COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF MIDDLETOWN WASTE DISPOSAL, INC. FOR AN ADJUSTMENT IN RATES PURSUANT TO THE ALTERNATIVE RATE FILING PROCEDURE FOR SMALL UTILITIES	)))))	CASE NO. 2012-00375

NOTICE OF FILING OF COMMISSION STAFF REPORT

Notice is hereby given that, in accordance with the Commission's Order of October 10, 2012, as amended on November 30, 2012, the attached report containing the findings and recommendations of Commission Staff on the Applicant's proposed rate adjustment has been filed in the record of the above-styled proceeding.

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

DATE DEC 14 2012

cc: Parties of Record

STAFF REPORT

ON

MIDDLETOWN WASTE DISPOSAL, INC.

CASE NO. 2012-00375

Middletown Waste Disposal, Inc. ("Middletown"), a Subchapter S Corporation organized pursuant to KRS Chapter 271B, is a utility subject to Commission jurisdiction.[1] It owns and operates sewage collection and treatment facilities in Jefferson County, Kentucky, that serve 120 residential customers and 77 commercial customers.[2]

Middletown has applied pursuant to 807 KAR 5:076 to adjust its rates for sewer service based upon test-year operations, the calendar year ending December 31, 2011. In its application, Middletown provided a pro forma operating statement demonstrating that a revenue increase of $50,613, a 30.1 percent increase over pro forma present rate revenues of $168,163, is warranted. This operating statement is presented below in condensed form.

	Test Year	Adjustments	Pro forma Present Rate Operations	Required Increase	Pro forma Operations After Increase
Operating Revenues	$162,976	$ 5,187	$ 168,163	**$ 50,613**	$ 218,776
Operating Expenses	176,789	12,430	189,219		189,219
Net Operating Income	$ (13,813)	$ (7,243)	$ (21,056)	$ 50,613	$ 29,557

Middletown proposes to increase its rates in two phases over a 12-month period that would ultimately result in additional annual revenues of $42,041, a 25 percent

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

[2] *Annual Report of Middletown Waste Disposal, Inc. to the Public Service Commission for the Calendar Year Ended December 31, 2011 ("2011 Annual Report")* at 1 and 8.

increase. In the first phase, Middletown's rates would be adjusted to produce additional revenues of $33,633. In the second phase, which would occur 12 months after the date of this first increase in rates, Middletown's rates would be adjusted again to produce additional revenues of $8,408.

To determine the reasonableness of the requested rates, Commission Staff ("Staff") has performed a limited financial review of Middletown's test-year operations. The scope of this review is limited to determining whether operations reported for the test year were representative of normal operations. Known and measurable changes to test-year operations are identified and adjustments are made when their effects are deemed to be material. Insignificant or immaterial discrepancies have not been pursued or addressed. Staff's findings and recommendations are summarized in this report.

Pro forma Operating Statement

Middletown reported a Net Operating Loss of $13,813 during the test year. It proposes 14 adjustments to test year operating revenues and expenses that increase this loss by $7,243 to 21,056.[3] Staff finds that seven of Middletown's proposed adjustments are reasonable and recommends they be accepted. These adjustments are listed below.

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[3] Application, "Middletown WD 2012 Pro Forma."

Operating Expenses		
Owner/Manager Fee	$	3,600
Routine Maintenance Fee		420
Maintenance - Treatment & Disposal		(1,247)
Outside Services Employed		(4,944)[4]
Miscellaneous and General		48
Office Rent		600
Income Taxes – State		(175)
Total Adjustment to Operating Expenses	$	(1,698)

Staff proposes six additional adjustments to test-year operations. These adjustments and those Middletown proposed adjustments that Staff finds unreasonable are listed below.

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[4] Middletown reported test-year outside services expense of $17,690. It proposed to decrease this amount by $4,944 to reflect the hiring of a new treasurer in December, 2011 who is paid a monthly salary of $900. The treasurer purchased 8 percent of Middletown's stock in April, 2012, making the $900 monthly payment a related party transaction.

The test-year expense includes fees paid to: an office manager, $12,645; Kentucky Small Utility Consulting, Inc. – a rate consultant, $2,138; and a certified public accountant ("CPA"), $2,906. The new treasurer provides the services that the office manager and consulting firm previously provided and thus eliminated the test-year fees associated with them. Further, the hiring of the new treasurer has resulted in a reduction in the services that the CPA performs and has reduced fees paid to the CPA by $960. This results in a total annual savings of $4,944.

