

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF WILLOWCREST)
DEVELOPMENT, INC. FOR A RATE) CASE NO. 91-305
ADJUSTMENT PURSUANT TO THE RATE)
FILING PROCEDURE FOR SMALL UTILITIES)


O R D E R

On August 23, 1991, Willowcrest Development, Inc. ("Willowcrest") filed its application for Commission approval of a proposed increase in its rates for sewer service. Commission staff, having performed a limited financial review of Willowcrest's operations, has prepared the attached staff report containing staff's findings and recommendations regarding Willowcrest's proposed rates. All parties should review the report carefully and provide any written comments or requests for a hearing or informal conference no later than 15 days from the date of this Order.

IT IS THEREFORE ORDERED that all parties shall have 15 days from the date of this Order to provide written comments regarding the attached staff report or requests for a hearing or informal conference. If no request for a hearing or informal conference is received, then this case will be submitted to the Commission for a decision.

Done at Frankfort, Kentucky this 10th day of January, 1992.

PUBLIC SERVICE COMMISSION


For the Commission

ATTEST:


Executive Director

COMMONWEALTH OF KENTUCKY

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THE APPLICATION OF WILLOWCREST)
DEVELOPMENT, INC. FOR A RATE)
ADJUSTMENT PURSUANT TO THE RATE) CASE NO. 91-305
FILING PROCEDURE FOR SMALL)
UTILITIES)

STAFF REPORT

January 8, 1992

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STAFF REPORT

ON

WILLOWCREST DEVELOPMENT, INC.

CASE NO. 91-305

A. Preface

On August 23, 1991, Willowcrest Development, Inc. ("Willowcrest") filed its application seeking approval to increase its rates pursuant to the Alternative Rate Filing Procedure for Small Utilities. Willowcrest proposed to increase its annual operating revenue by \$26,096,¹ an increase of 157 percent² over test-period normalized revenues from rates of \$16,630.

In order to evaluate the requested increase, the Commission Staff ("Staff") chose to perform a limited financial review of Willowcrest's operations for the test-period, the calendar year ending December 31, 1990. On September 26, 1991, Mark Frost of the Commission's Division of Rates and Tariffs obtained Willowcrest's canceled checks for the test period and requested copies of their accountant's workpapers and test-period invoices. This information was provided by November 13, 1991 and the limited review of Willowcrest's test-period operations was performed at the Commission's offices in Frankfort, Kentucky.

¹ Proposed Rate	\$ 26.18
Less: Current Rate	- 10.19
Requested Increase in Rate	<u>\$ 15.99</u>

\$ 15.99 x 136 Customers x 12 Months = \$26,096.

² \$26,096 + \$16,630 = 157%.

Mr. Frost is responsible for the preparation of this Staff Report except for Section B, Operating Revenues; Section D, Rate Design; and Appendix A, which were prepared by Nicky Moore of the Commission's Research Division. Based on the findings contained in this report, Staff recommends that Willowcrest be allowed to increase its annual revenues from sewer rates by \$12,954.

Scope

The scope of the review was limited to obtaining information as to whether the test-period operating revenues and expenses were representative of normal operations. Insignificant or immaterial discrepancies were not pursued and are not addressed herein.

Commentary

In conducting its limited field review, Staff normally analyzes test-period invoices in determining a utility's appropriate level of operating expenses. However, in this instance Willowcrest failed to retain all of its test-period invoices. Therefore, Staff relied upon Willowcrest's accountant's workpapers, available invoices, and canceled checks in determining Staff's recommended level of test-period expenses.

B. Analysis of Operating Revenues and Expenses

Operating Revenues

Willowcrest reported test year revenue of \$16,607.00. Its application indicates that, at the time of filing, it had 136 customers. This number of customers would generate \$16,630.08 in revenue annually at current rates, a difference of \$23.00 over actual test-period revenue collected.

Operating Expenses

In its application, Willowcrest reported actual operating expenses of \$26,339 for the test period. The following are Staff's recommended adjustments to Willowcrest's actual test-period operations:

Routine Maintenance Fee: Willowcrest proposed a pro forma level of routine maintenance fee expense of \$8,300, an increase of \$5,349 above its test-period level of \$2,941. Willowcrest employed a new operator in 1991 to comply with an agreement it has with the Cabinet for Human Resources and Environmental Protection Agency to improve the operation of its treatment facility. This adjustment reflects Willowcrest's estimate of its new operator's annual fee.

