

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF WEST LAUREL WATER)
ASSOCIATION ORGANIZED PURSUANT TO)
CHAPTER 273 OF THE KENTUCKY REVISED)
STATUTES OF LAUREL COUNTY, KENTUCKY,) CASE NO. 9426
FOR A CERTIFICATE OF PUBLIC CONVENIENCE)
AND NECESSITY, AUTHORIZING AND)
PERMITTING SAID WATER ASSOCIATION TO)
INCREASE ITS RATES)

O R D E R

IT IS ORDERED that:

1. The Staff Audit Report for West Laurel Water Association, Inc., ("West Laurel") attached hereto as Appendix A shall be included as a part of the record in this proceeding.

2. West Laurel shall have until the close of business within 2 weeks of the date of this Order to file written comments concerning the contents of Appendix A.

Done at Frankfort, Kentucky, this 14th day of May, 1986.

PUBLIC SERVICE COMMISSION

Richard D. Demaris
Chairman

[Signature]
Vice Chairman

[Signature]
Commissioner

ATTEST:

Secretary

APPENDIX A
REPORT ON LIMITED AUDIT
OF
WEST LAUREL WATER ASSOCIATION, INC.

PREFACE

On September 20, 1985, West Laurel Water Association, Inc., ("West Laurel") filed an application with the Commission for a certificate of public convenience and necessity authorizing and permitting a waterworks construction project, and approval of the proposed plan of financing the project. This application was amended on October 15, 1985, to include authorization to increase rates.

The Commission staff performed an audit, limited in scope, on the operations of West Laurel. The audit was conducted by Aaron Greenwell of the Division of Rates and Tariffs on April 9 and 10, 1986, at the offices of Wood Creek Water District ("Wood Creek").

SCOPE

The scope of this audit was limited to determining whether or not the operating expenses for the test year ending June 30, 1985, as reported by West Laurel, were accounted for in accordance with the Uniform System of Accounts for Water Utilities ("Uniform System of Accounts") and were actually incurred during the test year. During the course of the audit, records relating to water purchases and sales were reviewed, monthly summaries of operating revenues and tap fees were examined, each test year expenditure

was examined, the minutes of West Laurel's commissioners' meetings were reviewed, an analysis of test year disbursements was compiled, invoices and other documents relating to test year expenditures were examined, an analysis was made of West Laurel's depreciation schedule and plant in service accounts, and the audit report of West Laurel's CPA, Cloyd, Hamilton and Company, ("Cloyd") was reviewed. In addition, questions were asked of Peggy Brown, Wood Creek's office manager, regarding West Laurel's financial policies and procedures and the accounting treatment accorded specific expenditures.

FINDINGS

According to contracts filed in the Application, Wood Creek provides the maintenance, office services and sells water to West Laurel. Wood Creek is managed by Peggy Brown, who also manages Laurel County Water District No. 2 ("Laurel No. 2"). Laurel No. 2, by contract, provides the maintenance and office services for East Laurel Water District ("East Laurel"). Wood Creek and Laurel No. 2 employ their own superintendents and maintenance crews. However, the expenses of Peggy Brown and her office staff are shared by Wood Creek and Laurel No. 2. West Laurel and East Laurel have no employees.

A review of West Laurel's accounting system revealed that the financial records were not maintained in accordance with the Uniform System of Accounts as required by the Commission. However, with only minor exceptions, the test year expenses were properly accounted for and accurately reflect West Laurel's test year operations.

Following is a discussion of the findings of the audit and the recommended adjustment to the test-period operating revenues and expenses:

Water Sales

Examination of the monthly summary of water sales revealed that West Laurel's water sales to customers were \$313,728.57 during the test year. However, West Laurel reported test year revenue from water sales of \$301,631.23 and the billing analysis submitted in the application produces revenue of \$308,207.05. The Commission staff has determined that, since operating revenues were afforded only a cursory review, no adjustment will be recommended in this report. However, additional information regarding test-year water sales will be pursued through an information request or additional staff review.

Maintenance - Mains

West Laurel reported an expense of \$33,700.79 for maintenance of mains during the test year. Examination of work orders revealed that 44 work orders in the amount of \$23,693.89, approximately 70 percent of the total expense, were for the replacement of 8-inch distribution mains. The magnitude of this expense suggests that this should be capitalized; however, it was found that the replacements were to repair line breaks and were not part of a construction program. Therefore, according to the Uniform System of Accounts, West Laurel has properly accounted for these replacements.

