COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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

COMMISSION STAFF'S NOTICE OF FILING

Commission Staff hereby gives notice that, pursuant to the Commission's Order of February 11, 2011, the attached report on the application of Hillridge Facilities, Inc. has been filed with the Commission this day.

Gerald E. Wuetcher
Public Service Commission
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P.O. Box 615
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Counsel for Commission Staff

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing Notice of Filing was served this 7th day of March, 2010 by first class mail, postage prepaid, upon Robert C Moore, Hazelrigg & Cox, LLP, 415 West Main Street,P.O. Box 676, Frankfort, KY 40602; David Edward Spenard, Office of the Attorney General, Utility and Rate Intervention Division, 1024 Capital Center Drive, Suite 200, Frankfort, KY 40601-8204; Janice Theriot, Laurence J Zielke, Zielke Law Firm PLLC, 1250 Meidinger Tower, 462 South Fourth Avenue, Louisville, KY 40202-3465

Gerald E. Wuetcher

STAFF REPORT

ON

HILLRIDGE FACILITIES, INC.

CASE 2010-00426

On November 1, 2010 Hillridge Facilities, Inc. ("Hillridge") filed its application seeking to increase its rates for sewer service pursuant to Administrative Regulation 807 KAR 5:076. Hillridge currently charges a flat monthly rate of $24.13 for sewer service. In its application, it proposes to increase this monthly rate to $32.50. Hillridge contends that the rate increase will produce a total increase in annual revenues of $72,317. It bases its proposed rate increase upon its operations for the calendar year ended December 31, 2009.

Hillridge also proposes to assess a monthly surcharge of $11.19 for a period of 36 months to fund repairs to its collection system. The proposed surcharge would produce total revenues of $290,001. Hillridge states that the proceeds are necessary to address infiltration and inflow problems that a recent video survey revealed.

Commission Staff performed a limited financial review of Hillridge's operations for the 12 months ended December 31, 2009 to determine the reasonableness of Hillridge's requested rate increase. Commission Staff limited the scope of this review to determining whether test year operating revenues and expenses were representative of normal operations. It did not pursue Insignificant or immaterial discrepancies and does not address them in this report herein.

Daryl Parks and Jason Green of the Commission's Financial Analysis Division performed the limited review. This report summarizes Commission Staff's findings and recommendations resulting from this review. Mr. Parks is responsible for all areas of this report concerning revenue requirements while Mr. Green is responsible for normalized revenues and rate design. Appendix A of this report shows Hillridge's reported test year operations and Commission Staff's adjustments for known and measurable changes. Commission Staff's calculation of Hillridge's revenue requirement is shown at Appendix B.

Based upon its review of test-year operations and after considering known and measurable changes, Commission Staff finds that Hillridge's annual revenue requirement is $309,744 - $101,261 or approximately 48.57 percent over normalized test year revenues of $208,483. To produce this level of annual revenue, Hillridge's monthly rate should be increased from $24.13 to $35.85, an increase of $11.72 or approximately 48.57 percent.

Commission Staff has also review the proposed surcharge and is unable to make a recommendation on its reasonableness. Hillridge contends that the surcharge is "to pay for sewer line repairs which are critically needed to avoid fines and sanctions from the Kentucky Division of Water." Hillridge has not provided any evidence to directly connect the proposed repairs to avoidance of Division of Water violations. Moreover, because Hillridge did not provide Commission Staff with a copy of the Inflow and Infiltration Study until March 4, 2011, Commission Staff is unable at this time to determine whether an inflow and infiltration problem presents exists, the extent of such problem, or whether the proposed repairs are necessary or the most reasonable means to remedy the alleged problems.

