COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF COW CREEK GAS, INC.	)	
FOR AN ADJUSTMENT OF RATES PURSUANT	)	CASE NO.
TO THE ALTERNATIVE RATE FILING	)	97-263
PROCEDURE FOR SMALL UTILITIES	)	

ORDER

On June 27, 1997, Cow Creek Gas, Inc. ("Cow Creek") filed its application for Commission approval of proposed gas rates. Commission Staff, having performed a limited financial review of Cow Creek's operations, has prepared the attached Staff Report containing Staff's findings and recommendations regarding the 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 10 days from the date of this Order.

IT IS THEREFORE ORDERED that all parties shall have no more than 10 days from the date of this Order, or 90 days after the date the application was filed, whichever is later, 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, this case will be submitted to the Commission for a decision.

Done at Frankfort, Kentucky, this 14th day of November, 1997.

ATTEST:

Executive Director

PUBLIC SERVICE COMMISSION

For the Commission

STAFF REPORT

ON

COW CREEK GAS, INC.

Case No. 97-263

A. Preface

On June 27, 1997, Cow Creek Gas, Inc. ("Cow Creek") filed an application for a rate adjustment pursuant to 807 KAR 5:076, the Alternative Rate Filing Procedure for Small Utilities ("ARF"). The rates proposed by Cow Creek, according to calculations incorrectly performed in its applications, would generate $4,811.50 in additional annual revenues or approximately 19 percent based on normalized test-year sales. In order to meet the minimum filing requirements for an ARF, a utility must have less than 500 customers and less than $300,000 in gross annual revenues. Cow Creek met the minimum requirements for an ARF filing.

The Commission Staff performed a limited financial review of Cow Creek's operations for the test year ending December 31, 1996. The Commission's objective was to reduce or eliminate the need for written data requests, decrease the time necessary to examine the application and, therefore, decrease the expense to the utility. Tammy Page and Leah Faulkner of the Commission's Division of Financial Analysis performed the staff review on August 20, 1997 at the office of John Allen, Jr. in Prestonsburg, Kentucky. Staff also had six telephone conferences with Barry Lucas, C.P.A. Mr. Lucas prepared the rate application. With the exception of the sections dealing with Normalized Revenues, Purchased Gas Expense, Tariffs, and Retail Rates, which were prepared by Ms. Faulkner, this report was prepared by Ms. Page.

Scope

The scope of the review was limited to obtaining information to determine that the operating expenses as reported in Cow Creek's application for the period ending December 31, 1996 were representative of normal operations, and to gather information to evaluate the pro forma adjustments proposed in Cow Creek's filing. Expenditures charged to test-year operations were reviewed, including any supporting invoices. Insignificant or immaterial discrepancies were not pursued and are not addressed herein.

B. Test-Year Restatements

Review Summary

The records supporting the financial statements contained in Cow Creek's application were the primary financial documents analyzed in this review. The account classifications used by Cow Creek to record its transactions and compile its financial statements are generally in conformity with the Uniform System of Accounts ("USoA") for gas utilities. Staff has adopted the financial statements supplied by Cow Creek for the year ended December 31, 1996 as the test period for rate-making purposes with the following modifications:

Organization Costs

When a corporation is formed, organization costs such as legal fees are incurred. In Case No. 94-321,[1] Leslie Oil and Gas Company ("Leslie Gas") and Cow Creek Gas, Inc. applied for approval to transfer the assets of Leslie Gas to Cow Creek. The transfer was approved by the Commission on January 6, 1995. Cow Creek had $5,450 in organization costs relating to the transfer. Staff informed Cow Creek that the attorney fees could either be capitalized or expensed as directed by their accountant. Cow Creek expensed $2,725, fifty percent of the cost in 1995. The remaining balance, $2,725, is being amortized over 20 years. The normal practice is to capitalize the costs and amortize it over the first few years of the company's existence. The organization costs primarily benefit the early years and should be amortized over a fairly short period. Staff recommends that the costs be amortized over 5 years. As a result of Staff's analysis, test-year actual amortization/depreciation expense has been restated to $936, which is an increase of $408 to the amount recorded by Cow Creek on the Income Statement. This adjustment has been included on Staff's restated Income Statement. The journal entries would be as follows:

406.00	Amortization of gas plant acquisition adjustment	408
110.00	Accumulated Provision for Depreciation, Depletion and Amortization	408

[1] Application of Elizabeth Stephens Bierbauer Attorney-In-Fact for D.C. Stephens, D/B/A Leslie Oil and Gas Company and Cow Creek Gas, Inc. for Approval of sale to Cow Creek, Inc. or 130 Hibbard, Pikeville, Kentucky, Pursuant to KRS 278.020(4), (5), Order dated January 6, 1995.

