

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF VERNA HILLS,)
LTD., FOR AN EMERGENCY AND) CASE NO. 9484
PERMANENT RATE INCREASE)

O R D E R

On December 19, 1985, Verna Hills, Ltd., ("Verna Hills") filed its application seeking an emergency increase in its rates for sewer service. The rates proposed would generate \$115,283, an increase of 1,127 percent or an increase from \$5.50 to \$61.98 per month. This application was preceded by Case No. 9389¹ in which the Commission found Verna Hills to be in violation of the Commission's rules and regulations. That case has been made a part of this proceeding by reference. The Commission in this Order finds revenues of \$37,942 reasonable for sewer service to the customers of Verna Hills. This represents an increase of \$27,742. In addition, surcharges have been allowed for plant improvements and past-due accounts totalling \$7.43 per month.

In order to expedite the proposed request for emergency status, the Commission performed a limited examination of Verna Hills' financial records for the test period, calendar year 1985. As a result of this examination a staff report was issued and made a part of the record on February 14, 1986. In that report, the

¹ An Investigation of the Condition of Verna Hills, Ltd.

Commission staff recommended that the rates be increased to \$20.21 per month excluding any costs of bringing the treatment plant into compliance with applicable regulations. Comments from Verna Hills were received on February 20, 1986.

On February 25, 1986, the Commission conducted a public hearing in this matter. Parties participating were the utility, the Attorney General's Office, the residents of Verna Hills and the Commission staff. Briefs were received by March 26, 1986, and all other requested information has been received. Letters of protest have been received from numerous residents of Verna Hills.

Background

For brevity's sake a restatement of Verna Hills' past and current financial concerns has not been included in this Order. However, reference is made to the brief of Verna Hills, the Commission's Order of November 11, 1985, in Case No. 9389 and the staff report for a complete recapitulation of these concerns.

Discussion

The Commission's role in a rate proceeding is to determine a rate which is reasonable both to Verna Hills and its customers. As stated in the staff report and the applicant's brief, Verna Hills' current poor operating condition was brought about by continued deterioration over a number of years. Therefore, neither Verna Hills nor its customers can reasonably expect an immediate turnaround. However, cooperation between management of Verna Hills and Verna Hills' customers will be essential in achieving a solution to these problems. Although there may be little visible progress immediately, the residents must in good faith continue to

pay the charges found reasonable herein since without these funds no progress can be made. On the other hand, the Commission will exert every effort to see that the management of Verna Hills utilizes these funds in a reasonable manner by (1) on-site inspections, (2) periodic progress reports of work completed, and (3) full verification of receipts and disbursements. These measures will be discussed in greater detail in a later section of this Order. If we find that Verna Hills has not fulfilled the obligations imposed by this Order, appropriate action will be taken including invoking penalties as permitted by KRS 278.990.

Revenue and Expenses

The staff report recommended a rate of \$20.21 per month, based on a revenue requirement of \$37,589. The Commission has used this level as the beginning point for further consideration of the testimony and other information submitted during and subsequent to the hearing.

In its brief Verna Hills stated that at a minimum an additional annual allowance of \$6,460 plus a reasonable cost of liability insurance should be added to the level of expenses recommended in the staff report. In addition Verna Hills requested that the Commission consider the need for routine legal and accounting fees on an annualized basis and to reconsider an allowance for reasonable mileage. Each of these items will be discussed in detail.

Record Keeping

The staff report found that Verna Hills' financial records were in need of substantial improvement. Thus, at the hearing,

Verna Hills presented testimony that approximately \$2,650 annually would be necessary to maintain its financial records properly rather than the \$900 recommended. The Commission concurs with the Attorney General that the level of accounting sophistication and detail necessary for a utility with 155 customers on flat rates is not extensive. It is the Commission's observation that most of what is needed is not state of the art equipment, but simple and accurate bookkeeping, maintained on a monthly basis (daily when applicable). Therefore, the Commission concurs with the staff's recommended level of \$900.