Assuming the existence of an infiltration and inflow problem that required the proposed repair work, Commission Staff is unable to find that the proposed surcharge is necessary to finance those repairs. A utility will generally finance repairs through internal funds or through the issuance of debt. Recognizing that financing the proposed repairs through general rates is not likely, Hillridge may borrow the funds and then seek recovery of the cost of borrowing through its general rates. Commission Staff is of the opinion that prior to the authorization of a surcharge, the utility should demonstrate reasonable efforts to obtain outside funding. Hillridge has not done so. It has applied only to one lending institution. The terms of that application are not set forth in the record. Reasonable efforts require the submission of applications to several lending institutions. Moreover, as Hillridge's proposed rate adjustment is likely to improve the utility's financial condition and will allow it a greater income stream, the likelihood for obtaining funding for the proposed repairs is likely to increase.

Commission Staff is also concerned regarding the effects of the proposed surcharge on the allocation of risks between utility ratepayers and the utility. Generally, the cost of major capital expenditure, such as those which Hillridge proposes, are funded by the utility and recovered through general rates over the utility plant's service life. Utility ratepayers paid for the expenditure as the capital asset depreciates. Hillridge's proposed surcharge, however, requires ratepayers to pay these capital expenditures in advance before using the asset. Instead of the utility bearing the risk that the asset will be fully used, the proposed surcharge will transfer that risk to ratepayers.

The potential involuntary connection of Hillridge's collection system to the Louisville-Jefferson County Metropolitan Sewer District's collection system heightens Commission Staff's concerns. The Kentucky DOW has advised Hillridge that its Kentucky Pollution Discharge Elimination System permit will no longer be renewed and that Hillridge should connect its collection system to MSD's collection system. In the event that this mandatory connection occurs after the imposition of the proposed surcharge and the completion of the required repair work, Hillridge may be eligible for compensation for the value of its utility assets. As the repair work is likely to have increased the value of Hillridge's assets, the utility will be compensated for repairs that ratepayers completely financed and effectively reap a windfall.

Signatures:

Daryl Parks

Prepared by: Daryl Parks
Public Utilities Financial Analyst
Water Revenue Requirements
Branch, Division of Financial
Analysis

Jason Green /GGW

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

APPENDIX A
STAFF REPORT CASE NO. 2010-00426
STAFF'S ADJUSTED OPERATIONS

	Test Year	Adjustment	Ref.	Pro forma
Operating Revenues				
Sewage Rates				
Residential Customers	$ 211,503	(3,020)	A	$ 208,483
Total Sewage Service Revenue	211,503	(3,020)		208,483
Other Operating Revenues				
Misc Operating Revenues	6,000	(6,000)	B	-
Total Other Operating Revenue	6,000	(6,000)		-
Total Operating Revenues	217,503	(9,020)		208,483
Operating Expenses				
Operation and Maintenance Expenses				
Owner/Manager Fee	-	3,600	C	3,600
Sludge Hauling	36,377	(9,679)	D	26,698
Fuel & Power for Pumping & Treatment	52,263	6,803	E	59,066
Chemicals	5,895	4,628	F	10,523
Routine Maintenance Fee	45,036	2,734	G	47,770
Maintenance of Structures and Improvements	9,880	-		9,880
Agency Collection Fee	7,516	-		7,516
Office Supplies and Other Expenses	3,022	-		3,022
Insurance Expenses	6,903	805	H	7,708
Misc General Expenses	519	-		519
Maintenance of General Plant	33,039	(1,275)	I	31,764
Outside Services - Testing	16,098	(4,088)	J	12,010
Outside Services - Legal	23,908	(6,704)	K	17,204
Total Operation and Maintenance Expenses	240,456	(3,176)		237,280
Depreciation	20,036	(312)	L	19,724
Amortization	-	1,652	M	1,652
Income Taxes	175	(175)	N	-
Taxes Other than Income	2,888	3,044	O	5,932
Total Operating Expenses	263,555	1,033		264,588
Utility Operating Income	(46,052)	(10,053)		(56,105)
Plus:				
Misc Nonoperating Income	8,164	(8,164)	P	-
Income Tax Refund	5,235	(5,235)	Q	-
Other Interest Expense	(4,848)	4,848	R	-
Income Available to Service Debt	$ (37,501)	(18,604)		$ (56,105)

A) Normalized Revenue. In the application, Hillridge produced a normalized annual revenue amount of $208,483. The amount was determined by multiplying the total number of customers (720) by the current monthly rate ($24.13) and then by 12 months. This amount is $3,020 below the revenue produced in the test year. Therefore, Hillridge adjusted the revenue by decreasing it $3,020. Commission Staff agrees with this adjustment.

