COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN ADJUSTMENT OF RATES OF EAST KENTUCKY UTILITIES, INC.	)) CASE NO. 98-280

ORDER

On June 17, 1998, the Commission accepted for filing an application from East Kentucky Utilities, Inc. ("East Kentucky") requesting a 26.28 percent increase in its rates for gas service. East Kentucky proposed a revenue requirement of $898,291; an increase of $167,590 over test year normalized revenues of $730,701. On July 14, 1998, the Attorney General ("AG") filed a motion to intervene that was granted by the Commission.

To determine the reasonableness of the proposed rates, the Commission set a public hearing to be held October 14, 1998. The AG participated in the hearing.

At the conclusion of the hearing, following responses to all requests for information, and the submission of briefs by both parties, the matter was submitted to the Commission for final determination.

BACKGROUND

East Kentucky is a nonprofit corporation established to lease and operate the Floyd County gas distribution system. The system serves approximately 1,140 customers.

TEST PERIOD

East Kentucky proposed and the Commission has adopted the 12-month period ending February 28, 1998 as the test period for determining the reasonableness of proposed rates. Adjustments, where proper and reasonable, have been included to more clearly reflect current operating conditions.

REVENUES AND EXPENSES

The Commission has accepted the proposals included in East Kentucky's application with the following modifications:

Purchased Gas Expense

A 6.84 percent line loss was reported for the test period. When determining rates, it is the Commission's general practice to disallow the cost of gas for line loss in excess of 5 percent. Consequently, purchased gas expense will be reduced by $6,506.

The loss of gas creates a potential health and safety hazard and is within the sole control of East Kentucky. Gas utilities must be vigilant in conducting leak surveys and performing needed maintenance to insure that line losses do not exceed 5 percent. East Kentucky reported performing an annual leak survey and indicated that a timing difference in meter reading dates between the supplier and East Kentucky may indicate a higher line loss than actually experienced. Due to the health and safety concerns East Kentucky should be extremely vigilant in reducing the line loss. Within 90 days of the date of this Order, East Kentucky should provide a plan to minimize its line loss.

Salary Expense

East Kentucky proposed adjustments to payroll expense recorded in the following accounts: mains and services labor, accounts supplies and expenses, and administrative and general salaries. A portion of the salary paid to John Allen, Jr. was recorded in the outside services account; however, no adjustment to that account was proposed. East

Kentucky's adjustment to payroll accounts normalized a 3.28 percent pay increase that took effect July 1, 1997. Payroll expenses will be normalized for the test period pay increase.

The increase also reflected 8 months of a July 1, 1998 increase to salaries of 1.73 percent. The applicant requested and is using a historical test period normalized for changes that occurred during the test year. If operating expenses are to be adjusted for changes that occur four months beyond the end of the test year, the matching principle would require adjusting revenues for known changes to insure proper matching of revenues and expenses. Since East Kentucky did not propose adjustments to revenues and other expense accounts for out-of-period changes, the proposed adjustment to reflect the July 1, 1998 salary increase will be disallowed.

Four members of the Allen family that are described as full-time employees of East Kentucky also work for one or more other entities. David Allen, the utility's president, serves as Floyd County Treasurer and is the bookkeeper for Allen Rentals, Inc. According to its annual report, he is also the vice-president of Mountain Utilities, Inc. ("Mountain"), a company co-owned by John Allen, Jr., although he receives no salary from Mountain. Considering the numerous positions held by David Allen, East Kentucky has not provided sufficient, credible evidence to convince the Commission that he works full-time for East Kentucky. For a less than full-time employee, David Allen's test year salary of $45,782 certainly appears to be excessive.

