

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE PETITION OF BLUEGRASS GAS SALES, INC.)	
FOR APPROVAL OF A CERTIFICATE OF CONVENIENCE)	
AND NECESSITY TO CONSTRUCT FACILITIES,)	CASE NO.
APPROVAL OF FINANCING, APPROVAL OF INITIAL)	94-433
RATES AND OPERATION OF A NATURAL GAS)	
DISTRIBUTION SYSTEM)	

O R D E R

On November 9, 1994, Bluegrass Gas Sales, Inc. ("Bluegrass") applied for authority to borrow \$147,500 from Transfinancial Bank of Glasgow, Kentucky, for a Certificate of Convenience and Necessity to construct certain natural gas distribution facilities located in Metcalfe, Barren, and Hart counties in Kentucky, for approval of initial rates, and for authority to operate a natural gas distribution system.

On October 6, 1995, the Commission entered an Interim Order in this proceeding approving the proposed financing and granting Bluegrass a Certificate of Convenience and Necessity to construct the proposed facilities. Bluegrass was further ordered to provide notice of its proposed rates to the 52 customers it was acquiring from Natural Gas of Kentucky ("Natural Gas"). On November 3, 1995, Bluegrass filed a copy of the notice which was mailed directly to those customers.

OPERATING REVENUES AND EXPENSES

In support of its proposed rates, Bluegrass submitted financial projections for its first 10 years of operation. The

Commission has reviewed the financial information and finds it to be acceptable subject to the following modifications.

The company projected a residential customer base of 125 in year one with 50 additional residential customers added in year two and another 75 residential customers in year three. Five commercial and industrial customers were projected in year one and beyond. The Commission accepts these projections and has determined that the sales revenues and operating expenses projected by the company in year three should be used as the basis for adjustments for rate-making purposes. Year three was chosen in order to reflect the full complement of customers Bluegrass estimates it will serve in addition to the operating costs Bluegrass estimates it will incur to serve those customers as a result of completing the construction approved as a part of this proceeding.

The cost of gas is set at Bluegrass's most recent gas cost projection of \$2.50 per Mcf for the commodity cost of gas. The transportation component of gas cost from Natural Gas has been suspended and is undergoing Commission review.¹ Thus, the rates approved herein do not contain a component for gas transportation. Bluegrass's proposed tariff contains a Gas Cost Adjustment ("GCA") clause which it may use to propose a transportation rate as part of its expected gas cost, as well as updating its commodity cost of gas. Bluegrass should make its GCA filing to avoid a notice period

¹ Case No. 95-547, The Tariff Filing of Natural Gas of Kentucky to Establish Distribution Transportation Service, Order entered December 8, 1995.

delay in passing through any rate subsequently approved for transportation service to be provided by Natural Gas.

Bluegrass has incurred \$27,600² in legal, accounting and engineering fees. The company proposed to amortize these costs to regulatory commission expense over a three year period. Included in these fees was \$9,752 for engineering costs related to the construction project. The Uniform System of Accounts for Natural Gas Utilities ("USoA") requires that amounts paid for work done by others for the company such as engineering costs associated with construction be allocated to the plant accounts in such a way as to ensure that each unit bears its equitable proportion of such costs.³ The Commission has proportionately allocated the engineering fees totalling \$9,752 over the depreciable utility plant account totals as shown in Appendix A to this Order.

The Commission believes the legal and accounting costs totalling \$17,848 included in the regulatory commission expense account should not be included in the operating expenses in one year. These expenses benefit more than one financial reporting period and should be recorded in Account No. 186, Miscellaneous Deferred Debit, and amortized to expense over a 10 year period in order to provide reasonable recovery of these costs. This results in an annual regulatory commission expense of \$1,785.

² Response to information requested by the Staff at an Informal Conference held on August 3, 1995.

³ Gas Plant Instruction No. 4, Uniform System of Accounts, Code of Federal Regulation, Parts 150 to 279 revised April 1, 1992, page 194.

Bluegrass proposed to depreciate meters and regulators over 30 years, distribution lines over 40 years, and measuring station equipment over 25 years.⁴ The Commission finds these depreciable lives to be within an acceptable range and has applied the corresponding depreciation rates to the plant account balances as reflected in Appendix A to this Order. This results in an annual depreciation expense of \$4,941.

