


COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF FARMDALE DEVELOPMENT) CASE NO.
CORPORATION FOR AN ADJUSTMENT OF RATES) 2011-00048

NOTICE OF FILING OF COMMISSION STAFF REPORT

Notice is hereby given that, in accordance with the Commission's Order of June 21, 2011, the attached report containing the findings and recommendations of Commission Staff regarding the Applicant's proposed rate adjustment has been filed in the record of the above-styled proceeding.


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

DATED: JUL 05 2011

cc: Parties of Record

STAFF REPORT
ON
FARMDALE DEVELOPMENT CORPORATION
CASE NO. 2011-00048

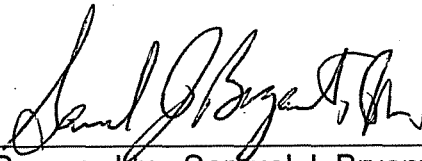
On February 9, 2011, Farmdale Development Corporation ("Farmdale") filed its application to increase its rates for sewer service pursuant to 807 KAR 5:076. Farmdale proposes to increase its current monthly rate from \$32.60 to \$42.38, an increase of 30 percent. The proposed increase would produce additional revenues of \$27,462 annually. The application is based upon utility operations for the calendar year ended December 31, 2009.

Commission Staff performed a limited financial review of Farmdale's operations for the 12 months ended December 31, 2009 to determine the reasonableness of Farmdale's requested rate increase. The scope of this review was limited to obtaining information as to whether the test year operating revenues and expenses were representative of normal operations. Insignificant or immaterial discrepancies were not pursued and are not addressed herein.

Sam Bryant and Eddie Beavers of the Commission's Financial Analysis Division performed the limited review. This report summarizes Staff's findings and recommendations resulting from their review. Mr. Bryant is responsible for all areas of this report concerning revenue requirements while Mr. Beavers is responsible for normalized revenues and rate design.

Appendix A of this report details Farmdale's reported test period operations and Commission Staff's adjustments for known and measurable changes. Appendix B provides a detailed calculation of Farmdale's revenue requirement.

Commission Staff finds Farmdale's annual revenue requirement should be \$108,266. This requirement requires an increase of \$16,815, or approximately 18.38 percent, over normalized test year revenues from rates of \$91,541. This revenue requirement is \$10,737 less than Farmdale's requested amount and results in a monthly rate of \$38.56, a 18.3 percent increase over the current monthly rate of \$32.60. Accordingly, Commission Staff recommends that Farmdale's proposed monthly rate be denied.



Prepared by: Samuel J. Bryant, Jr.
Financial Analyst, Water and Sewer
Revenue Requirement Branch
Division of Financial Analysis



Prepared by: Eddie Beavers
Rate Analyst, Water and Sewer
Rate Design Branch
Division of Financial Analysis

APPENDIX A
STAFF REPORT 2011-00048
REQUESTED AND RECOMMENDED
PRO FORMA INCOME STATEMENTS

	2009	Proforma Adjustment	Ref	Staff Adjustment	Final Recommended
Revenues					
Residential	\$ 78,850	\$ 12,691	A	\$ 0	\$ 91,541
Surcharge	<u>27,915</u>	<u>(27,915)</u>	B	<u>0</u>	<u>0</u>
Total Operating Revenues	\$ 106,765	\$ (15,224)		\$ 0	\$ 91,541
Expenses:					
Owner/Manager Fee	9,600	(3,600)	C	(2,400)	3,600
Sludge Hauling	2,650	1,600	D	(1,600)	2,650
Utility Service-Water	2,202				2,202
Other Labor, Materials and Expense	8,570				8,570
Fuel and Power for Pumping	17,275	1,137	E	(904)	18,412
Chemicals	1,840				1,840
Routine Maintenance Fee	12,000	1,020	F		13,020
Maintenance of Collection System	1,565				1,565
Maint. Of Treatment & Disposal	7,031	1,680	G	(3,720)	4,980
Agency Collection Fee	11,785	1,946	H	(4,577)	9,154
Maint. Of Other Plant	98				98
Office Supplies and Other Exp.	844				844
Outside Services Employed	14,432	(4,928)	I		9,504
Regulatory Commission Expense	250				250
Miscellaneous General Expense.		543	J	(543)	0
Rent		600	K		600
Total Admin. & Gen, Exp.	<u>\$ 90,142</u>	<u>\$ (2)</u>		<u>\$ (12,480)</u>	<u>\$ 76,385</u>
Depreciation Expense	322	1,425	L		1,747
Amortization Expense	31,066	(17,887)	M	(5,667)	7,512
Taxes other Than Income	<u>2,145</u>	<u>740</u>	N		<u>2,885</u>
Total Operating Expenses	<u>\$ 123,675</u>	<u>\$ (15,724)</u>		<u>\$ (18,507)</u>	<u>\$ 88,529</u>
Operating Income	\$ (16,910)	\$ 500		\$ 10,244	\$ 3,012
Income Taxes					
Interest & Dividend Income					
Interest on Debt- Associated					
Interest on Long-Term Debt	<u>8,613</u>	<u>0</u>		<u>(8,613)</u>	<u>0</u>
Net Income	<u>\$ (25,523)</u>	<u>\$ 500</u>		<u>\$ 18,857</u>	<u>\$ (6,166)</u>