Barbara Allen, John Allen, Jr., and Mary Leslie also work for Mountain. According to Mountain's 1997 annual report, all of its employees are full-time although David Allen testified that Barbara, John and Mary are part-time employees of Mountain. Mountain's annual report identified John as president at a salary of $31,522. John also runs Computer & Utility Services, Inc. and Allen Building, Inc. and owns Tax Consulting, Inc. During the test year, East Kentucky paid Barbara Allen $22,678, John Allen, Jr. was paid $16,112, and Mary Leslie received $15,323. David Allen testified he does not know how many hours per week these individuals work for East Kentucky or Mountain. He said there is no attempt to allocate their time between the two companies and they have never tracked their time for even a week. Without time records or other reliable information regarding the method of allocating time and wage expense between the related companies, it is impossible for the Commission to determine how much of the employees' time is spent working for East Kentucky and whether the payroll expense reported by East Kentucky is fair and reasonable.

Based on the evidence in the record regarding multiple employers and the lack of evidence documenting the amount of time devoted to East Kentucky, the Commission will allow for ratemaking purposes 75 percent of the normalized test year salaries for David Allen, Barbara Allen, John Allen, Jr., and Mary Leslie. The related payroll expenses will also be adjusted to reflect the authorized salary level. In view of East Kentucky's status as a nonprofit corporation, the bonus of $250 paid to all full-time employees will also be eliminated for rate-making purposes. Any funds remaining after paying expenses should be used for the benefit of the utility and its ratepayers, rather than paying gratuitous bonuses to employees. The total adjustment to test year payroll is a reduction of $24,693.56.

In future rate cases, East Kentucky must provide a basis for its method of establishing employee salary levels if it seeks full rate recovery of payroll expenses. In addition, it must provide documentation of a logical allocation of time and payroll expense between East Kentucky and the other companies owned by Allen family members. Time records or a time study would be a part of this documentation.

Outside Services

East Kentucky proposed no changes to this account. During his testimony, David Allen advised that the services previously provided by Mike Spears, CPA are now being provided by an employee, John Allen, Jr. The amount of $2,604.76 paid to Mr. Spears in fees during the test year will be removed from operating expenses to more clearly reflect current operations.

Employee Benefits

East Kentucky proposed to normalize health insurance expense for an increase that took effect December 1997. The company provides health insurance to 5 employees at no cost to the employee. David Allen is one of the employees receiving this benefit.

The Staff Report in the previous rate case, Case No. 90-002,[1] recommended denial of East Kentucky's proposal to shift the cost of David and Barbara Allen's health insurance to the utility. At that time, Mr. Allen had family plan coverage provided by Floyd County Government as a benefit of his position as County Treasurer. East Kentucky stated that the insurance coverage should be provided by the utility since he was a full-time employee

[1] Case No. 90-002, The Application Of East Kentucky Utilities, Inc. For Adjustment Of Rates, For Changes In Rules And Regulations And Approval In Indebtedness Pursuant To 278.300

whereas his position with the county was part-time. Staff held that East Kentucky should be making efforts to provide service at the lowest costs possible; and, since there was no threat of Mr. Allen losing his coverage through the county, the proposal was rejected.

Mr. Allen continues to serve as County Treasurer and is still eligible to obtain coverage through the county. In response to a data request, East Kentucky reported that coverage is now provided by the utility because the coverage under the county plan decreased and the premiums increased. The company said it would be unfair for David to have less favorable coverage than that of the other employees of East Kentucky. The Commission is of the opinion that East Kentucky should not be bearing the cost of Mr. Allen's insurance coverage since he is eligible to obtain coverage through the County and is affiliated with at least two other related party companies that should be sharing in the cost of coverage. Therefore, the cost of coverage for Mr. Allen will be disallowed. The type of documentation that will be required in future rate cases for recovery of shared costs is discussed in a subsequent section title Related Party Transactions.

Eliminating coverage for David Allen will reduce the proposed health insurance coverage by $2,518.32. The health insurance premiums for the remaining employees will be normalized for the increase that took effect during the test year. The expense for retirement benefits will be normalized for the changes to salary discussed earlier. The test year contribution rate of 8.65 percent was used in calculating the adjustment to retirement benefits. The total adjustment reduces employee benefits by $3,041.51.

