COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

APPLICATION OF ELAM UTILITY COMPANY FOR A GENERAL INCREASE IN RATES	))	CASE NO. 9375

O R D E R

On June 27, 1985, Elam Utility Company, Inc., ("Elam") filed its application with the Commission for a general increase in its rates of $37,256 annually or a 9.3 percent increase above test-period normalized operating revenue. Elam stated that the requested annual increase in revenues was necessary to provide for operating costs, to service Elam's debt, and to provide a reasonable return to Elam's stockholders.

The proposed rates were to be effective for gas service rendered on and after July 18, 1985. On July 2, 1985, the Commission suspended the proposed rates pending an investigation of the reasonableness of the requested increase. On July 9, 1985, the Utility Rate Intervention Division of the Office of the Attorney General moved to intervene in this proceeding, which motion was granted. No other parties intervened. On November 12, 1985, a hearing was conducted in this matter with all parties of record being represented.

This Order addresses the Commission's findings and determinations on issues presented and disclosed in the hearing and investigation of Elam's revenue requirement and rate design.

This Order finds that Elam's adjusted test-period revenues are sufficient to provide for the costs of operations, to service Elam's debt, and are sufficient to provide a reasonable cash surplus. Therefore, this Order grants no additional revenues.

COMMENTARY

Elam operates as a public utility providing natural gas service to approximately 393 customers in West Liberty and Daysboro, Kentucky.

TEST PERIOD

Elam has proposed and the Commission has accepted the 12-month period ending March 31, 1985, as the test period for determining the reasonableness of the proposed rates. In using the historical test period, the Commission has given full consideration to known and measurable changes found reasonable.

VALUATION

Elam proposed a net investment rate base of $473,417. The Commission has accepted the proposed rate base with the following modifications:

Extraordinary Property Losses

Elam proposed to include in its rate base the unamortized portion of $34,924 in extraordinary property losses[1] resulting from abandoning a portion of its distribution system in 1980.[2]

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1 Exhibit No. 2, page 1 of application filed June 27, 1985.

2 Transcript of Evidence ("T.E.") dated November 12, 1985, pp. 26-27.

In Case No. 8178, Notice to Adjust Rates by Elam Utility Company, Inc., Morgan County, Kentucky, the Commission found that the extraordinary property losses should be disallowed as part of net investment rate base "...as these items of plant are no longer in service." When asked if the circumstances surrounding the extraordinary property loss had changed since the Commission's decision in Case No. 8178, Elam stated, "Circumstances have materially changed during the past several years and can be observed by a review of Elam's financial position and the rapidity with which Elam has filed applications for rate relief with the Commission. The continued lack of adequate rate relief has drained all resources of the company. The inclusion of extraordinary property losses in rate base is an effort to provide a rate base on which the Commission can provide a return which will allow Elam to service its debt, pay expenses, and provide a return to its stockholders."[3]

The Commission is of the opinion that utility plant must meet certain minimum criteria for inclusion in rate base. Basically, to be included in rate base, an item must be used and useful; it must be associated with the utility service provided, and the investment must have been prudently incurred. Elam has presented no evidence in this case to show that any of these critera apply in this instance. Therefore, in consideration of the treatment accorded this item in Case No. 8178, and the lack of any additional persuasive evidence, the Commission finds that

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[3] Response to Item No. 2, October 11, 1985.

the unamortized balance of $34,924 in extraordinary property losses is not eligible for inclusion in rate base.

Cash Working Capital

Elam proposed to include a cash working capital allowance of $13,401, based on its proposed operating statement. The Commission has reduced this amount to $13,201 in order to allow 1/8 of the adjusted operating and maintenance expenses less purchased gas found reasonable herein.

Thus, the Commission has determined Elam's net investment rate base to be as follows:

Utility Plant	$ 523,477
Reserve for Depreciation	<105,377>
Net Utility Plant	$ 418,100
Add:	
Prepayments	2,103
Materials and Supplies	4,889
Cash Working Capital	13,201
Net Investment Rate Base	$ 438,293

REVENUES AND EXPENSES

Elam reported net income of $8,923 for the test period. In order to reflect current operating conditions, Elam proposed several adjustments to revenues and expenses resulting in an adjusted net loss of $25,098. The Commission is of the opinion that the proposed adjustments are generally proper and acceptable for rate-making purposes with the following modifications:

