

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

THE APPLICATION OF FERN HILL)
UTILITIES, INC., FOR AN ADJUST-)
MENT OF RATES PURSUANT TO THE) CASE NO. 9102
ALTERNATIVE RATE ADJUSTMENT FOR)
SMALL UTILITIES)

O R D E R

On July 13, 1984, Fern Hill Utilities, Inc., ("Fern Hill") filed an application with the Commission to increase its rates pursuant to 807 KAR 5:076, Alternative Rate Adjustment Procedure for Small Utilities ("ARP"). The proposed rates would produce additional revenue of approximately \$36,547 annually, an increase of 43 percent. Based on the determination herein, no deficiency exists in the revenues of Fern Hill and, therefore, no increase in revenues has been allowed.

The Consumer Protection Division in the Office of the Attorney General ("AG") intervened in this case. A hearing was not requested in this case, and in accordance with the provisions of the ARP, no hearing was conducted. However, at the request of Fern Hill a formal conference was held on January 3, 1985, on the limited issue of interest expense. The decision of the Commission is based on information contained in the application, written submissions, annual reports, transcripts of the formal conference and other documents on file in the Commission's offices.

COMMENTARY

Fern Hill is a privately-owned sewage treatment system organized and existing under the laws of the Commonwealth of Kentucky and serves approximately 446 customers in Jefferson County, Kentucky.

TEST PERIOD

Fern Hill has proposed and the Commission has accepted the 12-month period ending December 31, 1983, 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. The financial data from the 1983 Annual Report has been used as the basis for determining revenue requirements. Fern Hill proposed adjustments to revenue and expenses as reflected in the comparative income statement filed in Part II of the application. The Commission has made adjustments to reflect actual and anticipated operating conditions which the Commission deems are proper and acceptable for rate-making purposes.

Normalized Revenue

Fern Hill's 1983 Annual Report and its application filed in this case show annual revenues of \$84,994. On September 27, 1984, in response to an information request Fern Hill furnished the Commission with a listing of customers served during the test year, and corrected its application. Therefore, the Commission

has decreased test year revenue by \$808 to reflect adjusted test year revenue in the amount of \$84,186.

Sludge Hauling

The reported test-period sludge hauling expense was \$5,840. Fern Hill proposed an adjustment of \$1,920 based on a \$40 per load increase in costs. In response to a Commission request, Fern Hill recalculated its request based on a \$35 per load increase, thus requesting an increase of \$1,340 annually.¹ The Commission considers the latter adjustment reasonable and finds an adjusted test-period sludge hauling expense to be \$7,180.

Electricity Expense

Fern Hill proposed an adjustment to increase test-year electricity expense to \$14,775 based on increased rates by its supplier, Louisville Gas & Electric Company ("LG&E"). At the AG's request, Fern Hill provided copies of its test-year electricity bills for examination.² No evidence was presented by Fern Hill that the increased cost was a result of increases in electric usage above actual test period amounts. Therefore, the Commission has determined, by applying actual test-year electric usage to currently effective LG&E rates, that electricity expense should be adjusted to reflect an annual expense of \$12,749.

¹ Response to Commission's Information Request dated August 29, 1984, Item No. 7.

² Response to AG's Data Request dated August 15, 1984, Item No. 1(c).

Routine Maintenance

Fern Hill reported test-year routine maintenance service expense of \$7,800 and proposed no adjustment to this account. Since the contract is between mutually-owned companies, Fern Hill and Andriot-Davidson Service Company, Inc., ("Andriot-Davidson"), the transaction is, by definition, at less than arms-length. Therefore, the burden of proof is on Fern Hill to demonstrate that the monthly charge for routine maintenance service is fair, just and reasonable, and to justify the basis for increasing the level of this fee from the amount found reasonable in Case No. 7803, Application of Andriot-Davidson Service Company, Inc., d/b/a Fern Hill Utility, Inc. for Authority to Acquire and Operate the Sewage Treatment Plant Operated by Fern Hill Company, Inc. in Jefferson County, Kentucky and Application of Andriot-Davidson Service Company, Inc., d/b/a Fern Hill Utility, Inc., for an Order Adjusting the Rates Currently Charged by Fern Hill Company, Inc., as reflected in the Commission's Order dated December 18, 1980. Fern Hill was put on notice to this effect and the Commission requested information necessary to make a decision on this matter; however, Fern Hill provided incomplete responses to the requests.³

Presumably, as support, Fern Hill provided hourly mechanics' labor charges at several car dealerships for comparison.⁴ However, this information is basically irrelevant and no evidence

³ Response to Commission's Information Request dated November 19, 1984, Item No. 7.