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A. Revenues. Farmdale proposes an adjustment of \$12,691 to normalize test-period revenues. Farmdale reported 234 customers receiving sewer service during the test period and test period revenues of \$78,850. Applying the present rate to Farmdale's current number of customers produces total annual revenues of \$91,541, or \$12,691 more than test period revenues.¹ Commission Staff concurs with the proposed adjustment.

B. Surcharge Revenues. During the test-period, Farmdale assessed a monthly surcharge of \$9.92. To determine the revenue requirement needed based on normal ongoing operations, Farmdale proposes to remove from pro forma operations all reported surcharge revenues and surcharge related expenses. Commission Staff concurs with the proposed adjustments.

C. Owner/Manager Fee. Farmdale reported an owner-manager fee of \$9,600 for the test-period and proposes to reduce the fee for ratemaking purposes to \$6,000 to reflect the level that the Commission found reasonable in Farmdale's last rate case proceeding.²

Commission Staff does not agree with the proposed adjustment. While acknowledging that the Commission previously found that an owner-manager fee of \$6,000 was reasonable, Commission Staff is of the opinion that this decision is not controlling precedent. Since the issuance of its order in Case No. 2007-00434, the Commission has not approved an owner-manger fee in excess of \$3,600 for a sewer

¹ \$32.60 per month X 234 customers X 12 bills per customer per year = \$91,541.
\$91,541- \$78,850 = \$\$12,691.

² Case No. 2007-00436, *Farmdale Development Corp.* (Ky. PSC July 30, 2008) at 3-6.

utility of Farmdale's size.³ Moreover, Commission Staff has found no other decisions involving sewer utilities of Farmdale's size in which the Commission has awarded an owner-manager fee in excess of \$3,600 in the absence of unusual circumstances.

Applying the guidance set forth in Case No. 2007-00434 to the evidence presented in this proceeding, moreover, Commission Staff finds no basis for an owner-manager fee of \$6,000. In that proceeding, the Commission 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."⁴ Farmdale has presented no documentary evidence as to the actual time that its owner has expended performing duties on behalf of the sewer utility. It has contracted most operational and management duties to outside parties.⁵

³ See, e.g., Case No. 2008-00042, *Cedarbrook Treatment Plant* (Ky. PSC July 29, 2008); Case No. 2008-00355, *Thomas Country Estates Wastewater Treatment Plant* (Ky. PSC Oct. 24, 2008); Case No. 2008-00482, *Purchase Public Service Corp.* (Ky. PSC Mar. 24, 2007); Case No. 2008-00501, *Ledbetter Water Dist.* (Ky. PSC May 22, 2009); Case No. 2008-00506, *Powell's Valley Water Dist.* (Ky. PSC Apr. 14, 2009); Case No. 2009-00075, *Longview Land Co.* (Ky. PSC July 20, 2009); Case No. 2009-00227, *Middletown Waste Disposal, Inc.* (Ky. PSC Apr.30, 2010); Case No. 2009-00403, *Evergreen Disposal System, Inc.* (Ky. PSC July 29, 2010); Case No. 2010-00231, *Purchase Public Service Corp.* (Ky. PSC Sept. 9, 2010).

⁴ Case No. 2007-00436, *Farmdale Development Corp.* (Ky. PSC July 30, 2008) at 6-7.

⁵ See also Case No. 97-456, *Farmdale Development Corp.* (Ky. PSC Oct. 1998) ("Farmdale is a relatively small utility that should require minimal attention from the owner-manager since routine maintenance, repairs, sludge hauling, billing and collection, and bookkeeping are all contracted services.").