Annual Treasurer Fee ($900 x 12)	$10,800
Annual CPA Fee	1,946
Pro forma	12,746
Less: Test Year	(17,690)
Savings	$4,944

Staff finds that the fees paid to the new treasurer are reasonable. Prior to the new treasurer's hiring, Middletown paid $900 monthly for bookkeeping services. Furthermore, the treasurer provides services previously performed by the consulting firm and the CPA in return for the $900. Middletown has maintained records detailing all hours spent by the treasurer performing bookkeeping and management duties. These records reflect an hourly rate of $15.63 for the new treasurer's services.

Operating Revenues	$ 11,866
Operating Expenses	
Utilities	554
Chemicals	1,580
Insurance	1,096
Depreciation	(9,404)
Amortization	(3,982)
Total Adjustments to Operating Expenses	$ (10,156)

Operating Revenues. Middletown reported test-year sewer service revenues of $162,976 and provided a billing analysis to verify this amount. Applying current rates to customer monthly water consumption during the test year resulted in billed revenues of $168,163.[5] Based on this analysis, Middletown proposed to increase test-year sales by $5,186.

Middletown incorrectly calculated the revenue generated from commercial and industrial customers in its billing analysis. Middletown currently charges its commercial customers a minimum bill that includes the treatment of 7,500 gallons of wastewater and a volumetric rate for each 1,000 gallons of wastewater in excess of 7,500 gallons. It currently assesses its industrial customers a minimum charge that includes 20,000 gallons of wastewater and a volumetric charge per 1,000 gallons of wastewater in excess of 20,000 gallons.

In its billing analysis, Middletown erroneously applied the volumetric rate to all gallons of wastewater treated for commercial and industrial customers who exceeded the minimum usage, including volumes included within the minimum charges and failed to consider the revenue from minimum charge. Correcting for this error results in billed

[5] Middletown's bills are based upon a customer's water consumption. A customer is assumed to place the same volume of wastewater into Middletown's sewer system as the volume of water purchased from the customer's water supplier.

revenue of $174,842. Staff finds that test-year revenues should be increased by $11,866 to properly account for the billing analysis.

Sludge Hauling. Middletown reported test-year sludge-hauling expense as $6,383. It proposes to adjust this amount to $10,358 to annualize the first six months of sludge-hauling expense for the year 2012. Middletown states that this adjustment reflects the plant's operation under a new operator who has increased the frequency of sludge hauling. Staff recommends that the proposed adjustment be rejected. Middletown has presented no evidence to demonstrate that the annualized amount for 2012 is more representative of Middletown's normal operations than the actual test-year expense, or that the annualized amount is equal to the annual, recurring expense. It has failed to meet its burden to demonstrate the reasonableness of the proposed adjustment.

Utilities. Middletown reported $39,933 for utilities expense in the test year: purchased power expense of $35,338 and purchased water expense of $4,595. It proposes to increase utilities expense by 25 percent, or $9,983, to reflect an expected increase in purchased power expense. In support of its adjustment, it provided a news report[6] of Louisville Gas and Electric Company's ("LG&E") application for a seven percent rate increase to be effective in January 2013. The news report also pointed to a previously granted 18 percent rate increase to fund environmental equipment upgrades.

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[6] *LGE, KU Propose Base Rate Increase*, AP Alert, June 12, 2012, 13:16:06. Middletown provided a copy of this story as republished on the internet site of a local television station. *See* http://www.lex18.com/news/lgande-ku-propose-base-rate-increase/ (last visited Dec. 12, 2012).

LG&E has applied for an adjustment in its base rates for electric service.[7] On November 19, 2012, LG&E and the parties to the Commission proceeding on LG&E's proposed rate adjustment filed with the Commission a settlement agreement that provides, among other things, for an increase in LG&E's base rates. As of this date, the Commission has not approved the terms contained in the agreement. Accordingly, Staff finds that any adjustment for future changes in electric rates after December 31, 2012 is not currently known or measurable and should be denied.

