COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ALTERNATIVE RATE FILING ADJUSTMENT FOR DELAPLAIN DISPOSAL COMPANY	))	CASE NO. 2010-00349

ORDER

Delaplain Disposal Company ("Delaplain") has applied pursuant to 807 KAR 5:076[1] for an adjustment of rates to increase its annual operating revenues by $173,460, or 63.8 percent, over pro forma operating revenues. By this Order, we establish rates that will generate annual revenues of $316,481, an increase of $44,708, or 16.45 percent, over normalized revenues from rates of $271,773.[2]

BACKGROUND

Delaplain, a Subchapter S Corporation organized pursuant to KRS Chapter 271B, is a utility subject to Commission jurisdiction.[3] It owns and operates sewage collection and treatment facilities in Scott County, Kentucky, that serve 236 residential customers and 30 commercial customers. Its rates were last adjusted in 2008.[4]

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[1] 807 KAR 5:076 provides a simplified and less expensive procedure by which small utilities may apply for rate increases.

[2]

$10.73 (Flat Rate) x 236 (Residential Customers) x 12 Months =	$ 30,387
$7.63 (Per 1,000 Gal.) x 31,636,496 (Commercial Usage) =	+ 241,386
Normalized Operating Revenues from Sewer Service	$ 271,773

[3] KRS 278.010(3)(f); KRS 278.040.

[4] Case No. 2008-00369, *Delaplain Disposal Co.* (Ky. PSC Sep. 30, 2008).

PROCEDURE

On August 31, 2010, Delaplain filed its application with the Commission. It anticipated to place its proposed rates into effect on October 1, 2010. On September 22, 2010, the Commission initiated this proceeding and, pursuant to KRS 278.190(3), suspended the operation of the proposed rates. After engaging in discovery, Commission Staff prepared a report of its findings and recommendations concerning Delaplain's application. On May 11, 2011, the Commission released that report.

In our Order of May 11, 2011, we directed Delaplain to respond to each finding and recommendation contained in the report and advised Delaplain that its failure to respond to a finding or recommendation would be construed as agreement with the finding or recommendation. We further directed that, unless waived by Delaplain, a hearing would be held in this matter on June 9, 2011.

On May 25, 2011, Delaplain submitted a written response to the Commission Staff report in which it stated its objections to certain findings and recommendations. It stated "assuming the Commission's Final Order addresses the objections raised herein, Delaplain should not require a formal hearing." Delaplain subsequently advised the Commission that it was waiving any right to a formal hearing in the matter on the condition that the objections raised in its response to the Commission Staff Report were expressly addressed and discussed in the Commission's final Order. In our Order of June 8, 2011, we noted our statutory duty to consider and address Delaplain's objections, acknowledged and accepted Delaplain's conditional waiver, and ordered that this case stand submitted for decision.

DISCUSSION

Commission Staff reported that, based upon adjusted test-period operations, Delaplain required $308,664 from rates, an increase of $36,891, or 13.6 percent, over normalized revenues from rates of $271,773. Staff arrived at this recommendation after determining that Delaplain had reasonable operating expenses of $266,838 during the test period and applying an operating ratio of 88 percent to this expense level.[5]

Delaplain has taken exception to Commission Staff's recommendations in four areas: owner/manager fee; depreciation for the capital expenditures that were originally expensed as repairs and maintenance in calendar years 2007 and 2008; office overhead costs; and depreciation expense for post-test-period plant additions. As Delaplain has not objected to Commission Staff findings in other areas or the methodology used to develop a revenue requirement, and as our review indicates that those findings are reasonable and supported by the evidence of record, we have accepted those findings and the general methodology used to derive a total revenue requirement and will focus our attention on the areas in dispute.

Owner Manager/Fee. During the test period, Delaplain paid Elbert Ray, its President and Chief Engineer, $46,550 as compensation for oversight of Delaplain's day-to-day operations and for various engineering services.[6] Commission Staff found

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[5] In reaching its recommended revenue requirement, Commission Staff also considered Delaplain's interest expense and income. See Commission Staff Report at Table 1.