B) Miscellaneous Operating Revenue. Hillridge removed sewer tap fees from its normalized revenue calculation. The fees are placed in Contributions in Aid of Construction account, and therefore, are not included in the normalized revenue calculation. Commission Staff concurs with this adjustment.

C) Owner/Manager Fee. In its annual report for calendar year 2009, Hillridge did not include an expense for the Owner/Manager Fee. Hillridge proposes an adjustment of $21,575 to this account. The adjustment consists of an owner/manager fee of $12,000, a bookkeeping fee of $6,000 and an annual rent expense of $3,575. Finding that Hillridge failed to provide adequate justification for an owner/manager fee of $12,000, Commission Staff recommends an owner/manager fee of $3,600. This amount is consistent with the level of such fees awarded in other Commission proceedings in which the utility has failed to provide any documentary evidence to support an owner's alleged workload.

As to the bookkeeping fee of $6,000, Hillridge noted that the fee was previously paid to Palmetto Land Company ("Palmetto"), a Hillridge affiliate that was administratively dissolved in 2009. In its application, Hillridge states that Sonja Ridge has taken over the bookkeeping duties that Palmetto previously preformed. Hillridge, however, failed to obtain competitive bids for the bookkeeping service or describe the nature of the duties perform or provide evidence of the cost of such services in the local Louisville market. Accordingly, Commission Staff recommends that the proposed adjustment be denied.

As to the proposed rent expense of $3,575, this amount was originally paid to Palmetto. Since Palmetto is no longer in business, however, Hillridge currently does not pay rent expense. Hillridge failed to provide any justification for the rent expense. Accordingly, Commission Staff recommends this adjustment be denied.

D) Sludge Hauling Expense. In its application, Hillridge removed $9,679 from the Sludge Hauling account because the expense was misclassified. The expense was actually for work that plant operator performed and should have been placed in the Routine Maintenance Fee account. Commission Staff agrees with this adjustment.

E) Fuel & Power Expenses. Hillridge proposes an increase of the electric and water expense. Hillridge notes that Louisville Gas and Electric Company (LG&E) implemented a new rate schedule effective August 1, 2010 that increased residential bills by 9.6 percent. Accordingly, Hillridge increased its 2009 electric expense of $35,967.22 by 9.6 percent to produce a pro forma amount of $39,420.07, or an increase of $3,452.85. Commission Staff finds that, as LG&E provides electric service to Hillridge as a general service customer, not a residential customer, Hillridge's use of the 9.6 percent increase is inappropriate. To determine the appropriate expense level, Commission Staff applied the current General Service rate schedule to Hillridge's 2009 electric bills. Hillridge receives electric service at five different metering points and thus receives five bills each month. It was, however, unable to provide billing invoices for the months of July and September. Commission Staff, therefore applied the new rates to the available 50 billing invoices. The test year total of these 50 bills, minus any late fees paid, was $29,080.71. When the new rate schedule was applied, this amount increased to $33,606.91, for a difference of $4,526.20 or 13.5 percent. Commission Staff believes that if the new rate schedule was applied to the remaining bills, the level of increase would be the same. The total of the other 10 bills was $5,728.35. When this amount is increased by 13.5 per cent, the total for these 10 bills becomes $6,501.68, or $773.33 above the test year amount. Based upon these calculations, Commission Staff finds that the total pro forma electric cost is $40,108.59, an increase of $5,299.53 over the test year amount and an increase of $1,846.53 over Hillridge's proposed adjustment. Commission Staff recommends that that electric expense be increased by $5,299.53.

