COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

THE APPLICATION OF NEWMARKET, INC. FOR A RATE ADJUSTMENT PURSUANT TO THE ALTERNATIVE FILING PROCEDURE FOR SMALL UTILITIES	))))	CASE NO. 9117

O R D E R

On August 1, 1984, Newmarket, Inc., ("Newmarket") filed an application with the Commission to increase its rates pursuant to 807 KAR 5:076, Alternative Rate Adjustment Procedure for Small Utilities ("ARF"). The proposed rates would produce additional revenue of approximately $14,463 annually, an increase of 43.4 percent. Based on the determination herein, the operating revenue of Newmarket will increase by $4,607 annually over test-year operating revenue, an increase of 13.7 percent.

A hearing was not requested in this matter and, in accordance with the provisions of the ARF, no hearing was conducted. 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's offices.

COMMENTARY

Newmarket is a privately owned sewage treatment system organized and existing under the laws of the Commonwealth of Kentucky and serves approximately 146 customers in Jefferson County, Kentucky.

TEST PERIOD

Newmarket 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. Newmarket proposed adjustments to revenue and expenses as reflected in the comparative income statement filed in Part II of the application. The Commission is of the opinion that the proposed adjustments are generally proper and acceptable for rate-making purposes with the following modifications to reflect actual and anticipated operating conditions:

Revenue Adjustment

Newmarket reported test-year operating revenues of $33,348. It is the Commission's policy to normalize test-year operating revenues to reflect all revenue provided for by the utility's tariff on file with the Commission. Newmarket indicates that its owner-manager receives sewer service at no cost. As Newmarket's tariff makes no provision for providing free service to any of its customers, the Commission has increased test-year revenues to reflect the elimination of the effect of providing free service to the owner-manager. The Commission has included for rate-making purposes a manager's fee of a level consistent with that allowed other small privately owned sewage systems. Allowing additional compensation in the form of free service unfairly requires Newmarket's customers to pay higher rates to make up for the lost revenue associated with the cost to provide the service. Therefore, the Commission finds Newmarket's provision of free service to the owner-manager inappropriate for rate-making purposes and has adjusted operating revenue by $176, the amount of the foregone revenue, to $33,524.

Management Fee

Newmarket proposed a management fee of $5,000, which was subsequently amended to $3,000,[1] based on "fees charged for rental properties in the real estate industry." Responses to requests by the Attorney General and the Commission to justify this as an appropriate basis for setting the management fee cited similarities between the functions of managing a utility and managing real estate property; similarities such as overseeing, repairs, maintenance, billings, bookkeeping, etc.[2] However, Newmarket provided no evidence which related the scale of operations of the entity being managed with appropriate management compensation. Furthermore, no evidence was provided which

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1 Response, Commission's letter of September 10, 1984, Item No. 6.

2 Response, Attorney General's letter of September 4, 1984, Item #1.

supported the position that the management fee for Newmarket should be any higher than that of any other small, privately owned sewer utility. Moreover, contracts with outside services provide for the majority of the operational responsibilities cited as justification for the higher fee.

Newmarket further argued that since it was an 1120 S tax status corporation and annual income from the utility is taxed to the shareholders rather than the utility the "management fee would need to be more than what typical sewer utilities of this size would be to allow its shareholders to realize a normal return after taxes."[3] For small privately owned sewer utilities such as Newmarket, the Commission determines revenue requirements on the basis of the operating ratio method. The Commission typically allows an operating ratio of .88 which provides for all justifiable operating costs of the utility plus a reasonable return to the owners. The salary paid to the utility's owner-manager should not be confused with the return allowed the utility. The owner-manager fee allowed by the Commission is based on the actual services provided by the owner-manager in the operation of the utility. In this instance, the fact that Newmarket is an 1120 S tax status corporation has no bearing on what the reasonable level should be for the owner-manager fees being provided.

It is the Commission's opinion that Newmarket has failed to meet its burden of proof as to why a higher than normal management

3 Ibid.

fee should be allowed. Therefore, the Commission will allow $1,800 for management fees, which is the level of expense normally allowed for small, investor-owned sewer utilities which operate without full-time employees.

Utility Service-Water

Newmarket proposed an adjustment to increase test-year water expense to $2,812 based on an increase in Louisville Water Company's rates effective January 1, 1984. Test-year water bills were attached to the application. The Commission has determined, by applying actual test-year water usage to currently effective Louisville Water Company rates, that water expense should be adjusted to reflect an annual expense of $2,873.