[6] Delaplain's Response to Commission Staff's Second Information Request, Item 2 (filed Feb. 25, 2011).

that, given the nature of Mr. Ray's duties, this level of compensation was excessive and recommended that for ratemaking purposes this amount be reduced to $3,600.[7]

Delaplain advances several reasons in support of the current compensation level. First, it states that due to the age of Delaplain's facilities, their operations must be closely monitored by a professional engineer to ensure compliance with environmental regulations and the parameters of Delaplain's Kentucky Pollutant Discharge Elimination System Permit. The level of Mr. Ray's pay and the number of hours that he worked during the test period is consistent with the compensation paid to professional engineers and the needs of Delaplain's facilities.

Delaplain further justifies the level of compensation based upon the size and complexity of its operations. It notes that it is the largest privately owned sewer system in terms of capacity and gross plant subject to Commission jurisdiction.[8] Unlike other sewer utilities subject to Commission jurisdiction, industrial and commercial users--not residential users–generate the majority of its wastewater flow. Accordingly, the services of a professional engineer are necessary to address daily operational matters.[9] Moreover, Delaplain's size and unique customer mix result in greater administrative duties for its management than would be required for the management and operation of other wastewater utilities that the Commission regulates.

Finally, Delaplain argues that the $3,600 standard for owner/manager compensation upon which Commission Staff relies is outdated and fails to reflect

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[7] Commission Staff Report, App. C at 1-4.

[8] *Id.* at 2.

[9] *Id.*

changing costs. It notes that the Commission first employed the $3,600 standard over 20 years ago and that "the impact of inflation alone makes it obsolete for even the small package plant."[10]

We have previously held that the payment of an owner-manager fee does not involve an arms-length transaction. Therefore, a utility seeking to recover such fee must demonstrate by substantial evidence that the fee is reasonable. The reasonableness of "the fee will depend on the circumstances of the particular utility, to include its owner's responsibilities and duties, and the size and complexity of the sewer utility's operations."[11]

Delaplain has not demonstrated that the level of compensation that it paid to Mr. Ray during the test period is reasonable. While Delaplain is one of the larger privately-owned sewer utilities subject to Commission regulation, its size and number of customers does not place it outside the class of other Commission-regulated sewer utilities. Similarly, while Delaplain has several commercial customers, it has not demonstrated that the nature of its customer composition requires greater owner attention or the specialized services of a professional engineer to a greater degree than similarly situated sewer utilities. Finally, we find insufficient evidence in the record to support Delaplain's contention that the administrative duties associated with its management and operation far exceed those of similarly sized sewer utilities.

[10] Response to Commission Report at 3 (filed May 25, 2011).

[11] Case No. 2007-00436, *Farmdale Development Corp.* (Ky. PSC Jul. 30, 2008) at 6-7.

We note that Delaplain's records indicate that a significant portion of the compensation paid to Mr. Ray was for check-signing activities. Commission Staff asserted in its report that, based upon Mr. Ray's billing records, Delaplain paid Mr. Ray $21,000 in compensation to review and sign 245 checks.[12] We concur with Commission Staff's assessment that the level of compensation for these duties was unreasonable and should not be recovered through rates.[13] We find that the appropriate level for this expense is $3,600.[14]

Repairs and Maintenance. In its application, Delaplain proposes to increase its test-period repairs and maintenance expense of $50,494 by $8,645 to reflect a three-year average of the amounts that were reported in Account No. 714, Maintenance of Treatment and Disposal Plant.[15] Delaplain contends that, as a result of the rate reduction that occurred in 2007, it was unable to fund and was forced to postpone several repair projects in 2009 and that the test-period repairs and maintenance

[12] Response to Commission Report at 3 (filed May 25, 2011).

[13] In its response to the Commission Staff Report, Delaplain proposes an owner/manager fee of $25,000 as an alternative. Response to Commission Report at 2-3 (filed May 25, 2011). The discussion contained in this Order regarding the test-period amount applies equally to this proposal.

