COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF JOANN ESTATES UTILITIES, INC. FOR RATE ADJUSTMENT FOR SMALL UTILITIES PURSUANT TO 807 KAR 5:076	)))	CASE NO. 2013-00307

NOTICE OF FILING OF COMMISSION STAFF REPORT

Notice is hereby given that, in accordance with the Commission's Order of October 7, 2013, the attached report containing the findings of Commission Staff regarding the Applicant's proposed rate adjustment have been filed in the record of the above-styled proceeding. Pursuant to paragraphs 2, 3, and 4 of the Commission's October 7, 2013 Order, Joann Estates Utilities, Inc. ("Joann Estates") is required to file written comments regarding the findings of Commission Staff no later than December 13, 2013.

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

DATED NOV 27 2013

cc: Parties of Record

STAFF REPORT

ON

JOANN ESTATES UTILITIES, INC.

CASE NO. 2013-00307

Joann Estates Utilities, Inc. ("Joann Estates") operates five wastewater treatment plants that provide service to approximately 277[1] customers that reside in Joann Estates, Timberland, and Wilmington Chiles Subdivisions in McCracken County, Kentucky.[2] On August 5, 2013, Joann Estates tendered an application to the Commission for an adjustment in its flat monthly wastewater service rate pursuant to 807 KAR 5:076. The proposed rate would increase a monthly bill from $19.66 to $35.00, an increase of $15.34, or 78.03 percent.

Joann Estates based its application on the test year ended December 31, 2012. Using operations reported for the test year, Joann Estates determined that a revenue increase of $62,417, or 95.51 percent, is warranted.[3] To minimize consumer rate shock, Joann Estates proposed a rate that would increase revenue by $50,622, a 77.46 percent increase.

To determine the reasonableness of the proposed rate, Staff performed a limited financial review of Joann Estates' test-year operations. The scope of the review was limited to determining whether operations reported for the test year were representative of normal operations. Known and measurable changes to test-year operations were

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[1] Application at 3.

[2] *Annual Report of Joann Estates Utilities, Inc. to the Public Service Commission for the Calendar Year Ended December 31, 2012* at 1.

[3] Application at 1.

identified and adjustments were made when their effects were deemed to be material. Insignificant and immaterial discrepancies were not pursued or addressed.

Based on its review, Staff determined that Joann Estates' adjusted test-year operations support a monthly flat rate of $30.66, an $11.01 increase, or 55.95 percent, to its current rate of $19.66. Staff's calculations are shown and discussed in the remaining sections of this report. Daryl Parks reviewed the calculation of Joann Estates' Overall Revenue Requirements. Jason Green reviewed Joann Estates' reported revenues and rate design.

Pro Forma Operating Statement

Joann Estates' Pro Forma Operating Statement for the test year ended December 31, 2012, as determined by Staff, appears in the following table:

	Test Year	Adjustments	Ref.	Pro Forma Present Rate	Adjustments	Ref.	Pro Forma Proposed Rates
Operating Revenue							
Sewer Service Revenue	$ 57,634	$ 7,716	(A)	$ 65,350	$ 36,566	(A-1)	$ 101,916
Total Operating Revenue	57,634	7,716		65,350	36,566		101,916
Operating Expenses							
Operation and Maintenance							
Owner/Manager Fee		3,600	(B)	3,600			3,600
Collection System	13,000	3,800	(C)	16,800			16,800
Treatment System - Sludge Hauling			(D)				
Treatment System - Water Cost	13,741	1,625	(E)	15,366			15,366
Treatment System - Other	12,031	17,357	(F)	29,388			29,388
Rents	6,790	(6,790)	(G)				
Agency Collection Fee		6,535	(H)	6,535	3,657	(H)	10,192
Office Supplies and Other Expenses	89			89			89
Insurance Expense		2,726	(I)	2,726	1,525	(I)	4,251
Transportation Expenses	3,354	(3,354)	(C)				
Miscellaneous General Expenses	2,264	(396)	(J)	1,868			1,868
Total Operation and Maintenance Expenses	51,269	25,103		76,372	5,182		81,553
Amortization		2,004	(K)	2,004			2,004
Depreciation	2,233	(177)	(L)	2,056			2,056
Taxes Other Than Income	7,928	(829)	(C)				
		(5,520)	(K)	1,579			1,579
Total Operating Expenses Before Income Taxes	61,430	20,580		82,010	5,182		87,192
State Income Taxes					736	(M)	736
Federal Income Taxes					2,098	(M)	2,098
Total Operating Expenses	61,430	20,580		82,010	8,016		90,027
Net Operating Income	$ (3,796)	$ (12,864)		$ (16,660)	$ 28,550		$ 11,890

(A) Operating Revenue. As discussed in more detail in this report at Reference Item (H), Paducah Water and West McCracken Water District ("West McCracken") provide contracted billing and collection services to Joann Estates in return for 10 percent of the revenue they collect for Joann Estates. The agents remit the collections to Joann Estates after removing their contract fees. Joann Estates reported the test-year remittances of $57,634 as revenue.