Outside Services

Elam reported $4,819 in test-period outside services expense. Elam proposed an adjustment of $2,500 to increase this expense based on a 2-year amortization of expected rate case

expenses of $5,000. The evidence of record shows that Elam has incurred rate case expenses of $5,490.[4]

The Commission is of the opinion that the actual amount of expenses incurred is a fair and reasonable amount for rate case expenses. However, the Commission does not agree with the proposed 2-year amortization period for rate-making purposes. The current annual inflation rate is low in comparison to recent historical levels. Elam's up-to-date renovated utility plant should not require unexpected or inflation-sensitive construction expenses. Nor should Elam's cost of debt rise appreciably under inflationary pressure since the large majority of the long-term debt is at low fixed interest rate and other debt is non-interest earning. Additionally, the revenue sufficiency found herein should also delay the necessity of future rate cases. Therefore, the Commission is of the opinion that a 3-year amortization period is more appropriate.

Based on the actual amount of rate case expenses and a 3-year amortization period, the Commission has determined a fair and reasonable amount of outside services expense to be $6,649 annually for rate-making purposes.

Income Taxes

Elam reported no income tax expense for the test period. Elam proposed an adjustment to increase income tax expense by $1,520. The adjustment to income tax expense proposed by Elam did not consider the amortization of investment tax credits associated

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[4] Response to Item No. 1, October 11, 1985.

with its plant restoration in 1980. Elam incurred plant restoration costs of $385,903[5] which is subject to investment tax credit benefits of 10 percent for 15-year public utility property.

The ratepayers are obligated to pay for the full cost of service as determined fair and reasonable by the Commission. This obligation includes fully normalized income tax expense. Normalized income tax expense should, however, be reduced by the amortization of investment tax credits over the life of the property. Therefore, the Commission has amortized the total available investment tax credits of $38,590 over the 30-year depreciable life of Elam's property associated with the credits which results in an annual tax reduction of $1,286.

Based on the rate of return on rate base as found reasonable elsewhere herein, including the reduction for the amortization of available investment tax credits, the Commission has determined the normalized amount of income tax expense to be $930 annually.

Interest Expense

Elam reported long-term interest expense of $32,176 associated with a 5 1/8 percent loan from the Department of Local Government. Elam proposed to reduce the reported amount of long-term interest by $1,005 to reflect the reduction in the loan balance.

The Commission has found a fair and reasonable net investment rate base of $438,293. According to the test-period

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5 Response to Item No. 7, October 11, 1985.

balance sheet as filed, Elam reported long-term debt of $615,009, other capitalization of $29,264, and net proprietory equity of a negative $134,183 for a total long-term net capitalization of $510,090.

Elam's ratepayers are obligated to compensate Elam for the cost of capitalization to provide gas service. Excluding the negative equity of $134,183, Elam's capitalization exceeds net investment rate base, which is the measure of the amount of capitalization devoted to service, by $205,980. The Commission is of the opinion that it is unfair to require Elam's customers to pay for capitalization from which they receive no benefits. Therefore, the Commission has reduced total long-term capitalization by $205,980. Using the 5 1/8 percent actual cost rate of Elam's long-term debt and applying the cost to the net investment rate base and capitalization found reasonable herein, the Commission has determined a fair and reasonable amount of normalized interest expense to be $22,463 annually.

Elam reported for the test period $7,092 in short-term interest expense. Elam proposed to reduce the amount of interest expense by $3,079 based on an anticipated reduction in the outstanding balance of its delinquent gas purchases owed to its suppliers, Columbia Gas Transmission, Inc., and Capitol Oil, Inc.

Elam's reported test-period short-term interest expense contained $4,883 in interest expense associated with delinquent gas purchases.[6] The Commission is of the opinion that allowing

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[6] Response to Item No. 11, October 21, 1985.

debt service associated with past operating expenses, which provides no benefit to current ratepayers, constitutes retroactive rate-making. Additionally, Elam reported $8,923 in net income after all expenses and expense accruals, which clearly demonstrates Elam's ability to have paid the arrearages owed to Columbia Gas Transmission, Inc. Therefore, the Commission has reduced short-term interest expense by $4,883 to $2,209 annually for rate-making purposes.

In determining the amounts of short- and long-term interest expense for rate-making purposes, the Commission is not prohibiting the adequate funding of the actual test-period interest expenses. Based on the adjusted level of revenues allowed herein, Elam's cash flow is adequate and sufficient to service all debt and operating expenses.

With the previously discussed considerations in mind, the Commission has determined a fair and reasonable amount of interest expense to be $24,672 annually.