[14] As the level of the owner/manager fee is based on each utility's circumstances and not the application of a rigid standard, the Commission finds Delaplain's argument that inflationary conditions required a greater fee than $3,600 in the present case unconvincing. The fee should be based upon the evidence of the owner's responsibilities and work performance as well as any benefits that an owner derives from his ownership of the utility.

[15] Application, Attachment A, Adjustment C, Repairs and Maintenance Expense. For the three-year period from 2007 through 2009, Delaplain reported a total maintenance expense of $177,416, which results in an average annual expense of $59,139.

expense level of $50,494, therefore, is not reflective of normal operations.[16] It argues that the use of a three-year average will better reflect Delaplain's normal operations and will generate funding for the deferred repair projects.[17] Delaplain suggested its proposed adjustment was similar to the Commission's use of averaging to normalize expenses that are subject to significant variations, such as storm-damage repairs.[18]

In its report, Commission Staff found that Delaplain had failed to demonstrate that its repairs and maintenance expense was subject to significant variation. Commission Staff further found that Delaplain had incorrectly expensed nonrecurring/capital expenditures in the amount of $55,725 between 2007 and 2009. When these errors were corrected, Delaplain's average annual repairs and maintenance expense were $40,564,[19] which is $9,930 below the reported test-period level. Accordingly, Staff recommended that the Commission deny Delaplain's proposed adjustment and that repairs and maintenance expense be reduced by $7,573[20] to remove the capital expenditures that were incorrectly expensed in 2009.

Delaplain has not contested Commission Staff's finding or recommendation regarding the repairs and maintenance expense, but instead requested that the

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[16] Delaplain's Response to Commission Staff's First Information Request, Item 5(c).

[17] *Id.*

[18] *Id.*

[19] $177,416 (Three Year Total Maintenance Expense) - $55,725 (Nonrecurring/ Capital Expenditures) = $121,691 ÷ 3 Years = $40,564.

[20] $2,046 (Install New Main Motor, Starter and Power Control) + $2,065 (Sludge Withdraw Piping to Digester) + $1,967 (Purchase and Install Transformer) + $1,495 (Surge Pump) = $7,573.

Commission increase test-period depreciation expense by $6,879[21] to include depreciation expense on the capital expenditures incorrectly classified as repairs or maintenance expenses. It proposed that a seven-year useful life be used to determine the depreciation expense on the expenditures.[22]

Based upon our review, the Commission Staff Report, and Delaplain's response, we concur with Commission Staff's finding and accept its recommendation on this issue. We further find that $48,152 of Delaplain's repairs and maintenance expenditures for 2007 and 2008 were actually capital expenditures and pro forma depreciation expense should be increased to reflect depreciating the capital assets over their estimated useful lives. We accept Delaplain's proposed adjustment to depreciation expense of $6,879.

Outside Services. Delaplain reported a test-period outside service expense of $57,141, which includes $43,030 in payments to Ray Consultants, an affiliated entity,[23] and a $4,025 payment to Steve Singleton, Delaplain's Secretary and Treasurer. Ray Consultants billed Delaplain for 660 hours for administrative services and 11 hours for accounting services. Ray Consultants' hourly rates[24] included: a payroll tax factor; an employee benefit factor; an office overhead factor; and an adjustment to market factor.

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[21] $23,452 (Calendar Year 2007) + $24,700 (Calendar Year 2008) = $48,152 ÷ 7 years = $6,879.

[22] Response to Commission Report at 3 (filed May 25, 2011).

[23] Ray Consultants, LLC is a limited liability company that is organized pursuant to KRS Chapter 275. As of June 6, 2011, Elbert C. Ray was the sole member of that company. *See* http://apps.sos.ky.gov/ImageWebViewer/%28S%28ausbcgmc2o3ydq45s1bb5dm0%29%29/OBDBDisplayImage.aspx?id=4792098 (last visited June 28, 2011).