Staff recommends that test year purchase power expense be increased by $554 to account for the current rates paid to LG&E and to correct test year meter misreads. Staff further recommends that, if the Commission were to approve the rates contained in the agreement prior to issuance of a final Order in this proceeding, Middletown's test-year purchased power expense should be increased by $996, which would increase Staff's recommended revenue requirement by $1,192.[8] Staff further recommends that test-year purchased water expense be increased by $233 to reflect for a 3.75 percent increase in Louisville Water Company's rates that became effective on January 1, 2012.

After accounting for the adjustments to purchased water and purchase power, Staff finds that pro forma utilities expense is $40,487 and that test-year utilities expense should be increased $554 as shown on the next page.

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[7] Case No. 2012-00222, *Application of Louisville Gas and Electric Company for an Adjustment of Its Electric And Gas Rates, A Certificate of Public Convenience and Necessity, Approval of Ownership of Gas Service Lines and Risers, and A Gas Line Surcharge* (Ky. PSC filed July 10, 2012).

[8] $996 (Increase in Electric Expense) $53 (Insurance Premium Impact) = $1,049 ÷ 88% (Operating Ratio) = $1,192.

Pro Forma Electric	$	36,657
Pro Forma Water		4,829
Pro Forma Utilities		40,487
Less: Test Year		(39,933)
Increase	$	554

Chemicals. Middletown proposes to increase test-year chemical expense from $3,363 to $5,222, an increase of $1,859. To calculate its adjustment, Middletown annualized the chemical cost incurred in the first six months of 2012. Based upon its review of Middletown's 2012 chemical invoices, Staff finds that the rates for chemicals used in Middletown's treatment facilities have increased and that Middletown is using a different chemical, Prestochlorine Granular, in its treatment process. Applying current rates for chemicals to test-year chemical usage and taking into consideration the cost of Prestochlorine Granular, Staff calculates a pro forma chemical expense of $4,943, an increase of $1,580 over test-year chemical.

Insurance. Middletown proposes to increase its test-year insurance expense by $1,658 from $7,885 to $9,543. Middletown states that its insurance premiums are based on revenues and, therefore, will increase as rates increase. The Commission has previously recognized this effect.[9] The current liability premium is $5,816. Middletown states that the proposed revenue increase of 25 percent will increase its insurance premium by $1,658.

Staff finds that Middletown's test-year expense should be increased by $1,096. This adjustment accounts for removal of a $1,000 deductible payment on an insurance claim; an audit adjustment in the amount of $552 for general liability insurance; removal

[9] Case No. 2009-00227, *Alternative Rate Filing Application of Middletown Waste Disposal, Inc.* (Ky. PSC Apr. 30, 2010) at 5, n. 13.

of financing charges; and the increase in the commercial business premium that will result from Staff's recommended revenue increase. The calculation of Staff's recommended adjustment is shown below.

Insurance Premium	$ 188,356	$ 0.040511	$ 7,630
Surplus Lines	7,630	3.00%	229
Muncipal Tax	7,630	5.75%	439
KY Surcharge	7,630	1.50%	114
Pro Forma Liability Premium			8,413
Add: Commercial Bus. Package			568
Pro Forma Insurance			8,981
Less: Test-Year Insurance			(7,885)
Pro Forma Adjustment			$ 1,096

Depreciation. Middletown proposes to reduce test-year depreciation expense from $18,478 to $2,087, a reduction of $16,391, to eliminate depreciation reported on contributed property. Staff concurs and recommends acceptance of this adjustment.

In 2012, Middletown replaced its air header at a cost of $14,019 and its diffusers at a cost of $12,548. It proposes to amortize these assets over five years. The correct method to recover the replacement of plant is through depreciation rather than amortization, as Middletown proposed. Staff finds that the air header should be depreciated over five years and the diffusers over three years. Staff further finds that depreciation expense should be reduced by $9,404 to reflect the removal of depreciation on contributed property and the addition of plant.[10]

[10]

Air Headers	$	14,019	÷ 5 Years =	$ 2,804
Diffusers	$	12,548	÷ 3 Years =	4,183
CIAC Depreciation				(16,391)
Pro Forma Adjustment				$ (9,404)

Amortization. Middletown proposes to increase test-year amortization expense by $13,044 from $20,182 to $33,226. It has identified $43,627 of nonrecurring emergency repairs made in 2012 and $4,093 of abnormal levels of sludge removed in 2012. It proposes to amortize the nonrecurring expenditures over a compressed life of five years and to amortize the sludge hauling costs over three years. It also proposes to amortize estimated legal fees of $10,500 over a three-year period.