Willowcrest's operator is paid a flat rate of \$550 for working a minimum of 40 hours per month and \$9 per hour for any overtime in excess of the minimum hours. Staff determined that in the test period, Willowcrest's operator worked approximately 112 hours³ of overtime. Based on the flat rate of \$550 per month, 112 hours of test period overtime, and the current \$9 per hour

³ Test-Period Operator Fee	\$ 2,470
Flat Rate Paid in Test Period	- 1,800
Test-Period Overtime Pay	<u>\$ 670</u>

\$670 + \$6 Test-Period Hourly Rate = 112 Hours.

overtime rate, Willowcrest's routine maintenance fee expense would be \$7,608.⁴

Staff is of the opinion that a routine maintenance fee of \$7,608 is reasonable and therefore, has increased routine maintenance fee expense by \$4,667.

Miscellaneous Expense: Willowcrest reported miscellaneous expense of \$1,625 for the test period. Included in that amount were payments of \$1,300 in civil penalties assessed for various violations at Willowcrest's sewage treatment plant. It is the responsibility of management to insure Willowcrest's treatment plant is operated and conforms to the appropriate regulatory guidelines. Any fine or penalty assessed for Willowcrest's failure to meet the established guidelines should be borne by management and not Willowcrest's customers. In addition, these expenses should not be expected to recur in the future. Accordingly, Staff recommends that the civil penalties of \$1,300 be excluded for rate-making purposes.

Maintenance: Willowcrest reported test-period maintenance expense of \$11,963. Staff noted that Willowcrest misclassified numerous expenses. The following are items incorrectly classified in maintenance expense:

Testing - Kenviron	\$ 3,289
Chemicals - Kroger	\$ 901

⁴ Flat Fee	\$550 x 12 Months =	\$ 6,600
Overtime Hours	\$9 x 112 Hours =	+ 1,008
Routine Maintenance Fee		<u>\$ 7,608</u>

The incorrect classification of an expense will not affect the overall determination of Willowcrest's revenue requirement. However, reclassification or removal of these items will assist Staff in calculating other pro forma expense adjustments and have been addressed elsewhere in this report. Thus, Staff recommends that maintenance expense be reduced by \$4,190.⁵

Included in test-period maintenance expense is \$1,405⁶ in payments to various vendors for services performed in the previous year. Accordingly, Staff recommends that maintenance expense be decreased by \$1,405 to eliminate items that occurred outside the test period.

Based on its analysis of Willowcrest's available invoices, Staff determined that the following expenditures were capital in nature:

Associated Motor Control - Rebuild Effluent Pump	\$ 141
Associated Motor Control - Rebuild Starter	\$ 203
Robert M Green & Son - Replace Pipe at Treatment Plant	\$ 603

After consulting with the Commission's Engineering Division ("Engineering"), Staff determined that the pump and starter should be depreciated over a 3 year period, and the pipe replacement should be depreciated over a 5 year period. Thus, maintenance

⁵ \$3,289 Testing + \$901 Chemicals = \$4,190.

⁶

Arts Electric, Inc.	\$ 1,126
Associated Motor Control	147
Robert M. Green & Son	+ 132
Total Previous Years Expenditures	<u>\$ 1,405</u>

expense has been decreased by an additional \$947 and depreciation expense increased by \$236.⁷

A review of Willowcrest's canceled checks and accountant's workpapers revealed that maintenance expense included a payment of \$46 to the Shell Oil Company for gasoline and an oil change. Willowcrest does not own a vehicle nor does it report any other transportation expense, therefore, Staff recommends that maintenance expense be reduced by an additional \$46.

Based on the above recommended adjustments, maintenance expense has been reduced by \$6,588,⁸ and depreciation expense increased by \$236.

Testing: Willowcrest pays Kenvirons, Inc. a fee of \$100 per month for effluent testing required by the Division of Water. The annualization of this fee results in a normalized testing expense of \$1,200.⁹ During the test period, Kenvirons, Inc. also charged Willowcrest \$64 for its participation in the annual Commission inspection of Willowcrest's treatment plant. Accordingly, operating expenses have been increased by \$1,264.¹⁰

7	Effluent Pump	\$ 141	+ 3-Years	= \$ 47
	Starter	203	+ 3-Years	= 68
	Pipe Replacement	603	+ 5-Years	= 121
	Adjustments	<u>\$ 947</u>		<u>\$ 236</u>

8	Misclassified Expenses	\$ 4,190
	Previous Years Expenditures	1,405
	Capital Expenditures	947
	Car Expenditures	+ 46
	Recommended Adjustment	<u>\$ 6,588</u>

9 \$100 x 12-Months = \$1,200.

