

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ALTERNATIVE RATE FILING OF HILLRIDGE ) CASE NO. 2010-00426  
FACILITIES, INC. )

ORDER

Pursuant to 807 KAR 5:076, Hillridge Facilities, Inc. ("Hillridge"), has applied for an adjustment of rates for sewer service provided to its customers in Jefferson County, Kentucky. By this Order, the Commission establishes rates that will produce additional annual revenues of \$106,358, an increase of 51 percent over normalized test-year revenues.<sup>1</sup>

Hillridge, a Kentucky corporation, owns and operates sewage treatment facilities that serve approximately 720 customers in the Hillridge, Hillridge East, Kirby Lane, Watterson Trail, and Bristol Oak Subdivisions of Jefferson County, Kentucky. Hillridge's monthly service rate was last adjusted in 2002.<sup>2</sup>

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<sup>1</sup> The Attorney General ("AG") sought leave to intervene in this matter. The Commission granted his motion for intervention on November 29, 2010. Louisville and Jefferson County Metropolitan Sewer District ("MSD") also sought to intervene in this matter and was granted leave to intervene on January 24, 2011. The Commission authorized MSD's intervention on the grounds that it would assist in the development of facts and issues related to the need for the proposed surcharge. On April 28, 2011, the Commission found that, in light of the withdrawal of Hillridge's request for a surcharge, no basis existed for MSD's continued intervention in this proceeding. The Commission rescinded MSD's leave to intervene in this matter and dismissed MSD as a party. VR: 04/28/2011; 10:35:40 – 10:36:15.

Several Hillridge customers sought to intervene in this matter. Finding that the AG already represented the interests of these customers and that their intervention would unduly delay and complicate this matter, the Commission on January 24, 2011 denied those customers' requests for intervention.

<sup>2</sup> Case No. 2001-00062, *Application of Hillridge Facilities, Inc. for an Adjustment of Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC Jan. 31, 2002).

On November 1, 2010, Hillridge filed with the Commission its application for an adjustment of its monthly rate from \$24.13 to \$32.50, an increase of 34.7 percent. It also requested authorization to assess a monthly surcharge of \$11.19 for a period of 36 months to fund repairs to its collection system. Hillridge contended that the proposed surcharge was necessary “to pay for sewer line repairs which are critically needed to avoid fines and sanctions from the Kentucky Division of Water.”<sup>3</sup>

On March 7, 2011, Commission Staff issued a report of its findings and recommendations regarding the proposed rate and Hillridge’s operations during the test period. It found that, based upon Hillridge’s test-period operations, Hillridge required total revenues of \$309,744 to meet its reasonable operating expenses and earn a reasonable rate of return. It further found that, to reach this level of revenue, Hillridge required a rate adjustment to generate additional annual revenue of \$101,261, or 48.57 percent, over normalized revenue from rates of \$208,483. Commission Staff recommended that Hillridge be authorized a monthly rate of \$35.85. Finding that Hillridge had not provided any evidence to directly connect the proposed rates to avoidance of Kentucky Division of Water (“DOW”) violations, Commission Staff did not recommend authorization of the proposed surcharge.<sup>4</sup>

Considering the recommended rate to be inadequate, Hillridge filed objections to Commission Staff’s findings and recommendations.<sup>5</sup> After conducting discovery upon

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<sup>3</sup> Application, “Hillridge Facilities Surcharge Explanation and Calculation” (filed Nov. 1, 2010).

<sup>4</sup> Commission Staff Report at 2.

<sup>5</sup> The AG also filed comments on the report. While noting his agreement with Commission Staff’s recommendations regarding the proposed monthly surcharge, the AG objected to Commission Staff’s estimated purchased power expense in the absence of billing information for two months of the test period and to its recommendation of a monthly service rate in excess of the proposed rate.

Commission Staff, however, Hillridge moved for leave to withdraw its request for a surcharge. The Commission granted this motion on April 27, 2011.