Applying an interest rate of 10.5 percent, as approved in the Interim Order issued on October 6, 1995, to long-term debt of \$147,500 produces a normalized interest expense of \$15,488 to be included for ratemaking purposes.

RATE BASE

Bluegrass proposed a net investment rate base of \$162,138.75 at the end of the third year of operations when the utility estimates it will have attained 250 residential customers.⁵ This represents the total level of investment approved for the initial start up of the operations of Bluegrass. The Commission will approve a net investment rate base of \$183,238 based on 250 customers calculated as follows:

⁴ See notes to financial statements filed as Exhibit 8 to the responses to the February 22, 1995 Commission Order.

⁵ Response to Item 24, Exhibit 8, of the Commission's February 22, 1995 Order.

Utility Plant	\$183,972 ⁶
ADD: Working Capital	<u>4,207⁷</u>
SUBTOTAL:	\$188,179
LESS: Accumulated Depreciation	<u>4,941</u>
NET INVESTMENT RATE BASE	<u>\$183,238</u>

CAPITALIZATION

According to the August 9, 1995 filing, Bluegrass's capitalization consists of \$71,083 in common stock and long-term debt of \$110,531. This results in a total capitalization of \$181,614, calculated as follows:

	Test Year End Balance	Percentage of Total
Debt	\$110,531	61.00%
Common Equity	<u>71,083</u>	<u>39.00%</u>
Total	<u>\$181,614</u>	<u>100.00%</u>

In determining a reasonable rate of return on common equity the Commission has given consideration to the nature of Bluegrass's operations and its economic circumstances. The Commission has determined that a 12.0 percent rate of return on common equity is reasonable for Bluegrass under the current economic conditions.

⁶ \$170,000 depreciable plant
9,752 engineering costs
3,620 acquisition adjustment
600 start up costs
\$183,972 gross utility plant

⁷ Operating Expenses \$ 96,152
Less: Gas Purchases 62,500
Subtotal \$ 33,652
Working Capital (12.5% of total) *12.5%
Total Working Capital \$ 4,207

This results in an overall rate of return on capitalization of 11.09 percent, shown as follows:

	<u>Percentage</u>	<u>Cost</u>	<u>Overall Rate of Return</u>
Debt	61.00	10.50	6.41%
Common Equity	39.00	x 12.00	4.68%
Overall Return on Capitalization			<u>11.09%</u>

REVENUE REQUIREMENTS

The Commission has determined that Bluegrass's revenue requirements should be based on the allowed return on capital. The application of an 11.09 percent rate of return on Bluegrass's capitalization yields a net operating income of \$20,141. This approach, including an allowance of \$1,049 for state and federal income taxes and \$177 for the Public Service Commission assessment as shown in Appendix B, will require \$117,519 in total revenues. This level of revenues should allow Bluegrass to meet its operating expenses and provide for reasonable equity growth when the company is fully operational.

The utility's cost of service is based upon the full complement of residential customers (250), complete draw down of the debt, and completion of the construction. Based on the company's projections of its operations, and the modifications approved herein, the utility's pro-forma operating statement is as follows:

REVENUES		\$117,519
EXPENSES:		
NATURAL GAS PURCHASES	62,500	
OFFICE SUPPLIES	5,000	
OUTSIDE SERVICES	7,075	
PROPERTY INSURANCE	4,500	
EMPLOYEE PENSION/BENEFITS	874	
GENERAL ADVERTISING	500	
RENT	1,200	
TRANSPORTATION	2,400	
REGULATORY COMMISSION EXPENSE	1,785	
MISCELLANEOUS GENERAL EXPENSE	5,141	
INCOME TAXES	1,049	
PSC ASSESSMENT	177	
DEPRECIATION	4,941	
AMORTIZATION	236	
INTEREST EXPENSE	<u>15,488</u>	
TOTAL OPERATING EXPENSES		<u>112,866</u>
NET INCOME		<u>\$ 4,653</u>

RATE DESIGN

Bluegrass had proposed a flat rate per Mcf with a minimum bill equal to the cost of 1 Mcf. Using this rate design with the revenue requirements found reasonable herein, applied to 17,500 Mcf per year for residential service and 7,500 Mcf per year for commercial service, yields a rate of \$4.7008 per Mcf. This rate, which is also the minimum bill, includes gas cost of \$2.50 per Mcf.

