COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION FOR ALTERNATIVE RATE FILING OF FERN LAKE COMPANY	))	CASE NO. 2013-00172

NOTICE OF FILING OF COMMISSION STAFF REPORT

Notice is hereby given that, in accordance with the Commission's Order of July 12, 2013, the attached report, which contains Commission Staff's findings and recommendations regarding Fern Lake Company's proposed rate adjustment, has been filed in the record.

Jeff Derouen
Executive Director
Public Service Commission
P.O. Box 615
Frankfort, Kentucky 40602

DATED JUL 29 2013

cc: Parties of Record

STAFF REPORT
ON
FERN LAKE COMPANY
CASE NO. 2013-00172

Fern Lake Company ("Fern Lake"), a Kentucky corporation that is organized as a Subchapter S Corporation, is a utility subject to Commission jurisdiction.[1] It owns and operates a lake that serves as the raw water source for Water Service Corporation of Kentucky's ("WSKY") Middlesboro facilities.

Fern Lake has applied to the Commission for an adjustment of water rates pursuant to 807 KAR 5:076. In developing its proposed rates for water service, Fern Lake used the calendar year ended December 31, 2012 as its test year. Fern Lake proposed rates that it estimated would generate additional revenues of $64,596. These rates, which are set forth in Appendix A to this Report, would increase WSKY's monthly water bill for minimum purchases of 41,667,000 gallons from $7,100 to $12,483 or 75.8 percent.

Staff has performed a limited financial review of Fern Lake's test-year operations to determine whether reported test-year operations were representative of normal operations. Known and measurable changes to test-year operations were identified and adjustments were made when their effects were deemed to be material. Insignificant or immaterial discrepancies were not pursued or addressed.

This report contains the findings of Staff's review. Mark Frost reviewed the pro forma income statement and the calculation of revenue requirement. Jason Green reviewed the billing analysis, reported revenues, and rate design.

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[1] KRS 278.010(3)(d).

Pro Forma Operating Statement

Fern Lake reported a Net Operating Loss of $60,455 during the test year.[2] Its only proposed adjustment to test-year operating revenues and expenses is an offsetting increase of $3,800 to reflect collecting fees for a third party's use of the lake.[3] Because the fishing club/boat dock usage fees are not related to the sale of raw water by Fern Lake, Staff finds that this revenue should not be included in pro forma revenues or expenses.

Fern Lake's Pro Forma Operating Statement for the test-year ended December 31, 2012, as determined by Staff, appears in the table below.

	Test-Year Operations	Pro Forma Adjustments		Pro Forma Operations
Operating Revenues:				
Water Sales - Commercial	$ 85,200	$		$ 85,200
Rents from Water Property				0
Total Operating Revenues	85,200	0		85,200
Operating Expenses:				
Operation & Maintenance Expenses:				
Salaries and Wages - Employees	93,109	1,801	(A)	94,910
Employee Pensions and Benefits	15,939	2,061	(B)	18,000
Insurance	5,174			5,174
Contractual Services - Accounting	825			825
Miscellaneous	515			515
Total Operation & Maintenance Expenses	115,562	3,862		119,424
Taxes Other Than Income Tax				
Property Tax	5,310			5,310
Payroll Tax	9,334			9,334
PSC Assessment	1,613			1,613
Income Tax	13,835	(13,660)	(C)	175
Total Operating Expenses	145,654	3,862		135,856
Net Operating Income	$ (60,454)	$ (3,862)		$ (50,656)

2 Application, ARF Form 1 SAO – W at 2.

3 *Id* at 3.

(A) Salaries. In the test year, Fern Lake reported salaries and wages – employee expense of $93,109. Fern Lake currently employs two full-time and one part-time employee. The employees are responsible for security at the lake, cleaning up after storms, maintaining the dam, and mowing. The table below shows the calculation of Fern Lake's pro forma salaries and wages – employee expense.

Title	Wage Rate		Hours/Weeks	Amount
Labor - Regular	$ 15.00	x	2,080 (Hours) =	$ 31,200
Labor- - Overtime	22.50	x	1,000 (Hours) =	22,500
Sub-total Labor				53,700
Manager/Labor	675.00	x	52 (Weeks) =	35,100
Mowing	10.00	x	611 (Hours) =	6,110
				$ 94,910

A comparison of the employee wage rates paid by Fern Lake to the rates paid by the Northern Kentucky Water District[4] for comparable positions shows that Fern Lake's employee rates are within a range of reasonableness. Further, given that Fern Lake is located in a remote area, Staff is of the opinion that it requires around-the-clock monitoring to ensure that trespassers do not pollute WSKY's raw water source. Staff finds that salaries and wages – employee expense should be increased by $1,801 to reflect the pro forma amount calculated in the table above.