Joann Estates' cash basis of accounting for revenues is in violation of the Uniform System of Accounts ("USoA")[4] and understates the test-year cash based revenues by the amount of the contract collection fees that were retained by the collection agents. To correct these accounting errors, it increased test-year revenue by $7,716 to state pro forma present rate revenues at $65,350.[5] Staff agrees that this amount represents accrual basis revenue at present rates.

(A-1) Required Revenue Increase. As discussed in the Allowed Net Operating Income ("NOI") section of this report, Staff determined that Joann Estates is entitled to

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[4] USoA for Class C and D Sewer Utilities (Oct. 15, 1979) at 15, available at http://psc.ky.gov/agencies /psc/forms/usoa/0900.pdf.

[5]

Present Rate	$ 19.66
Times: Number of Customers	277
12 Months	12
Pro Forma Present Rate Revenue	65,350
Less: Test Year	(57,634)
Increase	$ 7,716

earn $11,890 in NOI. A revenue increase to pro forma present-rate revenues in the amount of $36,566 is required to generate this NOI.

(B) Owner/Manager Fee. Joann Estates' operations are directed by its sole stockholder, B.G. Waid. No wages for Mr. Waid were reported in Joann Estates' test-year operations. The Commission has historically allowed a small, investor-owned sewer utility recovery of a $3,600 owner/manager fee to be paid to the utility's owner for serving as its chief executive officer. In the cases of the very small utilities, the fee is also considered compensation for providing additional services.[6] In this case, Joann Estates has requested recovery of a $3,600 owner/manager fee in return for Mr. Waid's service to Joann Estates as its executive officer. It is Staff's opinion that Joann Estates' request is consistent with prior Commission rulings. Staff increased Joann Estates' test-year expenses by $3,600.

(C) Collection System. Joann Estates' wastewater operations are required to be monitored by a certified operator pursuant to 401 KAR 5:010, Section 1. During the test year, Joann Estates employed Jim Waid to serve as its certified operator. He also performed all routine and non-routine maintenance of its facilities. During the test year,

[6] In Case No. 2007-00397, *Application of Woodland Estates Sewage System for an Adjustment of Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC. Dec. 27, 2007), the Commission found that the $3,600 owner/manager fee awarded to Woodland Estates Sewage System, which served 24 customers at the time its rate application was filed, was appropriate compensation for the owner serving as the utility's executive officer and for the owner's contribution to the utility of office space, office supplies, telephone service, billing and collection services, and bookkeeping services. In Case No. 2005-00036, *Application of Lewis Sanitation Company, Inc. - Garden Heights Sewer System for Adjustment of Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC Apr. 14, 2005), the Commission found that the $3,600 owner/manager fee was appropriate compensation for only the owner's executive oversight of the utilities operations. In addition to the owner/manager fee, the Commission allowed rate recovery for expenses that were incurred by the utility for bookkeeping services, office rent, office supplies, office utilities, and reimbursement to the owner for transportation expenses. Lewis Sanitation Company, Inc. served 108 customers at the time its rate application was filed.

Mr. Waid's wages and benefits totaled $17,183.[7] In April, 2013, Mr. Waid's resigned and was replaced with Todd Teas. Mr. Teas is a contracted operator who is paid $1,400 per month, or $16,800 annually. Joann Estates requested to decrease test-year expenses by $383[8] to account for the Teas contract. Staff agrees with the adjustment and decreased test-year expenses by $383.

(D) Sludge Hauling. Joann Estates' wastewater treatment facilities have been in service for over 30 years. Each facility has at least one lagoon. The facilities serving the Wilmington-Chiles Subdivision include three lagoons. Operation of the lagoons has allowed Joann Estates to avoid sludge hauling and disposal expenses in previous years. In its Application, Joann Estates states that sludge has accumulated in each lagoon over the years and that significant sludge hauling is now required.

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Wages	$ 13,000
Mileage	3,354
Payroll Taxes	829
Total Operator Fees	$ 17,183

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	Pro forma	Less: Test Year	Adjustment
Wage/Service Fee	$ 16,800	$ (13,000)	$ 3,800
Mileage	-	(3,354)	(3,354)
Payroll Taxes	-	(829)	(829)
Net Increase	$ 16,800	$ (17,183)	$ (383)

With its Application, Joann Estates submitted two proposals from Summit Contracting, LLC ("Summit") to reduce sludge levels in all five lagoons by two feet.[9] Pursuant to the first proposal, Summit would vacuum wet sludge from the lagoons and haul it to the Paducah Waste Water Treatment Facility ("Paducah Waste Water") for disposal. The estimated cost for this option is $365,250, but this estimate does not include the disposal fees to be paid to Paducah Waste Water.[10] Testing of the sludge would be required to determine whether this option is feasible. The second proposal is to dry the sludge before hauling it to the Waste Path Landfill in Calvert City, Kentucky. Summit's estimated cost for this alternative is $1,156,320.

