COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF GAINSBORO UTILITIES, INC., FOR AUTHORITY TO ACQUIRE THE ASSETS OF NETTLECREEK TREATMENT PLANT, INC., IN JEFFERSON COUNTY, KENTUCKY: AUTHORITY TO BORROW THE NECESSARY FUNDS TO FINANCE PURCHASE AND A PETITION FOR AN ADJUSTMENT OF THE RATES CHARGED CUSTOMERS	)	CASE NO. 9470

O R D E R

On November 2, 1985, Gainsboro Utilities, Inc., ("Gainsboro") filed an application for authority to acquire the assets of Nettlecreek Treatment Plant, Inc. ("Nettlecreek"); to incur indebtedness of $143,000; and to increase the rates charged to customers.

The proposed rates would increase annual revenues by $47,808 annually over reported 1984 revenues, an increase of 151.9 percent; this represents an increase of $46,257, or 140 percent, over test-year normalized revenues. Based on the determination herein, the revenues will increase by $2,296 over normalized test year revenues as established herein, an increase of 6.9 percent.

The Attorney General's Consumer Protection Division ("AG") and the Consumer Advocacy Groups ("Consumers") intervened.

A public hearing was held in the Commission's offices in Frankfort, Kentucky, on April 9, 1986.

COMMENTARY

Gainsboro is a privately-owned sewage treatment utility with 141 residential customers in Jefferson County, Kentucky.

TEST PERIOD

The 12-month period ending December 31, 1984, was used as the test period for determining the reasonableness of the proposed rates. In utilizing the historical test period, the Commission has made appropriate adjustments for known and measurable changes.

REVENUES AND EXPENSES

For the test period, Gainsboro reported a net operating loss from sewage operations of $35,519. Gainsboro proposed several pro forma adjustments to revenues and expenses to reflect more current and anticipated operating conditions. These adjustments are generally proper and acceptable for rate-making purposes, with the following modifications:

Revenue Normalization

Gainsboro reported test-year sewage service revenues of $31,477. In normalizing test year revenues, the Commission has applied the present rate of $19.52 to the 141 customers at the time of the filing as reported in the application, and finds that the normalized revenue for Gainsboro is $33,028.

Management Fee

Consumers argued that since all of Gainsboro's work is done by subcontractors owned by the owner, Carroll Cogan, the management fee of $150 per month should be reduced, so as not to pay the owner twice for the same work. However, funds must be allowed for the general administration of a utility, and the $150 per month

currently in effect is not excessive for a sewer system the size of Gainsboro. In future proceedings, the Commission will continue to scrutinize the management of Gainsboro to determine whether the administrative duties are conducted efficiently and will make adjustments to this expense if warranted. However, no adjustment to this expense has been made herein.

Electricity Expense

Gainsboro reported test year charges for electricity service of $12,155.

Although $12,155 is the correct test year amount, there is substantial evidence in the record indicating that this level of expense is not reflective of normal operating conditions for Gainsboro. The level of electric expense for the 5 most recent years has been as follows:

1981	$ 6,847
1982	$ 9,929
1983	$ 7,073
1984	$12,155
1985	$ 9,617

These sums make it apparent that the test year level of electricity expense is unusual in the operating history of Gainsboro. Moreover, among the reasons Gainsboro cited for the additional test year expense were colder than normal weather requiring extra heating and more frequent operation of blowers due to solid load buildups.[1] These events are extraordinary in nature and confirm that there were factors present during the test year which required greater electricity usage than normal.

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1 Response to Commission's First Information Request, Item No. 11.

Consumers argued that 1983 should be used as the basis for determining a normalized electricity expense and proposed that the 1983 level of $7,073 should be adjusted to reflect the Louisville Gas and Electric Company ("LG&E") increase of 6.1 percent in 1984, thus resulting in an expense of $7,505. The Commission is concerned that this methodology does not fully recognize operating levels subsequent to 1983. The amount proposed by Consumers is significantly lower than the 1984 level of $12,155 and 1985 level of $9,167, and though the 1984 level was extraordinary, the Commission is of the opinion that the adjustment proposed by Consumers would not be representative of the on-going level of expense. The Commission therefore finds that the proposed adjustment by Consumers is not appropriate for normalization of electricity expense.