(B) Employee Pensions and Benefits. In the test year Fern Lake reported employee pension and benefit expense of $15,939. Fern Lake provides its manager/labor with family health insurance coverage under Appolo Fuel's Blue Cross

[4] Northern Kentucky Water District's Response to Commission Staff's First Request for Information, Item 9 (filed July 13, 2012) (filed in Case No. 2012-0072, *Application of Northern Kentucky Water District for an Adjustment of Rates, Issuance of Bonds, and Financing* (Ky. PSC filed June 29, 2012)).

and Blue Shield plan.[5] At the close of the calendar year, Fern Lake reimburses Appolo for the employee health insurance premium.[6] Given that the three employees are members of the same family, providing family coverage to the manager/labor provides health insurance coverage to all three Fern Lake employees.

In 2013 the family health insurance premium increased from $1,334 to $1,500[7] per month for an annual cost of $18,000. The 2013 premium translates into a monthly cost to Fern Lake of $500 per employee, which Staff finds to be reasonable. Staff is increasing employee pension and benefit expense by $2,061 to reflect the pro forma level.

(C) Income Tax. In the test year Fern Lake reported income tax expense of $13,835. When first organized, Fern Lake elected to be taxed under Subchapter S of Chapter 1 of the Internal Revenue Code. A Subchapter S Corporation ("S-Corp") is a pass-through entity that has no federal income tax liability. Its annual earnings are automatically passed through to its stockholders and recognized as taxable income on the stockholder's individual federal income tax returns. This tax treatment is drastically different from taxes levied pursuant to Subchapter C of Chapter 1 of the Internal Revenue Code.

A Subchapter C Corporation ("C-Corp") accrues and pays federal income taxes that are calculated on its reported earnings. Earnings that remain after deducting income tax expense do not automatically pass through to stockholders. Instead, these earnings may be distributed to stockholders through dividend payments at the discretion

5 Fern Lake's Response to Commission Staff's Information Request, Item 6(a).

6 *Id.*

7 *Id.*

of the C-Corp's Board of Directors. Dividends are recognized as taxable income by the stockholder in the year they are received. This results in double taxation of the C-Corp's earnings. First, taxes accrue to the C-Corp when income is recognized. Taxes again accrue on these earnings when it is distributed as stockholder dividends. Double taxation is a distinct disadvantage when compared to the single taxation of S-Corps.

Kentucky State Income Tax Statutes for pass-through entities, including S-Corps, are currently different from Federal Statutes but were not always. For tax years that began prior to January 1, 2005, the Kentucky Department of Revenue's taxation of S-Corps conformed to the federal tax treatment. All earnings were passed through to stockholders for state income tax purposes. No income taxes were accrued or paid by the corporate body. This changed when the 2005 General Assembly passed House Bill 272. House Bill 272 made pass-through entities, including S-Corps, subject to state corporate income taxes. This meant double taxation at the state level on pass-through entities for tax years beginning on or after January 1, 2005.

The effects of House Bill 272 were short lived. On June 28, 2006, during a Special Legislative Session, the General Assembly enacted House Bill 1 that included "Income Tax Relief for Small Businesses." House Bill 1 reversed House Bill 272. After this reversal, state taxation on pass-through entities again conformed to federal tax law. But, House Bill 1 created a new Limited Liability Entity ("LLE") tax to be imposed on C-Corps and pass-through entities.

The LLE tax became effective for all taxable years beginning on or after January 1, 2007. The minimum annual LLE tax by all LLE's is $175. An additional LLE tax is required for entities reporting annual gross receipts or gross profits that are greater than $3,000,000.[8] The additional LLE tax may be used by the LLE's owner as a personal income tax credit reducing the owner's income tax liability by the amount of the additional LLE tax. The $175 minimum LLE tax may not be used as a credit.

The Commission has long recognized the different tax treatments of pass-through entities and C-Corps when determining their overall revenue requirements. Generally, the Commission has found that federal and state income tax expense reported by a C-Corp is an annual, recurring operating expense of the C-Corp for which rate recovery is necessary to allow the utility a reasonable opportunity to earn its authorized rate of return. Conversely, the Commission has not allowed recovery of federal or state income taxes for S-Corps, finding that there is no double taxation on the earnings of S-Corps and that the only income tax that is accrued on an S-Corp's earnings is a tax liability of the S-Corp's stockholder.[9]

When determining the revenue requirement of an S-Corp, the Commission has not distinguished the LLE tax from state income tax. Following Staff's findings, the Commission has identified the LLE tax as a state income tax for which rate recovery is not appropriate.[10] In this instance, Fern Lake is reporting combined state income tax and LLE tax of $13,835, but has not requested rate recovery of this expense. After reexamining the LLE tax, Staff finds that recovery of the minimum LLE tax is appropriate. Staff is reducing reported income tax expense by $13,660 to include the $175 LLE tax in Fern Lake's pro forma operating expenses.

