

COMMONWEALTH OF KENTUCKY


BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ALTERNATIVE RATE FILING APPLICATION OF	)	CASE NO.
EAST DAVIESS COUNTY WATER ASSOCIATION,	)	2013-00366
INC.	)	

NOTICE OF FILING OF COMMISSION STAFF REPORT

Notice is hereby given that, in accordance with the Commission's Order of November 13, 2013, the attached report has been filed in the record of the above-styled proceeding. Pursuant to the Commission's November 13, 2013 Order, East Daviess County Water Association, Inc. is required to file written comments regarding the findings in this report no later than February 14, 2014.

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

DATED JAN 31 2014

cc: Parties of Record

STAFF REPORT  
ON  
EAST DAVIESS COUNTY WATER ASSOCIATION, INC.

CASE NO. 2013-00366

East Daviess County Water Association, Inc. ("East Daviess"), a water association organized in 1970, provides retail water service to approximately 4,400 customers that reside in the Kentucky counties of Daviess, Hancock, and Ohio.<sup>1</sup> On October 7, 2013, East Daviess filed an application with the Commission requesting to increase its water service rates by 7.3 percent pursuant to 807 KAR 5:076.

The proposed rates would increase a monthly bill for 5,000 gallons of water purchased through a 5/8-inch meter from \$27.95 to \$29.99, an increase of \$2.04, or 7.3 percent. East Daviess based its application on the test year ended December 31, 2012. Using operations reported for the test year, East Daviess determined that a revenue increase of \$104,674, or 7.3 percent, is warranted.<sup>2</sup> The financial exhibits presented in its application that support the requested revenue increase are shown below in condensed form.

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<sup>1</sup> *Annual Report of East Daviess County Water Association, Inc. to the Public Service Commission for the Calendar Year Ended December 31, 2012 ("Annual Report")* at 5 & 27.

<sup>2</sup> Application at 3.

Pro Forma Operating Expenses	\$ 1,350,357
Plus: Average Annual Debt Service Payments	237,330
Additional Working Capital	<u>37,161</u>
Total Revenue Requirement	1,624,848
Less: Other Operating Revenue	(80,923)
Interest Income	<u>(4,729)</u>
Revenue Required from Rates	1,539,196
Less: Revenue from Sales at Present Rates	<u>(1,434,522)</u>
Required Revenue Increase	<u>\$ 104,674</u>
Percentage Revenue Increase	<u>7.3%</u>

To determine the reasonableness of the proposed rate, Commission Staff (“Staff”) performed a limited financial review of East Daviess’s test-year operations. The scope of the review was limited to determining whether operations reported for the test year were representative of normal operations. Known and measurable changes to test-year operations were identified and adjustments were made when their effects were deemed to be material. Insignificant and immaterial discrepancies were not pursued or addressed.

Staff’s findings and recommendations are summarized in this report. Daryl Parks reviewed the calculation of East Daviess’s Overall Revenue Requirements. Sam Reid reviewed East Daviess’s reported revenues and rate design.

#### Summary of Findings

1. Overall Revenue Requirement and Required Revenue Increase. By applying the Debt Service Coverage (“DSC”) method, as generally accepted by the Commission, to East Daviess’s adjusted test-year operating revenues and expenses, Staff found East Daviess’s overall revenue requirement to be \$1,611,803 and that a

revenue increase of \$108,011, or 7.62 percent over pro forma present rate revenues, is necessary to generate the overall revenue requirement.

2. Rates. East Daviess proposes an across-the-board increase in rates of 7.3 percent. East Daviess has not performed a cost-of-service study. The Commission has previously found that an across-the-board increase is an appropriate and equitable method of revenue allocation in the absence of a cost-of-service study. Given this precedent, Staff finds that an across-the-board increase is the appropriate means to allocate the increased revenue requirement. Staff finds that the rates requested by East Daviess will generate approximately \$4,500 less than the revenue requirement calculated by Staff. The revenue generated from the utilities' proposed rates will allow the utility to meet or exceed all of the requirements of its bond ordinances. Therefore, Staff finds the rates requested by East Daviess as shown in Attachment A should be approved by the Commission.

3. Depreciable Lives. In this report, Staff revised the depreciable lives assigned to many of East Daviess's assets for ratemaking purposes. The revised lives should be used for accounting purposes in all future reporting periods. They better match the life expectancy of East Daviess's assets and will better match expenses to the revenues generated by the water rates approved in this proceeding. This action will minimize the erosion of East Daviess's equity. No adjustment to accumulated depreciation or retained earnings should be made to account for the retroactive effect of this change in accounting estimate.

## Pro Forma Operating Statement

East Daviess's Pro Forma Operating Statement for the test-year ended  
December 31, 2012, as determined by Staff, appears below.