⁴ Response to Commission's Information Request dated August 29, 1984, Item No. 9.

was provided as to why the Commission should consider the wages of auto mechanics when determining the reasonableness of transactions between mutually-owned companies or the fees for maintenance of sewage treatment plants.

It is the Commission's opinion that Fern Hill has not met its burden of proof as to why the routine maintenance fee paid to Andriot-Davidson is reasonable. Therefore, the Commission has made an adjustment to reduce the reported test-year routine maintenance expense to \$5,336, which was the fee allowed in Fern Hill's last rate case. In making this adjustment, the Commission does not find the allowed fee of \$5,336 a reasonable expense but merely establishes a point of reference where it will not allow further increases in transactions with affiliated companies without persuasive justification.

The Commission recognizes that this case was an ARF proceeding in which a hearing was not held. Therefore, Fern Hill is hereby apprised that the Commission will consider a motion for a formal hearing on this matter should Fern Hill indicate that it intends to submit persuasive proof in support of its test year expense for routine maintenance service.

Maintenance of Treatment and Disposal Plant

The test period level of maintenance of treatment and disposal plant was reported in the amount of \$9,554. A breakdown of this amount included \$4,361 expended for the installation of

aerators.⁵ Expenditures of a capital nature provide benefit for more than one accounting period and as such are not legitimate operating costs for accounting or rate-making purposes. The proper method for recognizing the benefit foregone of a capital expenditure to earn revenues is the depreciation of the asset during its respective useful life. Therefore, the Commission has reduced the test period expense to \$5,193 and has determined an appropriate level of associated depreciation expense described later herein.

Rate Case Amortization

Fern Hill proposed an adjustment to operating expense of \$300 annually for the amortization of costs incurred in this proceeding. The Commission is of the opinion that \$300 is a reasonable amount for an ARF proceeding and accepts this adjustment.

Insurance Expense

The reported test period level of insurance expense was \$1,195. Fern Hill proposed an adjustment increasing this expense by \$500 citing past casualty losses as a contributing factor in raising the level of insurance expense to \$1,695 annually. In response to an information request for all executed insurance contracts and related billings for the proposed level of insurance expense, Fern Hill provided only one contract of \$788 annually for

⁵ Response to AG's Data Request dated September 15, 1984, Item No. 3(d).

property and liability insurance.⁶ The Commission then requested Fern Hill to provide any evidence of why insurance expense should not be reduced to reflect only the cost of the insurance contract in effect for 1984.⁷ Fern Hill provided no such additional evidence and it is the opinion of this Commission that Fern Hill has not shown that the actual or projected level of insurance expense is reasonable for rate-making purposes. Therefore, the Commission has reduced test-period insurance expense by \$407 to \$788 annually.

Transportation Expense

The reported test period level of transportation expense was \$595 to which Fern Hill had proposed no adjustments. Fern Hill provided no documentation, explanation, or any support whatsoever for the \$595 in annual transportation expense.⁸

The Commission realizes that in small utilities there exists in practice a wide variation in accounting expertise and it attempts to accommodate such variation. However, where no documentation, explanation, or description of the validity of the expense or of benefits received by the utility's ratepayers for expenditures exists, the Commission cannot include such costs in the revenue requirements determination. Therefore, the Commission

⁶ Response to Commission's Information Request dated August 29, 1984, Item No. 12.

⁷ Response to Commission's Information Request dated November 9, 1984, Item No. 4.

⁸ Response to Commission's Information Request dated August 29, 1984, Item No. 11.

is of the opinion that Fern Hill has not met its burden of proof on this issue and has excluded the reported transportation expense of \$595 herein.

