

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF ORCHARD GRASS)	
UTILITIES, INC. FOR A RATE ADJUSTMENT)	CASE NO.
PURSUANT TO THE ALTERNATIVE RATE)	97-458
FILING PROCEDURE FOR SMALL UTILITIES)	

ORDER

Orchard Grass Utilities, Inc. ("Orchard Grass") has applied for Commission approval of a proposed increase in its rates for sewer service. Orchard Grass proposes rates that would generate additional annual revenues of \$54,932, an increase of 87 percent. By this Order, the Commission denies the proposed rate adjustment and establishes new rates that will generate additional annual revenues of \$14,226, an increase of 19.7 percent over existing rates.

Procedure

On December 10, 1997, Orchard Grass applied pursuant to Administrative Regulation 807 KAR 5:076 for a rate adjustment. The City of Orchard Grass Hills, Kentucky ("the City") intervened in this matter. After conducting a limited review of Orchard Grass's financial records, Commission Staff on June 24, 1998, issued a report in which it recommended a \$14,227 increase in the utility's annual operating revenues for sewer service. Orchard Grass subsequently requested an informal conference to discuss the Commission Staff Report.

Following the conference, which was held on July 28, 1998, Orchard Grass submitted specific objections to Commission Staff's findings and recommendations. On

August 17, 1998, Commission Staff responded to these objections and amended certain portions of its report. On August 24, 1998, Orchard Grass submitted a written reply to these amendments. The City has voiced no objections to Commission Staff's findings and recommendations. Pursuant to the Commission's Order of August 20, 1998, this case stood submitted for decision on August 30, 1998, when no party requested a hearing in this matter.

Discussion

As the parties to this case have accepted most of Commission Staff's findings and recommendations, the Commission addresses in this Order only those issues in dispute.

Owner-Manager Fee

During the test period,¹ Orchard Grass paid its owner and president, Carroll Cogan, a management fee of \$10,000. Commission Staff found a reasonable management fee to be \$3,600 and recommended that \$6,400 of this expense be disallowed for rate-making purposes. Commission Staff reasoned that, given Orchard Grass's relatively small size,² it required minimal attention from its owner. It noted, moreover, that contractors perform Orchard Grass's primary operations – routine and non-routine maintenance, billing and collection, bookkeeping, and sludge hauling.

Orchard Grass contends that the recommended fee of \$3,600 is inadequate. Such fee, it contends, fails to adequately compensate its owner for the duties and

¹ The test period for determining Orchard Grass's revenue requirements was Calendar Year 1996.

² Orchard Grass had only 335 customers during the test period.

liabilities inherent in the operation of a sewage treatment plant. It further contends that the recommended fee fails to reflect the skills and experience that its owner brings to the utility.

The Commission finds little merit in Orchard Grass's argument. The primary purpose of the management fee is to compensate the management for duties performed for the utility. In the case at bar, the owner's duties are limited and his involvement in day-to-day operations is not significant. As contractors perform the bulk of the utility's operations, and as the utility's owner is compensated through utility earnings, we find the management fee of \$10,000 to be unreasonable and that a management fee of \$3,600 should be used for rate-making purposes.

Routine Maintenance Fee

Orchard Grass proposes to increase its test year routine maintenance expense of \$7,800 by \$4,380 to reflect a proposed contract change with Jefferson Environmental Services, Inc. ("Jefferson Environmental"). During the test period, Jefferson Environmental provided routine maintenance services at a monthly fee of \$650. Under the proposed contract, Jefferson Environmental, in addition to performing its present maintenance services, would perform a second daily inspection of the Orchard Grass sewage treatment plant and would also perform a weekly "supervisor" inspection. Orchard Grass contends that these additional inspections are required to ensure the proper performance of its sewage treatment plant and to ensure that inspectors whom Jefferson Environmental retains are properly maintaining the sewage treatment plant.