10 \$1,200 + \$64 = \$1,264.

Chemical: Willowcrest reported test-period chemical expense of \$901. During the test period, Willowcrest purchased liquid chlorine from Kroger to treat its effluent. Willowcrest did not preserve any of its Kroger invoices to document either the cost or amount of chlorine used during test period.

Willowcrest now treats its effluent with granular rather than liquid chlorine. Willowcrest estimated that it would use 200 pounds of granular chlorine in a 6 week period at a cost of \$236 and provided an invoice documenting that cost. Based on Willowcrest's estimated usage and documented cost, Staff has determined a chemical expense of \$2,028¹¹ and recommends that operating expenses be increased by this amount.

Administrative and General: Willowcrest reported test-period administrative salary expense of \$3,600, which represents the owner/manager fee Willowcrest paid Glen D. Purdy. In addition to being the sole stockholder of the company, Mr. Purdy also serves as general manager and is responsible for conducting the daily affairs of Willowcrest. The Commission's past practice has been to limit owner/manager fees to a maximum of \$2,400 per year. Accordingly, Staff recommends a decrease in administrative and general expense of \$1,200.

Interest: Willowcrest proposed a pro forma level of interest expense of \$3,933, an increase of \$2,045 above its test-period

¹¹ \$236 + 6-Weeks = \$39 Weekly Chemical Cost.
\$39 x 52-Weeks = \$2,028.

level of \$1,888. Willowcrest's proposed adjustment is based on the amount of outstanding debt at the time the application was prepared.

Willowcrest last filed for a rate increase on October 15, 1982;¹² since then Willowcrest contends that its operating expenses have increased by 30.5 percent while revenues have remained constant. For this reason, Willowcrest has continued to operate at a deficit and has borrowed \$35,500 from its owner, Mr. Purdy, to pay for its current operations.¹³

It is the responsibility of management to periodically review the financial condition of the utility and seek rate relief when conditions require. Willowcrest's admission that it continued to operate with "substantial" deficits and not seek rate relief in a timely manner, shows management failed to meet its responsibility. Since Willowcrest's indebtedness is the direct result of management's failure to act, interest expense associated with the debt should not be recovered from the ratepayers, but rather borne by its owner/manager. Furthermore, to allow Willowcrest to recover interest expense on debt incurred to pay past operating expenses would constitute retroactive rate-making, which the Commission has not allowed traditionally.

¹² Case No. 8680, Application of Willowcrest Development Corporation for an Adjustment of Rates Pursuant to the Alternative Procedure for Small Utilities, Order entered on January 27, 1983.

¹³ Exhibit D attached to the application.

Accordingly, Staff recommends that Willowcrest's adjustment be rejected and operating expense reduced by \$1,888, to reflect the elimination of interest expense.

Rate Case: Willowcrest proposed a pro forma level of rate case expense of \$300, based on amortizing its projected cost of preparing this rate case over a 3-year period. During the course of the field review, Staff advised Willowcrest that all pro forma adjustments must meet the rate-making criteria of being known and measurable, and must be supported by some form of documentation (e.g., invoice or contract.) Willowcrest was requested and failed to provide documentation to support its projected rate case cost. Therefore, Staff recommends that this adjustment be rejected.

Sludge Hauling: Willowcrest proposed a pro forma level of sludge hauling expense of \$3,240. This adjustment is based on Willowcrest's estimate that it will haul three loads of sludge per month at a cost of \$90 per load.

Willowcrest provided documentation showing that in the first 11 months of 1991 it hauled 15 loads of sludge, which results in an average of 1.4 loads per month. Staff determined that Willowcrest's pro forma sludge hauling expense will be \$1,530,¹⁴ based on the annualization of the monthly average and the current rate of \$90 per load.

¹⁴ 1.4 Loads x 12-Months = 17 Loads per Year.

17 Loads x \$90 = \$1,530.

After conferring with Engineering, Staff determined that it is reasonable to expect Willowcrest to haul 17 loads of sludge per year. Accordingly, test-period operating expenses have been increased by \$1,530.

Postage: Willowcrest proposed a pro forma level of postage expense of \$292, an increase of \$62 above its test-period level of \$230. In January 1991 the postage rate for second class mail increased from \$0.15 to \$0.19, which is the basis for this adjustment.

Based on the number of customers used to calculate Willowcrest's normalized operating revenue and the current second class postage rate of \$0.19, Staff has determined that Willowcrest's postage expense will be \$310.¹⁵ Accordingly, test-period postage expense has been increased by \$80.