Joann Estates did not propose to perform either of the Summit alternatives, nor did it request rate recovery for the cost of either alternative in its Application. Instead, it requested annual recovery of $9,600. It states that this amount is the minimum level of sludge hauling expense that is required on an annual basis. In support of its request, it provided invoices for sludge hauling that was performed in April, June, and July of 2013. These invoices total $1,600.

Staff agrees that Joann Estates' lagoons have been in service for many years and that they may require significant sludge removal in future periods, but Staff believes that inclusion of a significant sludge removal expense in pro forma operations in this case is premature. Joann Estates has not provided a sludge analysis demonstrating that significant sludge removal is immediately necessary, nor has it provided evidence demonstrating that the Kentucky Division of Water ("DOW") has ordered such removal.

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[9] App. Ex. 8.

[10] *Id.* at 2.

Further, it has not demonstrated that $9,600 is the minimum annual requirement for sludge hauling expenses. It is Staff's opinion that rate recovery should be denied in this proceeding and that the Commission should require Joann Estates to submit a formal work plan for sludge removal. The plan would describe the scope of the work to be performed and include a timeline for its completion, bids from three independent contractors detailing the project's estimated cost, and a plan for financing the cost with long-term debt if necessary.[11] It is Staff's opinion that the projects described in the Summit proposals represent an extraordinary expense that is necessary to maintain and operate the lagoons. Generally Accepted Accounting Principles allows for this expense to be accounted for as a regulatory asset.[12] In its work plan, Joann Estates should request the Commission's approval to report all project costs as a regulatory asset using account 183, Other Deferred Debits. The appropriateness of rate recovery for the amounts reported to account 183 would be determined in Joann Estates' next rate proceeding.

As an alternative to the plan outlined above, Staff would agree to allow recovery of the requested $9,600 if Joann Estates agrees to: 1) expend this amount for sludge removal on an annual basis for a minimum of five years; 2) file another rate application five years from the date of the Commission's Final Order in this proceeding; 3) use account 701-C, Labor and Expense, Treatment System, Sludge Hauling, exclusively to

[11] Generally, small sewer utilities such as Joann Estates have no assets that a commercial bank will accept as mortgaged collateral. Absent these assets, lending institutions will only provide loan funds to these small sewer utilities when the company's stockholders provide a personal guarantee of repayment of the loan. The Commission provides compensation to the stockholders for assuming this responsibility, as well as other ownership risks, by allowing the utility rate recovery of a NOI from which the utility may make stockholder dividend payments through application of the operating ratio method of calculating revenue requirements.

[12] Accounting Standards Codification 980-340-25-1.

report annual sludge hauling expenses in its Annual Financial and Statistical Reports; and 4) include invoices with its reports filed with the Commission that support the amounts shown in account 701-C. Allowing recovery of $9,600 increases the monthly rate for wastewater service calculated by Staff by $4.05.[13]

(E) Treatment System – Utility Service. Joann Estates reported $13,741 for test-year Utility Service expense. This amount included $90 for purchased water and $13,651 for power purchased from Kentucky Utilities ("KU") and Jackson Purchase Rural Electric Cooperative ("Jackson"). Joann Estates requested to increase the purchase power expense by $1,975 to account for increases to the electric rates charged by KU and Jackson that were authorized by the Commission in Case No. 2012-00221[14] and in Case No. 2013-00068,[15] respectively.

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[13] Inclusion of the Sludge Hauling Expense will increase revenues which will in turn increase all other components of the revenue requirement that were based on revenues. These components include general liability insurance, billing and collection expense, state and federal income taxes, and the NOI allowable by the operating ratio.

Pro Forma Sludge Hauling Expense	$	9,600
Increase to General Liability Expense		561
Increase to Billing and Collection Expense		1,345
State and Federal Income Taxes		374
Margin Provided by Operating Ratio		1,569
Impact on Revenue Requirement		13,449
Divide by: Number of Bills		3,324
Impact on Monthly Bill	$	4.05

[14] Case No. 2012-00221, *Application of Kentucky Utilities Company for an Adjustment of its Electric Rates* (Ky. PSC Dec. 20, 2012).

[15] Case No. 2013-00068, *Application of Jackson Purchase Energy Corporation for Approval of Flow Through Rates Pursuant to KRS 278.455* (Ky. PSC Oct. 29, 2013).

Staff agrees with the portion of Joann Estates' adjustment to power purchased from KU, but not the adjustment for purchases from Jackson. At the time Joann Estates submitted its application for rate adjustment with the Commission, the Commission had not issued a Final Order in Case No. 2013-00068. Joann Estates increased test-year purchases by the 21 percent increase requested in Jackson's rate application. On October 29, 2013, the Commission issued its Final Order authorizing Jackson to increase the rates charged to Joann Estates by approximately 16.55 percent. Staff applied this increase and the 5.6 percent increase awarded by the Commission to KU to calculate the increase to Joann Estates' test-year purchase power expense to be $1,625.[16]

(F) Treatment System – Other. During the test year, Joann Estates reported $12,031 for Treatment System – Other expenses. It proposed two adjustments that increased this amount by $19,519. As shown in the table below, Staff made three adjustments that increase the test-year amount by $17,356. An explanation of Joann Estates' and Staff's adjustments follows the table.

