

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

GENERAL ADJUSTMENT OF RATES)
OF THE JOHNSON COUNTY WATER) CASE NO. 9488
DISTRICT)

O R D E R

IT IS ORDERED that:

1. The Staff Audit Report for Johnson County Water District attached hereto as Appendix A shall be included as a part of the record in this proceeding.

2. Johnson County Water District shall have 10 days from the date of this Order to file written comments concerning the contents of Appendix A.

Done at Frankfort, Kentucky, this 27th day of May, 1986.

PUBLIC SERVICE COMMISSION

Richard D. Leman
For the Commission

ATTEST:

Secretary

APPENDIX A

**STAFF REPORT
ON
JOHNSON COUNTY WATER DISTRICT**

**Prepared By: Dennis Jones
Public Utilities Financial
Analyst, Chief**

PREFACE

On January 2, 1986, Johnson County Water District ("Johnson County") filed its general rate application seeking to increase its rates by \$165,838 or an increase of approximately 55 percent in its customers average bill.

As part of its endeavor to shorten the regulatory process the Commission chose to perform an audit of Johnson County's test period operations, the twelve month period ending September 30, 1985. The Commission's objective was to substantially reduce the need for written data requests, decrease the time necessary to examine the application and therefore, decrease the expense to the utility. Mr. Dennis Jones and Mr. Sam Bryant of the Commission's Division of Rates and Tariffs performed the audit on March 12-15, 1986, at the office of Johnson County located in Prestonsburg, Kentucky.

SCOPE

The scope of the audit consisted of proving the original cost of Johnson County's plant in service; varifying the level of assets and liabilities; and proving Johnson County's major operating expenses which consisted of purchased water, fuel purchased, outside services, and uncollectible accounts. The primary focus of this audit was to verify the accuracy of the above accounts and to assure that no improper or extraordinary expenses were included in test year operations. In order to determine this, expenditures charged to plant in service or to test year operations were reviewed and the invoices of large or

potential improper charges were examined. Insignificant discrepancies were not pursued and are not addressed herein.

Record Keeping

The staff's examination of Johnson County's operations revealed that the records kept of Johnson County's past operations were incomplete and inadequate. The current operators of Johnson County are currently endeavoring to correct the situation and are in the process of computerizing these records. In order to avoid future difficulties staff recommends that the plant, revenues and expenses of Johnson County be recorded in compliance with the Uniform System of Accounts for Water Utilities and supporting journals necessary to verify the amounts recorded in the annual report should be maintained. At a minimum this should consist of a journal of cash receipts and disbursements.

FINDINGS

Utility Plant In Service

An examination of the records of Johnson County was inconclusive in directly determining the accuracy of the amount in utility plant in service of \$1,341,174 recorded on the test period balance sheet. This is due in large part to the inadequate records kept by Johnson County prior to 1981 when the administration of Johnson County was taken over by the Water Resources Assistance Corporation ("WRAC"). However, the EDA bonds of \$147,000 used to finance the original construction when added to all the other forms of contributions in aid of construction including tap-on fees and grants of \$1,171,975 as shown in the 1984 annual report and \$13,000 of tap fees listed as revenues in

the application would support a level of plant in service of \$1,331,975 a difference \$9,199 from the application and \$795 from the 1984 annual report. It was staff's opinion that under the circumstances these differences were minor and thus no effort was made to reconcile further.

Staff's investigation also disclosed that \$120,662 had erroneously been recorded as pump stations and should have been recorded as storage tanks. Therefore, Account 325 - Electric Pumping Equipment should be reduced by \$120,662 and Account 342 - Distribution Reservoirs and Standpipes should be increased by \$120,662.

Contributions In Aid of Construction

In its application for rate relief Johnson County in its schedule F listed contributions in aid of construction of \$964,500. Staff has determined that this amount should be \$1,184,975 based on the 1984 annual report and the \$13,000 of tap-on fees which had previously been included as revenue. The difference of \$220,475 would more appropriately be included in the general operating reserve resulting in an adjusted deficit balance of \$474,401.

Test period revenues have also been reduced by \$13,000.

Purchased Water Expense

Johnson County proposed a pro forma purchased water expense of \$163,570 based on actual purchases during the test period of 121,162,900 gallons from its supplier Paintsville Utilities at the anticipated contract cost of \$1.35 per 1000 gallons. Johnson County billed its customers for only 64,392,000 gallons,

indicating a line loss of 46.86 percent. This line loss was attributed by representatives of Johnson County to a faulty master meter owned by Paintsville Utilities and a major line break during the test period which has been repaired. Rob Nicholas of the Water Resources Assistance Corporation, responsible for the operation of Johnson County, stated during the staff's investigation that line loss for Johnson County following the replacement of Paintsville's faulty master meter should not exceed the 15 percent allowed by the Commission for rate-making purposes. Therefore, the staff recommends reducing the pro forma purchase water expense from \$163,570 to \$102,270, a reduction of \$61,300 based actual sales of 64,392,000 gallons, allowable line loss of 11,363,294 gallons and the proposed contract price of \$1.35 per 1000 gallons.