Based upon its review of the evidence, Staff finds that test-year amortization expense of $20,182 should be decreased by $3,982 to $16,200[11] to reflect the following concerns:

- In Case No. 2009-00227,[12] the Commission permitted Middletown amortize expenditures of $21,033 that the Commission identified as nonrecurring. As of December 31, 2012, $11,537 of these nonrecurring expenditures will be fully recovered. Staff recommends that the remaining expenditures be re-amortized over three years to permit Middletown the opportunity to recover 100 percent of these non-recurring expenditures. Re-amortizing these items over three years results in an amortization expense of $3,846.[13]

- Middletown amortized items costing $3,423 that are normal maintenance expenses. These costs are not included Staff's calculation of pro forma amortization.

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[11] $3,846 (Re-Amortization) + $9,496 (2009-00227 with Amortization Lives Greater than 3 Years) + $2,858 (Post-Test Year) = $16,200.

[12] Case No. 2009-00227, *Alternative Rate Filing Application of Middletown Waste Disposal, Inc.* (Ky. PSC Apr. 30, 2010).

[13] $11,537 ÷ 3 years = $3,846.

- Amortizing the remaining post-test-year nonrecurring costs, which are set forth below, over their estimated useful lives results in an increase to amortization expense of $2,858.

	Staff - Amortization		
	Cost	Life	Amortization
Surge Tank Repair & Rewired Control Panel Blower	1,357	10	$ 136
Change Disconnects on Pump Station	2,100	7	300
Rebuilt Chlorinator & Replaced Sulfonator	1,957	10	196
Rebuilt 10 Hp Pump	2,310	7	330
Replace Electrical Equip - Lift Station (Lighting Hit Lift Station)	852	7	122
Repair Original Lift Station Pump	4,085	7	584
Removal and Installation of #2 Pump	1,159	7	166
Skim Loads	2,094	4	524
Skim Loads	2,000	4	500
			$ 2,858

- As of the date of the Staff Report, Middletown has not retained an attorney or incurred any costs associated with this rate case proceeding. Accordingly, Staff does not recommend inclusion in amortization expense for Middletown's proposed legal fees of $10,500.

Middletown's condensed pro forma operating statement after accounting for Staff's recommended adjustments to revenues and expenses is shown below.

	Test Year	Adjustments	Pro Forma Present Rate Operations
Operating Revenue	$ 162,976	$ 11,866	$ 174,842
Operating Expenses	176,789	(11,854)	164,935
Net Operating Income	$ (13,813)	$ 23,720	$ 9,907

Allowable Net Operating Income

The Commission has historically used an operating ratio approach[14] to determine the revenue requirement for small, privately-owned utilities. This approach is used primarily when there is no basis for a rate-of-return determination or the cost of the utility has fully or largely been funded through the receipt of contributions. Staff finds that the operating ratio method should be used to determine Middletown's revenue requirement.

Under state law, a Subchapter S Corporation is viewed as a separate legal entity from its shareholders and is granted the same liability protection as is afforded a shareholder of a Subchapter C Corporation. However, taxation of Subchapter S Corporations resembles that of a partnership in that there is a single income tax levied at the shareholder level. In contrast, Subchapter C Corporations face a double taxation; an income tax is levied at the corporate level on the net income and the shareholders pay income taxes for any dividends that they receive.

The Commission has previously found that the income tax liability is the responsibility of the shareholder and should not be reported as an expense of the utility.[15] Therefore, the Commission has not included a provision for income taxes in the calculation of the revenue requirement for a utility that is formed as a sub-S corporation.

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[14] Operating Ratio is defined as the ratio of expenses, including depreciation and taxes, to gross revenues. It is illustrated by the following equation:

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

[15] Case No. 2006-00271, *Application of Cow Creek Gas, Inc. for Authority to Adjust Its Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC Jun. 8, 2006).

Accordingly, Staff recommends no provision for income tax when calculating Middletown's revenue requirement.

Applying the operating ratio methodology to Middletown's pro forma operating expense and then adding pro forma interest expense, Staff calculated Middletown's allowable net operating income to be $23,421. This level of revenue produces an operating ratio of 87.57 percent. To generate this net operating income, Middletown requires total revenues of $188,356 and a revenue increase of $13,514, or 7.73 percent. Staff's calculations are shown below.