Commission Staff recommended the proposed adjustment be rejected and that the monthly expense be limited to \$625. It noted that transactions between Jefferson Environmental and Orchard Grass were related party transactions. Orchard Grass's owner, Carroll Cogan, is the father of one of Jefferson Environmental's principal owners.³ It further noted that Jefferson Environmental provides maintenance services to four of Mr. Cogan's sewer utilities and that these sewer utilities are of comparable size.⁴ In each instance, Jefferson Environmental charges a different maintenance fee. Commission Staff recommended that, in the absence of any explanation for the differing fees, the lowest monthly fee of \$625 should be used.

After reviewing the record, the Commission finds no reasonable explanation for the increased inspections. Orchard Grass has not pointed to any regulatory or statutory requirement for increased inspections nor has it articulated any significant benefit to accrue from these inspections. Moreover, the Commission finds no reasonable basis for ratepayers to bear additional costs to ensure that Jefferson Environmental's contract inspectors are properly performing their duties. We concur with Commission Staff's recommendation and include a monthly routine maintenance fee of only \$625 in Orchard Grass's revenue requirements.

³ Martin Cogan is the son of Carroll Cogan and is a principal shareholder of Jefferson Environmental. Martin Cogan is also vice-president of Orchard Hills.

⁴ These utilities are Hayfield Utilities, Orchard Grass Utilities (Willow Creek Sewer System), Orchard Grass Utilities (Orchard Grass Hills), and Farmdale Development Corporation.

Legal Fees

Orchard Grass reported test year legal fees of \$2,075. The support billing invoices fail to indicate the nature or subject matter of the expense. Unable to verify the nature of the expenses or to determine if they resulted from reasonable business practices, Commission Staff recommended that these expenses be disallowed. The utility, though objecting to the recommendation, has failed to provide any evidence to refute Commission Staff's recommendation. Given the lack of supporting evidence, the Commission finds that these fees should not be considered in determining the utility's revenue requirements.

Outside Services Employed – Other Consulting Fees

During the test period, Orchard Grass paid a monthly fee of \$150 to Martin and Associates, Inc. to serve as a liaison between the utility and state environmental regulators and to file monthly discharge monitoring reports. Martin and Associates' primary service was to transfer information from the utility's discharge monitoring reports, which Beckmar Laboratory prepares, to an electronic spreadsheet. Martin Cogan, Carroll Cogan's son and vice-president of Orchard Grass, is the principal shareholder and owner of Martin and Associates and directly provided these services.

The Commission finds that these fees involve transactions between related parties and that Orchard Grass must demonstrate that these fees were reasonable and prudent business expenses. It has failed to do so. The owner-manager's primary responsibility is to deal with state environmental regulators. The owner management fee serves as reasonable compensation for such duties. Orchard Grass has failed to

demonstrate that its owner-manager could not provide these services or that the fees were reasonable. Accordingly, the Commission finds that such fees should not be included in the calculation of Orchard Grass's revenue requirements.

Depreciation

Orchard Grass proposed to increase test year depreciation expense by \$2,009 to include the depreciation of a Purestream comminutor over a 5-year period. The utility reportedly purchased the comminutor from Jefferson Environmental at a cost of \$10,045. Jefferson Environmental originally purchased the comminutor at a price of \$8,067 and then charged an additional amount to the utility to cover sales tax and overhead.

The Commission finds that the proposed depreciation expense should be based on the actual price of the comminutor plus any sales tax. Under the terms of Orchard Grass's routine maintenance contract with Jefferson Environmental, all parts and materials in excess of \$150 must be invoiced directly to Orchard Grass. Jefferson Environmental, therefore, should have only billed Orchard Grass \$8,635⁵ for the comminutor. The Commission further finds that, assuming arguendo that this contract provision did not exist, the transaction between Orchard Grass and Jefferson Environmental was not an arm's length transaction, did not reflect the fair market value of the equipment, and the amounts charged in excess of Jefferson Environmental's purchase price should be disallowed for rate-making purposes.