Depreciation, Amortization and Interest on Long-Term Debt

For the test period Fern Hill reported depreciation expense of \$12,139 based on reported plant in service of \$226,753. In response to a request for information regarding the original cost of plant in service (to include the useful life of assets, date acquired, original cost, associated accumulated depreciation and copies of invoices to support all items costing \$1,000 or more), Fern Hill provided information which showed that \$207,438 of gross plant was attributable to the allocation of the purchase price,⁹ upon the acquisition of Fern Hill by Carroll Cogan Companies ("CCC"). The Uniform System of Accounts for Class C and D Sewer Utilities ("Uniform System of Accounts") requires that utility plant purchased or sold be recorded as follows:

1. Recording the utility plant acquired at its original cost to the person first devoting it to public service, estimated if not known, in the appropriate utility plant in service accounts;

2. Crediting the requirements for accumulated provision for depreciation and amortization applicable to the original cost of the properties acquired to the appropriate account for accumulated provision for depreciation and amortization;

⁹ Response to Commission's Information Request dated November 19, 1984, Item No. 1.

3. Transferring the cost of any nonutility property to Account No. 121--Nonutility Property;

4. Crediting contributions in aid of construction to Account No. 271--Contributions in Aid of Construction; and,

5. Including in Account No. 108--Utility Plant Acquisition Adjustment, any difference between the purchase price and the original cost of the utility plant and nonutility property less the amounts credited to accumulated depreciation and amortization reserves and contributions in aid of construction.

Since the Uniform System of Accounts has no provision for the method used by Fern Hill to record the utility plant at the purchase price, the depreciation expense recorded for the test period is improper, without basis, in violation of the guidelines established in the Uniform System of Accounts, and unacceptable for financial reporting purposes as well as for rate-making purposes. Accordingly the Commission has reduced depreciation expense by \$5,671 to exclude depreciation improperly recorded on plant booked on the basis of the purchase price.

In Case No. 7803, the Commission did not allow depreciation expense on the entire value of plant in service at the time of the transfer. Although the Order in that case does not explicitly deny depreciation on the basis of the plant being totally contributed, it is implied, by the allowance of only \$1,749 in annual depreciation expense, that only a small portion of the original cost plant was to be depreciated for rate-making purposes. At the time of the transfer, Fern Hill showed \$4,875 of

plant in service. Consequently, this value of plant was the basis for the depreciation allowance of \$1,749 in the last case. Based on the value of plant on the books at the time of the transfer, and the level of depreciation expense of \$1,749, the original cost plant should be fully depreciated. Therefore, no depreciation has been allowed herein for plant on the books at the time of the transfer.

Since the acquisition of Fern Hill by CCC, plant additions have been made at a total cost of \$14,439. Annual depreciation expense on these plant additions based on straight-line depreciation over the average service life of 5 years is \$3,266. Furthermore, as stated previously in this Order, Fern Hill expensed certain items costing \$4,361 during the test period which should have been capitalized. The annual depreciation expense on the test period additions is \$1,453. The resulting annual depreciation expense included herein for rate-making purposes is \$4,719.

As stated previously, at the time of the acquisition of Fern Hill by CCC, plant in service was recorded at \$4,875. In previous cases involving Fern Hill as well as in this case, the Commission has attempted to obtain information to be used as a basis for recording the plant in service in accordance with the requirements of the Uniform System of Accounts. Because of the poor, at best, or non-existent records of the previous owners, no documentation has been provided to support the original cost of plant in service. The Commission must conclude, by virtue of the fact that Fern Hill had reported only \$4,875 of plant in service immediately prior to acquisition, the plant was either fully

depreciated, fully contributed and/or fully recovered through the sale of lots. Although the evidence of debt existing at the time of the transfer could be construed as a portion of investment not recovered by the previous owners, evidence in Case No. 7803 indicates that the funds of the previous owner were so heavily commingled with construction and development costs that it is questionable as to whether any of the debt of Fern Hill was associated with the original cost of the sewage facilities. No evidence has been presented to date that would substantiate that the debt of Fern Hill, which was assumed by CCC, was for the sole purpose of construction of sewage facilities. Moreover, the evidence that does exist strongly indicates the contrary. Fern Hill defaulted on its loans and was under foreclosure by Citizens Fidelity Bank and Trust Company at the time of the acquisition by CCC.