Accumulated Amortization

Because of the change in the amortization period for the organization costs, accumulated amortization will have to be restated. For the test year, Cow Creek reported $272 of accumulated depreciation/amortization relating to the organization costs. With the change in the amortization period, Accumulated Provision for Depreciation, Depletion and Amortization relating to the organization costs should have a balance of $1,090 for the test year. Therefore, the Accumulated Provision for Depreciation, Depletion and Amortization account should increase $818 to reflect the change. The Accumulated Provision for Depreciation, Depletion and Amortization account should reflect a balance at December 31, 1996 of $21,249. Staff has adjusted the Balance Sheet to reflect this total. The journal entries are:

216.00	Retained Earnings	410	
110.00	Accumulated Provision for Depreciation, Depletion and Amortization		410

Customer Deposits

During a telephone conversation, Mr. Allen stated the customer deposits on the balance sheet should be $700 and not $400 as previously reported by Mr. Lucas. Mr. Allen provided Staff with documentation that supports the $700 balance. Mr. Allen stated that he is unsure why Mr. Lucas reduced customer deposits to reflect a balance of $400. Staff has restated customer deposits on the balance sheet to reflect the new balance.

Cow Creek reported miscellaneous general expense of $257 for the test year. Upon review, Staff learned that this expense was customer deposit refunds. Mr. Lucas said that his journal entry at the end of the year was a debit to expense and a credit to the bank account and he believes that the correct journal entry would actually be the following:

480.00	Sales	xxx	
235.00	Customer Deposits		xxx
235.00	Customer Deposits	xxx	
131.00	Bank Account		xxx

Mr. Lucas is assuming that customer deposits are included in sales. If the customer deposits had been included in sales, the correct thing to do would be to reduce sales by a corresponding expense. Mr. Allen stated that customer deposits are not included in sales and is unsure why Mr. Lucas expensed the refunds. Since the customer deposits were not included in sales, the refunds are not an expense item and should not be included in the income statement. When a customer deposit is refunded it should be charged to Account No. 235, Customer Deposits. Staff proposes the following journal entry to correct customer deposits:

216.00	Retained Earnings	557	
235.00	Customer Deposits		557
235.00	Customer Deposits	257	
930.200	Miscellaneous General Expense		257

Retained Earnings

As a result of the adjustment made to the Accumulated Amortization account, the change in Amortization Expense and the change made to Customer Deposits and Miscellaneous General Expense, Retained Earnings has been adjusted to reflect the corrected balance.

These adjustments result in the following restated test-year Financial

Statements:

Cow Creek Gas, Inc.
Balance Sheet
For the Year Ended 12/31/96

	Per Annual Report	Staff Adjustments	Staff Restated Test-Year
Assets			
Utility Plant	$ 32,100	$ 0	$ 32,100
Less: Accumulated Provision for Depreciation, Depletion and Amortization	20,431	818	21,249
Net Utility Plant	11,669	818	10,851
Current Assets:			
Cash	586	0	586
Customer Accounts Receivable	1,932	0	1,932
Total Current Assets	2,518	0	2,518
Total Assets	$14,187	$ (818)	$ 13,369
Liabilities and Other Credits			
Proprietary Capital			
Common Stock	$ 1,000	$ 0	$ 1,000
Unappropriated Retained Earnings	(7,428)	(1,118)	(8,546)
Total Proprietary Capital	(6,428)	(1,118)	(7,546)
Long-Term Debt	17,080	0	17,088
Current and Accrued Liabilities:			
Accounts Payable	3,127	0	3,127
Customer Deposits	400	300	700
Total Current and Accrued Liabilities	3,527	300	3,827
Total Liabilities and Other Credits	14,187	(818)	13,369