Allowable Net Operating Income

Operating Expenses	$ 164,935
Divide by: Operating Ratio	88%
Operating Revenues	187,426
Less: Operating Expenses	(164,935)
NOI necessary for 88 percent ratio	22,491
Plus: Interest Expense	930
Allowable NOI	$ 23,421

Required Revenue Increase

Operating Expenses	$ 164,935
Allowable NOI	23,421
Revenue Requirement	188,356
Less: Pro Forma Present Rate Revenues	(174,842)
Required Revenue Increase	$ 13,514
Percentage	7.73%

Operating Ratio

Operating Revenues	$	188,356
Operating Expenses		(164,935)
NOI	$	23,421
Operating Ratio		87.57%

Interest Expense. Middletown reported test-year interest expense in the amount of $9,822. It proposes to reduce this amount by $6,088 to allow recovery of $3,754. Middletown removed interest expense that accrued on loans for which the Commission has previously denied recovery of interest expense.[16] The interest for which it seeks recovery includes $890 accrued on the loan necessary to purchase land at the site of the wastewater treatment facility and $2,864 accrued on financing necessary for an improvement project performed in 2012 that totaled $47,721. Interim financing for the project came from internal funds and a $20,000 loan from Middletown's stockholders.

In its rate application, Middletown states that this amount will be refinanced with permanent financing at a six percent annual rate of interest to replenish cash reserves and repay the stockholder loan. On November 30, 2012, after filing its rate application, Middletown applied to the Commission for authorization to enter a loan agreement to borrow $35,000 with annual interest accruing at 5.90 percent per annum.[17] In that application, it states that the proceeds of the loan will be used to fund Middletown's operations and repay its owners for an emergency loan of $20,000.[18] It further states

[16] Staff Report on Middletown Waste Disposal, App. C at 15 (Ky. PSC filed Apr. 1, 2009 in Case No. 2009-00227).

[17] Case No. 2012-00526, *Application of Middletown Disposal, Inc. for Approval of Financing Pursuant to KRS 278.300* (Ky. PSC tendered Nov. 30, 2012).

[18] App. ¶ 2 (Ky. PSC filed Nov. 30, 2012 in Case No. 2012-00526).

that it sought a loan of $47,000 but its lender has approved a loan for the lower amount.[19]

Staff proposes to reduce test-year interest expense by $8,892 to include recovery of only $930, the three-year average annual interest accrued on the land loan. Interest on this loan was allowed by the Commission in Case No. 2009-00227. Staff agrees with Middletown's removal of interest on loans that were previously disallowed by the Commission.

Staff recommends that interest accrued on the 2012 improvements not be allowed. At the time Staff prepared its report, the permanent financing requested by Middletown had not been approved by the Commission. Absent the Commission's approval to execute the loan, the pro forma interest is not known and measurable. Its recovery is therefore not appropriate. If the Commission approves the loan, interest would be includable in revenue requirements following the Commission's traditional method of calculating the operating ratio.

Recommended Rates

Middletown developed its requested rates by applying the revenue increase to all rates evenly across the board. This method fairly assigns the increase to all customer classes in an unbiased manner absent an allocation based on consumption and usage characteristics. The rates appended hereto were developed using this methodology and will produce annual revenues of $188,356. Staff recommends that the Commission approve these rates and that Middletown's proposed rates be denied.

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[19] *Id.* at ¶ 3.

Mark Frost prepared Middletown's revenue requirements using the Commission's historic operating ratio method, and Jason Green calculated the rates necessary to produce the revenue requirement.

Signatures

Mark Frost

Prepared by: Mark Frost
Financial Analyst, Water and Sewer
Revenue Requirements Branch
Division of Financial Analysis

Jason Green

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

APPENDIX
STAFF REPORT, CASE NO. 2012-00375
STAFF'S RECOMMENDED RATES

Monthly Charges

Residential Rate	$18.855 Per Month
Industrial Rate	
First 20,000 Gallons	$100.62 Minimum Bill
Over 20,000 Gallons	$5.03 Per 1,000 Gallons
Commercial Rate	
First 7,500 Gallons	$37.735 Minimum Bill
Over 7,500 Gallons	$5.03 Per 1,000 Gallons

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