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	Test Year	Percentage Increase	Increase
KU	$ 5,797	5.60%	$ 325
Jackson	7,855	16.55%	1,300
Total Increase			$ 1,625

Increase for Chemicals	$	9,964
Increase for Testing		8,898
Decrease for Capital Items		(1,506)
Net Increase	$	17,356

Chemicals. Joann Estates reported $1,746 for chemical expenses. During the test year, Joann Estates received a Notice of Violation from DOW for inadequate chlorination of wastewater during the treatment process and for not dechlorinating wastewater prior to its discharge from the treatment facilities. To correct these deficiencies, Joann Estates now applies one 55-pound pail of chlorination tablets and one 45-pound pail of dechlorination tablets per month at each of the three subdivisions it serves. Joann Estates requested to increase test-year chemical expenses by $9,165 to account for its increased chemical costs. Staff calculated the additional chemical expense to be $9,964.[17]

Testing. Pursuant to the Kentucky Pollutant Discharge Elimination System ("KPDES") permits issued by DOW, Joann Estates is required to perform testing at its wastewater treatment facilities. Joann Estates reported test-year testing expenses of

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Monthly Dechlorination Expense	$ 529
Monthly Chlorination Expense	447
Total Monthly Expense	976
Times: 12 Months	12
Pro forma	11,710
Less: Test Year	(1,746)
Increase	$ 9,964

$3,478. This amount included monthly $200 testing fees charged by the certified operator and supplies used by the operator during the testing process.

Adjustments are required to the test-year expense to account for two changes to Joann Estates' testing practices. First, on April 1, 2013, Joann Estates began using McCoy & McCoy Laboratories ("McCoy") to perform the necessary testing. McCoy's fees are $182 per test at each wastewater facility. Second, the current KPDES permit for the facilities serving Joann Estates Subdivision became effective August 1, 2012. The permit for the facilities at Wilmington Chiles Subdivision became effective November 1, 2012. These permits changed the frequency of the testing required at these facilities.

Based on these changes, Joann Estates calculated pro forma testing to be $13,832, requiring a $10,354 increase to test-year expenses. Joann Estates' calculation is shown below.

Subdivision	Testing Frequency	Number of Tests per Year	Cost Per Test	Pro Forma
Joann Estates	Weekly	52	$ 182	$ 9,464
Wilmington Chiles	Monthly	12	182	2,184
Timberland	Monthly	12	182	2,184
Pro forma				13,832
Less: Test Year				(3,478)
Increase				$ 10,354

Staff noted that Joann Estates' calculation incorrectly includes monthly testing at the Wilmington Chiles facilities. Quarterly testing is required at those facilities.

Correction of this error results in an $8,898 increase to test-year testing expense. The calculation of this increase is shown below.

Subdivision	Testing Frequency	Number of Tests per Year	Cost Per Test	Pro Forma
Joann Estates	Weekly	52	$ 182	$ 9,464
Wilmington Chiles	Quarterly	4	182	728
Timberland	Monthly	12	182	2,184
Pro forma				12,376
Less: Test Year				(3,478)
Increase				$ 8,898

Capital Assets. Test-year expenses included $1,506 that was incurred to purchase two pumps and a motor. The pumps and motor are capital assets whose costs should be removed from test-year expenses and reported as utility plant in service. As shown in Staff's adjustment to test-year Depreciation Expense, Staff depreciated these assets over 10 years when calculating Joann Estates' pro forma Depreciation Expense.

(G) Rents. During the test year, Joann Estates reported $6,790 for rental fees paid to its sole stockholder, B.G. Waid, for the use of equipment owned by him. As explained below, Staff eliminated all rental fees due to lack of documentation supporting the need and use of the equipment.

The test-year rental fees include 13 $350 rental payments for the use of a jetter. The total expense was $4,550. Mr. Waid stated the jetter is needed to clean out a six-inch sewer collection main, as required by a court order, to prevent wastewater from flooding nearby property. He stated that the cleanout is performed monthly. Mr. Waid could not provide Staff with a copy of the court order. Absent the order, Staff could not verify the need for the monthly use of the jetter. Staff removed the expense from test-year operations.

Furthermore, it is Staff's opinion that renting a jetter on a monthly basis is not economically feasible. Staff calculated the annual cost of ownership of the jetter to be $2,240.[18] If Joann Estates adequately supports the need for the monthly use of the jetter when responding to this report, Staff would limit annual recovery to $2,240.