Based on the evidence of record in this case and previous cases, the Commission is of the opinion that the plant was recovered by the original developers through the sale of lots or through depreciation of the assets, and that the purchase was at a price in excess of net book cost which requires the recording of a plant acquisition adjustment. With the information available at this time the appropriate acquisition adjustment should be \$207,438. However, if the original cost of the plant, accumulated depreciation at the time of the sale, and contributions in aid of construction are documented to the Commission's satisfaction, the plant acquisition adjustment may be modified accordingly. Fern Hill should attempt to establish the proper values for the

original cost of plant and seek Commission approval of the appropriate entries in order to comply with the Uniform System of Accounts.

It is the Commission's opinion that it is unfair to require the ratepayers to provide additional monies for the value of utility plant simply because it has been sold at a cost above book value. Allowing acquisition adjustments could result in the transference of property in order to increase its value for rate-making purposes. However, whether the amortization of an acquisition adjustment should be allowed must be determined on the merits of the evidence supporting the arguments in a particular case. The Commission must examine the facts and circumstances concerning a proposed acquisition adjustment. It may disallow the entire amount, or it may determine, based on substantial service improvements, operating efficiencies and the like, that a portion or all of the adjustment should be allowed. The record must demonstrate that the consumers are benefited by the acquisition. In this instance, Fern Hill has provided no evidence as to how the ratepayers have benefited from the sale and transfer. In most circumstances involving the sale and transfer of a sewer utility there is little opportunity to substantially improve service. Commission statutes require a high standard of service to be provided by sewer utilities and local authorities monitor them closely as well. In this case, as concerns the day-to-day operations of Fern Hill, the Commission does not see substantial benefits resulting from the sale and transfer. Both before and after the transfer a third party, Andriot-Davidson, was responsible for

the day-to-day operations of the plant and the billing was being done by another firm. This being the case, the ratepayers of Fern Hill would have scarcely noticed the change of ownership. The evidence of record in this case is insufficient to allow the amortization of the acquisition adjustment. The Commission has therefore excluded this expense for rate-making purposes herein.

Of fundamental importance in the pursuit of what is fair to the utility and the ratepayers are the issues of (1) recovery of investment through depreciation expense; (2) where plant is purchased at a price in excess of net book value, the amortization of the plant acquisition adjustment; and, (3) the recovery of debt used to finance the purchase of the utility when the plant was originally contributed.

In this instance, the Commission has denied depreciation expense and the amortization expense on the plant acquisition adjustment. In similar instances the Commission would not allow the interest expense on debt to finance the acquisition of the plant. However, in this case the circumstances are somewhat unique and the Commission has given further consideration to the interest expense issue. First, upon the acquisition of Fern Hill by CCC, the mortgage was reissued at the amount outstanding at the time of the transfer plus amounts for certain prior period operating losses which were disallowed for rate-making purposes in Case No. 7803. The prior mortgage had been legally secured by an exclusive pledge of the assets of Fern Hill and in full force of legal fact was an obligation to Fern Hill. Therefore, the lien on the sewer property was valid and consequently became an obligation

of the sewer utility. Second, the Commission allowed, in Case No. 7803, the purchase of Fern Hill by CCC and included interest on the long-term debt in determining the revenue requirements of Fern Hill under the new ownership. Third, the payment of principle and interest on the outstanding debt of Fern Hill requires a cash outlay which cannot be met without some provision for interest expense for rate-making purposes. Therefore, in the interests of fairness to the utility and as a measure of security for the continued safe and reliable operation of Fern Hill for the benefit of the ratepayers the Commission will include a provision for interest on long-term debt for rate-making purposes in this instance. As a means of minimizing the impact of this cost to the ratepayers and to spread the financing cost to the ratepayers equally over the life of the loan, the Commission will continue the methodology established in Fern Hill's last case of using the average interest expense over the life of the loan. Therefore, in consideration of the realities of Fern Hill's extremely unique situation, and upon a thorough review of the reasonableness of the rates granted herein, the Commission concludes that \$21,239 is the appropriate annual interest expense to be utilized for rate-making purposes in this instance.

Income Taxes

Fern Hill requested \$4,254 in annual state and federal income taxes.¹⁰ The proposed amount of annual income tax expense was based upon the requested level of taxable income and did not

¹⁰ Fern Hill's Application, p. 2.

consider the normalization of investment tax credits.¹¹ Fern Hill currently has available investment tax credits of \$5,432.¹² Normalizing the investment tax credits over the composite useful life, 7 years, of plant additions (subject to investment tax credit) since the acquisition of Fern Hill, results in an allowable income tax expense of \$1,767 annually based on the amount of annual revenues and expenses determined herein to be fair and reasonable. Therefore, the Commission has determined the amount of \$1,767 to be a fair and reasonable annual amount of income tax expense.