On April 28, 2011, the Commission conducted a hearing in this matter. At this hearing, Commission Staff and Hillridge stipulated the principal issues in this matter.<sup>6</sup> The AG advised the Commission that he was fully aware of the terms of the stipulation and did not object. Upon submission of this stipulation, the AG and Hillridge agreed that the evidentiary record should be closed<sup>7</sup> and presented no further evidence.

Following the hearing, Hillridge moved to amend its application to revise its requested monthly rate to \$36.52. It further advised its customers by mail of its proposed amendment and of the opportunity to submit written comments on the proposed amendment.

Prior to rendering our findings, we note considerable public opposition to the proposed rate adjustment. The record indicates that more than 40 members of the public filed comments with the Commission in which they objected to Hillridge's proposed rate adjustment. In addition to the magnitude of the proposed adjustment, many customers noted the poor quality of sewer service. Several questioned why the sewer utility is permitted to operate when the facilities of MSD are in the vicinity and MSD has openly stated its willingness to provide service to the area. Approximately 15

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<sup>6</sup> VR: 04/28/2011; 13:30:26 – 13:44:55.

<sup>7</sup> Aside from the oral stipulation between Commission Staff and Hillridge, the only other evidence presented at the hearing related to the proposed adjustment was invoices related to Hillridge's rate case expenses. VR: 04/28/2011; 13:40:434. The Commission granted Commission Staff leave to file its revised calculations of Hillridge's purchased power expenses. Commission Staff filed this information with the Commission following the hearing. See Letter of Gerald Wuetcher, Commission Staff Counsel, to Jeff Derouen, Executive Director, Kentucky Public Service Commission (Aug. 30, 2011).

customers repeated these concerns after being apprised of Hillridge's amended proposed rate.<sup>8</sup>

While the Commission empathizes with these customers, Kentucky law limits our discretion in this matter. It requires the establishment of rates that will produce sufficient revenues to meet the utility's reasonable operating expenses and to provide a fair rate of return on the utility's investment.<sup>9</sup> It prohibits us, when establishing rates, from taking into account the quality of service that the utility provides.<sup>10</sup> Simply put, the Commission cannot reduce a utility's rates merely because of complaints regarding the quality of its service.

Notwithstanding the limits on our discretion, we view these complaints very seriously and are of the opinion that an investigation should be commenced to determine whether Hillridge has failed to provide reasonable and adequate service and to identify the measures that are necessary to ensure Hillridge's provision of reasonable and adequate service. Within ten days of the issuance of this Order, we will initiate such investigation.

Many of the public comments urged that MSD be permitted to assume responsibility for the provision of sewer collection and treatment service in Hillridge's

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<sup>8</sup> On March 23, 2011, the Commission held a public meeting in Louisville to take public comment on the proposed rate adjustment. Approximately 71 members of the public attended this meeting. Sixteen persons addressed the Commission. All opposed the proposed adjustment.

<sup>9</sup> See, e.g., *City of Covington v. Pub. Serv. Comm'n*, 313 S.W.2d 391, 393 (Ky. 1958) ("In the case of *privately-owned* public utilities, the standard theory of rate-fixing is that the rates should be so fixed that after payment of operating expenses and depreciation expense, the company will earn a net fair return on its investment").

<sup>10</sup> See *South Cent. Bell Tel. Co. v. Utility Regulatory Com.*, 637 S.W.2d 649, 653 (Ky. 1982) ("The rate making process is to provide for the utility a reasonable profit on its operations so that its owners may achieve a return on their investment. Such matters are purely those of a financial nature. . . . [T]he quality of service is not germane to the normal, time-tested factors that go into the determination of a proper rate for the services rendered by a utility").

service area. The Commission notes that such action is consistent with the Commonwealth's longstanding policy of promoting the consolidation of wastewater distribution systems and the creation of regionalized wastewater suppliers.<sup>11</sup> Such consolidation is likely to result in greater economies of scale and a higher quality of service.