Salaries

West Laurel has no direct employees. The reported test-year salaries expense of \$22,188.04 was based on charges under the maintenance contract with Wood Creek. According to Peggy Brown, these charges represent the cost of supervision and the associated transportation expense. Under the terms of the maintenance contract, Wood Creek charges West Laurel the actual cost of materials and labor. The Uniform System of Accounts requires that the cost of supervision be recorded in the operation labor account of the appropriate operating function or capitalized as necessary. Supervision not chargeable directly to a particular function may be charged to administrative and general salaries. Since the cost of supervision is and has been recorded in the total operation and maintenance expenses, no adjustment has been proposed. However, in the future, West Laurel should record this cost in the appropriate operating expense accounts and capitalize any applicable labor and related costs.

Office Contract

West Laurel has also entered into a contract for office services with Wood Creek. These services are provided at an annual cost of \$27.60 per customer. West Laurel charges the full amount of these expenses to Account No. 921 - Office Supplies and Other Expenses. During the test year, \$53,210.65 was charged to this account. According to the Uniform System of Accounts, these expenses should be distributed to the applicable administrative or general department. However, the supervision fees and expenses paid under this contract should be charged to Account No. 923 -

Outside Services Employed. In this instance, no adjustment has been proposed; however, West Laurel should distribute these expenses to the appropriate department in the future.

Depreciation Expense

West Laurel reported test year depreciation expense of \$51,819 in the income statement. However, the balance sheet submitted by West Laurel in this case reflects an increase of \$52,452 in the accumulated provision for depreciation for the test year. A review of the depreciation schedule, working trial balance and adjustments prepared for West Laurel by Cloyd revealed that depreciation on plant additions was being computed for a full year in the year of the acquisition and that, in some instances, payments by consumers for line construction was being credited to plant rather than contributions in aid of construction. The staff computation of test year depreciation agreed with the \$51,819 included in the income statement by West Laurel. The staff will accept this amount, without adjustment, as the test-year depreciation expense.

Miscellaneous Expenses

West Laurel recorded \$313.62 during the test year as miscellaneous expenses. Examination of the items included in this account revealed that \$287.50¹ represented refunds. These should

| ¹ | <u>Check</u> | | <u>Payee</u> | <u>Explanation</u> |
|--------------|--------------|---------------|--------------|--------------------|
| | <u>No.</u> | <u>Amount</u> | | |
| | 1206 | \$ 37.50 | James Arnold | Meter Refund |
| | 1233 | \$250.00 | Vera Wolf | Tap Refund |

be reflected on the balance sheet rather than the income statement. Therefore, test-year operating expenses have been reduced by \$287.50 removing these refunds from miscellaneous expenses.

SUMMARY

The following is a summary of the effect of the adjustment on West Laurel's test-year operating statement:

| | <u>Test Year Reported</u> | <u>Staff Adjustments</u> | <u>Test Year Adjusted</u> |
|-----------------------------------|-------------------------------|------------------------------|-------------------------------|
| <u>Operating Revenue:</u> | | | |
| Water Sales | \$301,631.23 | \$ -0- | \$301,631.23 |
| Other Operating Revenue | | | |
| Service Charges | 4,092.12 | -0- | 4,092.12 |
| Penalties | 2,698.57 | -0- | 2,698.57 |
| Miscellaneous | 1,701.69 | -0- | 1,701.69 |
| Total Operating Revenue | <u>\$310,123.61</u> | <u>\$ -0-</u> | <u>\$310,123.61</u> |
| <u>Operating Expenses:</u> | | | |
| Purchased Water | \$113,268.16 | \$ -0- | \$113,268.16 |
| Power - Pumping | 8,921.42 | -0- | 8,921.42 |
| Supplies Exp. - Pumping | 1,443.14 | -0- | 1,443.14 |
| Maintenance - Pumping | 292.63 | -0- | 292.63 |
| Water Testing | 138.00 | -0- | 138.00 |
| Total Supply & Pumping | <u>\$124,063.35</u> | <u>\$ -0-</u> | <u>\$124,063.35</u> |
| Operation Labor | \$ 10,968.39 | \$ -0- | \$ 10,968.39 |
| Maintenance - Tanks | 491.13 | -0- | 491.13 |
| Maintenance - Mains | 33,700.79 | -0- | 33,700.79 |
| Maintenance - Services | 2,804.59 | -0- | 2,804.59 |
| Maintenance - Meters | 2,329.82 | -0- | 2,329.82 |
| Meter Reading Labor | 9,157.75 | -0- | 9,157.75 |
| Connecting Labor | 1,653.75 | -0- | 1,653.75 |
| Total Transmission & Distribution | <u>\$ 61,106.22</u> | <u>\$ -0-</u> | <u>\$ 61,106.22</u> |
| <u>Admin. & General:</u> | | | |
| Salaries | \$ 22,188.04 | \$ -0- | \$ 22,188.04 |
| Office Contract | 53,210.65 | -0- | 53,210.65 |
| Insurance | 1,091.12 | -0- | 1,091.12 |
| Legal & Accounting | 3,230.43 | -0- | 3,230.43 |
| Taxes | 720.20 | -0- | 720.20 |
| Commissioner's Fees | 3,600.00 | -0- | 3,600.00 |
| Miscellaneous | 313.62 | <295.62> | 18.00 |
| Total Admin. & General | <u>\$ 84,354.06</u> | <u>\$ <295.62></u> | <u>\$ 84,058.44</u> |
| Depreciation | <u>51,819.00</u> | <u>-0-</u> | <u>51,819.00</u> |
| Total Operating Expenses | <u>\$321,342.63</u> | <u>\$ <295.62></u> | <u>\$321,047.01</u> |