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[8] The additional tax is equal to the lesser of $0.095 per $100 of Kentucky gross receipts or $0.75 per $100 of Kentucky gross profits. The amount of the additional tax is decreased using a formula for entities reporting annual gross receipts or gross profits that are less than $6,000,000.

[9] *See* Case No. 2012-00375, *Application of Middletown Waste Disposal, Inc. for an adjustment in Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC Apr. 2, 2013).

[10] *Id.*

The minimum LLE tax is a state tax liability of a pass-through entity. It is not a tax liability accruing to the LLE's owner. Also, the minimum tax represents double taxation. The minimum LLE tax liability is calculated on the same gross receipts and gross profits that are passed through to the personal state income tax return of the LLE's owner. Recovery of the minimum LLE tax is therefore appropriate.

If rate recovery is ever requested for the additional LLE tax, the Commission's decision will be more difficult. While the additional LLE tax is a tax to the LLE, there is no double taxation on this amount since the additional LLE tax may be credited to the LLE's owner's personal income tax liability.[11]

The Commission will likely never be required to address the reasonableness of rate recovery of the additional LLE tax. The level of gross receipts and gross profits required to trigger the additional LLE tax is relatively high when compared to the receipts and profits of the utilities regulated by the Commission that are pass-through entities.

<u>Calculation of Overall Revenue Requirement and Revenue Increase</u>

Using an operating ratio of 88 percent, Fern Lake determined its overall revenue requirement to be $149,796. An annual revenue increase of $64,596 is needed to meet the overall requirement as shown in the table below.

Operating Expenses Before Income Taxes	$ 131,819
Divided by: Operating Ratio	88%
Overall Revenue Requirement	149,794
Less: Normalized Operating Revenue	(85,200)
Requested Increase in Revenue from Rates	$ 64,594
% Increase	75.815%

[11] This credit is limited to the amount of the owner's income taxes that resulted from their recognition of the pass-through entities income.

Fern Lake is the raw water source for WSKY's Middlesboro operations. However, a fishing club/boat dock is permitted to operate on the lake. Fern Lake is not compensated by the fishing club/boat dock for its use of the lake, but several of the expenses (labor, insurance, and property taxes) incurred by Fern Lake benefit the fishing club/boat dock. Given that the fishing club/boat dock receives a benefit, then logically the fishing club/boat dock should be allocated a share of these costs. One allocation method available is a 50/50 sharing between Fern Lake and the fishing club/boat dock.

If Fern Lake is responsible for 100 percent of the pro forma operating expenses, then Fern Lake should be granted its requested rates, which produce the overall revenue requirement of $149,794. However, if 50 percent of the identified costs are allocated to the fishing club/boat dock, Fern Lake's net operating expenses should be reduced to $69,492.[12] As shown in the Table below, Fern Lake's overall revenue requirement would then be $78,968 and would require a

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Pro Forma Operating Expenses - Staff						$	135,856
Salaries and Wages - Employees	$	94,910	x	50%	(Allocation Factor) =		(47,455)
Employee Pensions and Benefits		18,000	x	50%	(Allocation Factor) =		(9,000)
Insurance		5,174	x	50%	(Allocation Factor) =		(2,587)
Payroll Tax		9,334	x	50%	(Allocation Factor) =		(4,667)
Property Tax		5,310	x	50%	(Allocation Factor) =		(2,655)
Net Pro forma Operating Expenses						$	69,492

decrease in the annual revenue of $(6,232). The rates to achieve this overall revenue requirement are attached to this report as Appendix B.

Net Pro forma Operating Expenses	$	69,492
Divided by: Operating Ratio		88%
Overall Revenue Requirement		78,968
Less: Normalized Operating Revenue		(85,200)
Requested Increase in Revenue from Rates	$	(6,232)
% Increase		-7.315%

Signatures

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APPENDIX A
STAFF REPORT, CASE NO. 2013-00172
FERN LAKE COMPANY'S REQUESTED RATES

Monthly Water Rates

First	41,667,000	gallons	$ 12,483	Minimum bill
Additional	1,000	gallons	0.30	per 1,000 gallons

APPENDIX B
STAFF REPORT, CASE NO. 2013-00172
RATES TO PRODUCE THE ALTERNATIVE REVENUE REQUIREMENT

Monthly Water Rates

First	41,667,000	gallons	$	6,581	Minimum bill
Additional	1,000	gallons		0.167	per 1,000 gallons

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