The authority to direct any transfer of responsibility, however, lies with DOW. On July 28, 2011, DOW denied Hillridge's application to renew its Kentucky Pollutant Discharge Elimination System Permit and stated its intention to require the connection of Hillridge's collection mains to MSD.<sup>12</sup> While the Commission has no legal standing in this controversy, we strongly encourage MSD and DOW to promptly take all lawful and reasonable steps consistent with the Commonwealth's longstanding policy that will lead to improved quality of sewer service for those residing within Hillridge's service area.

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

1. The calendar year ending December 31, 2009 should be used as the test period to determine the reasonableness of Hillridge's existing and proposed rates.
2. Based upon pro forma test-period operations, Hillridge's pro forma annual revenues are \$208,483.
3. Based upon pro forma test-period operations, Hillridge's pro forma total operating expenses, after adjusting for known and measurable changes, are \$268,941.

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<sup>11</sup> See, e.g., KRS 224A.300(1).

<sup>12</sup> Letter from Jory Becker, Manager, Surface Water Permit Branch, Kentucky Division of Water, to Donald Ridge, President, Hillridge Facilities, Inc. (July 28, 2011).

Appendix A to this Order provides a breakdown of Hillridge's pro forma operating expenses.

4. Hillridges's pro forma amortization expense of \$6,051 includes the amount of rate case expenses that Hillridge had incurred as of April 28, 2011 to pursue its rate adjustment application. These expenses are amortized over a three-year period.

5. Hillridge and Commission Staff stipulated that Hillridge had incurred \$15,000 of rate case expense in addition to \$2,400 that Hillridge had incurred to retain a consultant to prepare its rate application.<sup>13</sup> In support of this expense level, Hillridge presented invoices for legal and consultant fees totaling \$17,340 that were incurred to prosecute its rate application after the filing of its application. The invoices for legal fees include \$4,144 for legal services to represent Hillridge before DOW. A listing of these fees is set forth in Appendix B to this Order. Elimination of these fees results in total rate case expense of \$13,196 in addition to the consultant's fee for application preparation.<sup>14</sup>

6. As Hillridge is a corporation and is taxed as a Sub-Chapter C corporation, provision should be made for income taxes on its net income.

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<sup>13</sup> VR: 04/28/2011; 13:32:22 – 13:33:27.

<sup>14</sup> We place all parties, their counsel, and Commission Staff on notice that, in future rate proceedings, when invoices for rate case expenses that include activities unrelated to the rate proceeding are submitted and fail to specifically identify the nature of the activity, its relationship to the rate proceeding, and the amount of time spent on the activity, the entire expense will be disallowed. The applicant has the burden of demonstrating that an expense is directly related to the prosecution of the rate proceeding. If it does not supply the specific details of the expense, it has failed to meet its burden.

7. Given that no basis exists to determine an appropriate rate of return for Hillridge, the use of an operating ratio<sup>15</sup> to determine its total revenue requirement is appropriate.<sup>16</sup>

8. An operating ratio of 0.88 will permit Hillridge to meet its reasonable operating expenses and provide a fair and reasonable return for equity growth and should be used to determine Hillridge's total revenue requirements.

9. Applying an operating ratio of 0.88 to Hillridge's pro forma total operating expenses of \$268,941 produces a total revenue requirement before taxes of \$305,615.<sup>17</sup>

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<sup>15</sup> Operating Ratio is defined as the ratio of expenses, including depreciation and taxes, to gross revenues. It is illustrated by the following equation:

$$\text{Operating Ratio} = \frac{\text{Operating Expenses} + \text{Depreciation} + \text{Taxes}}{\text{Gross Revenues}}$$

<sup>16</sup> See, e.g., Case No. 8468, *An Adjustment of the Rates of Plantation Hill Sewage Treatment Plant, Inc.* (Ky. PSC Jun. 25, 1982); 1 A.J.G. Priest, *Principles of Public Utility Regulation* (Michie 1969) 220-224.

<sup>17</sup> \$268,941 ÷ 0.88 = \$305,615.

