

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF THE ADAIR COUNTY WATER )  
DISTRICT, A WATER DISTRICT ORGANIZED PUR- )  
SUANT TO CHAPTER 74 OF THE KENTUCKY REVISED )  
STATUTES, IN ADAIR COUNTY, KENTUCKY, FOR )  
(1) A CERTIFICATE OF PUBLIC CONVENIENCE AND )  
NECESSITY, AUTHORIZING AND PERMITTING SAID )  
WATER DISTRICT TO CONSTRUCT WATER DISTRI- ) CASE NO.  
BUTION SYSTEM IMPROVEMENTS, CONSISTING OF ) 9518  
SEVENTY-SIX MILES OF WATER TRANSMISSION )  
LINES AND APPURTENANCES; (2) APPROVAL OF )  
THE PROPOSED PLAN OF FINANCING OF SAID )  
PROJECT; AND (3) APPROVAL OF INCREASED )  
WATER RATES PROPOSED TO BE CHARGED BY THE )  
DISTRICT TO ITS CUSTOMERS )

O R D E R

On March 3, 1986, Adair County Water District ("Adair") filed its application for an increase in water service rates, authorization to construct a \$2,105,700 waterworks project for 516 new customers, and approval of financing for the proposed project. The project financing consists of a 7 3/4 percent loan of \$1,155,000 from the Farmers Home Administration ("FmHA") evidenced by 40-year waterworks revenue bonds, a grant of \$891,000 from the FmHA, and \$59,700 from applicants for service.

On June 6, 1986, the Commission issued an Interim Order authorizing the construction and financing portion, and this Order will address the resulting revenue requirements and rate design.

Adair proposed rates calculated to produce total water sales of \$413,737, exclusive of penalties and other miscellaneous

revenues. This Order authorizes rates calculated to produce an annual sales volume of \$396,847.

TEST PERIOD REVENUES AND EXPENSES

Adair chose a 12-month test period ending August 31, 1985, which the Commission accepts, and filed financial statements showing a net operating loss of \$30,680. In response to a staff information request, Adair revised the actual and pro forma income statements. These revisions have been accepted by the Commission resulting in a pro forma net operating loss of \$41,521 for rate-making purposes, with the following exceptions:

Operating Revenue

Adair's statements showed test period operating revenues of \$292,009, but erroneously included tap-on fees from customers, which should be capitalized, of \$16,673. Accordingly, the Commission has reduced operating revenues by this amount.

Adair adjusted test period water sales revenue to \$266,857, to show a proportional increase in customers. Based upon an adjusted billing analysis, the Commission has determined water sales to be \$263,149 from existing rates. Therefore, the Commission has reduced pro forma water sales by \$3,708.

Cost of Meters

Adair reported \$23,496 for "install meter expense" for the test period, of which \$10,000 was for replacing old meters and \$13,496 for installation of new meters.<sup>1</sup> Since the meters will have a life of more than one year and will benefit future periods,

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<sup>1</sup> Response to Information Request, April 7, 1986.

these costs should be capitalized and allocated over several periods. Therefore, operating expenses have been reduced by \$23,496.

Depreciation Expense

Adair claimed depreciation expense of \$91,313, calculated on all depreciable property, including pro forma depreciation expense of \$28,875 on the noncontributed portion of the construction project. The Commission reduces depreciation expense for rate-making purposes by contributions in aid of construction, as a utility should not be allowed recovery of that portion of the plant which has been provided at no cost.

Based on the existing depreciation rate of 2.5 percent, depreciation expense has been reduced by \$55,769 and is calculated to be \$35,544 as follows:

Utility Plant (8/31/85)	\$2,498,308
Truck purchased	8,500
Meters previously expensed	23,496
Construction	<u>2,105,700</u>
Total plant (exclusive of land)	\$4,636,004
Less: Contributions (8/31/85)	2,236,886
Tap-on fees on construction	59,700
Grant on construction	891,000
Retirement for replaced meters	10,000
Tap-on fees existing customers	16,673
	<u>\$1,421,745</u>

Purchased Water Expense

Adair reported test period water purchases of \$67,502. Based on water sales and purchases of 58,703,530 and 73,099,600 gallons, respectively, Adair had an overall line loss of 19.7 percent. The Commission has excluded the gallonage for which settlement is being received for faulty construction, as discussed later in this