Electricity Expense

Newmarket proposed an adjustment to increase test-year electricity expense to $8,816 based on increased rates by its supplier, Louisville Gas and Electric Company ("LG&E"). Test-year electric bills were attached to the application. 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 $8,942.

Sludge Hauling

Newmarket proposed an adjustment to increase sludge hauling expense by $3,200 to $6,600 annually. This level was based on 40 loads of 4,000 gallons at $165 per load. At the Commission's request, Newmarket provided a copy of the sludge hauling contract between it and S&S Services dated May 28, 1981.[4] Page two, paragraph two, of this contract establishes a base price of $101 per 4,000 gallon load based on a current Metropolitan Sewer District ("MSD") dumping rate of $16 per load. A provision is included whereby increases by MSD from the $16 base level may be flowed through to Newmarket. Letters provided by Newmarket from MSD dated May 24 and June 25, 1984, reflect that, as of January 1, 1985, the dumping charge will be $.019 per gallon applied to 85 percent of the gallon capacity of the tanker truck. In Newmarket's case, this results in a dumping charge of $64.60[5] per load. This results in a $48.60[6] net increase over the $16 base established in the May 28, 1981, contract. Adding this to the base contract rate of $101, the Commission finds that $149.60 is the appropriate price per load to be used for rate-making purposes.

Also, Newmarket proposed to increase the number of loads from 32 to 40 annually. In support of this position, Newmarket stated "...the plant will be unable to control hydraulic loading on treatment equipment which will require maintaining a lower percentage of solids within the treatment unit which results in an increased number of sludge haulings."[7] Whereas that is the case,

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4 Response, Commission's letter dated September 10, 1984, Item No. 7.

5 4,000 gallons x .85 x $.019 = $64.60.

6 $64.60 - $16 = $48.60.

7 Response, Attorney General's letter dated September 4, 1984, Item No. 2.

Newmarket has provided no evidence that this was not the case during the test year or that the situation has worsened or will worsen. It is the Commission's opinion that Newmarket has not demonstrated that the adjustment from 32 to 40 loads is a known and measurable occurrence. As an alternative to relying on more sludge haulings, Newmarket may determine that additional maintenance on the plant to bring it up to a higher level of efficiency may be less expensive in the long run. Therefore, the Commission has used 32 loads to determine sludge hauling expense herein and finds the annual level of sludge hauling expense for Newmarket to be $4,787.

Maintenance of Treatment and Disposal Plant/Depreciation

Newmarket proposed to increase Maintenance of Treatment and Disposal Plant expense by $263 to $4,395 to reflect an increase in the cost of NPDES test fees required quarterly. However, an examination of test year invoices reflects that NPDES test fees of $332, representing fees for tests performed during the third and fourth quarters of 1982, were included in 1983 operations.[8] As these expenditures were incurred outside the test year, they have been excluded for rate-making purposes. Additionally, Newmarket states that the increase in NPDES test fees was $20, from $166 to $186, and that this increase occurred during the third quarter of 1983.[9] This statement is supported by the invoices.

8 Response, Attorney General's letter of September 4, 1984, Item No. 4, Invoice No. 3.

9 Response, Commission's letter of October 23, 1984, Item No. 4.

Accordingly, an adjustment of $40 has been made to reflect the $20 per test increase applicable to the first and second quarters of 1983.

Examination of test year invoices further reflected an expenditure of $2,927 to "fabricate frames with hardware cloth" which, in the Commission's opinion, should have been capitalized.[10] At the Commission's request to provide evidence as to why this expenditure should not be capitalized, Newmarket responded that it is agreeable to the depreciation of this expenditure over a period of 3 years.[11] Therefore, Maintenance of Treatment and Disposal Plant expense has been reduced by $2,927 and Depreciation expense increased by $826 to reflect the capitalization of this item.

The net result of these adjustments is to reflect a Maintenance of Treatment and Disposal Plant expense of $1,361 and a Depreciation expense of $826 to be used for rate-making purposes herein.

Chemicals

Newmarket proposed to increase the chemicals expense because "...the plant will be unable to control hydraulic loading on treatment equipment which then will require maintaining a lower percentage of solids within the plant."[12] However, Newmarket has

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10 Response, Attorney General's letter of September 4, 1984, Item No. 4, Invoice No. 16.