Hillridge also sought an adjustment to water expense to reflect an increase in the water service rates of the Louisville Water Company by 4.5 percent for the calendar year 2010. Hillridge noted in its application that the Louisville Water Company bills on a bi-monthly basis for a total of 6 yearly bills. Hillridge only paid five bills for water service in 2009 and therefore included the first bill of 2010 in its calculations to properly normalize this expense. Adding this bill required an adjustment of $1,777.46 to the water expense which increased the total to $13,457.67. Hillridge then applied the 4.5 percent increase to its water expense of $13,457.67, which produced an increase of $605.59 for a total pro forma amount of $14,063.26. Commission Staff agrees with Hillridge's adjustments and recommends that the Commission accept them.

The third proposed adjustment to this account results from a chemical charge of $880 that was incorrectly recorded in this account. Removing this amount from the account and placing it into the chemical expense account results in a decrease to Fuel and Water Expense of $880. Commission Staff concurs with the proposed adjustment and recommends its acceptance.

There were a total of 4 adjustments to the Fuel and Water Expense account, which are as followed, an increase of $5,299.53 for the electric expense, increases of $1,777.46 and $605.59 to account for a full years worth of water expense and to account for the 4.5% rate increase and an $880 decrease due to a misclassified chemical expense. All these adjustments result in an increase of $6,802.58 to the Fuel and Water Expense.

F) Chemical Expenses. For the test year, Hillridge recorded $5,895 in chemical expenses. Hillridge proposed to increase by $880 to reflect the removal of a misclassified expense from Fuel and Water Expense. For the year 2010, Hillridge expended $10,523 on chemical expenses, or an increase of $3,748 from the test year. Hillridge contends that this increase was due to personnel changes. Hillridge retained a new plant operator in late 2009. It contends that the prior plant operator failed to feed enough chemicals into the system during the test year and that the proper level of chemicals was added to the plant in calendar year 2010. Commission Staff finds the proposed explanation for the differing amounts to be reasonable and recommends that chemical expenses be increased by $4,628 to reflect the reclassification of the misclassified expense and the increase in chemical expenses due to the change in plant operators.

G) Routine Maintenance Fees. Hillridge proposes three adjustments. First, Hillridge reclassifies two payments to Routine Maintenance Fees, the first from Sludge

Hauling for $9,679 and the second from Outside Services Employed - Testing for $4,088. These reclassifications increase the Routine Maintenance Fee by $13,767. Commission Staff agrees with this adjustment.

Second, Hillridge proposes to remove all individual charges over $1,000 during the test year and request recovery of these charges through depreciation. The total amount of this proposed adjustment is $11,691. After examining the invoices in question, Commission Staff finds that none of the proposed expenses should be capitalized as the amount of those of items that can be capitalized is immaterial.

Third, Hillridge removed and amortized expenses totaling $11,033.69 that were incurred as a result of the ice storm in January 2009. Commission Staff agrees with these expenses cannot properly be considered as recurring expenses and are more appropriately amortized.

Accordingly, Commission Staff recommends that Routine Maintenance Fees be increase by $2,734.

H) Insurance Expense. Commission Staff recommends that Hillridge's annual insurance cost be increased $805 from its test year of $6,903 to $7,708 to reflect the current cost of insurance. Hillridge's most recent invoice for insurance reflects a quarterly premium of $1,927, or an annual expense of $7,708.

I) Maintenance of General Plant Expense. Hillridge proposes that all individual expenses over $1,000 be recovered through depreciation. It seeks to remove $18,910 from this account and depreciate it. After examining the invoices, Commission Staff finds that capitalization of the proposed expenses is inappropriate as the amount of items that can be capitalized is immaterial. Commission Staff recommends that the proposed adjustment be denied.

Hillridge also reclassified a $1,275 payment from Maintenance of General Plant Expense as an expense in Outside Services Employed – Legal. Commission Staff concurs with this adjustment.