Transportation Expenses

Test year expenses included the cost of leasing 4 trucks (two 1990s, a 1994, and a 1998) for $1,010.00 per month from Computer & Utility Services, Inc., a company co-owned by East Kentucky's president. There are no written lease agreements.

The staff report in the previous rate case determined that it would be economically advantageous to purchase rather than lease vehicles at the prices in effect at that time. The report directed East Kentucky to document the costs/benefits of leasing rather than purchasing before renewing or entering any new lease agreements. Over 8 years have passed since that time and East Kentucky renewed its lease to the extent of adding two new trucks, one in 1994 and one in 1998.

No evidence was presented by East Kentucky in this case to show that leasing is more economical than purchasing. East Kentucky's only evidence was a bid from a dealership to lease a 1998 truck. Although East Kentucky did not analyze its truck purchase options, the issue was pursued by the AG.

If East Kentucky had implemented a program to purchase its vehicles immediately following the last rate case, the two older vehicles would have been paid off prior to the test year and East Kentucky would have been making payments on only the 1994 and 1998 vehicles. Using the assumptions proposed by the AG during the hearing of no down payment, a 5-year term, and a 9 percent interest rate, the normalized test year cost of purchasing the vehicles would be $8,257.92. This analysis demonstrates that East

Kentucky's test year vehicle cost for the purchase alternative would have resulted in a savings of $3,862.08 over the lease alternative.[2]

Thus, the record evidence once again persuades the Commission that purchasing vehicles would have been less costly than acquiring two new vehicles under lease. East Kentucky will be allowed a normalized cost equal to the cost of purchasing the 1994 and 1998 vehicles that are currently being leased. This will reduce transportation expense by $3,862.08.

Payroll and Other Taxes

The company proposed adjusting payroll taxes to reflect the salary increases requested. Payroll taxes will be reduced by $1,242.98 to properly reflect the effect of changes made to salary levels discussed previously.

Test year expenses also included payments totaling $1,241.82 for city occupational tax. This is a payroll tax that should be withheld from the employees' wages and remitted to the taxing authority. This is not an expense of the utility and will be deducted from test year expenses.

Rate Case Expense

East Kentucky did not propose an adjustment to recognize rate case expense. In response to a data request, updated information on rate case expense was filed. In its

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[2] Description	Purchase Price	Monthly Payment	Annual Payments
1994 ½ ton	$15,088.68	$313.22	$3,758.64
1998 ½ ton	$18,062.00	$374.94	4,499.28
Annual payments to purchase 1994 and 1998 trucks			8,257.92
Test year leasing expense ($1,010 X 12)			12,120.00
Difference			$3,862.08

brief, East Kentucky suggested a 3-year amortization period that the Commission finds is reasonable. Utilizing the invoiced expenses filed in its data response, the Commission will increase expenses by $1,860.49 to reflect the cost of processing this case. While East Kentucky's brief proposed a higher level of rate case expenses, no invoices or other documentation were filed to support that higher level.

Related Party Transactions

In addition to the vehicle leasing arrangement, East Kentucky also leases an office, a shop, land, a computer, and software from three companies owned by David Allen and his 5 siblings. The AG requested that the company be required to adopt a code of conduct that would govern transactions with related parties and require competitive bidding. While the Commission will not order adoption of a code of conduct in this case, East Kentucky is advised that in future cases it must provide objective evidence to justify the reasonableness of all transactions with related parties.

There was little evidence in this proceeding to support many of the costs that were shared between East Kentucky and the business owned by related parties. In future rate proceedings the Commission will require detailed documentation of all direct and indirect costs that are incurred jointly with related parties as well as costs related to transactions between East Kentucky and related parties. In order to support costs associated with transactions between related parties East Kentucky may be required to produce financial information from the books and records of the related party. East Kentucky will also be required to show through appropriate cost allocation procedures that any shared costs, including payroll costs of employees that work for East Kentucky and other entities, are properly allocated.