11 Response, Commission's letter of October 23, 1984, Item No. 2.

12 Response, Commission's letter of October 23, 1984, Item No. 3.

provided no evidence that this is a recent development, not present in the test year, nor has it provided evidence supporting the necessity of using 25 cylinders of chlorine gas and 6 units of chlorine powder. The Commission finds that Newmarket's proposed increase in chemical usage is not known and measurable and therefore has used the test-year quantities of chemical usage of 20 cylinders of chlorine gas and 5 units of chlorine powder for rate-making purposes herein. Here again, Newmarket's response suggests inefficiency and the Commission cannot reward inefficiency by increasing rates to cover imprudent costs.

In determining allowable chemicals expense, the Commission has used actual test-year chemical usage and current chemical prices as indicated by Newmarket. This results in an allowable chemicals expense of $2,302.

Taxes Other than Income Taxes

Newmarket reports Taxes Other than Income Tax expense of $2,055. In support of this amount, Newmarket provided copies of test year tax bills. After a review of these bills, it is apparent that Jefferson County property tax bills and City of Northfield tax bills for both 1982 and 1983 were included in test year operations. In determining the appropriate level of Taxes Other than Income Tax expense, the inclusion of two years' tax bills is inappropriate. Therefore, the Commission has reduced Taxes Other than Income Tax expense by $644, the amount of the

1982 bills. This results in a Taxes Other than Income Tax expense of $1,411 to be used for rate-making purposes.

Interest Income

Newmarket proposed an adjustment of $86 to Interest Income in anticipation of higher earnings on its cash reserves. Newmarket reports beginning and ending balances in Other Investments of $15,062 and $15,926, respectively, resulting in an approximate average balance of $15,494. Based on Newmarket's reported test-year interest income of $864, it earned about a 5.6 percent return on its investment. It is the Commission's opinion, based on currently available Certificate of Deposit rates, that a 9.25 percent[13] return on investments is a more reasonable rate to use for rate-making purposes. Prudent investment of excess cash serves to increase income thus lowering customers' rates; therefore, the Commission makes this adjustment to eliminate the effects of inefficient cash management by Newmarket. In applying the 9.25 percent return to the average balance of $15,494, the Commission finds interest income of $1,433 reasonable to use for rate-making purposes herein.

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

13 The Wall Street Journal, November 12, 1984, p. 39.

	Actual Test Period	Pro Forma Adjustments	Adjusted Test Period
Operating Revenues	$33,348	$176	$33,524
Operating Expenses	34,766	50	34,816
Net Operating Income	$<1,418>	$126	$<1,292>
Interest Income	864	569	1,433
Net Income	$ <554>	$695	$ 141

REVENUE REQUIREMENTS

Newmarket based its requested increase in revenue on an operating ratio methodology and requested revenue sufficient to produce a ratio of .88. The Commission is of the opinion that the operating ratio is a fair, just and reasonable method for determining revenue requirements in this case. The Commission finds that an operating ratio of 88 percent will allow Newmarket to pay its operating expenses, service its debt and provide a reasonable return to its owners. The use of this ratio results in Newmarket requiring additional operating revenue of $4,607 over normalized test-year operating revenues.

Rate Design

Newmarket's billing analysis shows that it presently serves 11 commercial customers who use a total of 37.1 residential equivalents. In response to an information request, Newmarket furnished the Commission with billing information from Louisville Water Company showing the annual usage for each customer.

The Commission has determined from this information that the 11 commercial customers actually use a total of 53.51 residential equivalents each month. The residential equivalents are based on 12,000 gallons per month. Commercial customers who use less than 12,000 gallons per month should pay a minimum of one residential equivalent. Therefore, the rates in Appendix A reflect this increase in the number of residential equivalents used each month by Newmarket's commercial customers.

SUMMARY

1. The rates in Appendix A are fair, just and reasonable rates for Newmarket and will produce gross annual operating revenue sufficient to pay its operating expenses and provide a reasonable surplus for equity growth.

2. The rates proposed by Newmarket would produce revenue in excess of that found to be reasonable herein and therefore should be denied on application of KRS 278.030.

IT IS THEREFORE ORDERED that the rates contained in Appendix A are hereby approved for services rendered by Newmarket on and after the date of this Order.

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

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

Done at Frankfort, Kentucky, this 3rd day of January, 1985.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ATTEST:

Secretary

APPENDIX A

APPENDIX TO AN ORDER OF THE PUBLIC SERVICE
COMMISSION IN CASE NO. 9117 DATED 1/3/85

The following rates are prescribed for the customers in the area served by Newmarket, Inc., located in Jefferson County, Kentucky. 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.

<u>RATES:</u> Monthly

Single Family Residential	$14.80
Commercial (per residential equivalent)	22.60