COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN ADJUSTMENT OF RATES OF THE SOUTH SHORE WATER WORKS COMPANY) CASE NO. 10334

O R D E R

Background

On February 16, 1988, South Shore Water Works Company ("South Shore") filed an application seeking approval of an increase in water service rates, Case No. 10166.[1] The proposed rates were based upon a 13.25 percent return on rate base and would generate additional revenues of $71,559 annually, an increase of 27.79 percent.

Commission Staff performed a field review of South Shore's 1987 test-year financial records on March 18, 1988. On May 31, 1988, Staff issued its report recommending rates that would produce additional revenues of $29,319 annually, an increase of 11.39 percent. Staff's recommended increase was based upon a 1.2X debt service coverage ("DSC") utilizing a 40-year amortization period of the existing long-term debt. On June 2, 1988, South Shore filed its response to the Staff Report accepting all

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1 Case No. 10166, An Adjustment of Rates of South Shore Water Works Company.

recommendations except for the method used to determine revenue requirements and, therefore, requested a hearing.

Prior to the scheduled hearing, a water shortage emergency occurred at South Shore which necessitated immediate revenue support. South Shore requested, in a supplemental application filed on June 29, 1988, Commission approval to construct a temporary water line and requested the Commission to include in its determination of South Shore's revenue requirement the additional net purchased water expense of $13,332 associated with the temporary line.

On July 7, 1988, the Commission issued a final Order in that proceeding granting an increase in rates of $42,651 annually, based upon the $29,319 recommended in the Staff Report plus the $13,332 additional purchased water expense. In addition, the Commission granted a surcharge of $1.22 per customer per month for 18 months to cover the cost of the temporary line.

On August 1, 1988, South Shore filed another application initiating this proceeding. South Shore requested a $28,337 increase in rates based upon the difference in revenue requirements utilizing the requested 13.25 percent rate of return on rate base and the previously allowed 1.2X DSC.

Since South Shore's application was based upon the same test period as in the previous case, Staff did not perform any additional field work nor issue another report.

A hearing was held on September 29, 1988 at the Commission's offices in Frankfort, Kentucky, addressing the issue of the determination of revenue requirements. Mr. Joe Hannah, President of South Shore, and Ms. Angela Martin, Commission Staff, testified during the hearing. No other party sought intervention in this proceeding.

On October 24, 1988, Mr. Bruce Clark, counsel for South Shore, filed a brief setting forth South Shore's position on why the Commission's revenue requirements determination in the last proceeding was not adequate. South Shore asserted in its brief that in order to meet the minimum operating needs of its customers, its revenue requirement must be determined either utilizing a 13.25 percent rate of return on rate base or a 1.2X DSC with a 6-year amortization period of its long-term debt.

In a prior rate proceeding, Case No. 9563,[2] the Commission determined South Shore's revenue requirement using a 1.2X DSC with a 6-year amortization period of its existing long-term debt. Per its brief, South Shore stated that the method recommended by Staff and affirmed by the Commission in the last case should be rejected as being inconsistent with earlier treatment by the Commission. In addition, South Shore stated that the change in the determination of revenue requirements from a 1.2X DSC with a 6-year amortization period or a 13.25 percent return on rate base

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2 Case No. 9563, An Adjustment of Rates of South Shore Water Works Company.

to a 1.2X DSC with a 40-year amortization period is not supported by a corresponding change in circumstances.

Purchase of Treasury Stock

As stated in the final Order of Case No. 9330,[3] dated January 13, 1986, South Shore's purchase of treasury stock has occurred three times and is the primary cause of South Shore's depleted financial condition. South Shore initially had 250 shares of stock outstanding which has been reduced by the purchase and retirement of treasury stock to 31-1/2 shares with a reduction to South Shore's retained earnings and a resultant appropriation to South Shore's past stockholders of an estimated $500,000. In every instance treasury stock was purchased, South Shore's accumulated earnings were depleted to zero or below.

This repurchase of treasury stock has caused South Shore's capital structure to change drastically over the last 4 years. In 1984, South Shore's debt to equity ratio was approximately 13 percent; however, in 1987, South Shore's debt to equity ratio was approximately 80 percent.

This repurchase of treasury stock is also the major cause for the discrepancy between South Shore's rate base and capital

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[3] Case No. 9330, Application of South Shore Water Works Company for a General Rate Increase.

structure. As of December 31, 1987, South Shore's rate base is $409,525[4] while its capital structure totals only $299,581.

At the time of the latest purchase of 63 shares of treasury stock for $200,000, an offer was made to South Shore of $1.8 million for its entire operation, but was turned down to maintain the family held ownership. Since South Shore's total equity per the December 31, 1985 Balance Sheet was only $38,268, it is apparent that in light of the $1.8 million offer, South Shore's equity portion of the capital structure is significantly undervalued.