[24] Ray Consultants billed Delaplain for administrative services at an hourly rate of $64.95 and for accounting services at an hourly rate of $105.

In its report, Commission Staff recommends a reduction of $23,489 in test-period outside service expense. Finding that many of the services that Mr. Singleton provided were duplicative of those provided by Delaplain's certified public accountant and provided no benefit to Delaplain's ratepayers, Commission Staff recommended against recovery of the payment of $4,025 through rates.

Commission Staff also takes issue with the four factors used to determine the billable rate for outside services. It found that Ray Consultants' use of billable hours per employee, rather than actual hours worked, to calculate payroll tax and employee benefit factors resulted in an allocation of expenses to Delaplain that are not directly related to the provided services. Staff recommended adjustments to these factors to reflect the actual hours each employee worked annually. Commission Staff also found no reasonable basis for the adjustment to market factor and the office overhead factor and recommended their elimination when determining the cost of outside services provided to Delaplain. Application of Commission Staff's recommended adjustments results in a billable rate of $35.37 per hour for administrative services and of $26.18 for accounting services for outside services.[25]

In its response, Delaplain asserts that that the hourly rate billed by Ray Consultants "fell within rates charged by a **named** local accounting firm and thus would appear to reasonably indicate market cost."[26] It noted that obtaining from a third party the minimum facilities necessary to transact business, including office space, office supplies, transportation and cellular telephone service, would cost at least $10,000

[25] Commission Staff Report at 7-9.

[26] Response to Commission Report at 3 (filed May 25, 2011).

annually and would justify some office overhead factor in Ray Consultants' billable rates.[27]

Based upon our review of the record, we find insufficient evidence to support the reasonableness of the payments for outside services that Delaplain has made to affiliated entities. Because these transactions are not arms-length, Delaplain bears the burden of demonstrating the reasonableness of the transaction. Delaplain has failed to produce documentary evidence to indicate the rate at which non-affiliated parties would provide the services. For example, Delaplain furnishes no documentary evidence to support its contention that the cost of operating an office and other overhead services were easily in excess of $10,000. The record contains little evidence to allow us to determine the reasonableness of the estimated costs. At a minimum, cost, invoices, or estimates from third-party vendors are necessary to support the reasonableness of these costs.

Finding Delaplain has failed to adequately demonstrate the reasonableness of the payments made to Ray Consultants for test-period outside services expense and that the reductions Commission Staff proposes to address the questionable cost allocations are reasonable, we reduce test-period outside service expense by $23,489 for ratemaking purposes.

Depreciation Expense. In its application, Delaplain proposes to increase its test-period depreciation expense of $16,247 by $33,687 to reflect: (1) 12 months of depreciation for utility plant placed in service in 2009; (2) depreciation of repairs that were completed in 2010 and that total $5,765; and (3) depreciation of planned capital

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[27] *Id.* at 4.

projects whose cost totals $154,872 and which Delaplain contends are necessary to ensure the reliable operation of its treatment plant.[28]

In its report, Commission Staff recommends denial of Delaplain's proposal to include depreciation expense of $30,974 for future capital projects. Noting that Delaplain has no definite or specific date for the construction to be performed, Commission Staff found the proposed adjustment is not known and measurable. It further found that the project's uncertain timing meant that the proposed adjustment violated the matching principle.[29] Failure of the proposed recovery period of a capital expenditure to match the expenditure's expected life, Commission Staff cautions would result in current customers paying a cost in their rates that provide a benefit to future rate-payers. Commission Staff further recommends adjustments to depreciation expense to eliminate depreciation on utility plant funded by Contributions In Aid of Construction and to reflect depreciation on 2009 and 2010 capital projects.

While not contesting the merits of Commission Staff's findings and recommendations, Delaplain asserts that Commission Staff does recognize "the reality of the current lending environment."[30] It notes that in its present situation, it cannot obtain funding to finance the proposed capital projects. Emphasizing its need for the projects, Delaplain suggests that depreciation expense may serve as alternative means

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[28] Application, Attachment A, Adjustment E, Depreciation and Amortization Expense.