The Commission uses an averaging process to normalize extraordinary expenses, as the least arbitrary method to determine an appropriate normalized amount. The average of electricity expenses for the years 1983, adjusted for the 6.1 percent 1984 rate increase by LG&E; 1984; and 1985 results in an adjusted test-year electricity expense of $9,759 for rate-making purposes.

Chemicals Expense

Gainsboro included in $298 reported for test-year chemicals expense $100 which represented a deposit on a gas cylinder. As deposits do not represent an expense, and are returned when the cylinder is, test-year chemical expense was reduced to remove this from test year expenses.

Insurance Expense

Gainsboro reported test-year insurance expense of $813, represented by three statements for property and liability insurance, for the following periods and amounts:

Period	Amount
2/1/83 - 2/1/84	$325
2/1/84 - 2/1/85	$488
2/1/85 - 2/1/86	$650

The $813 reported test year amount is apparently the result of the recording of the premium for 2 years, 1983 and 1984. Therefore, the Commission has made an adjustment to reflect an insurance expense of $650 for the test period, the most recent 1-year insurance premium.

Miscellaneous General Expenses

Gainsboro reported test year charges of $1,550 to miscellaneous general expenses. Gainsboro subsequently stated that this amount is incorrect and that the actual amount should be $2,031, which represents the total of late payment charges of $1,883 from Andriot-Davidson's Service Company, Inc., ("Andriot-Davidson") and $148 for telephone expense.[2]

In regard to the late payment charges, the Commission has held that finance charges imposed by Andriot-Davidson upon companies owned by Carroll F. Cogan, are not allowable.[3] The circumstances in this case are identical. Gainsboro has advanced

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2 Response to Consumers' First Request, Item No. 5.

3 Order dated July 8, 1983, in Case No. 8688, The Application of Enviro Utilities, Inc., for an Adjustment of Rates.

no substantive evidence in this proceeding as to why the charges should be allowed in this instance and the Commission has accordingly made an adjustment to reduce expenses by $1,402, the amount of late charges first reported.

The $148 charge to test-year operating expenses for telephone expense represents the amount of 1 monthly bill pertaining to all companies operated out of the offices at 4141 Bardstown Road, of which Gainsboro is one. Gainsboro stated that this monthly telephone bill is rotated among the various sewer companies that occupy this office and that the expense is allocated to Gainsboro once each 2 years. The Commission's records reflect that Carroll Cogan presently owns 31 sewer companies, and since there are several additional companies operated from this office which benefit from the same telephone line, the Commission is of the opinion that 3 years is a more appropriate time span between which Gainsboro should be expected to be allocated a monthly telephone bill. The Commission has therefore amortized the $148 expense over a 3-year period for rate-making purposes. This results in a $49 expense as the amount allowed for telephone service herein.

By applying this treatment to telephone expense herein for rate-making purposes, the Commission does not intend to condone the practice employed by Carroll Cogan of rotating telephone bills through the various sewer companies that occupy the same office but, rather, seeks to provide recognition of a telephone expense allowance. In future periods, Gainsboro should attempt to determine that portion of each monthly bill allocable, or directly chargeable, to Gainsboro. This procedure should be implemented so

that this expense will more nearly reflect the actual cost of doing business for Gainsboro.

Testing and Health Department Assessment

Gainsboro reported test year charges of $460 for quarterly laboratory testing and for the Department of Health assessment of $600. The invoices supporting these amounts were provided.[4] Consumers contends that the bills were not paid by Gainsboro and therefore, should not be allowed as expenses for rate-making purposes. The Commission does not agree with this argument. Rates are set on a prospective basis and inasmuch as Gainsboro will incur these legitimate expenses in future periods, rates should be set to allow for their recovery. Therefore, no adjustments to test year have been made with regard to these expenses.