Order, and has determined net water loss for rate-making purposes to be 13.1 percent.<sup>2</sup>

In order to properly match purchased water and the billing analysis, the Commission has determined allowable purchases for existing customers to be 67,175,000 gallons. Considering the additional revenue from the settlement, the Commission finds 72,733,000 gallons or \$69,096 to be the appropriate level of water purchases for existing customers. For the customers to be added by the new construction, Adair projected usage of 30,134,000 gallons based on average usage of 160 gallons per day per customer; however, the historical average is 5,345 gallons per customer per month. Thus the Commission finds the usage to be 33,096,240 gallons. Using an allowance for line loss of 13.1 percent, the Commission finds the allowable purchases for the projected customers to be 38,085,431 gallons or \$25,804 and \$17,478, respectively, from the two suppliers. Therefore, the Commission finds allowable water purchases for rate-making to be 110,818,431 gallons, or \$112,378, an increase of \$10,630.

Therefore, the test period income statement of Adair has been adjusted herein as follows:

	Adair Test-Period Pro Forma	Inc. <Dec.> Commission Adjustment	Commission Adjusted
Operating Revenue	\$292,009	<\$20,381>	\$271,628
Operating Expense	333,529	< 68,635>	264,894
Operating Income <Loss>	<u>&lt;\$41,520&gt;</u>	<u>\$48,254</u>	<u>\$ 6,734</u>

<sup>2</sup> \$5,280 ÷ \$.95/1000 gallons = 5,558,000 gallons excluded from water purchases.

#### REVENUE REQUIREMENT

The average annual debt service of Adair for the next 5 years is \$120,584. The adjusted operating income plus interest income of \$4,269 results in income for rate-making purposes of \$11,003 and would allow Adair a debt-service coverage ("DSC") of only .09X, which would not be sufficient. To achieve a DSC of 1.2X, which the Commission is of the opinion is the fair, just, and reasonable coverage necessary for Adair to pay its operating expenses and to meet the requirements of its creditors, Adair would require a net operating income of \$144,701. Accordingly, the Commission has determined that additional revenue of \$133,698 is necessary.

#### ACCOUNTING COMMENTARY

Due to the settlement Adair has reached regarding the previous faulty construction, the Commission directs Adair to provide certain accounting treatment to adequately disclose and present the settlement. Roy Brothers Construction Company ("Roy Brothers") performed construction for the facilities of Adair. Major problems arose with the construction, and United States Fidelity and Guaranty Company ("USF&G") was held to Roy Brothers' performance bond. Until the final settlement was reached, Adair was being compensated under warranty provisions of the construction contracts by USF&G for all water losses in excess of 12 percent. Finally, an agreement was reached to satisfy all claims associated with the faulty construction. These amounts, totaling \$715,360, are to be paid to Adair by an annuity provided by the Executive Life Insurance Company of New York. The agreement was

subject to the approval of FmHA, which has restricted the \$8,000 annual amount only to repairs related to the faulty construction, and \$5,280 annually to use against the cost of purchased water.<sup>3</sup> In addition, the settlement provided for payment of periodic lump sums of \$50,000, receivable in 1994, 1999, 2004 and 2009, and \$100,000 each in 2014 and 2019, all of which are to be for replacements or major repairs. The Commission will require Adair to set up restricted cash and deferred credit accounts for receipt of these payments. These accounts shall be decreased as expenditures related to the faulty construction are incurred by Adair.

An additional journal entry will be required for the \$5,280 for water purchases. Adair will be required to appropriately flow the \$5,280 from the deferred account on the balance sheet to the income statement as revenues since water purchases will reflect gross expenses.

In addition, if any of the funds from the settlement result in an addition to plant in service, those funds shall be accounted for as contributions in aid of construction and records shall be maintained to determine the appropriate level of the account for rate-making purposes. Also, the future annual reports of Adair shall include a summary statement of the activity in these accounts for the applicable period.