[29] *See* Case No. 10481, *Kentucky-American Water Co.* (Ky. PSC Aug. 22, 1989) at 5 ("Adjustments for post test-period addition to utility plant in service should not be requested unless all revenue, expenses, rate base and capital have been updated to the same period as plant additions").

[30] Response to Commission Report at 5 (filed May 25, 2011).

of funding the proposed projects, which Delaplain insists are necessary to replace aging infrastructure. Delaplain further asserts the additional funds from the depreciation expense will make lending institutions more likely to provide financing for the proposed improvements.

The Commission finds no legal authority to support Delaplain's proposal. Rates must be based upon known and measurable expenses. Even in those instances where rates are based upon a future test-period, the Commission must have some assurance that the expense will be incurred. In the current instance, no such assurances exist. The record contains no evidence to suggest when or if the proposed projects will be undertaken. Delaplain has presented no evidence of its inability to obtain financing for its proposed capital projects and, therefore, cannot justify its requested relief. In the absence of such evidence, Delaplain's proposals must be denied.

Revenue Requirements Determination. In its report, Commission Staff reported Delaplain's adjusted operating expenses for the test period as $266,838. In light of our acceptance of Delaplain's proposed adjustment to deprecation expense of $6,879, we find that Delaplain's operating expenses should be $273,717. We further find that, using the operating ratio of 88 percent to determine Delaplain's revenue requirement

Delaplain's revenue requirement is $316,481, an increase of $44,708 or 16.45 percent, over normalized revenue from sewer rates of $271,773.[31]

SUMMARY

Based upon the evidence of record and being otherwise sufficiently advised, the Commission finds that:

1. The findings contained in the Commission Staff Report that are not in conflict with the express findings contained in this Order are reasonable and should be incorporated by reference into this Order.

2. Based upon adjusted test-period operations, Delaplain has adjusted test period operating expenses of $273,717.

3. The operating ratio methodology is the most appropriate rate-making methodology to determine Delaplain's revenue requirements.

4. An operating ratio of 88 percent will allow to provide for adequate revenues to meet its reasonable expenses and provide for reasonable equity growth.

5. Based upon the application of an operating ratio of 88 percent to Delaplain's adjusted test period operating expenses, Delaplain requires $316,481 in annual revenues from sewer rates to meet its reasonable expenses and to provide for reasonable equity growth.

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[31]

Operating Expenses	$	273,717
Divided by Operating Ration	÷	.88
Net Operating Income	$	311,042
Add: Interest Expense	+	5,488
Required Revenue Requirement	$	44,708
Less: Interest Income	-	49
Revenue Requirement – Sewer Rates	$	316,481
Less: Normalized Operating Revenue	-	271,773
Required Increase in Revenue from Rates	$	44,708

6. Delaplain's proposed rates will produce revenue in excess of $316,481 and should be denied.

7. The rates set forth in the Appendix to this Order will produce annual revenues of $316,481 and should be approved for service Delaplain renders on and after the date of this Order.

IT IS THEREFORE ORDERED that:

1. The findings contained in the Commission Staff Report that are not in conflict with those contained in this Order are hereby adopted and incorporated by reference into this Order as if fully set out.

2. Delaplain's proposed rates are denied.

3. The rates set forth in the Appendix to this Order are approved for service that Delaplain renders on and after the date of this Order.

4. Within 20 days of the date of this Order, Delaplain shall file a revised tariff sheet reflecting the rates approved in this Order.

By the Commission

ENTERED
JUN 29 2011
KENTUCKY PUBLIC
SERVICE COMMISSION

ATTEST:

Jason D. Greenwell for
Executive Director

APPENDIX

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2010-00349 DATED JUN 29 2011

The following rate is prescribed for the customers in the area served by the Delaplain Disposal Company. 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.

Residential	$12.50 per month
Commercial/Industrial	$ 8.89 per 1,000 gallons

Elbert C Ray
President
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