Bookkeeping

Gainsboro reported test year charges of $1,200 for bookkeeping. Consumers advances the argument that since the bookkeeping is done by Andriot-Davidson the transaction is not at arms-length and the fee cannot be justified.

The law imposes upon Gainsboro a duty to maintain its books accurately and in accordance with the Uniform System of Accounts for Sewer Utilities ("USoA"). Although it is apparent that Gainsboro failed in performing this duty, funds must be made available for accounting expenses. The $100 per month is consistent with

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4 Response to Commission's First Information Request, Item No. 8.

the amounts allowed in other recent cases involving utilities of this size and nature, and is not considered by the Commission to be exorbitant. It is, however, a sufficient amount such that Gainsboro's submissions of accounting data to the Commission should be timely, accurate and in accordance with the USoA.

Maintenance of Treatment and Disposal Plant

Gainsboro reported test year maintenance of treatment and disposal plant expense of $6,422, but filed invoices showing only $5,941. Gainsboro conceded that $5,941 should be considered as the corrected amount. The Commission has adjusted reported test-year operating expenses accordingly.

Included in the test year invoices provided was CSC Contracting Company's invoice no. 525-1 for $562, dated May 25, 1983. Inasmuch as this invoice is related to maintenance work outside of the test year, the Commission has reduced operating expenses by the amount of this invoice.

The invoices included several maintenance projects which will benefit more than one period. Maintenance projects providing such long-term benefits should be charged to utility plant accounts and charged off to depreciation expense during the future periods benefited. The invoices reflected that $2,901 of capital items was improperly charged to maintenance expense during the test year; therefore, an adjustment of this amount has been made to reduce operating expenses to reflect a more normal, accurate and reasonable level of maintenance expense.

In applying appropriate depreciation rates, it was determined that a $373 adjustment to depreciation expense was necessary to

reflect the capitalization of these expenditures. Following is a schedule reflecting the amounts of capitalization entries and the determination of the adjustment to depreciation expense:

Invoice Date*	Amount	Depreciation Rate (%)	Depreciation
2/24/84	$ 562	10	$ 56
3/29/84	371	10	37
8/8/84	828	20	166
10/8/84	1,140	10	$114
	$2,901		$373

*All invoices are from Andriot-Davidson

Routine Maintenance

Gainsboro reported test-year routine maintenance expense of $6,456. This amount is pursuant to a monthly contract between Gainsboro and Andriot-Davidson, a company also owned by Carroll Cogan.

On June 5, 1985, the Commission held a generic hearing regarding the routine maintenance fee charged by Andriot-Davidson to Carroll Cogan-owned sewer companies, under the Docket No. 9101, The Application of Enviro Utilities, Inc., for an Adjustment of Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities. At the April 9, 1986, hearing, Gainsboro agreed to the stipulation that whatever decision reached by the Commission in the Enviro proceeding would be controlling for this case.[5]

As of the date of this Order, no definitive decision has been made by the Commission regarding the routine maintenance issue.

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5 Transcript of Evidence ("T.E."), April 9, 1986, page 188.

However, for the purposes of expediting this case the Commission will limit Gainsboro to the routine maintenance fee in effect at the time of the most recent case involving this utility. This was the position taken by the Commission in its Order dated January 31, 1985, in Case No. 9101, and is the position Carroll Cogan seeks to overturn in the generic proceeding. If, upon final disposition of Case No. 9101, amounts greater than the fee allowed in the most recent case are found to be reasonable, the Commission will make appropriate adjustments to the rates of Gainsboro to reflect recovery of the current contract amount.

The routine maintenance fee in effect at the time of the last proceeding involving this utility in Case No. 8126, An Adjustment of Rates of Nettlecreek Treatment Plant, Inc., was $295 per month.[6] The Commission has therefore reduced operating expense by $2,916 to reflect the allowable routine maintenance amount of $3,540.

Depreciation Expense

Gainsboro reported test-year depreciation expense of $9,351. This amount is supported by the depreciation schedule filed by Gainsboro[7] and is appropriate for financial reporting purposes.