The remaining test-year rental fees, in the amount of $2,240, were incurred for the use of other equipment owned by Mr. Waid. These fees included four $500 rental fees and one $240 rental fee. Joann Estates could not provide invoices documenting the details of these transactions. During Staff's field visit, Mr. Waid stated that he could not recall the equipment that was provided in return for these rental fees or the reason the equipment was needed by Joann Estates. He stated that the expense was likely for

[18] Staff's calculation of the cost of ownership, which is based on Mr. Waid's original purchase price of $16,000, is shown below. In the calculation, Staff assumed that the jetter would be depreciated over 12.5 years and its cost would be financed at a 6 percent annual rate of interest. Ownership of a jetter may or may not increase Joann Estates' property tax expense, general liability insurance expense, and fuel expense. It is Staff's opinion that any increase to these expenses would be immaterial and were not included in Staff's calculation. If Joann Estates believes these expenses are material and should be considered by the Commission, it should provide an estimate of these expenses when responding to this report.

Original Cost	$ 16,000	
Divide by: Depreciable Life	12.5	Years
Annual Depreciation Expense	1,280	
Plus: Annual Interest at 6 Percent	960	
Total Cost of Ownership	$ 2,240	

the rental of a backhoe or bush hog to perform general maintenance. Staff cannot determine the reasonableness of these fees without knowing the equipment that was provided or the use of the equipment. Staff removed the entire amount from test-expenses.

(H) Billing and Collection Fee. JoAnn Estates' wastewater customers receive water service from either Paducah Water or West McCracken Water District. Both water utilities provide billing and collection services to JoAnn Estates in return for 10 percent of the monthly sewer fees they collect on behalf of Joann Estates. Joann Estates' test-year billing and collection expense was $6,404, which was reported as a reduction to revenues. Because the fee is set at 10 percent of Joann Estates' revenues, the test-year expense will increase by an amount that is equal to 10 percent of the revenue increase awarded to Joann Estates in this proceeding. Accordingly, JoAnn Estates proposed to increase the test-year expense by $5,594 to match the level of expense to the level of revenues that will result from the rate increase it requested in its Application.

The Commission has long found that billing and collection fees that are set equal to a percentage of revenues are unreasonable. Specifically, the Commission has found it to be unreasonable that the level of the expense will grow with revenues and that with each additional increase in the monthly sewer rate, an additional billing and collection expense would be incurred with no new service being provided. It has further found that such fees, when equal to 15 percent of revenues, results in a high level of expense.[19]

[19] Case No. 2007-00436, *Application of Farmdale Development Corporation for an Adjustment in Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC July 30, 2008).

In the earliest cases, the Commission found that a billing and collection fee assessed by a water district to a privately owned sewer utility should be based on the actual costs incurred by the district to perform the billing and collection service rather than based on a percentage of the sewer utility's revenues. Unable to calculate the water district's actual costs, the Commission limited the wastewater utility's rate recovery for billing and collection costs to $1 per customer. This per customer charge was calculated using the average billing and collection costs, adjusted for inflation, that were reported by 40 small wastewater systems using account 903, Customer Records and Collection Expense, in their 1980 Annual Reports.[20]

In more recent cases, the Commission allowed rate recovery of either the billing and collection expense calculated as a percentage of normalized test-year revenues;[21] the amount awarded to the company in its previous rate case;[22] or the actual billing and collection expense reported for the test year.[23] In each case, the collection fee was equal to 15 percent of revenues and the Commission disallowed rate recovery of the increase to the billing and collection expense that would result from the rate increase

[20] Case No. 8102, *Application and Petition of the Farmdale Development Corporation, Inc., for an Order Authorizing Said Corporation to Revise Rates* (Ky. PSC Aug. 5, 1981); Case No. 8493, *Notice of Adjustment of Rates of 4-Way Enterprises, Inc., D/B/A Coolbrook Sewage Treatment Plant to Become Effective April 20, 1982* (Ky. PSC Nov. 4, 1982).

[21] Case No. 91-394, *Application of Four-Way Enterprises, Inc. for Rate Adjustment Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC Feb. 18, 1992).

[22] Case No. 2007-00436, *Application of Farmdale Development Corporation for an Adjustment in Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC July 30, 2008).

[23] Case No. 98-284, *Application of 4-Way Enterprises, Inc., Coolbrook Sanitation Division for a Rate Adjustment Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC March 25, 1999); Case No. 2010-00314, *Alternative Rate Filing of Coolbrook Utilities, LLC* (Ky. PSC June 6, 2011); Case No. 2011-00433, *Alternative Rate Filing of Coolbrook Utilities, LLC* (Aug. 30, 2012). In Case No. 2011-00433, Coolbrook reported test-year fees of $17,534. In its report, Commission Staff recommended this amount be increased by $71 to allow recovery of the amount agreed to in Coolbrook's previous rate case, but Staff did not include the adjustment in Coolbrook's pro forma financial statements. The Commission accepted the financial statements prepared by Staff without the $71 adjustment.

that was authorized by the Commission in the proceeding. The Commission also instructed each wastewater utility to take efforts to determine whether more economical billing and collection alternatives were available than those provided by the water district.