Property Taxes: After reviewing the canceled checks and accountant's workpapers, Staff determined that Willowcrest paid property taxes of \$191 in the test-period. Willowcrest mistakenly excluded this expense from its application. To correct Willowcrest's mistake, Staff recommends that operating expenses be increased by \$191.

Amortization: Upon review of the test-period invoices, Staff noted that Kenvirons, Inc. billed Willowcrest \$2,025 for nonrecurring services. The services included participation in an administrative conference, preparing responses to the Division of

¹⁵ $\$0.19 \times 136 \text{ Customers} \times 12\text{-Months} = \$310.$

Water, and evaluation of permit exceedances. After consulting with Engineering, Staff determined that the cost of these services should be amortized over a 3-year period. Thus, operating expenses have been increased by \$675.¹⁶

Operations Summary

Based on the recommendations of Staff contained in this report, Willowcrest's operating statement would appear as set forth in Appendix B to this report.

C. Revenue Requirements Determination

The approach frequently used by this Commission to determine revenue requirements for small, privately-owned utilities is the operating ratio. This approach is used primarily when there is no basis for rate-of-return determination or the cost of the utility has fully or largely been recovered through the receipt of contributions. Staff recommends the use of this approach in determining Willowcrest's revenue requirement.

Staff adjusted operations provide Willowcrest with an operating ratio of 156.6 percent.¹⁷ Combined with Willowcrest's proposed increase of \$26,096, the result is an operating ratio of 60.93 percent.¹⁸

¹⁶ $\$2,025 + 3\text{-Years} = \$675.$

¹⁷

Pro Forma Operating Expenses	\$ 26,034
Normalized Operating Revenue	+ 16,630
Operating Ratio	<u>156.6%</u>

¹⁸ $\$26,034 + (\$16,630 + \$26,096) = 60.93\%.$

Staff is of the opinion that an 88 percent operating ratio would allow Willowcrest sufficient revenues to cover its operating expenses and to provide for future equity growth. An operating ratio of 88 percent results in a revenue requirement of \$29,584.¹⁹ Therefore, Staff recommends that Willowcrest be allowed to increase its annual operating revenue by \$12,954.²⁰

D. Rate Design

Under the existing rate schedule, all residential customers are paying a flat rate.


Using the existing rate design, Staff has developed a flat rate that will produce the revenue required to meet annual operating expenses. Therefore, Staff recommends that the schedule of rates in Appendix A be approved for services rendered.

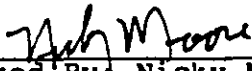
¹⁹ $\$26,034 + 88\% = \$29,584.$

²⁰

Revenue Requirement	\$ 29,584
Normalized Operating Revenue	- 16,630
Recommended Increase	<u>\$ 12,954</u>

E. Signatures


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APPENDIX A
TO STAFF REPORT CASE NO. 91-305

The Staff recommends the following rate be prescribed for customers of Willowcrest Development Corporation.

<u>Customer Class</u>	<u>Rates</u>
Residential	\$18.15

APPENDIX B

TO STAFF REPORT CASE NO. 91-305

	Actual Operations -----	Pro Forma Adjustments -----	Pro Forma Operations -----
Operating Revenues:			
Residential Flat Rate	\$ 16,607	\$ 23	\$ 16,630
Operating Expenses:			
Operating & Maint Exp:			
Routine Maintenance Fee	\$ 2,941	\$ 4,667	\$ 7,608
Utilities	2,609	0	2,609
Misc Supplies & Exp	1,625	(1,300)	325
Maintenance Expense	11,963	(6,588)	5,375
Testing Expense	0	1,264	1,264
Chemical Expense	0	2,028	2,028
Administrative & General Exp	3,600	(1,200)	2,400
Office Supplies Expense	547	0	547
Interest Expense	1,888	(1,888)	0
Rent Expense	936	0	936
Rate Case Expense	0	0	0
Sludge Hauling Expense	0	1,530	1,530
Postage Expense	230	80	310
	-----	-----	-----
Total Operation & Maint	\$ 26,339	\$ (1,407)	\$ 24,932
Depreciation Expense	0	236	236
Amortization Expense	0	675	675
Taxes Other Than Income Taxes	0	191	191
	-----	-----	-----
Total Operating Expenses	\$ 26,339	\$ (305)	\$ 26,034
	-----	-----	-----
Net Operating Income	\$ (9,732)	\$ 328	\$ (9,404)
	=====	=====	=====