Johnson County further proposed to include \$24,000 for the retirement over a 3-year period of \$60,000 in past due billings from Paintsville Utilities. Although not explicitly stated, it is assumed that accrued interest was also included. This amount has been challenged by Johnson County which asserts that the master meter serving Johnson County is faulty and that the rate at which the water was billed was incorrect for at least part of the test period. Since the accuracy of Paintsville Utilities' master meter is in dispute, the staff is of the opinion that it would not be fair or reasonable to require customers of the district to pay for water which may never have been received by the district or if received constitutes excessively high levels of line loss and recommends this be disallowed for rate-making purposes.

Depreciation Expense

Johnson County proposed a pro forma depreciation expense of \$34,172. Traditionally the Commission has viewed depreciation expense as a method of cost recovery with the depreciable basis being the utility's actual investment in the property. Therefore, no allowance is made for depreciation expense on contributed property. This prevents a utility from recovering the cost of contributed property more than once by passing a no cost investment on to its customers via the depreciation expense. Thus staff recommends the disallowance of depreciation expense on contributed property and has reduced Johnson County's depreciation expense by \$27,392 from \$34,172 to \$6,780.

Water Resources Assistance Corporation

Johnson County has contracted with the Water Resources Assistance Corporation ("WRAC") to manage its operations. WRAC has been providing this service since 1980. As a result of cash flow problems Johnson County during this period of time became delinquent in its payments to WRAC. This delinquency now totals \$55,892. In its application this delinquency has been amortized at \$12,000 per year. Since the \$55,892 represents an amount accumulated over a 5-year period for the performance of normal operations the staff recommends that the amortization of the principal amount not be allowed. This recommendation is consistent with past Commission practice to set rates only on a going forward basis and not to engage in retroactive rate-making.

However, if this expense had been kept current the customers of Johnson County may have been required to support

rates greater than those currently in effect; in addition the cash flow problems being experienced by Johnson County are at least partially due to its difficulties with Paintsville Utilities. Since neither the Commission nor Johnson County has any control over the actions of Paintsville Utilities, or any other municipally-owned utility and given that Johnson County has apparently entered into "good faith" discussions with Paintsville Utilities to eliminate these difficulties the staff recommends that the delinquent debt to WRAC be treated as short term debt and be allowed an imputed interest rate of 10 1/2 percent.¹ This action is consistent with the manner in which Johnson County may now be required to retire this past due billing. This recommendation would reduce Johnson County's pro forma expenses by \$12,000 and increase interest expense by \$5,869.

Department of Transportation

Johnson County included in its proposed operations a \$4,546 one time payment to the Kentucky Department of Transportation ("KY. DOT") for the relocation of 1,400 linear feet of the District's waterline on U.S. Highway 23. This relocation was necessitated by the construction of a housing project near U.S. Highway 23. The relocation was originally paid for by the federal government, however, due to error by the engineering firm contracted to relocate the line it had to be moved again. The engineering firm has since gone bankrupt and KY. DOT, in order to

¹ Interest rate for proposed bank loan to retire past due EDA bond payments.

prevent delay in the construction project and with the agreement of the District, paid for the second relocation which was then billed to the District.

Due to the circumstances surrounding this expense staff recommends that it be included in Johnson County's operating expenses, however since it is a non recurring expenditure staff further recommends that it be amortized over a 3-year period. This reduces Johnson County's expenses by \$3,030.

E.D.A. Payments

Johnson County is currently \$38,918 in arrears on its payments to E.D.A. for the "Johnson County Water District Water System Revenue Bond, Series of 1974," dated July 1, 1974. Johnson County proposes to retire this delinquency consisting of \$8,000 in principal and \$30,918 in interest by securing a loan from a local bank and amortizing the loan over a 5-year period at an interest rate of 10 1/2 percent. According to KRS 278.300 a loan payable over more than a 2-year period requires prior approval of the Commission. Johnson County did not seek this approval in its application. Staff recommends that Johnson County amend its application to seek this approval and further recommends that the proposed financing be disallowed for rate-making purposes pending this action and the approval of the Commission. This reduces Johnson County's proposed expense level by \$10,038.

Johnson County further proposed to include \$3,113 in annual payments on a bank loan taken out in 1981 to repay a previously delinquent amount to E.D.A. The amount of the original note was \$18,675. The current amount outstanding is \$7,838 as of September

30, 1985. Utilizing the proposed interest rate on the previously discussed financing of 10.5 percent the staff recommends allowing interest expense of \$823 but disallowing repayment of principal. This reduces Johnson County's proposed expense by an additional \$2,290.

Interest Expense

In determining its revenue requirements Johnson County included \$8,107 in interest expense in calculating its total expense level of \$392,590. The \$8,107 was also included in the debt service on the E.D.A. bonds of \$10,107 consisting of \$2,000 in principal and \$8,107 in interest. To eliminate this double counting staff has reduced Johnson County's interest expense by \$8,107.