Accordingly, Commission Staff finds that an owner-manager fee at the level of \$3,600 is reasonable and recommends that the owner-manager be established for ratemaking purposes at that level.

D. Sludge hauling expense. During the test-period Farmdale incurred sludge-hauling expense of \$2,650. Contending that test-period expense level is lower than “what can reasonably be expected in normal years,” it proposes to increase this expense to \$4,250 – the expense level that the Commission found reasonable in Case No. 2007-00434.⁶

Commission Staff recommends that the proposed adjustment be denied. Farmdale has chosen calendar year 2009 as its test period. It has not presented any evidence to suggest that its operations in 2009 were unusual or otherwise required fewer loads of sludge to be hauled. To the contrary, the same number of sludge loads was hauled from Farmdale’s treatment facilities in 2008 and 2009.⁷ In the absence of any evidence to suggest that the test period operations are not reflective of normal operations, Commission Staff recommends that the proposed adjustment be denied and that sludge hauling expense remain at test-period level.

E. Fuel and Power Expense. During the test-period, Farmdale incurred fuel and power expense of \$15,303. Farmdale proposes to adjust this expense by \$1,137 to normalize for increases in the rates of Blue Grass Energy, Farmdale’s retail electric supplier. Commission Staff agrees that adjustments are required to reflect three

⁶ Case No. 2007-00436, *Farmdale Development Corp.* (Ky. PSC July 30, 2008) at 8.

⁷ *Annual Report of Farmdale Development Corporation to the Kentucky Public Service Commission for the Year Ended December 31, 2008*, at 11; *Annual Report of Farmdale Development Corporation to the Kentucky Public Service Commission for the Year Ended December 31, 2009*, at 11.

revisions that have occurred in Blue Grass Energy's rates since January 1, 2009.⁸ Finding errors in the methodology that Farmdale used to calculate the proposed adjustment, Commission Staff recalculated Farmdale's fuel and power expense using Farmdale's actual energy usage during the test-period and Blue Grass Energy's current rate. The results of this calculation, which is set forth in Table I, show that an adjustment of \$ to test-period fuel and power expense is required.

F. Routine Maintenance Fees Expense. Farmdale reported test-period Routine Maintenance Fees Expense of \$12,000. It proposes to adjust this expense by \$1,020 to correct for the improper recording of \$1,020 of routine maintenance fees as maintenance of treatment & disposal expenses. Commission Staff concurs with the proposed adjustment and recommends its acceptance.

G. Maintenance of Treatment & Disposal Plant. Farmdale proposes to reduce this test year expense by \$1,020 to correct for the improper recording of \$1,020 of routine maintenance fees as maintenance of treatment & disposal expenses. Commission Staff concurs with the proposed adjustment and recommends its acceptance.

Farmdale also proposes to increase test-period Maintenance of Treatment & Disposal Expense by \$2,700 to reflect an annual expense for main surveys. Finding that Farmdale has failed to adequately support the proposed adjustment, Commission Staff recommends that it be denied. Farmdale has failed to provide at least three quotes to demonstrate that the quoted price of the survey is representative of the

⁸ Case No. 2008-00411, *Blue Grass Energy* (Ky. PSC Mar. 31, 2009); Case No. 2008-00524, *Blue Grass Energy* (Ky. PSC July 15, 2009); Case No. 2010-00169, *Blue Grass Energy* (Ky. PSC Jan. 14, 2011)

present market. The only price quote provided is three years old and should be considered stale.⁹ Furthermore, Farmdale has failed to explain why the proposed survey cannot be performed under its existing contracts for services.

H. Agency Collection Fees. Farmdale reported test-period expenses of \$11,785. It proposes to increase this expense to \$13,731 to reflect increased billing and collection expense that will be to Farmdale Water District if the proposed rates are permitted to become effective. Farmdale Water District charges Farmdale a fee for billing and collection services equal to 15 percent of the amount billed for general rates.¹⁰

In Case No. 2007-00434, the Commission limited the recovery of agency collection fee expenses to ten percent of normalized revenues¹¹ and placed the utility on notice that in future rate proceedings it would be required to demonstrate the reasonableness of its agency collection expense and to show that it had undertaken reasonable efforts to develop an alternative to its present collection methods.