Chemical Expenses

At the hearing, Verna Hills proposed that chemical expense of approximately \$4,320 be allowed. The staff report recommended \$360. Verna Hills' higher proposal was based on information provided by its consultant. Upon further review the Commission concurs with the higher level.

Liability Insurance

Verna Hills did not obtain a quote for liability insurance for its treatment plant. Even though the Commission realizes the need for insurance, no allowance can be granted without at least an estimate. When Verna Hills is able to provide proof of insurance, the Commission will appropriately modify its position, if material.

Electricity

An analysis of electric bills for the test period indicated that the annual cost was approximately \$4,800, a reduction of \$1,200 from the level recommended in the staff report. However,

on cross-examination, Verna Hills pointed out that one of the lift stations did not function during the test period and therefore the necessary electric consumption was understated and recommended an additional allowance of \$750. The Commission concurs; however, this represents \$450 less than the level recommended in the staff report.

Mileage Expense

The staff report denied any allowance for mileage and transportation by the owner of Verna Hills' treatment plant in Winchester and the business office in Louisville. At the hearing Verna Hills agreed that the business office had voluntarily been moved to Louisville from its former location in Clark County.² The Commission finds that a management decision to locate its business office 90 miles from its service territory should not be paid for by utility ratepayers in the form of travel expenses.

Routine Legal and Accounting

In its brief, Verna Hills requested an allowance for routine legal and accounting fees. Although it is difficult to separate the owner's personal and business difficulties, the Commission is of the opinion some allowance is justified. It has been the Commission's experience in other similarly-sized utilities to approve annual professional fees ranging from less than \$1,000 to greater than \$2,500. Based on its experience and the simplicity of Verna Hills' operations, the Commission finds an allowance for professional fees of \$1,200 annually to be reasonable.

² Transcript of Evidence, February 25, 1986, pages 36-37.

Based on the above changes to the staff report, the Commission finds that Verna Hills would have a net operating loss of \$23,159, determined as follows:

	<u>Proposed</u>	<u>Staff</u>	<u>Adjusted</u>
Operating Revenues	\$ 10,094	\$ 10,230	\$ 10,230
Operating Expenses	68,788	28,679	33,389
Net Operating Loss	\$(58,694)	\$(18,449)	\$(23,159)

Ongoing Revenue Requirements

Verna Hills' adjusted operation results in a negative operating ratio which will not permit it to meet its financial or operating obligations. The Commission finds an operating ratio of .88 reasonable to provide Verna Hills sufficient revenues to meet its operating expenses and provide for reasonable financial growth. This results in a gross operating revenue requirement from normal operations of \$37,942, an increase of \$27,742. Other requirements will be discussed later in this Order.

Other Nonrecurring Issues

Amortization of Past Due Accounts

In its original application Verna Hills requested an allowance of some \$75,000 for past-due accounts payable arising from various past expenditures to be amortized over 3 years. In the staff report a recommendation was made that only \$25,482 be recognized as reasonable and that the utility and ratepayers share equally in the responsibility over a 3-year period. In its brief, Verna Hills requested the Commission to consider the entire \$25,482 in addition to also allowing legal fees in the amount of \$7,412. (This amount was amended to \$8,600 at the hearing.)

In its brief, Verna Hills stated that the legal services have benefited Verna Hills and its customers by insulating Verna Hills from multiple litigation, by assisting in repurchasing the stock, in dealing with Kentucky Utilities and by assisting in the preparation of the rate application.³ On the other hand the brief of the Attorney General asserted that the vast majority of the expenses claimed were the result of work on the Verna Hills Chapter 11 bankruptcy with no benefits accrued to the customers of Verna Hills.⁴

After further review of these legal fees the Commission finds legal services were performed both for the bankruptcy proceeding and the rate case with many legal fees possibly covering both. It is impossible to discern one amount from the other; thus, the Commission finds the methodology of sharing as recommended in the staff report to be reasonable for legal services in the amount of \$8,600.