It is Staff's opinion that, as a rule, contracted billing and collection fees should not be determined as a percentage of revenues; however, in this case, as shown in the table below, a $10,192 fee that is equal to 10 percent of Joann Estates' pro forma proposed rate revenues as determined by Staff compares favorably to the fees recently accepted by the Commission in Case No. 2010-00314 and Case No. 2011-00433 and calculated by Staff in Case No. 2013-00258[24] when stated on a cost-per-bill basis. Based on this comparison, Staff is of the opinion that the billing and collection fee that will result from the rates calculated by Staff should be allowed for rate recovery in this case. Staff urges Joann Estates to seek renegotiation of its contracts to a cost basis to prevent unreasonable billing and collection charges that may occur in future periods.

	Coolbrook Utilities Case No. 2010-00314	Coolbrook Utilities Case No. 2011-00433	Classic Construction Case No. 2013-00258	Joann Estates Case No. 2013-00307
Billing and Collection Expense	$ 17,605	$ 17,534	$ 5,398	$ 10,192
Divide by: Number of Annual Bills	5,220	5,220	1,284	3,324
Cost Per Bill	$ 3.37	$ 3.36	$ 4.20	$ 3.07

[24] Case No. 2013-00258, *Application of Classic Construction, Inc. for Rate Adjustment for Small Utilities Pursuant to 807 KAR 5:076* (Ky. PSC Oct. 31, 2013). This application is still pending before the Commission. On October 31, 2013, the Commission Staff issued a report wherein rate recovery of test-year billing and collection fees was allowed to follow the method most recently applied by the Commission.

(I) General Liability Insurance. Joann Estates did not report general liability insurance expense during the test year. It stated that this insurance is a necessary and prudent business expense, but that its current rates do not produce revenues that are sufficient to purchase the insurance. It requested to increase test-year expenses by $4,800 to include a provision for general liability expense in pro forma operations and stated that it will "pursue" insurance coverage if the Commission accepts its proposed adjustment to test-year expenses.

Joann Estates provided a copy of a quote from Nelson Insurance Agency, Inc. ("Nelson") in support of the amount requested.[25] As shown below, the insurance coverage limits and the premium factor[26] shown in the Nelson quote for Joann Estates are consistent with those of other general liability insurance policies accepted by the Commission for other small investor owned sewer utilities, Coolbrook and Middletown, and the premium is generally consistent with the amounts accepted by the Commission for the wastewater divisions of Symsonia Water District and Southern Water and Sewer District.

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[25] App., Ex. 2, Item J.

[26] A premium factor is multiplied by a utility's revenues to calculate the insurance premium.

	JoAnne Estates	Coolbrook Utilities 2011-00433	Middletown Waste 2012-00375	Symsonia Wastewater Division 2012-00517	Southern Wastewater Division 2012-00309
Coverage Limits					
Policy Aggregate	$1,000,000	$ 1,000,000	Unavailable	Unavailable	$ 5,000,000
Products Aggregate	1,000,000	1,000,000			
Personal Injury	1,000,000	1,000,000			
Each Occurrence Limit	1,000,000	1,000,000			
Fire Damage	50,000	100,000			
Medical Payments	5,000	5,000			
Contractors Pollution	1,000,000				
Cost					
Estimate Revenue	$ 115,000	$ 155,000	$ 188,356	$ 83,568	$ 214,035
Times: Premium Factor, Per $1,000	33.910	32.408	40.511		
Premium	3,900	5,023	7,630		
Taxes and Fees, 23 percent of Premium for Joann Estates	900	755	782		
Total Payment for General Liability	$ 4,800	$ 5,778	$ 8,412	$ 3,368	$ 13,073
Number of Connections	277	435	196	264	335

Staff agrees that Joann Estates should obtain general liability insurance to protect itself against the risk of potential loss and that the amount of the Nelson Insurance quote is based on a premium factor that is consistent with factors approved by the Commission for other small sewer utilities. Because the premium factor is multiplied by revenues to calculate the insurance premium, the annual insurance expense will generally fluctuate with the amount of reported revenues. The $4,800 Nelson Insurance quote was based on estimated annual revenues of $115,000. As shown below, Staff calculated the pro forma present rate insurance expense to be $2,726 and the pro forma proposed rate insurance expense to be $4,251.

	Pro Forma Present Rate Expense		Pro Forma Proposed Rate Expense	
Estimated Revenue	$	65,350	$	101,916
Times: Premium Factor, Per $1,000		33.910		33.910
Premium		2,216		3,456
Taxes and Fees, 23 percent of Premium		510		795
General Liability Pro Forma Expense	$	2,726	$	4,251

Staff included the pro forma insurance costs in the calculation of Joann Estates' revenue requirements, but such cases should remain only if Joann Estates purchases general liability insurance and provides proof of purchase when responding to this report. Proof of purchase should include a copy of the insurance policy, a vendor invoice showing the amount charged for the policy, and a copy of the cancelled check used to pay the vendor invoice. If Joann Estates were not to provide proof of purchase, Staff would remove the insurance costs from pro forma operations.