In the current proceeding, Farmdale has failed to demonstrate that the proposed expense level is reasonable. Aside from negotiating an agreement with Farmdale Water District not to bill for surcharge collections, Farmdale has taken no actions to reduce its billing and collection costs. It has provided no evidence to demonstrate that no others could provide these services at a lower cost or that Farmdale Water District's

⁹ Farmdale had filed the same quote in support of a proposed adjustment to the same expense in Case No. 2007-00434.

¹⁰ Farmdale Water District collects fees associated with Farmdale's surcharge at no cost. Accordingly, Farmdale pays only a billing and collection fee equal to 11.9 percent of the total amount billed.

¹¹ Commission Staff interprets the Commission's Order as limiting agency collection fees to ten percent of normalized revenues. We acknowledge that others may interpret the Order as capping agency collection fees at Farmdale's 2005 expense level of \$8,091.

fees are reasonable when compared to other billing and collection entities. As the proposed fee would amount to \$4.89 per month for each customer and is much higher than that of other jurisdictional utilities, Commission Staff recommends that Agency Collection Fee expense be limited to \$9,154.

I. Outside services employed. Farmdale proposes to reduce this expense by \$4,928 to a pro forma level of \$9,504. The removed expenses relate to a previous rate case proceeding but were paid in the test period. Actual test period expenses that are included in this account are:

Legal Services	\$3,204
CPA fees	\$2,400
Bookkeeping	\$3,000
DMR Reporting	<u>\$ 900</u>
Total	<u>\$9,504</u>

J. Insurance Expense. Although reporting no insurance expense for the test period, Farmdale proposed an insurance expense of \$543. Given that no expense was incurred by the utility in the test period and that Farmdale has failed to produce any evidence that the utility is currently has insurance coverage, Commission Staff recommends that the proposed adjustment be denied.

K. Rent Expense. Farmdale reported no rent expense for the test period, but proposes an adjustment of \$600 to reflect costs incurred by an affiliate to house Farmdale's operations. Recognizing that Farmdale's operations are run out of an affiliated entity's offices, that \$600 for office space and facilities is not an unreasonable, and the Commission permitted the recovery of this level of expense in Farmdale's most recent rate case, Commission Staff recommends that the proposed adjustment be allowed.

L. Depreciation Expense. Farmdale reported test period depreciation expense of \$322. It proposes to increase this account by \$1,425 to reflect depreciation on nonrecurring expenditures that were originally expensed but subsequently determined by the Commission to be capital expenditures. Commission Staff concurs with the proposed adjustments.

M. Amortization Expense. During the test period, Farmdale reported amortization expense of \$31,066. It proposes to remove \$23,554 of this expense to reflect the complete amortization of rate case expenses incurred in 2007 and 2008. Farmdale further proposes to amortize 17,000 of rate case expense associated with the current rate proceeding over a three-year period. This proposal results in additional amortization expense of \$5,667.

Commission Staff concurs with the proposal to remove prior rate case expense from Amortization Expense. As \$15,000 of the current rate case expense is relate to potential legal fees for a hearing and other litigation that have not yet incurred, Commission Staff recommends that this portion of the proposed adjustment of \$5,667 be disallowed.

As to the consulting fees, Commission Staff recommends that no amortization of that expense be permitted. Commission Staff finds that, given Farmdale's circumstances, the use of a consultant to prepare its rate application was unreasonable. 807 KAR 5:076 provides that upon request Commission Staff assistance may be obtained to prepare a rate application. Farmdale made no such request. Farmdale contends that use of a consultant was reasonable because of delays that it would likely experience in obtaining Commission Staff assistance. In light of Farmdale's

failure to request Commission Staff assistance, the claims of delay are mere speculation. Moreover, given that Farmdale has two officers who have significant experience in utility operations and have pursued a large number of rate cases before the Commission and that the procedures under which Farmdale submitted its application involve simplified procedures, the need for a consultant is subject to question.¹²

N. Taxes Other Than Income. Farmdale proposes to increase this account by \$740 to reflect the amortization of its KPDES permit fee of \$3,700 over a five-year period. Staff recommends the proposed adjustment be accepted.

¹² Commission Staff agrees that the use of a consultant would not be unreasonable where the utility owner is unfamiliar with Commission procedures, using more formal procedures, or would be required to delay its application a considerable time to wait for Commission Staff assistance.