This utility, however, has a well-established history with regard to depreciation allowable for rate-making purposes. Though Gainsboro has failed to record amounts in Account No. 271 - Contributions in Aid of Construction, it was established in Case

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6 Intervenor's Exhibit 1, filed at April 9, 1986, hearing.

7 Response to Intervenor's First Request, Item No. 24.

No. 8126 and was included as a specific finding of the Commission that all but $55,864 of the original cost of the plant was contributed. In its procedure of recording the purchase Gainsboro failed to make the proper entries to reflect the contributed portion of the plant; however, inasmuch as the assets being considered in this proceeding are the same as those in Case No. 8126, the Commission finds no reason to deviate from the findings in that case. Gainsboro offered no evidence in opposition to this treatment. Therefore, $55,864 is continued as the original cost basis for determination of depreciable non-contributed plant herein. The test-year composite rate of 2.98 percent reported by Gainsboro has been applied to this amount, and $373 related to additional items capitalized herein has been added, resulting in an adjusted depreciation expense of $2,038.

Sludge Hauling

Gainsboro reported test-year sludge hauling expense of $4,480. This amount was supported by invoices rendered by CFS Services, Inc., and is based on 20 loads of sludge hauled at $120 per load and 16 at $130 per load; for a total of 36 loads during the test year.

There is much evidence in the record that indicates that the level of sludge hauling incurred during the test year is excessive for a plant the size of Gainsboro, and that the additional hauling was necessary due to inefficient operating conditions at the plant [evidenced by the number of violation citations from the Jefferson County Board of Health ("Board of Health")]. Moreover, the number of loads hauled during the test year is inconsistent with the

levels of the prior and subsequent years. Twelve loads were hauled during 1983 and 13 during 1985. Ten additional loads of accumulated sludge were hauled in cleaning out the tertiary lagoon during 1985; however, since this expense is non-recurring, and of an extraordinary nature, it will not be included for rate-making purposes herein.

Consumers argued that 13 loads was the appropriate level of sludge hauling to be used for rate-making purposes. In addition to the historical record of sludge hauling for Gainsboro, this position was supported by the testimony of Sarah Lynn Cunningham, Manager of the Water Pollution Control Section of the Jefferson County Board of Health. She testified that an efficiently operating plant with the number of customers as Gainsboro should require approximately 13 loads of sludge hauled per year.[8] This derivation is based on a calculation centered on the environmental engineering standard that each person on the system will generate 2.14 cubic feet of sludge every 60 days. Under the assumptions applicable to Gainsboro that there are 140 homes, 4 persons per home, and each load consists of 4,300 gallons of sludge, 12.7 loads should be required assuming normal operations. The Commission accepts this calculation. Ms. Cunningham further testified that the additional loads were in fact necessary due to a chronic bulking problem, but that this problem was a result of numerous and ongoing violations of Board of Health regulations at the plant. These violations are delineated in Consumers' Exhibit

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8 T.E., page 117.

4a. Based upon the record of violations occurring from December 1982 to April 1986, it was the opinion of Ms. Cunningham that the plant had not been operated efficiently during this time period.[9]

The Commission is of the opinion that the ratepayers should not be responsible for excessive sludge hauling resulting from the operator's failure to operate the treatment plant efficiently. Therefore, the Commission has reduced test-year sludge hauling expense for rate-making purposes to 13 loads, a cost of $130 per load. This level is consistent with the levels incurred in the years immediately prior and subsequent to the test year, and is also the normal level for a system of Gainsboro's size as reflected in the testimony of the Consumers' Board of Health witness.

This results in an adjusted sludge hauling expense of $1,690.

Interest Expense

Gainsboro reported test-year interest expense of $16,355. This amount represents interest on $143,000 borrowed by Gainsboro from Citizen's Fidelity Bank and Trust Company ("Citizen's Fidelity") to finance the purchase of Nettlecreek. The sum of $143,000 was borrowed though the actual purchase price per the purchase agreement was only $86,012; the balance of the funds borrowed was used to pay off past debts incurred by Nettlecreek with the exception of $14,620 which has not yet been advanced to Gainsboro.

