COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

THE APPLICATION OF GILBERT CONSTRUCTION SERVICES, INC., GRAHAM ESTATES SUBDIVISION SEWER FACILITY FOR AN ADJUSTMENT OF RATES PURSUANT TO THE ALTERNATIVE RATE FILING PROCEDURE FOR SMALL UTILITIES	)	CASE NO. 9391

O R D E R

On August 1, 1985, Gilbert Construction Services, Inc.-Graham Estates Subdivision Sewer Facilities ("Graham Estates") filed an application with the Commission to increase its sewer rate pursuant to 807 KAR 5:076, Alternative Rate Adjustment Procedure for Small Utilities ("ARF").

Graham Estates' proposed rates would produce additional revenues of approximately $8,154 annually, an increase of 240 percent over test-period actual operating revenues of $3,408. Based on the findings herein, the revenues of Graham Estates will increase by $5,509 annually, an increase of 161.65 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, the staff audit report, annual reports and other documents on file in the Commission offices.

COMMENTARY

Graham Estates is a privately-owned sewage treatment plant and serves approximately 47 residential customers in Daviess County, Kentucky. Graham Estates is owned and operated by Gilbert Construction Services ("Gilbert Construction"), a corporation which also owns Wright Acres Subdivision Sewer Facilities ("Wright Acres").

TEST PERIOD

Graham Estates proposed the 12-month period ending December 31, 1983, as the test period for determining the reasonableness of the proposed rates. At the time the application was filed, the 1984 Annual Report was available; therefore, in accordance with the provisions of the ARF, the Commission has adopted the 12-month period ended December 31, 1984, the immediate past year. In utilizing the historical test period, the Commission has given full consideration to known and measurable changes found reasonable.

REVENUES AND EXPENSES

For the test period, Graham Estates reported a net operating loss from sewage operations of $8,730. Graham Estates proposed several pro forma adjustments to expenses to reflect more current and anticipated operating conditions.

Staff Audit Report Adjustments

In the course of its investigation in this case, the Commission staff performed a limited audit to verify reported test-year expenses and to determine if these expenses had been properly allocated. The objective was to determine whether the operating expenses, as reported in the 1984 Annual Report, were accounted for in accordance with the Uniform System of Accounts for Sewer Utilities and were properly allocated. The Staff Audit Report of Graham Estates' operations for the calendar year 1984 was filed as a part of the record in this case on October 21, 1985. Based upon the findings contained in the Staff Audit Report of Graham Estates, the Commission made adjustments to the test-year operating expenses to reflect a net operating loss from sewage operations of $7,267.

In its response to the audit report, Graham Estates voiced disagreement with the staff's adjustments regarding the allocation of certain expenses: the capitalization of items represented by an invoice from Lanham Electric and the assumptions underlying an adjustment to depreciation expense. The Commission, having reviewed the response, is of the opinion that the adjustments contained in the audit report were proper and that Graham Estates has not presented evidence to the contrary. The extensive commingling of personal expenses, predominantly channeled through the stockholder-loan account, supports the 1/3 allocation factor for the test year. The work performed by Lanham Electric was of a capital nature and should be capitalized. The depreciation allowed in the audit report for accounting purposes was fair and reasonable.

The Commission is concerned with the record-keeping practices of Graham Estates and herein reminds Graham Estates that its accounting records are to be maintained in accordance with the

Uniform System of Accounts for Class C and D Sewer Utilities. The Commission is also concerned with the method of allocation of certain expenses to Graham Estates. The Staff Audit Report adjusted the test-year allocation factor to a reasonable level; however, as more resources of Gilbert Construction are used for non-utility operations, the need for more detailed documentation will increase. The policy of commingling personal expenses with utility operations should be discontinued so that a clear picture of utility operations is presented. Graham Estates is hereby apprised that, in all future rate proceedings before this Commission, it will be required to provide the concise, detailed information necessary for the Commission to thoroughly analyze test-year operations.

The Commission has made additional adjustments to the test year, as determined in the audit report, based on the following findings of fact to reflect more normal and current operating conditions:

<u>Telephone/Pager Expense</u>

Graham Estates proposed an adjustment of $122 to test-year telephone expenses. This adjustment was occasioned by a change in telephone service in connection with a move by Gilbert Construction into private offices. A phone answering device was replaced by call-forwarding and a one-way pager. While Mr. Gilbert's desire to maintain 24-hour telephone service is to be commended, the Commission feels that this goal can be accomplished more prudently by listing Mr. Gilbert's home phone for use at times other than regular office hours. The Commission is of the opinion that the test-year expense is reasonable and will allow no adjustment to this expense.

Warehouse Rental Expense

Graham Estates proposed an adjustment of $246 for rented warehouse space. Gilbert Construction determined this adjustment by allocating 50 percent of the annual rent to Graham Estates. Of the $492 annual rent, $313 was actually included in the test-year rent expense with 1/3, or $104, allocated to Graham Estates. In the application, Mr. Gilbert explains that this additional space was needed to improve storage of equipment, tools and supplies; however, it was discovered during the audit that this space is also used for storage of personal items. The Commission has determined that Graham Estates' storage needs are minimal, that the level of test-year expense is reasonable, and allows no adjustment to this expense.