	<u>Test Year</u>	<u>Adjustments</u>	<u>Ref.</u>	<u>Pro forma</u>
Operating Revenue				
Water Sales				
Metered Water Sales	\$ 1,432,842	\$ (14,702)	(A)	\$ 1,418,140
Fire Protection Revenue	1,680	(1,680)	(B)	
Other Water Revenue	80,923			80,923
Total Operating Revenue	<u>1,515,445</u>	<u>(16,382)</u>		<u>1,499,063</u>
Operating Expenses				
Operation and Maintenance				
Salaries and Wages - Employees	302,851	18,644	(C)	321,495
Salaries and Wages - Officers	12,750			12,750
Employee Pension and Benefits	95,427			95,427
Purchased Water	392,930	(19,258)	(D)	373,672
Purchased Power	31,509			31,509
Materials and Supplies	41,271			41,271
Contractual Services - Eng	1,679			1,679
Contractual Services - Acct	20,889			20,889
Contractual Services - Legal	4,165			4,165
Contractual Services - Water Testing	2,942			2,942
Contractual Services - Other	84,991			84,991
Transportation Expenses	29,762			29,762
Insurance	22,700			22,700
Bad Debt	6,192			6,192
Miscellaneous Expenses	30,540			30,540
Total Operation and Maintenance Expense	1,080,598	(614)		1,079,984
Deprecation	271,655	(41,986)	(E)	229,669
Taxes Other Than Income	27,794	1,426	(F)	29,220
Total Operating Expenses	<u>1,380,047</u>	<u>(41,174)</u>		<u>1,338,873</u>
Net Operating Income	135,398	24,792		160,190
Interest and Dividend Income	4,729			4,729
Income Available to Service Debt	<u>\$ 140,127</u>	<u>\$ 24,792</u>		<u>\$ 164,919</u>

(A) Metered Water Sales. East Daviess's application made no adjustment to test-year Metered Water Sales of \$1,432,842.<sup>3</sup> During the test year, East Daviess received a decrease in the wholesale price of water from its supplier and filed an application with the Commission decreasing its rates effective June 1, 2012.<sup>4</sup> East Daviess's Billing Analysis was produced from reports generated by the utility's billing software program. Inadvertently, this analysis used an incorrect number of bills for the 5/8-inch meter customers. Staff performed a Billing Analysis that is included in Attachment C.

(B) Fire Protection Revenue. East Daviess's application included Fire Protection Revenues in the amount of \$1,680.<sup>5</sup> Upon review of East Daviess's tariff, Staff found that no rates for Fire Protection Service were included in the utility's schedules authorizing the charges; therefore Staff reduced operating revenues by \$1,680.

(C) Salaries and Wages – Employees. East Daviess reported test-year Salaries and Wages – Employees expense of \$302,851. Currently, East Daviess has eight full-time employees and one part-time employee. To calculate pro forma wage expense, Staff multiplied the current pay rate of each employee by the actual hours each employee worked during the test year. This calculation takes into account any pay increases, promotions or employees that have left since the start of the test year. The table below contains Staff's calculations.

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<sup>3</sup> Application at "Schedule of Adjusted Operations", 1 of 3.

<sup>4</sup> See Case 2012-00159, *Purchase Water Adjustment filing of East Daviess Water Association* (Ky. PSC June 5, 2012).

<sup>5</sup> Application at "Schedule of Adjusted Operations", 1 of 3.

	Current Pay Rate	Test-Year Hours		Pro Forma Salaries
		Regular	Overtime	
Employee #1	\$ 16.28	2,080	1	\$ 33,887
Employee #2	Salary			58,677
Employee #3	19.26	2,080	81	42,401
Employee #4	11.00	205		2,255
Employee #5	19.77	2,080	8	41,359
Employee #6	15.30	2,080		31,824
Employee #7	20.54	2,080	224	49,625
Employee #8	14.80	2,080		30,784
Employee #9	14.72	2,080	3	<u>30,684</u>
Pro Forma Salary Expense				321,495
Less: Test-Year Salary Expense				<u>(302,851)</u>
Increase in Pro Forma Salary Expense				<u>\$ 18,644</u>

(D) Purchased Water. East Daviess reported test-year purchased water expense of \$392,930. East Daviess's wholesale water provider, Owensboro Municipal Utilities ("Owensboro"), decreased its wholesale rate from \$1.36 to \$1.20 per 1,000 gallons for purchases made by East Daviess on and after June 1, 2012. East Daviess's test-year purchases from January through May must be adjusted to account for the new rate. As shown below, Staff calculated the required adjustment to be \$19,258.