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9 Ibid., page 133.

The purchase price of Nettlecreek was $86,012; this amount represents the principle and interest due at the date of closing on a promissory note payable to Citizen's Fidelity by Nettlecreek. This promissory note was the subject of a finding in Case No. 8126 in which the Commission disallowed all associated interest for rate-making purposes citing that this represented,

> . . .imprudent borrowing which would have been averted if the Applicant had properly sought authorization of the Commission whereby the Commission would have the opportunity to evaluate the new indebtedness by the Applicant.

Gainsboro was given the opportunity to respond to this finding; its response was that it was not familiar with Case No. 8126.[10] Inasmuch as the amount of $86,012 represents the same debt related to the same assets as was disallowed in the previous case, and no rebuttal evidence has been advanced, the Commission finds that all interest associated with the purchase price should be excluded for rate-making purposes.

As for the balance of the debt which was used to pay off past-due billings owed by Nettlecreek, the Commission has established a precedent in numerous proceedings that the interest on such debt should not be borne by the ratepayers. In this instance one corporation, Gainsboro, has borrowed funds to pay off the debts of another, Nettlecreek. Gainsboro has failed to justify passing on the interest to the ratepayers; therefore, the interest on all debt in excess of the purchase price has been disallowed herein.

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[10] Response to Commission's Second Information Request, Item No. 8.

The result of the aforementioned findings is to eliminate all reported test-year interest expense.

Rate Case Expense

Gainsboro indicated a projected expense of $1,650. The Commission finds this amount to be reasonable for a proceeding of this nature and will therefore allow the full amount amortized over a 3-year period. Operating expenses have been increased by $550 to reflect this amortization.

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

	Actual Test Period	Pro Forma Adjustments	Adjusted Test Period
Operating Revenues	$ 31,477	$ 1,551	$33,028
Operating Expenses	50,641	<20,573>	30,068
Net Operating Income	$<19,164>	$ 22,124	$ 2,960
Other Income	-0-	-0-	-0-
Other Deductions	16,355	<16,355>	-0-
NET INCOME	$<35,519>	$ 38,479	$ 2,960

REVENUE REQUIREMENTS

Gainsboro based its requested increase in revenue on an operating ratio methodology and requested revenue sufficient to produce a ratio of .88. The Commission finds that an operating ratio of 88 percent is fair, just and reasonable and will allow Gainsboro to pay its operating expense, service its debt, and provide a reasonable return to its owners.

The use of an 88 percent after-tax operating ratio applied to the adjusted test-year operating expense results in a revenue

requirement of $35,324. Therefore, Gainsboro should be allowed additional revenues of $2,296 over normalized test year revenues of $33,028.

Sale and Transfer

Consumers contended that the sale of the utility should be disallowed. This position was premised on the argument that Carroll Cogan's background indicated a history of negligence, corporate mismanagement, oversight, inattention, disregard for Commission precedence, and a total departure from standard business practices.[11] Consumers, however, did not propose an alternative were this sale and transfer to be disallowed. Representatives for Nettlecreek did not participate in this proceeding and Gainsboro indicated that it could not make contact with them. Were the sale and transfer to be denied, the ongoing operating of the system would be placed in jeopardy. Therefore, the Commission will allow the sale and transfer.

However, the Commission is concerned with Carroll Cogan's delay in filing this application for approval of the transfer. Mr. Cogan purchased and began operating the system, without Commission approval, in February 1983. He then waited 33 months before filing an application for approval of a sale and transfer. The Commission admonishes Mr. Cogan that future negligence such as this could result in penalties being assessed.

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[11] Brief of Consumers, page 1.

OTHER ISSUES

Included within the asset purchase agreement is a provision that Gainsboro "shall receive a fee for contribution in aid of construction in the amount of $400 per new customer." No service connection charges are listed in Gainsboro's tariff, and no deviation from the policy disallowing service connection charges for privately-owned sewer utilities has been noted. No such charges can be imposed until approval of this Commission has been obtained.