The Attorney General disputes the inclusion in the audit report of \$6,500 plus accumulated interest borrowed in 1980 for the purpose of filing a Chapter 11 bankruptcy for the owner's personal finances. The Attorney General contended that the debt was not incurred as a result of providing service to the ratepayers nor did the ratepayers benefit as a result of the loan.

After reviewing the transcript, it is the Commission's conclusion that the loan in the amount of some \$6,500 was paid

³ Brief of Verna Hills, pages 9 and 10.

⁴ Brief of Attorney General, page 3.

directly to Verna Hills and then endorsed to the owner's attorney for the personal bankruptcy of the owner of Verna Hills. Verna Hills was used as a conduit in the personal bankruptcy proceeding and should not be held responsible for this debt for rate-making purposes. Thus, the Commission concurs with the Attorney General to disallow this loan along with its accumulated interest totaling \$12,582.

Verna Hills also argues that the past-due accounts should not be shared equally with the ratepayers, the position taken in the staff report. The staff's position was based on the fact that Verna Hills' unstable financial position was in part due to its inadequately low rates and extended period of neglect by its management. Verna Hills contends that the failure to seek timely rate relief was due to the uncertainty of ownership. The Commission understands Verna Hills' position, but does not believe the ratepayers should be held responsible for Verna Hills' management decisions or the owner's personal financial problems. Thus, the Commission finds the shared responsibility proposed in the report to be a reasonable and even generous alternative.

Plant Improvements

Verna Hills' plant is seriously deficient and service is impaired. As stated earlier in this Order, monies for plant improvements were not provided for in the staff report, but estimates were requested during the audit. At the hearing of February 25, 1986, Verna Hills provided an estimate by a consultant of \$36,475 to bring the treatment plant into compliance with applicable regulations. This estimate did not include any amount

to clear the lagoon. On March 10, 1986, Commission staff visited the Verna Hills plant site for a routine inspection and to determine the reasonableness of the consultant's proposal. The Commission is of the opinion that some items in the proposal were not necessary at this time and should be delayed; however, an estimate of \$18,000 was determined to be necessary to clear the sludge lagoon to an acceptable condition. In summary, the Commission finds that plant improvements totaling \$15,505 are necessary for the restoration of the plant, \$7,285 to refurbish the lift station and \$18,000 to clean the lagoon, a total of \$40,790. A more detailed list of the plant improvements necessary is in Appendix B.

Special Accounting and Rate-Making Treatment of Surcharge

Surcharge

The Commission after much consideration has determined that the customer portion of the past-due accounts payable and the monies for plant improvements can only be borne by Verna Hills' ratepayers through a surcharge to the basic rates. The Commission is allowing this surcharge only because it appears to be the only viable course of action. It is evident from the record that a loan could not be negotiated, or would be very costly, without the security of the surcharge. Sale of the stock was possible during the bankruptcy process, but the present owner was the only bidder. Abandonment is out of the question since sewer service is essential to the ratepayers.

In the staff report, 3 years was utilized to amortize the customer portion of past-due accounts payable and the Commission finds this reasonable. However, amortization of the necessary

capital expenditures presents a problem. First, if the amortization period is too lengthy, the receipts will be too small to provide expeditious renovation of the treatment plant. On the other hand, if the period selected is too short, the burden on the ratepayers will be too excessive. In its decision of selecting an appropriate amortization period, the Commission has weighed both positions carefully and finds an amortization period of 48 months reasonable for the treatment plant. This will provide for a reasonable surcharge to the ratepayers along with a reasonable time period for Verna Hills to recover its expenditures.

Accountability

Verna Hills must immediately set up a special interest-bearing account in a bank or earnings institution and all monies from the plant improvement surcharge must be deposited in that account within 5 days of their receipt. Verna Hills must advise the Commission in writing of the name of the bank and the account number where the surcharge monies are deposited. All funds collected from the plant renovation surcharge shall be deposited into this account, and only monies for the actual improvements included in Appendix B shall be withdrawn. Verna Hills shall file a monthly statement of all deposits and disbursements with a reconciliation to the most recent bank statement.