The Commission, after considering the evidence of record and being otherwise sufficiently advised, finds that:

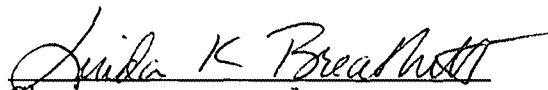
1. The rates proposed by Bluegrass will produce revenues in excess of those found reasonable herein and should be denied.
2. The rates in Appendix C approved herein are the fair, just, and reasonable rates for Bluegrass and will produce sufficient revenues to meet its reasonable operating expenses, and provide for future equity growth.


IT IS THEREFORE ORDERED that:

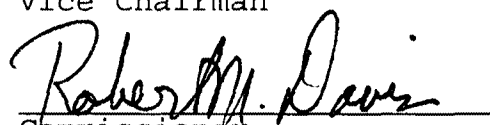
1. Bluegrass's proposed rates are denied.
2. The rates contained in Appendix C are approved for gas service rendered by Bluegrass on and after the date of this Order.
3. Within 30 days of the date of this Order, Bluegrass shall file with the Commission its revised tariffs setting out the rates approved herein.

Done at Frankfort, Kentucky, this 20th day of February, 1996.

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. 94-433 DATED FEBRUARY 20, 1996

	<u>CONSTRUCTION</u> <u>COST</u>	<u>ENGINEERING</u> <u>COST</u>	<u>CAPITALIZABLE</u> <u>COST</u>	<u>ASSET</u> <u>LIVES</u>	<u>ANNUAL</u> <u>DEPRE.</u> <u>EXPENSE</u>
METERS AND REGULATORS	\$ 29,675	1,792	31,467	30	1,049
DISTRIBUTION LINES	106,825	6,450	113,275	40	2,832
MEASURING STATION	25,000	1,510	26,510	25	1,060
RIGHT OF WAY	<u>8,500</u>	<u>0</u>	<u>8,500</u>	<u>0</u>	<u>0</u>
TOTAL	<u>\$170,000</u>	<u>\$9,752</u>	<u>\$179,752</u>		<u>\$4,941</u>

APPENDIX B

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TOTAL OPER. EXP. BEFORE TAXES, INT., AND PSC ASSESS.		\$ 96,152
TOTAL CAPITALIZATION	\$181,614	
RATE OF RETURN	<u>11.087%</u>	
REQUIRED OPERATING INCOME	20,141	
LESS: INTEREST EXPENSE	<u>15,488</u>	
TAXABLE INCOME	4,653	
ADD: TAX EXPENSE	<u>1,049¹</u>	
PRETAX INCOME AVAIL. FOR COMMON		5,702
INTEREST EXPENSE		15,488
PSC ASSESSMENT		<u>177</u>
TOTAL REVENUE REQUIREMENT		<u>\$117,519</u>

¹ TAX EXPENSE = (TAXABLE INCOME * GROSS-UP FACTOR) - TAXABLE INCOME.
TAX EXPENSE = (\$4,648 * 1.2254902) - \$4648 = \$1,048

* GROSS-UP FACTOR:

OPERATING REVENUES	1000.000000
LESS: PSC ASSESSMENT OF .001509	<u>1.509000</u>
NET INCOME BEFORE FED AND STATE INCOME TAX	998.491000
LESS STATE INCOME TAXES @ 4%	<u>39.939640</u>
NET INCOME BEFORE FED INCOME TAX	958.551360
LESS: FEDERAL INCOME TAX @ 15%	<u>143.768656</u>
NET INCOME	814.768656
GROSS-UP FACTOR	1.2254902
COMPOSITE TAX RATE	18.3%

APPENDIX C

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 94-433 DATED FEBRUARY 20, 1996

The following rates and charges are prescribed for the
customers in the area served by Bluegrass Gas Sales, Inc.

RATES:	Base Rate	Gas Cost Recovery Rate	Total
All Mcf (Minimum Bill)	\$2.2008	\$2.50	\$4.7008