Requiring the immediate purchase of insurance will require Joann Estates to expend funds prior to recovery of those funds from ratepayers. This is appropriate and reasonable. In this case, Staff applied the operating ratio method to calculate Joann Estates' overall revenue requirement. Using this method, inclusion of $4,251 for general liability insurance at the pro forma proposed rate level will result in an increase to Joann Estates' allowable NOI of $580.[27] This margin provides adequate compensation to Joann Estates for providing the working capital necessary to pay the insurance premium prior to its recovery from rate payers.

(J) Miscellaneous General Expenses. Joann Estates maintains a business checking account with U.S. Bank in return for which Joann Estates incurred $396 in service fees during the test year. U.S Bank offers many different business banking packages. Minimum balances and transaction fees depend on the package provided. Mr. Waid is not aware of the package used by Joann Estates. Staff removed the test-year service fees. These fees would be avoided if Joann Estates switched to a basic checking account that has no service fees.

(K) Amortization. During the test year, Joann Estates paid $2,960 and $2,560 to renew the KPDES permits for the treatment facilities serving the Joann Estates Subdivision and the Wilmington Chiles Subdivision, respectively. These fees were reported in Taxes Other Than Income. Joann Estates removed these expenses from test-year operations and requested that they be amortized over the five-year life of the permits. Staff agrees with the proposed accounting for these permit fees. This

[27] The effect of income taxes is not shown in the calculation below. Income taxes would increase, but would have no effect on the margin because the 88 percent ratio is applied to operating expenses before income taxes.

Insurance Premium	$	4,251
Divide by: 88 Percent Ratio		88%
Impact on Revenue		4,831
Less: Expense		(4,251)
Margin	$	580

treatment will match the cost of the permit with the reporting periods the permits will be in effect.

Joann Estates' current KPDES permit for the Timberland facilities expires on December 31, 2014. Joann Estates expects that the renewal fee for these facilities will be $2,750. It requested recovery of amortization expense for this fee over five years. Recovery at this time is not appropriate. A permit fee should be amortized during the reporting periods that the permit is in effect. Amortization of the Timberland renewal fee should not begin until January 1, 2015. Inclusion of the amortization for this fee in pro forma operations calculated in this proceeding is premature. The proper amount to include in this case is amortization for the permit that is currently in effect. The fee for this permit was $1,500. It became effective on December 31, 2009, and will remain in effect until December 31, 2014. One-fifth of its cost should be reported in each year the permit is in effect, including the test year. Because amortization expense was not reported for the test year, test-year expenses should be increased by $300 to properly account for the fee's five-year amortization.

Joann Estates also requested recovery of $1,000 to account for the three-year amortization of the $3,000 rate-case expense it incurred to prepare, file, and adjudicate the application filed in this proceeding. Staff agrees that recovery of amortization of this rate case expense is appropriate, but disagrees with the use of a three-year amortization period. Rate case expenses should be amortized over the useful life of the rates approved by the Commission. In this case, Staff expects this life to be five years.[28]

As shown below, Staff calculated total amortization expense to be $2,004.

		Cost	Amortization Period		Annual Amortization Expense
Permit Fees					
Joann Estates	$	2,960	5	$	592
Wilmington Chiles		2,560	5		512
Timberland		1,500	5		300
Rate Case Expense		3,000	5		600
Amortization Expense				$	2,004

(L) Depreciation. Joann Estates reported $2,233 for test-year depreciation expense. Staff made three adjustments that result in a net decrease of $177 to the test-year amount.

The test-year expense included $151 for depreciation accrued on blowers that were placed into service during 2009 and 2010. The double declining method of depreciation was applied to calculate this amount using a seven-year depreciable life. The Uniform Systems of Accounts requires that Joann Estates apply the straight-line method of depreciation. Application of the straight-line method to these assets results in a $54 reduction to the test-year depreciation expense as shown below.

[28] Generally, when there is no evidence to support an alternative amortization period, the Commission amortizes an intangible regulatory asset or liability identified in a rate proceeding over the anticipated life of the utility rates approved in that proceeding. This life is generally based on the frequency of the utility's historic rate case filings. Joann Estates' previous rate application was filed five years ago in Case No. 2007-00308, *Application of Joann Estates Utilities, Inc. for an Adjustment of Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC Oct. 12, 2007). It is reasonable to assume that the rates approved for Joann Estates in this proceeding will remain in effect for five years.

Equipment	Cost	Depreciable Life	Depreciation Expense
Blower	$ 1,393	7	$ 199
Blower	1,784	7	255
Pro Forma Depreciation Expense			454
Test-Year Depreciation Expense			(508)
Decrease in Depreciation Expense			$ (54)

Staff increased test-year depreciation expense to account for depreciation to be accrued in pro forma operations on the capital assets that were removed from test-year expenses by Staff in Reference Item (F). The calculation for depreciation on these assets is shown below.