SUMMARY OF STAFF RECOMMENDATIONS

Based on the recommendations proposed by the staff in this report, Johnson County's balance sheet and income statement are as follows:

Johnson County Water District
Balance Sheet
9/30/85

<u>Assets</u>	<u>Application</u>	<u>Staff Adjustments</u>	<u>Staff Recommended</u>
<u>Current Assets</u>			
Unrestricted Cash	\$ 19,203		\$ 19,203
Restricted Cash	45,848		45,848
Total Cash	<u>\$ 65,051</u>		<u>\$ 65,051</u>
Accounts Receivable/ Customer	<u>33,693</u>		<u>35,693</u>
Total Current Assets	\$ 98,744		\$ 98,744

Johnson County Water District
 Balance Sheet
 Page 2

<u>Fixed Assets</u>	<u>Application</u>	<u>Staff Adjustments</u>	<u>Staff Recommended</u>
Electric Pumping Equip.	\$ 179,525	\$ <120,662>	\$ 58,863
Distribution Reservoirs	354,034	120,662	474,696
Transl. Dist. Mains	686,485		686,485
Meters	85,907		85,907
Ofc. Furn./Equip.	304		304
Transportation Equip.	26,241		26,241
Communication Equip.	499		499
Meter Installations	6,457		6,457
Land	1,722		1,722
Subtotal	<u>\$1,341,174</u>		<u>\$1,341,174</u>
Accumulated Deprec.	<u><346,057></u>		<u><346,057></u>
Total Fixed Assets	\$ 995,117		\$ 995,117
TOTAL ASSETS	<u><u>\$1,093,861</u></u>		<u><u>\$1,093,861</u></u>
<u>Liabilities and Reserves</u>			
<u>Liabilities</u>			
Accounts Payable	\$ 119,183		\$ 119,183
Notes Payable	42,003		42,003
Deposits Payable	13,111		13,111
EDA Bonds Payable	<u>171,918</u>		<u>171,918</u>
Total Liabilities	\$ 346,215		\$ 346,215
<u>Reserves</u>			
Reserve/Conservation Fund	\$ 13,738		\$ 13,738
Reserve/FmHA Deposits for Line Extention	23,334		23,334
Contributions In Aid of Construction	964,500	\$220,475	1,184,975
General Oper. Reserve	<u><253,926></u>	<u><220,475></u>	<u><474,401></u>
Total Reserves	\$ 747,646		\$ 747,646
TOTAL RESERVES AND LIABILITIES	<u><u>\$1,093,861</u></u>		<u><u>\$1,093,861</u></u>

Johnson County Water District
Income Statement
9/30/85

	<u>Johnson County Pro Forma</u>	<u>Staff Adjustments</u>	<u>Staff Recommended</u>
Income			
Water Sales	\$ 215,447	\$ -0-	\$ 215,447
Tap Fees	13,000	<13,000>	-0-
Service Charges	400	-0-	400
Total Income	<u>\$ 228,847</u>	<u>\$ <13,000></u>	<u>\$ 215,847</u>
Expenses			
Purchased Water	\$ 163,570	\$ <61,300>	\$ 102,270
Purchased Fuel	11,500		11,500
Maint. Expenses	14,590		14,590
Operation Labor	300		300
Supplies & Expenses	275		275
Insurance	464		464
Reg. Comm. Exp.	234		234
Transportation	6,763		6,763
Outside Services	80,112		80,112
Uncollectible Accounts	4,000		4,000
Depreciation Expense	34,172	<27,392>	6,780 ²
Amortization	58,396 ³	<52,181>	6,215
Operating Expenses	<u>\$ 374,376</u>	<u>\$ <140,873></u>	<u>\$ 233,503</u>
EDA Debt Service	10,107		10,107
Interest Expense	<u>8,107</u>	<u><1,415></u>	<u>6,692</u>
Total Expenses	\$ 392,590	\$ <142,288>	\$ 250,302
Net Income	\$ <163,743>	\$ 129,288	\$ <34,455>

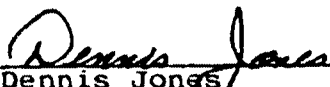
² For reporting purposes Johnson County would still calculate depreciation expense on contributed property.

³ Schedule C. Total additional revenue requirements of \$68,503 - EDA debt service of \$10,107 = \$58,396.

REVENUE REQUIREMENTS

Johnson County per books showed a negative debt service coverage ("DSC") for the test period and after staff adjustments its negative debt service is 1.7X. The staff is of the opinion that this negative coverage is neither fair, just nor reasonable. Staff is further of the opinion that this requirement would be met with a DSC 1.2X since this would provide sufficient revenue to meet the operating expenses recommended in this report and allow for reasonable equity growth. Therefore, staff recommends Johnson County be allowed to increase its revenues on an annual basis by \$36,476 calculated as follows:

1.2 DSC (\$10,107 Debt Service)	\$ 12,128
Short-term Interest Expense	6,692
Operating Expenses	<u>233,503</u>
Gross Revenues Required	\$252,323
Normalized Revenues	<u>215,847</u>
Required Increase In Gross Revenues	\$ 36,476



Dennis Jones
Financial Utilities Analyst, Chief