Cow Creek Gas, Inc.
Income Statement
For The Year Ended 12/31/96

Accounts	Test-Year End Balances 12/31/96	Staff Test-Year Adjustments	Staff Restated Test-Year
Operating Revenues	$10,640	$ 0	$10,640
Operating Expenses:			
Natural Gas Purchases	$ 4,904	$ 0	$ 4,904
Salaries	0	0	0
Repairs	219	0	219
Accounting & Collecting	4,500	0	4,500
Office Supplies	77	0	77
Misc. General Expenses	257	(257)	0
Depreciation/Amortization	528	408	936
Taxes Other than Income	773	0	773
Total Operating Expenses	$11,258	$ 151	$11,409
Net Operating Income	$ (618)	$ (151)	$(769)
Other Income	0	0	0
Other Deductions	0	0	0
NET INCOME	$ (618)	$ (151)	$ (769)

Recommended Rate-Making Adjustments

Normalized Revenues

Cow Creek proposed normalized revenues of $9,640. It calculated this amount based on 1996 Annual Report revenues, including other revenues from its late payment penalty of $215, which it then weather normalized for expected warmer than normal weather. Its weather normalization, which represented a $1,000 adjustment to test year revenues, was unsupported and should be rejected. Normalized test year revenues should be calculated as follows:

Test year sales	1,978 Mcf
Current Rate	x $5.25 per Mcf
	$10,384.50
Plus:	
Incidents of 0 usage	118
Minimum bill	$5.25
	$619.50
Total revenues from sales	$11,004

In calculating its billing analysis, Cow Creek correctly applied current rates to sales volumes of 1,978 Mcf, but failed to include revenues from its minimum bill. The notice to customers included in its application as well as information obtained during the field review indicated that Cow Creek currently charges a minimum bill which is equal to its volumetric sales rate. Therefore, Cow Creek's normalized revenue for the test year should include the same incidents of 0 usage that it used for calculating its revenues at proposed rates in its billing analysis.

Total normalized revenue including $215 in other revenues is $11,219.

Purchased Gas Expense

Cow Creek proposed normalized purchased gas expense of $6,404, which reflected an anticipated increase in gas cost as well as past due purchase expense. Cow Creek provided a copy of a gas purchase contract with its supplier, Interstate Natural Gas, showing a charge of $2.60 per Mcf for gas purchased effective October 1, 1997.

Cow Creek's test year normalized purchased gas expense should be calculated by multiplying test year sales of 1,978 Mcf by the new purchased gas cost rate of $2.60, and adjusting for one percent line loss. (Cow Creek simply assumed sales equal to purchases because of its supplier's inability to adequately meter purchases.) The resulting purchased gas expense is $5,194.

Tariffs

Cow Creek currently has no tariffs on file. It provided a proposed tariff sheet showing its proposed $7.25 per Mcf rate, as well as service charges as follows:

10% late payment penalty
$35 reconnection fee for nonpayment
$25 transfer service charge
$15 collection fee for delinquent bills
$20 returned check fee

The 10% late payment penalty is the only special charge indicated in the application or during the course of the field review that Cow Creek has been charging. Cow Creek should re-file its tariff reflecting the rate ultimately approved in the Commission's Order in this proceeding, and should include in that tariff only the additional charges that the company used during the test year. Cow Creek has not indicated anywhere in its application or during the field review that it proposed to establish new special charges, and should not be allowed to do so absent cost support showing the reasonableness of the charges.

Cow Creek's tariff, when it is filed, should also reflect all information required by Commission regulations, with particular attention being given to 807 KAR 5:006.

Operating Expenses

Cow Creek proposed 2 adjustments: an increase in salaries of $2,000 and an increase of $500 to repairs.

Salaries

Administrative and General Salaries, Account No. 920. The salaries proposed by Cow Creek in the amount of $2,000 are to be paid to the two shareholders, Jerome Kanney and Dennis Rohrer. For the test year, Cow Creek did not pay any administrative and general salaries. Mr. Lucas stated that he does not know how the $2,000 increase was determined, but for tax purposes, even though the shareholder's share of S corporation taxable income is not subject to self employment tax, if the shareholder performs services for the corporation, the shareholder must be paid a reasonable wage. Given the amount of time required to manage a company of this size, Staff believes that an increase of $2,000 is acceptable.