Therefore, test period operations have been adjusted to produce the following results:

	Reported Test Period	Adjustments	Adjusted Test Period
Operating Revenues	$ 742,710.57	$ (12,009.49)	$ 730,701.08
Operating Expenses	802,037.75	(111,851.05)	690,186.70
Net Operating Income	$ (59,327.18)	$ 99,841.56	$ 40,514.38

REVENUE REQUIREMENTS

East Kentucky proposed that its increase be calculated using the procedure utilized in the settlement agreement in its previous rate case. Using this method, operating expenses of $737,023, plus debt service coverage of $108,153, less depreciation of $36,714, were divided by .90, resulting in a revenue requirement of $898,291. East Kentucky calculated its debt service coverage based on the bond and principal interest payments due in 1998 and a monthly contribution to the depreciation fund of $2,084.

The .90 gross-up factor used in the previous case was based on a requirement of East Kentucky's 1979 bond issue to place 10 percent of income and revenues, less the payments required for the sinking fund, into a depreciation fund. The company is no longer subject to that requirement since the 1979 bonds were refinanced in 1991.

East Kentucky's current bond issue requires a coverage of 130 percent of the maximum debt service payments due in any remaining year of the life of the bonds and specifies that depreciation should be excluded in determining net revenues. The

Commission considers this a reasonable method for calculating revenue requirements for this nonprofit corporation. The Commission notes that the monthly contribution to the depreciation fund of $2,084 included in East Kentucky's computation was required by the 1991 bond issue, but the minimum balance required for the depreciation fund has been accumulated. Therefore, monthly deposits to the depreciation fund are no longer required and are not being made according to East Kentucky.

The increase in operating revenues will be calculated as follows:

Adjusted Operating Expenses	$690,186.70
130% X Debt Service Coverage	
(130% X $85,928.35)	111,706.86
Depreciation	(36,714.00)
Other Gas Revenues[3]	(93,085.54)
Increase in PSC Assessment	63.00
Total Revenue Requirement from Gas Service	672,157.02
Normalized Gas Revenues	637,615.54
Increase	$ 34,541.48

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

1. The rates proposed by East Kentucky would produce revenues in excess of those found reasonable herein and should be denied upon application of KRS 278.030.

2. The rates in Appendix A will produce gas service revenues of approximately $672,157.02 annually based on gas cost in effect at the time this case was filed and are fair, just, and reasonable rates in that they will produce revenues sufficient, when considering other gas revenues of $93,085.54, to permit East Kentucky to pay its operating

[3] Other gas revenues include penalties, service charges, interest income, and the Kentucky-West Virginia Gas Company surcharge.

expenses, service its debt, and provide a reasonable surplus. The rates in Appendix A reflect the most current gas cost for East Kentucky as approved in the October 21, 1998 Order in Case No. 90-002-BB.

IT IS THEREFORE ORDERED that:

1. The rates proposed by East Kentucky in its application are hereby denied.

2. The rates contained in Appendix A are approved for service rendered by East Kentucky on and after the date of this Order.

3. Within 30 days of the date of this Order, East Kentucky shall file with the Commission its revised tariff setting out the rates approved herein.

4. Within 90 days of the date of this Order, East Kentucky shall file a plan to minimize its line loss.

Done at Frankfort, Kentucky, this 14th day of December, 1998.

PUBLIC SERVICE COMMISSION

B. J. Helton

Chairman

Vice Chairman

Commissioner

ATTEST:

Helen C. Helton

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 98-280 DATED DECEMBER 14, 1998

The following rates and charges are prescribed for the customers served by East Kentucky Utilities, Inc. All other rates and charges not specifically mentioned herein shall remain the same as those under authority of this Commission prior to the effective date of this Order.

RATES: Monthly

First 1 MCF	$10.0250
Over 1 MCF	6.9102
Minimum Bill:	10.03

A surcharge in the amount of $.8048 per Mcf will be added to the above rates until the obligation owed to Kentucky West Virginia Gas Company has been discharged or is recalculated.