| | <u>Test Year Reported</u> | <u>Staff Adjustments</u> | <u>Test Year Adjusted</u> |
|------------------------------|-------------------------------|------------------------------|-------------------------------|
| Operating Income | <11,219.02> | 295.62 | <10,923.40> |
| <u>Other Income:</u> | | | |
| Interest | \$ 11,672.65 | \$ -0- | \$ 11,672.65 |
| <u>Other Deductions:</u> | | | |
| Interest - Long-Term Debt | <u>45,804.00</u> | <u>-0-</u> | <u>45,804.00</u> |
| NET INCOME | <u>\$<45,350.37></u> | <u>\$ 295.62</u> | <u>\$<45,054.75></u> |

CONCLUSIONS AND RECOMMENDATIONS

The Uniform System of Accounts requires that each utility keep its books on a monthly, accrual basis. In this manner, each utility will be able to readily furnish full information on any item in any account. In the notes to the 1984 and 1985 financial statements accompanying the audit report, Cloyd states that West Laurel maintains its books on a combination of cash and accrual basis accounting and that the financial statements are prepared on the accrual basis. While the financial statements do appear to fairly present the operations and financial position of West Laurel on the accrual basis, the numerous adjustments required to present the statements in this manner, may have been avoided if West Laurel had kept its books on the accrual basis. The notes to 1984 and 1985 financial statements state that revenues are recorded on an accrual basis. However, the revenue from water sales, as reported in the test-year income statement, appears to represent collections (cash basis) rather than revenues billed (accrual basis.) This apparent deviation from the Uniform System of Accounts results in a difference in reported test-period

operating revenue of approximately \$12,000 from the amount actually billed.

Other deviations were mentioned in the findings. The failure to allocate both the cost of supervision provided under the maintenance contract and the cost of services provided under the office contract to the appropriate operating function or administrative department, do not affect "total" operation and maintenance expenses. However, the cost of operating or administering a specific function or department is distorted.

The staff attempted to determine the accuracy of plant in service and test-year depreciation expense by analyzing test-year plant additions; however, the effect of computing depreciation on plant additions for a full year in the year of acquisition rather than from the date placed into service cannot be measured because of West Laurel's policy of offsetting consumer payments for line construction against plant additions.

Wood Creek maintains information, sufficiently detailed, so as to provide an accurate analysis of West Laurel's operations. The staff found this supporting information to be neat and orderly and except for the deviations mentioned in this report to be in accordance with the Uniform System of Accounts. West Laurel's books should be kept on a monthly accrual basis in accordance with the Uniform System of Accounts as required by this Commission. Therefore, West Laurel should convert their records to the monthly accrual basis retroactive to January 1, 1986, with the expenses from the maintenance and office contracts recorded in the proper accounts. West Laurel should also analyze its plant in service

additions from the date it began operations, determine the amount of customer contributions erroneously credited and make the necessary adjustments.

Respectfully Submitted,

Aaron Greenwell

Aaron Greenwell
Principal Public Utilities
Financial Analyst
PUBLIC SERVICE COMMISSION
Rates and Tariffs Division
Revenue Requirements Section