Amortization of Arrearages

Elam proposed an adjustment to amortize $57,617 in arrearages owed to Columbia Gas Transmission, Inc., over a 2-year period for rate-making purposes. Elam stated that the amortization of the arrearages should be allowed for rate-making purposes since Elam had made every effort to pay these past due amounts for the last 2 years, but has not succeeded due to the

marginal operating results brought about by inadequate earning levels authorized by Commission rate Orders.[7]

The Commission is of the opinion that, in this instance, the ratepayers provided the funds to meet Elam's obligations on a current basis. This was a fundamental fact established by the issuance of the Commission's final Order in Case No. 8929, Notice by Elam Utility Company, Inc., to Increase its Rates for Gas Service, issued on May 2, 1984. Past Orders fully included all gas purchase costs. Furthermore, Elam has a purchased gas adjustment clause available to track and recover all legitimate purchased gas costs. No reason exists for this bill to have not been paid, since the purchased gas adjustment clause fully tracks the cost of natural gas.

In a growing number of cases, gas utilities are failing to pay their gas bills, expecting the Commission to grant surcharges or to allow an adjustment as proposed by Elam. There is no surer way to jeopardize the utility's ability to provide gas service than to not pay for its gas purchases. It should be the first bill paid, not the last. If gas purchases cannot be paid from current funds, arrearages can either be financed by owners seeking bank loans or by owner-investment. In either case, no double recovery should be allowed on those funds for rate-making purposes. Therefore, on the basis of these considerations, the Commission denies inclusion of the amortization of delinquent gas purchases.

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7 Response to Item No. 10, August 21, 1985.

Late-Filed Adjustments

Elam filed two additional adjustments to its test-period statement of operations during the hearing on November 12, 1985. Elam proposed to increase salary and wage expenses by $2,139 and reduce revenues by $2,937 annually.

The Commission is of the opinion that these adjustments were filed too late to afford the Commission an opportunity to access the reasonableness of these adjustments. Therefore, the Commission denies these adjustments.

The Commission, after consideration of all pro forma adjustments and applicable income tax effects, has determined Elam's adjusted operating results to be as follows:

	Test Period Reported	Adjustments	Test Period Adjusted
Operating Revenues	$ 391,766	$ 5,585	$ 397,351
Operating Expenses	<346,715>	< 12,676>	<359,391>
Operating Income	$ 45,051	$< 7,091>	$ 37,960
Other Income	3,140	374	3,514
Other Deductions	< 39,268>	14,596	< 24,672>
Net Income	$ 8,923	$ 7,879	$ 16,802

RATE OF RETURN

Elam requested a rate of return on net investment rate base of 10 percent. In its most recent case, Elam was allowed a return of 9.85 percent. Since Elam's last case in May, 1984, interest rates in general have dropped and the Commission has correspondingly lowered returns allowed to jurisdictional utilities in some instances. At this time, the stockholders have no net investment

in the company. All utility plant is supported by a subsidized loan bearing an interest rate of 5 1/8 percent. By allowing any return at all, the Commission seeks not to compensate the stockholders of Elam, for there is no equity to compensate, but rather, to allow the company to maintain a reasonable level of cash reserves and remain a financially viable company. Under present circumstances, the need for cash reserves is minimal. With a newly built system, extraordinary maintenance should be low and the record in this case reflects no plans for major construction. Therefore, the Commission is of the opinion that a fair, just and reasonable rate of return on the net investment rate base should be 7.5 percent in that it will allow Elam to pay its operating expenses, service its debt, and provide a reasonable surplus for cash reserves.

REVENUE REQUIREMENTS

The Commission has determined that Elam does not need additional annual operating income to produce an overall return on net investment rate base of 7.5 percent. After the provision for income taxes of $930, there is an overall revenue sufficiency of approximately $6,393 annually which yields a rate of return on net investment rate base found reasonable herein of 9.46 percent. Therefore, the Commission denies any additional annual revenues.

FINDINGS AND ORDERS

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

1. The rates and charges proposed by Elam would produce revenues in excess of those found reasonable herein and should be denied upon application of KRS 278.030.

2. The rates of return granted herein are fair, just and reasonable and will provide for the financial obligations of Elam with a reasonable amount remaining for equity growth.

IT IS THEREFORE ORDERED that:

1. The rates and charges proposed by Elam be and they hereby are denied.

Done at Frankfort, Kentucky, this 13th day of January, 1986.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ATTEST:

Secretary