J) Outside Services Employed - Testing. In its application, Hillridge removed a $4,088 payment from this account and to place the payment in the Routine Maintenance Fees. Commission Staff concurs with this adjustment.

K) Outside Services Employed - Legal. Hillridge reported test year expenses for Outside Services Employed of $23,908. It proposed to adjust this expense level by $1,275 to reflect a bill for legal services that was improperly recorded to Maintenance of General Plant Expenses. It further proposed decreasing this adjusted level of $25,183 to a pro forma amount of $22,000, which includes $19,000 for legal fees and $3,000 for CPA fees. Hillridge reported $27,560.04 in Legal Expenses for calendar year 2010.

Finding that the level of expenses for calendar year 2010 are more representative of Hillridge's normal operations, Commission Staff recommends that the level of Outside Services Employed be $27,560.04 with the adjustments noted below. First, Commission Staff recommends that this level be reduced by $7,165.87 to remove services for which Hillridge failed to provide an itemized invoice that described the nature of the services provided. Absent such invoices, the utility cannot meet its burden of demonstrating that the expense is reasonably necessary. Commission Staff further recommends that the payment of $2,400 to Kentucky Small Utility Consulting be removed as it will be amortized. Finally, Commission Staff recommends that the following costs, which appear to be related to Hillridge's dealings with MSD for the acquisition of its sewage collection and treatment systems and which total $789.95, should be disallowed as unrelated to the provision of utility service:

Vendor	Date of Invoice	Amount	Service Excluded
Hazelrigg & Cox, LLP	06/06/2010	370.00	05/28/2010 – 2.0 hrs – Related to sales of WWTPs
Hazelrigg & Cox, LLP	09/07/2010	18.50	08/06/2010 – 0.10 hrs – Telephone conference with MSD
Hazelrigg & Cox, LLP	09/07/2010	18.50	08/09/2010 – 0.10 hrs – Telephone conference with S. Porter re documents from MSD
Hazelrigg & Cox, LLP	09/07/2010	194.25	08/24/2010 – 1.05 hrs – Review tape of inspection of sewer system and listing of issues provided by MSD; Telephone conference with S. Porter with MSD; Correspondence to S. Porter
Hazelrigg & Cox, LLP	10/11/2010	188.7	09/29/2010 – 1.02 hrs – Review documents from MSD; Telephone Conference with S. Porter; Correspondence to S. Ridge

These three reductions resulted in a total expense for Outside Services Employed - Legal for 2010 of $17,204.22, which is $6,703.78 lower than the test year amount. Therefore, Commission Staff recommend that Outside Services Employed - Legal be reduced by $6,703.78.

L) Depreciation Expense. For the test year, Hillridge claimed $20,036 in depreciation expense. Due to the useful life ending for some of the assets in 2010 and no additional assets being added to the depreciation schedule since the test year, the depreciation expense for Hillridge decreased $312. Commission Staff recommends that depreciation expense be reduced by $312.

M) Amortization Expense. Hillridge proposes an increase in amortization expense of $8,640. Hillridge proposes to include estimated rate case expenses of $17,400 amortized over three years. These rate case expenses include $2,400 for preparation of the rate case application and $15,000 for estimated legal fees. Commission Staff finds that the proposed amortization of the preparation costs of the rate case application is reasonable and further finds that, as the amount of legal expenses related to the rate case proceeding is currently unknown, they should not be included in amortization expense. Accordingly, Commission Staff recommends that amortization expense be increased by $800 to reflect the costs associated with preparing the rate case application.

Hillridge further proposes a three-year amortization period for the expenses related to the ice storm. The expenses related to the ice storm totaled $8,519. This amount is less than the amount transferred to the Amortization account due to being incorrectly placed in the Routine Maintenance Fee. Hillridge states in its application that it disputed the bill and agreed upon a lower amount. Commission Staff finds that the expenses associated with the ice storm are appropriate for amortization but that a longer amortization should be used. Applying the Commission's treatment of ice storm expenses for other utilities,[1] Commission Staff is of the opinion that ten years is a more appropriate period over which to amortize the expense and recommends that amortization expense for this item be $851.90. Therefore, Commission Staff recommends that the pro forma amortization be increased to $1651.90 to account for the ice storm expense and for the rate case preparation.