Office Expenses - Utilities and Rent

Graham Estates proposed an adjustment to increase office expense by $45. In August 1984 Gilbert Construction moved to private office space. The rent for these offices is $150 per month. Based on a 1/3 allocation, the annual rental expense for Graham Estates is $600. Test-year office rental expense, as shown in the audit report, was $482. The Commission has, therefore, increased rental expense by $118 for rate-making purposes.

Under the office rental agreement, Gilbert Construction is charged for half of the utilities expense. Since Gilbert Construction moved during the test year, actual test-year expenses do not reflect the increased utility cost. Correspondence from the landlord, itemizing the utility expense from September 1983 through August 1984, shows that Gilbert Construction's liability would be $685, which has been determined to be a reasonable annual charge. An allocation of 1/3 to Graham Estates results in an annual expense of $229. The difference between the $229 and the $125 included in the test-year expense results in an adjustment to increase utilities expense by $104.

Salaries and Wages

Graham Estates proposed an adjustment to increase salaries and wages by $2,220. This is the result of a 37 percent allocation of a $250 per month management salary for both Mr. and Mrs. Gilbert. Mr. Gilbert is the president and manager, and Mrs. Gilbert is the secretary, treasurer and controller.

The Commission generally allows a reasonable level for management expense. In the case at hand, the Commission has determined that, while there is indeed a need for management and bookkeeping, the need is minimal, since customer billing and collection is handled by Owensboro Municipal Utilities and test-year expenses provide for reimbursement of routine maintenance. As a result, the Commission will allow an annual expense of $1,200 for management salaries.

Depreciation

Graham Estates began sewer utility operations in 1970 and became subject to Commission jurisdiction effective January 1, 1975. The original owners, George and Eva Birkhead, sold the utility to Larry and Cathy Ebelhar and John Gasser. On June 4, 1980, Graham Estates was purchased by R. E. Gilbert and Kathryn

Beesley. Commission approval for the sale and transfer was not requested by the purchasers.

At the time of the acquisition, Gilbert Construction obtained no information regarding the original cost, depreciation or contributions in aid of construction of the Graham Estates facility. The Utility Plant Instructions of the Uniform System of Accounts for Sewer Utilities requires the recording of the original cost of the plant, the depreciation and the contributions in aid of construction, estimated if not known, by the purchaser. These instructions also require that, if possible, the utility procure and retain all records relating to the acquired property. Mr. Gilbert states, in his response to the Staff Audit Report, that, in determining the value and depreciation schedule for Graham Estates, he determined from manufacturers and vendors "...the replacement cost of each component to determine cost, and from the same such sources, determined the expected use life of each."[1]

The Commission has an established policy to disallow, for rate-making purposes, the expenses associated with contributed property. The Commission recognized the unique characteristics of sewer utilities in Case No. 6683[2] by stating that:

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1 Letter dated October 28, 1985.

2 Final Order dated January 16, 1979, Case No. 6683, The Amended Application of Orchard Grass Sanitation, Inc., for an Order Pursuant to Chapter 278 of the Kentucky Revised Statutes Authorizing an Adjustment in Rates for the Existing Sewage Treatment Plant Serving Orchard Grass Hills Subdivision, Oldham County, Kentucky.

> ...sewage utilities are unique to the extent that the cost of facilities has usually been included in the cost of the individual lot.

and that:

> ...it is common practice for a builder or developer to construct water and sewage facilities that add to the value and salability of his subdivision lots and to expense this investment cost in the sale price of these lots or, as an alternative, to donate these facilities to a utility company.

This view was reaffirmed in Case No. 8193[3] and the Commission has routinely disallowed depreciation on contributed property.

The original (and current) rates set for Graham Estates of $6 per month per customer would produce maximum gross annual revenues of $3,600.[4] This level of revenue clearly indicates that the revenues were intended to cover operating expenses and it is improbable that the utility could be operated at this rate if revenues included a return on the cost to construct the sewer facilities.

Based upon the foregoing discussion and the fact that no evidence was presented to the contrary by Gilbert Construction, it is the opinion of the Commission that the cost of the sewage facilities has been recovered through the sale of the lots and

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3 Final Order dated February 1, 1982, Case No. 8193, The Amended Application of Orchard Grass Sanitation, Inc., for an Order Pursuant to Chapter 278 of the Kentucky Revised Statutes Authorizing an Adjustment in Rates for the Existing Sewage Treatment Plant Serving Orchard Grass Hills Subdivision, Oldham County, Kentucky.

4 50 customers @ $6.00 per month X 12 months = $3,600.

represents contributed property. Therefore, the Commission will not include the associated depreciation of $1,524 and interest expense of $1,003 for rate-making purposes. The Commission will include depreciation expense of $147 which is the annual depreciation for the items placed in service during the test year as discussed in the Staff Audit Report.