In addition Verna Hills shall file monthly statements with the Commission disclosing all receipts and disbursements for its entire operations for the preceding month. These statements should identify all receipts from the basic bill, the surcharge for past-due accounts, the surcharge for plant improvements and

any other receipts along with all disbursements, specifically identifying payments of past-due accounts and the direct payment of plant renovation or bank loans taken out for the purpose of plant renovation found necessary in this Order. A copy of the monthly bank statement for its entire operation must also be included with this filing along with a complete bank reconciliation. Periodically the Commission will audit Verna Hills' accounts and engineering inspections will be made on a monthly basis.

Should the Commission find any improprieties it will not hesitate to invoke penalties under KRS 278.990, including fines, imprisonment or both.

The Commission is of the opinion that these surcharges be accounted for as contributions from the ratepayers and not as revenues. Accounting for these expenditures as contributions recognizes the source of the funds and accrues the benefits to that source, the ratepayers. To the extent that the amounts received from the surcharges are not used for the repayment of past due accounts or plant renovation by the end of the applicable surcharge period, the Commission will determine a reasonable period over which any unused amounts will be refunded to the ratepayers.

Financing

As discussed earlier, the Commission is approving a surcharge for the renovation of the treatment plant. Since the surcharge is estimated to generate about \$800 per month, the Commission recognizes that adequate funds will not be available to complete in a

timely manner the needed improvements, and that financing on the strength of the escrowed surcharge is necessary. Therefore Verna Hills should immediately attempt to make necessary financial arrangements with a lending institution (or the firm completing the renovation). Verna Hills should report its findings to the Commission as soon as available, but not later than its first required monthly report.

FINDINGS AND ORDERS

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

1. Verna Hills' proposed rate is unfair, unjust and unreasonable in that it produces revenues in excess of those found reasonable herein.

2. The basic rate in Appendix A will produce operating revenue of \$37,942 annually, and is fair, just and reasonable in that it will produce revenue sufficient to pay normal operating expenses and provide for a reasonable profit.

3. Verna Hills should be permitted to implement a surcharge of \$1.95 for 36 months to recover the utility's share of past-due accounts, not to exceed \$10,750.

4. Verna Hills should be permitted to implement a surcharge of \$5.48 for 48 months to renovate the utility's treatment plant, clean the sludge pond and repair the lift station. Any amounts collected in excess of the actual cost of the required renovation as described in Appendix B should be refunded.

5. Verna Hills should separately list each of the surcharges on the customers' bills.

6. Verna Hills should set up a special interest-bearing account and all monies from the plant improvement surcharge should be deposited in that account within 5 days of its receipt.

7. Verna Hills should provide the Commission the name of the bank and the account number where this surcharge is deposited.

8. Verna Hills should file a monthly statement of all deposits and disbursements, a copy of its bank statements with a reconciliation to the most recent bank statement.

9. Verna Hills should file monthly statements disclosing all receipts and disbursements for its entire operation as instructed in the text of this Order.

10. Verna Hills should file copies of its monthly bank statements with a complete bank reconciliation.

11. Verna Hills should file monthly progress reports and financial statements including the number of customers billed not later than 25 days past the end of each month during the surcharge period showing the detail requested in the text of this Order. The proceeds from the surcharge are to be used only for the purposes identified.

12. Verna Hills should record the receipt of the surcharges ultimately as contributions in aid of construction, but should comply with the Uniform System of Accounts for Sewer Utilities with respect to customer advances for construction. Expenditures for the renovation of the treatment plant should be recorded as capital additions while expenditures for the payment of past due accounts should be recorded to the applicable payable account.

13. Verna Hills should provide a list of past due customer accounts owing more than one month coincident with other required filings.

14. The report of expenditures from the surcharge funds must include the payee, the amount, the date and a description of the service provided.