Also drawing the attention of the Commission were the pro forma adjustments, based upon assumptions, made by Adair in its

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<sup>3</sup> FmHA Letter to Adair, November 16, 1984.

filing. It is the practice of the Commission to disallow assumptions which are not known or measurable for rate-making purposes; however, in this case, these assumptions were immaterial in relation to rates. The Commission has therefore permitted the pro forma adjustments in this case. Adair has also made some speculative increases in expenses for purposes of this filing. To what extent the expenses will actually increase is unforeseeable at this time. Due to the increased customer base from the construction, expenses may increase and as such actual expenses are indeterminable and estimates are sometimes used. The Commission has chosen to allow these adjustments; however, the Commission will expect Adair to adequately support and justify such increases in future filings. The decision to allow such adjustments in this case should not be considered a precedent in other filings.

The Commission also emphasizes the need for Adair to follow the USoA for its accounting.

#### RATE DESIGN

In its application dated March 3, 1986, Adair proposed rates that would produce revenues in excess of the revenue requirement given by the Commission in this Order. Therefore, the Commission has provided rates in Appendix A which produce sufficient revenue and which are considered to be fair, just and reasonable.

Included in total revenues from operations is \$19,149 which consist of \$16,673 in tap-on fees, \$1,199 in reconnection fees, and \$1,277 in penalties. Included in Appendix A are Adair's Service Connection Charges, its Special Service Charges, and its Late Payment Penalty Charge.

FINDINGS AND ORDERS

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

1. The rates proposed by Adair produce revenues in excess of the revenues found reasonable herein and should be denied upon application of KRS 278.030.

2. The rates and charges in Appendix A are the fair, just, and reasonable rates to be charged by Adair.

3. Adair should follow the USoA for Water Utilities as prescribed by the Commission.

IT IS THEREFORE ORDERED that:

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

2. The rates in Appendix A be and they hereby are approved for service rendered by Adair on and after the date of this Order.

3. Adair shall follow the USoA for Water Utilities as prescribed by the Commission.

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



Done at Frankfort, Kentucky, this 11th day of July, 1986.

PUBLIC SERVICE COMMISSION

*Richard D. Nemang*  
Chairman

*Robert J. L.*  
Vice Chairman

*James D. Williams*  
Commissioner

ATTEST:

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Secretary

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE  
COMMISSION IN CASE NO. 9518 DATED JULY 11, 1986.

The following rates and charges are prescribed for the customers receiving water service from Adair County Water District. 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.

Rates

Meter Size and Usage

5/8" X 3/4" Meter

First 2,000 gallons	\$11.30 Minimum Bill
Next 3,000 gallons	3.90 per 1,000 gallons
Next 5,000 gallons	3.50 per 1,000 gallons
Next 15,000 gallons	3.00 per 1,000 gallons
Over 25,000 gallons	2.00 per 1,000 gallons

3/4" Meter

First 3,000 gallons	\$15.20 Minimum Bill
Next 2,000 gallons	3.90 per 1,000 gallons
Next 5,000 gallons	3.50 per 1,000 gallons
Next 15,000 gallons	3.00 per 1,000 gallons
Over 25,000 gallons	2.00 per 1,000 gallons

1" Meter

First 5,000 gallons	\$23.00 Minimum Bill
Next 5,000 gallons	3.50 per 1,000 gallons
Next 15,000 gallons	3.00 per 1,000 gallons
Over 25,000 gallons	2.00 per 1,000 gallons

1 1/2" Meter

First 10,000 gallons	\$40.50 Minimum Bill
Next 15,000 gallons	3.00 per 1,000 gallons
Over 25,000 gallons	2.00 per 1,000 gallons

Rates

Meter Size and Usage

2" Meter

First 16,000 gallons	\$58.50 Minimum Bill
Next 9,000 gallons	3.00 per 1,000 gallons
Over 25,000 gallons	2.00 per 1,000 gallons

Service Connection Charges

5/8" X 3/4" meter	\$250
3/4" meter	250
1" meter	Actual cost
1 1/2" meter	Actual cost
2" meter	Actual cost

Reconnection Charge	\$15.00*
	20.00**
Disconnection Charge	15.00
Reinstallation Charge	30.00

Special Service Charges

Meter Reading Recheck Charge	\$25.00
Meter Test Request	17.50
Service Investigation Charge	25.00*
	30.00**
Late Payment Penalty Charge	10 percent

- \* During regular working hours
- \*\* After regular working hours