Interest and Dividend Income

Fern Hill reported no interest or dividend income for the test period, yet notes receivable from associated companies had opening and closing test year balances of \$4,000 and \$4,575, respectively. When asked to explain this discrepancy, Fern Hill disclosed that it had actually earned \$683 of interest and dividend income during the test period.¹³ Therefore, the Commission has increased test-period interest and dividend income to \$683.

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- 11 Response to Commission's Information Request dated August 29, 1984, Item No. 13.
- 12 Response to information requested at formal conference, dated January 25, 1985.
- 13 Response to Commission's Information Request dated August 29, 1984, Item No. 4.

Interest on Debt to Associated Companies

Included in Fern Hill's reported test period expenses was \$1,385 in interest on debt to associated companies. In response to a Commission request asking why notes payable to associated companies had opening and closing test period balances of \$0, yet interest on debt to associated companies had been charged with \$1,385 of interest expense, Fern Hill stated that the interest expense was the result of a prior period adjustment.¹⁴ To allow prior period adjustments for revenue determination would constitute retroactive rate-making; therefore, the Commission has reduced this test period expense to \$0.

After consideration of the aforementioned adjustments, the Commission finds Fern Hill's adjusted test period operations to be as follows:

	<u>Actual Test Period</u>	<u>Pro Forma Adjustments</u>	<u>Adjusted Test Period</u>
Operating Revenues	\$ 84,994	\$ <808>	\$84,186
Operating Expenses	63,666	<12,865>	50,801
Operating Income	<u>\$ 21,328</u>	<u>\$ 12,057</u>	<u>\$33,385</u>
Other Income	-0-	683	683
Other Deductions	35,288	<14,049>	21,239
	<u>\$<13,960></u>	<u>\$ 26,789</u>	<u>\$12,829</u>

REVENUE REQUIREMENTS

Fern Hill based its requested increase in revenue on an operating ratio methodology and requested revenue sufficient to produce a ratio of .88. In this case the Commission finds that an

¹⁴ Response to Commission's Information Request dated August 29, 1984, Item No. 4.

operating ratio of 88 percent is fair, just and reasonable and will allow Fern Hill to pay its operating expense, service its debt, and provide a reasonable return to its owners.

In this instance the use of an 88 percent after-tax operating ratio applied to the adjusted test-year operating expenses results in a revenue requirement of \$80,846 which is less than the actual test period revenues. Therefore, the Commission finds that no deficiency exists in the revenues of Fern Hill and has, therefore, allowed no increase in revenues.

SUMMARY

On January 14, 1985, Fern Hill submitted notice to the Commission of its intent to begin charging the rate advertised in its original application as of February 6, 1985. In its Order of February 6, 1985, the Commission ordered Fern Hill to maintain its records in such manner as will enable it, or the Commission, or any of its customers, to determine the amounts to be refunded and to whom due in the event a refund is ordered upon final determination of this case in accordance with 807 KAR 5:076, Section 8.

The Commission, after consideration of the evidence of record and being advised, is of the opinion and finds that the rate proposed by Fern Hill should be denied. Furthermore, the rate charged by Fern Hill on and after February 6, 1985, is in excess of the rate approved herein and, therefore, the difference should be refunded to the appropriate customers.

IT IS THEREFORE ORDERED that the proposed rate in Fern Hill's application be and it hereby is denied.

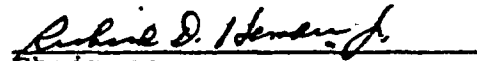
IT IS FURTHER ORDERED that the rate currently charged by Fern Hill shall remain in effect.

IT IS FURTHER ORDERED that the revenues collected by Fern Hill subsequent to February 6, 1985, through a rate in excess of that found reasonable herein shall be refunded in the first billing after the date of this Order.

IT IS FURTHER ORDERED that Fern Hill shall file a statement within 30 days of the date of this Order reflecting the number of customers billed, the amount collected under the rate put into effect on February 6, 1985, the number of customers receiving a refund, the amount refunded and the date of the refund.

Done at Frankfort, Kentucky, this 20th day of March, 1985.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Secretary