15. Engineering inspections of the treatment plant should be conducted monthly to verify compliance with applicable regulations and this Order.

16. Verna Hills should maintain its financial records in full compliance with the Uniform System of Accounts for Sewer Utilities.

17. Verna Hills should solicit funding from an external source for the plant renovation and provide the results to the Commission in its first monthly report.

IT IS THEREFORE ORDERED that:

1. The rate proposed by Verna Hills be and it hereby is denied.

2. The rate in Appendix A be and it hereby is approved to be charged by Verna Hills for basic service on and after the date of this Order.

3. A surcharge in the amount of \$1.95 per month per customer be and it is hereby approved for 36 months to repay past due accounts receivable.

4. A surcharge in the amount of \$5.48 per month per customer be and it is hereby approved for 48 months to recover the cost of plant renovation as described in Appendix B.

5. In the event proceeds from the surcharges are misappropriated, the surcharge shall be immediately terminated and any misappropriations refunded.

6. Proceeds from the surcharges shall be recorded as contributions in aid of construction and all other accounting instructions specifically identified shall be followed as if so ordered individually.

7. Monthly reports shall be provided to the Commission as described in findings 6 through 10, beginning with the first full month after the date of this Order and the first monthly report shall be inclusive of 1986 to date.

8. Verna Hills shall maintain its financial records in compliance with the Uniform System of Accounts for Sewer Utilities.

9. Any use of the surcharge funds other than those described in the text and findings of this Order shall result in full application of provisions of KRS 278.990.

10. A plan of financing shall be provided with the initial report as required in this Order.

Done at Frankfort, Kentucky, this 9th day of May, 1986.

PUBLIC SERVICE COMMISSION

Richard D. Henning
Chairman

R. D. L.
Vice Chairman

James J. Williams
Commissioner

ATTEST:

Secretary

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 9484 DATED MAY 9, 1986

The following rates and charges are prescribed for customers receiving sewer service from Verna Hills Ltd. 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.

<u>Customer Class</u>	<u>Monthly Rate</u>
Residential	\$20.40

A monthly surcharge of \$1.95 will be levied against each ratepayer for a period of 36 months for past due accounts.

A monthly surcharge of \$5.48 will be levied against each ratepayer for a period of 48 months for plant improvements.

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 9484 DATED MAY 9, 1986

ESTIMATED PARTS AND COSTS
FOR THE RENOVATION OF VERA HILLS TREATMENT PLANT

Plant Renovation

1. Replace air filters on all 3 blowers	142.92
2. Replace 24 diffuser drops with diffusers	4,213.44
Labor	480.00
3. Replace 5" comminutor	2,104.20
Labor	400.00
4. Replace air lines to sludge return pumps in clarifier (2)	285.00
Labor	380.00
5. 1 Sanuril Model 1001	869.40
Labor	360.00
6. Replace grating on chlorine contact tank	472.75
Labor	60.00
7. Replace grating on 65,000 STP	2,833.50
Labor	600.00
8. Furnish 1 supernate return pipe from sludge holding tank	289.00
Labor to weld on tank	250.00
9. Replace skimmers in clarifier (2)	285.00
Labor	380.00
Total Parts	\$11,495.21
Sales Tax (5%)	574.76
Freight	525.00
Labor	<u>2,910.00</u>
TOTAL	\$15,504.97

Lift Station

- | | |
|--|------------|
| 1. Clean wet well and pull both pumps,
have (1) pump rebuilt if possible
(estimate only) | \$3,000.00 |
| 2. Rewire central panel | 900.00 |
| 3. Replace 4 float switches | 200.00 |
| 4. Labor for pump station | 2,800.00 |

Total Parts	\$4,100.00
Sales Tax (5%)	205.00
Freight	180.00
Labor	<u>2,800.00</u>

TOTAL	\$7,285.00
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Lagoon

Clean Lagoon	\$18,000.00
Plant	15,504.97
Lift Station	<u>7,285.00</u>
TOTAL	\$40,789.97