Interest

In addition to the $1,003 interest expense disallowed by the Commission in the preceding section of this Order, test-year interest expense includes a charge of $1,720 representing interest on loans made by the stockholder to cover the operating losses of Graham Estates. The burden of obtaining sufficient revenues to meet operating costs rests with the utility. Graham Estates' failure to seek sufficient revenues to meet its operating costs in prior periods does not justify placing the burden of recovering these losses on the current ratepayers. The Commission is of the opinion that this treatment constitutes retroactive rate-making and will not include the interest charges of $1,720 for rate-making purposes herein. The interest expense of $196 included herein for rate-making purposes represents the finance charges on vendor accounts actually incurred during the test period.

Charitable Contributions

During the test year, Graham Estates expensed $50 for charitable contributions. The Commission has determined that this expense should not be borne by ratepayers and has disallowed this expense.

After consideration of the aforementioned adjustments, the Commission finds Graham Estates' adjusted test period operations to be as follows:

	Test Year per Staff Audit	Pro Forma Adjustments	Test Period Adjusted
Operating Revenues	$ 3,408	$ -0-	$ 3,408
Operating Expenses	7,706	< 55>	7,651
Operating Income	$<4,298>	$ 55	$<4,243>
Interest on Long-Term Debt	1,003	<1,003>	-0-
Interest on Debt to Stockholder	1,702	<1,720>	-0-
Other Interest Expense	196	-0-	196
Other Accounts	50	< 50>	-0-
Net Income (Loss)	$<7,267>	$ 2,828	$<4,439>

REVENUE REQUIREMENTS

Graham Estates determined the revenue requirements and rates requested based upon the computation of a per customer monthly charge for five items, one of which was the charge for salaries and wages discussed above. The other items are as follows:

1. Repayment of stockholder loans totaling $18,795. The computation included a 10 percent interest charge.

2. An 8 percent return on the original investment of $15,240.

3. Repayment of the remaining balance of the 10-year note for the purchase.

4. Repayment of $3,247 representing the balance of the 1983 operating loss not included in the stockholder loan.

In determining the revenue requirements of sewage utilities within its jurisdiction, the Commission has primarily used the operating ratio.[5] The Commission has used this method due to the unusual capital structure of sewage utilities and the difficulty in arriving at a fair value of investment for rate-making purposes. The ratio generally allowed has been in the range of 88 percent, although in past cases higher operating ratios have been granted.

The method used by Graham Estates to determine revenue requirements does not constitute sound rate-making, and in the case of Items 1 and 4, constitutes retroactive rate-making. The Commission is of the opinion that the operating ratio method is a fair, just and reasonable method for determining the revenue requirements in this case and finds that an operating ratio of 88 percent will allow Graham Estates to pay its operating expenses and provide a reasonable return to its owners.

The use of an 88 percent operating ratio applied to the adjusted test-year operating expenses results in a revenue requirement of $8,917. Therefore, the Commission finds that Graham Estates is entitled to increase its rates to produce total revenues of $8,917 which will require an increase in revenues of $5,509 annually.

SUMMARY

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

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5 Operating Ratio = $\frac{\text{Operating Expenses}}{\text{Gross Revenue}}$

1. The adjustments to test-year expenses contained in the Staff Audit Report are fair, just and reasonable.

2. Graham Estates should maintain its books of account in accordance with the Uniform System of Accounts for Class C and D Sewer Utilities prescribed by this Commission.

3. The original cost of sewage facilities to serve the Graham Estates was recovered by previous owners through the sale of lots and, therefore, should not be paid for a second time as a result of the transfer of ownership to Gilbert Construction.

4. The transfer of ownership of Graham Estates has not been authorized by this Commission.

5. The manner used by Graham Estates to determine revenue requirements does not constitute sound rate-making policy and should be denied.

6. The rate in Appendix A is the fair, just and reasonable rate for Graham Estates and will produce gross annual revenues sufficient to pay its operating expenses and provide a reasonable surplus for equity growth.

7. The rate proposed by Graham Estates would produce revenue in excess of that found reasonable herein and, therefore, should be denied upon application of KRS 278.030.

IT IS THEREFORE ORDERED that:

1. Graham Estates shall maintain its books of account in accordance with the Uniform System of Accounts for Class C and D Sewer Utilities prescribed by this Commission.

2. The rate in Appendix A attached hereto and made a part hereof is approved for service rendered on and after the date of this Order.

3. The rate proposed by Graham Estates is hereby denied.

4. Within 30 days from the date of this Order, Graham Estates shall file with the Commission its revised tariff sheet setting out the rate approved herein.

Done at Frankfort, Kentucky, this 12th day of December, 1985.

PUBLIC SERVICE COMMISSION

Richard D. Hemann Jr.
Chairman

Vice Chairman

Commissioner

ATTEST:

Secretary

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 9391 DATED 12/12/85

The following rates and charges are prescribed for the customers receiving service from Gilbert Construction Services, Inc. - Graham Estates. 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 effective date of this Order.

Customer Class	Rate
Residential (per month)	$15.80