10. After provision is made for federal and state taxes,<sup>18</sup> Hillridge requires total revenues of \$314,841.<sup>19</sup>

11. Given Hillridge's end of test-period customer level of 720 customers and considering the effects of rounding, a monthly rate of \$36.44 will produce the required total revenue requirement.

12. Hillridge's proposed rate will produce revenues in excess of those found reasonable herein and should be denied.

IT IS THEREFORE ORDERED that:

1. Hillridge's Motion to Amend Application for Rate Adjustment is granted.
2. Hillridge's proposed monthly rate of \$36.52 is denied.
3. Hillridge is authorized to assess the monthly fee set forth in Appendix C to this Order for sewer service provided on and after the date of this Order.
4. Within 20 days of the date of this Order, Hillridge shall file a revised tariff sheet with the Commission setting forth the rate approved in this Order.

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<sup>18</sup> A revenue conversion factor of 1.2515645 is applied to the utility's net income allowed after taxes to compensate for the effects of taxes. This factor is determined as follows:

Revenue	100.00000%
Less: State tax	<u>6.00000%</u>
Sub-total	94.00000%
Less: Federal tax, 15% of sub-total	<u>14.10000%</u>
Percent change in NOI	79.90000%
Revenue conversion factor (Revenue of 1 divided by percent change in NOI)	<u>125.15645%</u>

<sup>19</sup> Revenue Requirement is calculated as follows:

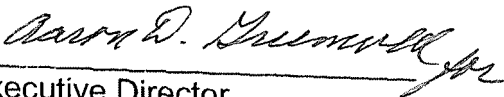
Total Revenue Required Before Taxes	\$305,615
Less: Pro forma Operating Expenses Before Taxes	<u>(268,941)</u>
Net Income Allowed After Taxes	36,674
Multiplied By: Tax Gross Up Factor	<u>1.2515645</u>
Net Operating Income Before Taxes	45,900
Plus Operating Expenses Before Taxes	<u>268,941</u>
Revenue Requirement	<u>\$314,841</u>



By the Commission

ENTERED PA  
AUG 31 2011  
KENTUCKY PUBLIC  
SERVICE COMMISSION

ATTEST:

  
Executive Director

Case No. 2010-00426

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE  
COMMISSION IN CASE NO. 2010-00426 DATED **AUG 31 2011**

Owner/Manager Fee	\$ 3,600
Sludge Hauling	26,698
Fuel & Power Expense	59,020
Chemicals	10,523
Routine Maintenance Fee	47,770
Maintenance of Structures and Improvements	9,880
Agency Collection Fee	7,516
Office Supplies and Other Expenses	3,022
Insurance Expense	7,708
Misc. General Expense	519
Maintenance of General Plant	31,764
Outside Services – Testing	12,010
Outside Services – Legal	17,204
Depreciation Expense	19,724
Amortization Expense	6,051
Taxes Other Than Income	5,932
<b>Total Operating Expenses</b>	<b>\$268,941</b>

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE  
COMMISSION IN CASE NO. 2010-00426 DATED **AUG 31 2011**

<b>Legal Fees Unrelated to Rate Case</b>	
<b>Date</b>	<b>Amount</b>
12/21/2010	37.00
01/12/2011	18.50
01/13/2011	240.50
01/14/2011	314.50
02/03/2011	111.00
02/11/2011	370.00
03/02/2011	388.50
03/03/2011	37.00
03/14/2011	185.00
03/25/2011	212.75
03/28/2011	351.50
03/29/2011	619.75
04/01/2011	370.00
04/07/2011	370.00
04/08/2011	518.00
<b>Total</b>	<b>\$4,144.00</b>

APPENDIX C

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE  
COMMISSION IN CASE NO. 2010-00426 DATED **AUG 31 2011**

The following rate is prescribed for the customers in the area served by Hillridge Facilities, Inc. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of the Commission prior to the effective date of this Order.

\$36.44 per month

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