SUMMARY

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

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

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

3. The present operator, Gainsboro, is ready, willing and able to purchase, operate and provide adequate service to the customers formerly served by Nettlecreek. Furthermore, the stockholders of Nettlecreek are ready and willing and they desire to sell, inasmuch as they wish to divest themselves of the ownership and operation of this sewage treatment system.

4. The quality of service to the present customers of Nettlecreek will not suffer in that Andriot-Davidson, which has

knowledge and experience in the maintenance of sewage treatment facilities, will be employed to operate the system. Furthermore, Andriot-Davidson is familiar with the construction and operation of this treatment plant.

5. The agreed-upon purchase price is $85,971.76 which was determined through negotiations between the stockholder of Gainsboro and the stockholder of Nettlecreek.

6. Gainsboro has filed with the Commission its Articles of Incorporation.

7. Gainsboro should maintain its books of account in accordance with the USoA prescribed by this Commission. Accounting for an acquisition includes:

a. 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.

b. 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.

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

d. Crediting contributions in aid of construction, estimated if not known, to Account No. 271 - Contributions in Aid of Construction.

e. 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.

8. In this instance the proper journal entries to record this transaction in accordance with Utility Plant Instruction 4 of the USoA are as follows:

	DR	CR
Plant Purchased or Sold	$143,000	
Long-Term Debt		$143,000
Utility Plant-in-Service	$313,843	
Plant Purchased or Sold		$313,843
Plant Purchased or Sold	$ 69,178	
Accumulated Depreciation		$ 69,178
Plant Purchased or Sold	$257,979	
Contributions		$257,979
Acquisition Adjustment	$156,314	
Plant Purchased or Sold		$156,314

9. While legal and proper for general accounting purposes, this acquisition transaction, if not at "book value", can either increase or decrease the debt and/or equity on the utility's books. Therefore, Gainsboro and its stockholders are hereby apprised that the Commission will not allow, for rate-making purposes, interest charges on debt that exceed those charges which would have been incurred to finance the original cost of plant-in-service excluding any acquisition adjustment less accumulated depreciation and contributions in aid of construction. Allowable interest charges should be computed using the weighted average cost of debt. The Commission also will not allow a return on

equity or amortization of an acquisition adjustment that resulted from this transaction for rate-making purposes.

10. Gainsboro requested authority to borrow $143,000 to finance the purchase of the assets of Nettlecreek. The purchase price is being financed by Citizen's Fidelity with the purchase price payable in 59 months with interest at the rate of the prime rate plus 3/4 percent. The financing of $143,000 by Citizen's Fidelity to Gainsboro should be approved. However, since the owner of Gainsboro and not the ratepayers is the beneficiary of the purchase, it shall be responsible for the retirement of said debt.

IT IS THEREFORE ORDERED that:

1. The rate design shall be changed as proposed and the rate contained in Appendix A is hereby approved for services rendered by Gainsboro on and after the date of this Order.

2. The rates proposed by Gainsboro be and they hereby are denied.

3. The transfer of Nettlecreek from its stockholder to Gainsboro and its stockholder, Carroll Cogan, be and it hereby is approved.

4. The financing of $143,000 as described in Finding No. 10 be and it hereby is approved.

5. In future rate cases the allowable interest charges for the purposes of setting rates shall be determined as set out in Finding No. 9.

6. Gainsboro shall make the necessary adjustments to its records in the areas specified herein in order to be in compliance with Commission regulations.

7. Gainsboro shall adjust its accounting practices to conform to the USoA.

8. Within 30 days from the date of this Order, Gainsboro shall file with this Commission its revised tariff sheets setting out the rates approved herein.

Done at Frankfort, Kentucky, this 7th day of August, 1986.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE PUBLIC SERVICE COMMISSION
IN CASE NO. 9470 DATED AUGUST 7, 1986.

The following rate is prescribed for the customers in the area served by Gainsboro Sewer System 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.

Rate: Monthly

Single Family Residential $20.90