CASE NO. 2011-00048

TABLE I

From	To	Name	Energy and Customer Charge					Demand			Fuel Adj		Envir. Surcharge		School Tax		Sales Tax		Total
			Cust Chrg	KWH	Rate	Amount	Subtotal	KWH	Rate	Amount	Rate	Amount	Rate	Amount	Rate	Amount	Rate	Amount	
01/01/2009	02/01/2009	SC-1 General Service (0-100KW)	27.79	11,762	\$ 0.08384	986.13	1,013.92	35.26	\$ 7.78000	196.52	\$ 0.00867	101.98	5.2200%	68.51	3.0000%	41.43	6.0000%	85.34	1,507.70
02/09/2009	03/01/2009	SC-1 General Service (0-100KW)	27.79	9,737	\$ 0.08384	816.35	844.14	37.24	\$ 7.78000	211.93	\$ 0.00643	62.61	7.1700%	80.21	3.0000%	35.97	6.0000%	74.09	1,308.95
03/09/2009	04/01/2009	SC-1 General Service (0-100KW)	27.79	12,633	\$ 0.08384	1,059.15	1,086.94	39.90	\$ 7.78000	232.62	\$ 0.00613	77.44	6.8500%	95.69	3.0000%	44.78	6.0000%	92.25	1,629.72
04/09/2009	05/01/2009	SC-1 General Service (0-100KW)	27.79	11,376	\$ 0.08384	953.76	981.55	31.54	\$ 7.78000	167.58	\$ 0.00758	86.23	6.8700%	84.87	3.0000%	39.61	6.0000%	81.59	1,441.43
05/09/2009	06/01/2009	SC-1 General Service (0-100KW)	27.79	12,257	\$ 0.08384	1,027.63	1,055.42	32.30	\$ 7.78000	173.49	\$ 0.00768	94.13	7.3500%	97.24	3.0000%	42.61	6.0000%	87.77	1,550.66
06/11/2009	07/01/2009	SC-1 General Service (0-100KW)	27.79	14,198	\$ 0.08384	1,190.36	1,218.15	31.84	\$ 7.78000	169.92	\$ 0.00360	51.11	7.0600%	101.61	3.0000%	46.22	6.0000%	95.22	1,682.23
07/01/2009	08/01/2009	SC-1 General Service (0-100KW)	27.79	13,552	\$ 0.08384	1,136.20	1,163.99	31.70	\$ 7.78000	168.83	\$ 0.00142	19.24	7.3300%	99.11	3.0000%	43.54	6.0000%	89.68	1,584.39
08/11/2009	09/01/2009	SC-1 General Service (0-100KW)	27.79	13,104	\$ 0.08384	1,098.64	1,126.43	32.07	\$ 7.78000	171.70	\$ 0.00138	18.08	7.2500%	95.43	3.0000%	42.35	6.0000%	87.24	1,541.23
09/08/2009	10/01/2009	SC-1 General Service (0-100KW)	27.79	11,642	\$ 0.08384	976.07	1,003.86	32.01	\$ 7.78000	171.24	\$ (0.01106)	(128.76)	7.6700%	80.25	3.0000%	33.80	6.0000%	69.62	1,230.01
10/08/2009	11/01/2009	SC-1 General Service (0-100KW)	27.79	14,175	\$ 0.08384	1,188.43	1,216.22	34.31	\$ 7.78000	189.13	\$ (0.00784)	(111.13)	7.4100%	95.90	3.0000%	41.70	6.0000%	85.91	1,517.73
11/09/2009	12/01/2009	SC-1 General Service (0-100KW)	27.79	13,339	\$ 0.08384	1,118.34	1,146.13	31.42	\$ 7.78000	166.65	\$ (0.01161)	(154.87)	4.7100%	54.54	3.0000%	36.37	6.0000%	74.93	1,323.75
12/08/2009	01/01/2010	SC-1 General Service (0-100KW)	27.79	11,760	\$ 0.08384	985.96	1,013.75	32.15	\$ 7.78000	172.33	\$ (0.01288)	(151.47)	5.3500%	55.35	3.0000%	32.70	6.0000%	67.36	1,190.02
Pro Forma																			17,507.82
Less: Actual																			17,275.00
Adjustment																			232.82

APPENDIX B
STAFF REPORT 2011-00048
RECOMMENDED RATE

Adjusted Operating Expenses	\$ 88,529
Divided by: .88 Operating Ratio	<u>0.88</u>
Revenue Requirement w/o Interest	\$ 100,601
Interest Expense	<u>7,665</u>
Total Revenue Requirement	108,266
Normalized Revenues	<u>(91,541)</u>
Increase	\$16,725

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