FINDINGS AND ORDERS

The Commission is of the opinion that due to the purchase and retirement of treasury stock, the relationship of South Shore's rate base to its capitalization is distorted and, thus, a revenue requirement determination based upon a rate of return on rate base is not appropriate. In addition, the Commission is of the opinion

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Utility Plant	$848,185	
Items Capitalized per the Staff Report	3,516	
Filtration System to be Acquired	22,578	$874,279
Less:		
12/31/86 Accumulated Depreciation	$216,947	
Test-year Depreciation Expense	17,599	<234,546>
Contributions-In-Aid of Construction		<225,872>
Customer Advances		<37,837>
Add Working Capital:		
Operating Expenses Per Staff Report	$272,278	
Add. Purchased Water Expense	13,332	
Less Test-year Depreciation Expense	<17,599>	
	$268,011	
	X 12.5%	33,501
Rate Base		$409,525

that a debt service coverage method is a fair and reasonable approach for determining South Shore's revenue requirement.

The main purpose of the loan was to purchase treasury stock from which South Shore's customers will not receive any direct benefit. In the prior case, South Shore was granted a 6-year amortization period for its existing debt. However, after analyzing South Shore's actual payments toward the loan, it is apparent that this amortization schedule is not being followed.

Based on the actual payments being made, the debt is being amortized over 40 years. Because the reduction of South Shore's revenues based upon Staff's recommended 40-year amortization period will create an undue financial hardship for South Shore, the Commission is of the opinion that an amortization period which recognizes the financial needs of the company, as well as the actual rate payment, is needed.

Staff recommended matching the amortization period of the debt to the estimated life of the existing plant. During the hearing Mr. Clark raised the issue that the average life of the existing plant should be 20 years instead of Staff's recommended 40 years.[5]

The Commission is of the opinion that the most useful measure of the appropriate amortization period is the useful life of the assets which are directly related to the debt. A 40-year amortization period would be appropriate for newly acquired assets. However, a 20-year amortization period is more

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5 Transcript Volume I, September 29, 1988, pages 76-79.

representative of the remaining life of South Shore's existing plant. If this amortization period is used, a balance between the financial needs of the company, the actual rate the debt is being paid, and the interests of the customers will be realized.

Since the loan has been in existence for 2 years, the remaining payoff period is 18 years. Therefore, based upon a 1.2X DSC, a 10.5 percent interest rate, the remaining payoff period, and inclusion of a provision for income taxes, South Shore's revenue requirement is $323,293.[6] An increase in revenues based

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6 Annual payment on the note:
$237,667 @ 10-1/2% over 18 years = $ 29,439 per year

Annual Debt Service		$ 29,439
		X 1.2
1.2X DSC		$ 35,327
Adjusted Operating Expenses		285,610
Other Interest Expense		148
Revenue Requirements before Income Taxes		$321,085
Income Taxes:		
Adj. Revenues	$321,085	
Adj. Expenses	(285,610)	
Other Interest Expense	(148)	
Interest Expense on Note	(24,955)	
Margin Exclusive of Income Taxes	10,372	
Composite Tax Rate	÷ .8245	
Margin Inclusive of Income Taxes	12,580	
Margin Exclusive of Income Taxes	(10,372)	
Margin for Income Taxes	$ 2,208	$ 2,208
Revenue Requirement		$323,293

upon this methodology will produce a net cash flow of $23,487 annually.[7]

The Commission is of the opinion that a 1.2X DSC will provide sufficient revenues to allow South Shore to meet its operating expenses, service its debt, and provide for reasonable equity growth. Thus, South Shore should be allowed to increase its revenues by $5,829 annually.[8] However, the Commission hereby notifies South Shore that any additional purchase of treasury stock and the resulting depletion of its financial condition will be closely examined in the future. Therefore, the Commission is of the opinion and finds that:

1. The rates in Appendix A, attached and incorporated hereto, are the fair, just, and reasonable rates to be charged by South Shore and should be approved.

2. The rates proposed by South Shore are unfair, unjust, and unreasonable and should be denied.

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7 Net Cash Flow:

Revenue Requirement		$323,293
Less:	Adj. Operating Expense	(285,610)
	Other Interest Expense	(148)
	Income Taxes	(2,208)
	DSC	(29,439)
Add: Depreciation Expense		17,599
		$23,487

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Revenue Requirement		$323,293
Less:	Normalized Revenues	(300,161)
	Other Operating Revenues	(16,200)
	Interest Income	(1,103)
		$ 5,829

3. Within 30 days from the date of this Order, South Shore should file its revised tariff sheets setting out the rates and charges approved herein.

BE IT SO ORDERED.

Done at Frankfort, Kentucky, this 27th day of January, 1989.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 10334 DATED 1/27/89

The following rates and charges are prescribed for the customers in the area served by South Shore Water Works Company. 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: Monthly

First 1,000 gallons	$4.11 Minimum Bill
Next 9,000 gallons	2.03 per 1,000 gallons
Next 20,000 gallons	1.70 per 1,000 gallons
Next 20,000 gallons	1.50 per 1,000 gallons
Over 50,000 gallons	1.11 per 1,000 gallons
Hydrant Charge	5.50

Surcharge: A surcharge of $1.22 per customer per month shall remain in effect for a period of 18 months or until a total of $42,498 has been collected.