognizes that these expenditures may be necessary to the operation of the sewer system, Sunshine has not obtained the appropriate financing. Therefore, the Commission cannot provide revenue in this Order for the proposed expenditures. Further, the Commission advises Sunshine to make application for approval of these expenditures and the related financing when such financing arrangements are complete.

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(6) Calculation:

	1.2 X Debt Service Coverage	$ 36,000*
Add:	Adjusted Operating Expenses	86,154
	Subtotal	$122,154
Less:	Adjusted Operating Revenues	107,160
	$95,045 (Sewer Service Revenues) + $12,115 (Interest and Dividend Income)	
	Increase in Gross Revenues	$ 14,994

*Debt Service of $30,000 X 1.2 = $36,000

(7) $36,000 - $18,719 (Interest Expense) = $17,281 (Taxable Income) - $380 (2.2 percent Jefferson County Tax) X 18.52 percent (Federal and State Corporate Composite Tax Rate) = $3,130.

Accounting Procedures

After comparing Sunshine's operating and maintenance expenses with those of other sewer utilities of similar size and age, the Commission has determined that the level of overall operating and maintenance expenses is not unreasonable. However, the Commission found that due to Sunshine's accounting procedures a comparison of specific costs could not be made. Therefore, the Commission will require Sunshine to review its accounting procedures and conform them to the Uniform System of Accounts pursuant to KRS 278.220.

SUMMARY

The Commission, after examining the evidence of record and being advised, finds that:

(1) The rates in Appendix A are the fair, just and reasonable rates to charge for sewer services rendered to Sunshine's customers and should produce annual revenues of approximately $110,039.

(2) The rates proposed by Sunshine will produce revenue in excess of the revenue found reasonable herein and should be denied upon application of KRS 278.030.

(3) Sunshine has filed a valid third-party beneficiary agreement with the Commission.

IT IS THEREFORE ORDERED that the rates in Appendix A be and they hereby are the fair, just and reasonable rates for Sunshine to charge for sewer service rendered on and after the date of this Order.

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

IT IS FURTHER ORDERED that Sunshine shall modify its accounting procedures to conform with the Uniform System of Accounts pursuant to KRS 278.220.

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

Done at Frankfort, Kentucky, this 7th day of March, 1983.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ATTEST:

Secretary

APPENDIX A

APPENDIX TO AN ORDER OF THE PUBLIC SERVICE COMMISSION IN CASE NO. 8650 DATED MARCH 7, 1983.

The following rates are prescribed for all customers served by Sunshine Sewer Systems, Inc. All other rates and charges not specifically mentioned herein shall remain the same as those in effect prior to the date of this Order.

Customer Category		Rate
Residential Users		$9.25 Per Month
Commercial, Apartments and Schools		
First	2,000 Gal.	$5.80 (Minimum Bill)
Next	7,000 Gal.	2.00 Per 1,000 Gal.
Next	35,000 Gal.	1.75 Per 1,000 Gal.
Next	104,000 Gal.	1.15 Per 1,000 Gal.
Over	148,000 Gal.	.65 Per 1,000 Gal.