N) <u>Income Taxes</u>. Hillridge removed an income payment of $175 since income tax is calculated as part of the revenue requirement. Commission Staff agrees with this adjustment.

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[1] Case No. 2009-00548, *Application of Kentucky Utilities Company for an Adjustment of Base Rates* (Ky. PSC July 30, 2010).

O) Taxes Other Than Income. Hillridge increased the Taxes Other than Income expense by $5,248. Hillridge states that it did not receive a bill for its property tax during the test year, but received two property tax bills in January of 2010 for a total of $4,426.70. It also states that it received a property bill from the Commonwealth of Kentucky for the amount of $1,759.32, which was $821.32 more than the bill it received during the test year. Therefore, Hillridge made its adjustment based on the property tax payments for 2010 and the increase of the State property tax. Commission Staff recommends that the payments made in 2010 be averaged over two years to compensate for the lack of payment in 2009 and produces a property tax expense of $2,213.35.

In addition to property tax expense of $2,213.35, Commission Staff finds that a payment of $1,600 to Louisville Metro Health Department, a payment of $344.31 to the Kentucky State Treasurer, a payment of $15 for the annual filing to the Secretary of State, and the $1,759.32 payment to the Commonwealth of Kentucky for property tax should be included in Taxes Other than Income. This pro forma amount totals $5,931.98 or an increase of $3,044 over the test year amount. Therefore, Commission Staff recommends that Taxes Other than Income expense be increased by $3,044.

P) Miscellaneous Nonoperating Income. Hillridge removed an insurance refund of $8,164 that was received in 2009 since it is not a common occurrence. Commission Staff agrees with this adjustment.

Q) Income Tax Refund. Hillridge removed a $5,235 tax refund that was received due to amendment of the 2005 and 2006 tax returns for a 2007 net operating loss carryback. Commission Staff agrees with this adjustment.

R) Other Interest Expense. Hillridge reported other interest expense of $4,848 for the test period. In its application, it provides as evidence of existing indebtedness an outstanding promissory note, executed on September 29, 2010, that it issued to Sonja Ridge for $54,985.90 as evidence of "the renewal of the $54,985.90 initial indebtedness between the maker and lender dated October 1, 2008 and subsequent indebtedness incurred between the maker and lender all of which was to be due September 30, 2010." According to its annual report for Calendar Year 2009, Hillridge owed $65,028 on a promissory note as of December 31, 2009. Hillridge has not provided the amount currently owed on the note of September 29, 2010.

Commission Staff recommends that the interest expense be disallowed and not included in general rates. Hillridge has presented no evidence regarding the use of the proceeds of the note nor demonstrate that the proceeds were used for reasonable purposes related to the provision of utility service. Moreover, as Sonya Ridge is an officer of Hillridge and not an unaffiliated party, the loan is not the product of an arms-length transaction. Hillridge, therefore, must demonstrate that the transaction was reasonable. Hillridge has offered no evidence in support of the reasonableness of the note.

APPENDIX B
STAFF REPORT CASE NO. 2010-00426
CALCULATION OF REVENUE REQUIREMENT AND RECOMMENDED RATE

Pro forma operating expenses before taxes	$ 264,588
Divide by: Operating ratio	88%
Total revenue required before taxes	300,668
Less: Pro forma operating expenses before taxes	(264,588)
Net income allowed after taxes	36,080
Multiply by: Tax gross up factor	1.251564456
Net operating income before taxes	45,157
Plus: Operating expenses before taxes	264,588
Revenue requirement	$ 309,744

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

Revenue Requirement	$ 309,744
Divide by: Pro forma number of bills, (107x12)	8,640
Recommended Rate	$ 35.85