⁵ Purchase Price (\$8,067) + Sales Tax (\$568) = \$8,635. Based upon a service life of 5 years, total depreciation expense for this item is \$1,727.

Interest Expense

Orchard Grass proposed to include in its revenue requirements \$1,932 of interest on a 3-year \$40,000 loan. The proceeds of this loan were used to finance operating expenses and the purchases of two blowers and a comminator. The Commission finds that none of this interest expense should be included in determining Orchard Grass's revenue requirements. Permitting recovery of this expense would effectively require Orchard Grass's current customers to pay for utility services already provided and would constitute retroactive rate-making. The remaining interest expense related to the proceeds used for small capital expenditures could have been financed from internal funds had the utility exercised reasonable cash management practices.

Conclusion

Having considered the evidence of record and being otherwise sufficiently advised, the Commission finds that:

1. The findings and recommendations contained in the Commission Staff Report, except those that directly conflict with the Commission's findings herein, are supported by substantial evidence, are reasonable, and should be adopted as the findings of the Commission.

2. Orchard Grass's total annual operating expenses, as set forth in Table I, are \$77,549.20.

TABLE I

OPERATING EXPENSES	
Management Fee	\$ 3,600.00
Sludge Hauling	9,214.00
Utility Service – Water Cost	3,681.00
Other – Labor	8,320.00
Fuel and Power	13,920.00
Chemicals	3,480.00
Routine Maintenance Fee	7,500.00
Maintenance of Collection System	2,738.00
Maintenance of Treatment Plant	12,548.00
Maintenance of Other Facilities	505.00
Agency Collection Fee	2,584.00
Office Supplies	225.00
Outside Services Employed	3,053.00
Insurance Expense	736.00
Regulatory Commission Expense	340.00
Transportation Expenses	0
Miscellaneous Expenses	693.20
Rents	600.00
Depreciation	2,242.00
Amortization	417.00
Taxes other than Income Taxes	<u>1,153.00</u>
Total Operating Expenses	\$77,549.20

3. Using an 88 percent operating ratio, Orchard Grass's revenue requirements are \$88,124.⁶

4. The rates in the Appendix to this Order are the fair, just and reasonable rates for Orchard Grass and will produce gross annual revenues of \$88,124 for sewer service. These rates will allow Orchard Grass sufficient revenues to meet its operating expenses, and provide for future equity growth.

5. The rates proposed by Orchard Grass will produce revenue in excess of that found reasonable herein and should be denied.

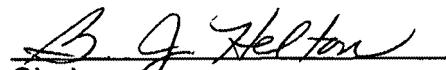
⁶ \$77,549.20 ÷ .88 = \$88,124.

IT IS THEREFORE ORDERED that:

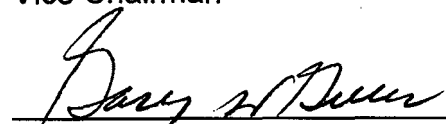
1. The findings contained in the Commission Staff Report, except those that directly conflict with the Commission's findings herein, are adopted and incorporated by reference into this Order as if fully set out herein.
2. The rates proposed by Orchard Grass in its application are denied.
3. Within 30 days of the date of this Order, Orchard Grass shall file with the Commission revised tariff sheets setting out the rates approved herein.

Done at Frankfort, Kentucky, this 9th day of October, 1998.

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. 97-458 DATED 10/9/98

The following rates and charges are prescribed for the customers in the area served by Orchard Grass Utilities, Inc. All other rates and charges not specifically stated herein shall remain the same as those in effect under authority of the Commission prior to the effective date of this order.

Single Family Residential	\$15.59 per Month
Rest Areas	\$15.59 per Residential Equivalent ¹

¹ The residential equivalent for each rest area has been set at 9,000 gallons per month.