Repairs

Maintenance of Plant, Account No. 769. Cow Creek has proposed an increase to repairs of $500. Cow Creek is replacing meters and working on some line problems that are expected to recur in the future. Therefore, Staff believes that the adjustment is appropriate.

Other Long-Term Debt

Other Long-Term Debt, Account No. 224. Cow Creek has Other Long-Term Debt in the amount of $17,088. The shareholders, Jerome Kanney and Dennis Rohrer, provided the money to purchase Cow Creek. Cow Creek is not paying the loan back at the present time and the shareholders do not expect any type of repayment any time soon. Cow Creek is not calculating interest expense on the loan. Staff realizes that Cow Creek is trying to keep the expenses to a bare minimum, however, rates should reflect all legitimate costs including interest expense. The circumstances surrounding this loan cause Staff to question whether this is properly classified as debt. Staff encourages Cow Creek to evaluate whether the debt should be reclassified as a shareholders' contribution to equity.

Based on the recommendations proposed in this Staff Report, Cow Creek's adjusted operations are as follows:

Accounts	Cow Creek's Test-Year	Staff Proposed Adjustments	Staff Adjusted Balances
Operating Revenues	$10,640	579	$11,219
Operating Expenses:			
Natural Gas Purchases	$ 4,904	$ 290	$ 5,194
Salaries	0	2,000	2,000
Repairs	219	500	719
Accounting & Collecting	4,500	0	4,500
Office Supplies	77	0	77
Misc. General Expenses	0	0	0
Depreciation/Amortization	936	0	936
Taxes Other than Income	773	0	773
Total Operating Expenses	$11,409	$ 2,790	$14,199
Net Operating Income	$ (769)	$(2,211)	($2,980)
Other Income	0	0	0
Other Deductions	0	0	0
Other Interest Expense			
NET INCOME	$ (769)	$ (2,211)	($ 2,980)

C. Revenue Requirements

Cow Creek did not calculate a proposed rate of return based on capital or rate base, or by use of the operating ratio method. The operating ratio method is used primarily when there is no sound basis for a rate of return determination using the required return on capital and/or rate base method. In order for the rate of return on equity to be conceptually valid, capitalization must be closely supported by rate base. Cow Creek's proprietary capital consists of common stock of $1,000 and unappropriated retained earnings of $(7,428). Net investment rate base for Cow Creek is $12,456. Therefore, since the capitalization is not a valid basis to determine the appropriate level of earnings, Staff believes that the operating ratio method should be used to determine revenue requirements.

Applying the 88 percent operating ratio to the Staff adjusted operating expenses, less purchased gas expense, results in a total revenue requirement of $15,427 which will require an increase in annual revenues of $4,208 before adjustments for the Public Service Commission assessment. Cow Creek did not propose an adjustment for the annual assessment, however, Staff has calculated this expense by applying the 1997 assessment rate of .0014720 to the recommended increase of $4,208 and determined that an additional $6 of expense should be recorded in Taxes Other than Income Taxes.

This additional adjustment results in a total recommended revenue increase of $4,214. This increase should allow Cow Creek to meet its operating expenses, and provide for reasonable equity growth. Therefore, Staff recommends an increase in operating revenue of $4,214.

The calculation of the total increase is shown below:

Total Operating Expenses	$14,199
Less: Purchased Gas	5,194
Subtotal	$ 9,005
Operating Ratio	.88
Subtotal	$10,233
Add: Purchased Gas	$ 5,194
Revenue Requirement	$15,427
Normalized Revenues	11,219
Subtotal	$ 4,208
Additional PSC Assessment	6
Increase Required	$ 4,214

Rates

Based on the recommended revenue requirement of $15,427, other revenues of $215, and Cow Creek's current and proposed rate structure, the following rates are recommended:

Minimum Bill	$7.26
All Mcf	$7.26

D. Signatures

Tammy Page

Prepared By: Tammy Page
Public Utility Financial
Analyst, Chief
Electric and Gas Revenue
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Leah Faulkner

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