Equipment	Cost	Depreciable Life	Depreciation Expense
Pump	$ 741	10	$ 74
Pump	368	10	37
Motor	398	10	40
Increase in Depreciation Expense			$ 151

Lastly, Staff removed test-year depreciation of $275 that was accrued on a 1998 Plant Upgrade. This asset became fully depreciated as a result of the test-year accrual. Depreciation on this asset should not be included in pro forma operations.

(M) State and Federal Income Taxes. When organized, Joann Estates elected to be taxed pursuant to the Sub-Chapter C of Chapter 1 of the Internal Revenue Code. Joann Estates is therefore subject to paying state and federal income taxes on its earnings. Staff included a provision for the accrual of $736[29] for state income taxes and $2,098[30] for federal income taxes in pro forma operations. Absent the inclusion of these income taxes, Joann Estates will not achieve the NOI to which it is entitled as calculated by Staff.

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Pro Forma Proposed Rate Revenues	$	101,916
Less: Pro Forma Operating Expenses Before Income Taxes		(87,192)
NOI for State Income Tax Purposes		14,724
Times: State Income Tax Rate		5%
State Income Taxes	$	736

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NOI for State Income Tax Purposes	$	14,724
Less: State Income Taxes		(736)
NOI for Federal Income Tax Purposes		13,988
Times: Federal Income Tax Rate		15%
Federal Income Taxes	$	2,098

Determination of Allowable NOI

Joann Estates calculated its allowable NOI using the operating ratio method as historically accepted by the Commission.[31] Pursuant to the Commission's method, the allowable NOI is calculated by dividing pro forma operating expenses before state and federal income tax expenses by 88 percent and then subtracting operating expenses before income taxes from the result. Using this method, Staff calculated Joann Estates' allowable NOI to be $11,890 as shown below.

Pro Forma Operating Expenses Before Income Taxes	$ 87,192
Divide by: Operating Ratio	88%
Sub-Total	99,082
Less: Pro Forma Operating Expenses Before Income Taxes	(87,192)
Allowable Net Operating Income	$ 11,890

[31] An operating ratio measures the difference between operating revenues and operating expenses. It is defined by the following equation.

$$\text{Operating Ratio} = \frac{\text{Operation \& Maintenance Exp.} + \text{Depreciation} + \text{Taxes}}{\text{Gross Revenues}}$$

The Commission has found that the operating ratio is a reasonable and necessary alternative to the rate of return method for calculating the allowable NOI for small sewer investor owned utilities. Specifically, it has found that the rate of return method cannot be used because there is "no basis" upon which to determine a rate of return for these utilities, Case No. 95-236, *Application of Thelma Waste Control, Inc. for a Rate Adjustment Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC. Apr. 15, 1996) at 6. Further, it has found that the operating ratio method is appropriate when plant investment is low and operating expenses are high, Case No. 7982, *Notice of Application of Fern Lake Company* (Ky. PSC. Aug. 27, 1981) at 3.

Calculation of Overall Revenue Requirement and Required Revenue Increase

To recover all pro forma operating expenses and to generate the allowable NOI, Joann Estates requires overall revenue of $101,916. As shown below, a $36,566 revenue increase, or 55.95 percent, is necessary to produce the overall revenue requirement.

Pro Forma Operating Expenses	$ 90,027
Plus: Allowable Net Operating	11,890
Overall Revenue Requirement	101,916
Less: Pro Forma Present Rate Revenue	(65,350)
Required Revenue Increase	$ 36,566
Percentage Increase	55.95%

As shown below, an 88.33 percent operating ratio will result from this overall revenue requirement.

Operation and Maintenance Expense	$ 81,553
Amortization	2,004
Depreciation	2,056
Taxes Other Than Income	1,579
State Income Taxes	736
Federal Income Taxes	2,098
Total Operating Expenses	90,027
Divide by: Pro Forma Proposed Rate Revenue	101,916
Operating Ratio	88.33%

Rate Calculated by Staff

By multiplying Joann Estates' current monthly rate of \$19.66 by the 55.95 percent revenue increase calculated by Staff, Staff determined that an \$11.01 rate increase is appropriate based on Joann Estates' pro forma operations. This increases Joann Estates' current rate to \$30.67. These calculations are shown below.

Current Rate	\$ 19.66
Times: Percent Increase	55.955%
Increase	11.01
Plus: Current Rate	19.66
New Rate Warranted	\$ 30.67

Signatures

for Daryl Parks

Prepared by: Daryl Parks
Financial Analyst, Water and Sewer
Revenue Requirements Branch
Division of Financial Analysis

Prepared by: Jason Green
Rate Analyst, Communications, Water
and Sewer Rate Design Branch
Division of Financial Analysis

ATTACHMENT A
STAFF REPORT, CASE NO. 2013-00307
RATE CALCULATED BY STAFF

Monthly Sewer Rate	$30.67

Billy G Waid
Owner
JoAnn Estates Utilities, Inc.
6500 US HWY 60 West
Paducah, KY 42001