Gallons Purchased January 1, 2012 through May 31, 2012	120,363,000
Reduction to Wholesale Rate per 1,000 Gallons	<u>\$ (0.16)</u>
Decrease to Test-Year Expense	<u>\$ (19,258)</u>

(E) Depreciation. East Daviess reported \$271,655 for test-year depreciation expense. East Daviess proposed to reduce the test-year expense by \$30,124<sup>6</sup> to

<sup>6</sup> East Daviess's Supplemental Filing, filed Dec. 11, 2013.

account for a change to the depreciable life assigned to water mains from 50 years to 62.5 years.<sup>7</sup>

Staff reviewed the depreciable lives assigned to all assets by East Daviess. A summary of Staff’s review is found at Attachment B of this report. To account for the effects of the changes to the depreciable lives recommended in Attachment B, Staff decreased test-year depreciation expense by \$41,986, as calculated below.

<u>Asset Classification</u>	<u>Original Cost</u>	<u>Depreciable Life</u>	<u>Pro Forma</u>	<u>Test Year</u>	<u>Adjustment</u>
Pumping	\$ 325,203	20	\$ 16,260	\$(17,437)	\$ (1,177)
Meters	865,156	40	21,629	(28,066)	(6,437)
Office Furniture & Equipment	21,089	22.5	937	(2,268)	(1,331)
Structures	254,075	37.5	6,775	(8,425)	(1,650)
Transportation	63,131	7	9,019	(10,286)	(1,267)
Mains	7,542,541	62.5	120,681	(150,804)	<u>(30,124)</u>
Pro Forma Adjustment					<u>\$ (41,986)</u>

(F) Taxes Other Than Income Tax. East Daviess reported \$27,794 for test-year Taxes Other Than Income. As shown below, Staff increased this amount by \$1,426 to account for the increase in payroll taxes that will result from Staff’s increase to test-year employee wages.

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Original Cost of Mains	\$ 7,542,541
Estimated Life Requested	<u>62.5</u>
Annual Depreciation Accrual	120,681
Less: Test Year Depreciation on Mains	<u>(150,805)</u>
Decrease	<u>\$ (30,124)</u>



Increase in Pro Forma Salary Expense	\$ 18,644
Times: FICA Rate	<u>7.65%</u>
Increase in Payroll Tax Expense	<u>\$ 1,426</u>

Overall Revenue Requirement and Required Revenue Increase

The Commission has historically applied the Debt Service Coverage (“DSC”) method to calculate the Overall Revenue Requirement of water districts and water associations.<sup>8</sup> This method allows for recovery of: 1) cash related pro forma operating expenses; 2) recovery of depreciation expense, a non-cash item, to provide working capital;<sup>9</sup> 3) the average annual principal and interest payments on all long-term debts, and 4) working capital that is in addition to depreciation expense. A comparison of East Daviess’s and Staff’s calculation of the Overall Revenue Requirement and Required Revenue Increase using the DSC method is shown below.

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<sup>8</sup> See Case No. 1989-00377, *Application of East Daviess County Water Association, Inc. to Reduce Water Rates to Residential Customers in South Hancock County, Kentucky* (Ky. PSC Oct. 19, 1990); Case No. 1999-00409, *An Adjustment of Rates for the Harrison County Water Association, Inc.* (Ky. PSC Apr. 27, 2000); Case No 2005-00477, *Application of the West Laurel Water Association, Inc. for Approval of a Proposed Increase in Rates for Water Service* (Ky. PSC May 15, 2006).

<sup>9</sup> The Kentucky Supreme Court has held that the Commission must permit a water district to recover its depreciation expense through its rates for service to provide internal funds to be used for renewing and replacing assets. See *Public Serv. Comm’n of Kentucky v. Dewitt Water Dist.*, 720 S.W.2d 725, 728 (Ky.1986). Although a water district’s lenders require that a small portion of the depreciation funds be deposited annually into a debt reserve/depreciation fund until the account’s balance accumulates to a required threshold, neither the Commission nor the Court requires that revenues collected for depreciation be accounted for separately from the water district’s general funds or that depreciation funds be used only for asset renewal and replacement. The Commission has recognized that the working capital provided through recovery of depreciation expense may be used for purposes other than renewal and replacement of assets. See Case No. 2012-00309, *Application of Southern Water and Sewer District for an Adjustment in Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC Dec. 21, 2012).

	East Daviess	Staff
Operating Expenses	\$ 1,350,357	\$1,338,873
Debt Service	237,330	237,330 (1)
Additional Working Capital	<u>37,161</u>	<u>35,600</u> (2)
Revenue Requirement	1,624,848	1,611,803
Less: Interest Income	(80,923)	(80,923)
Other Water Income	<u>(4,729)</u>	<u>(4,729)</u>
Revenue Requirement from Rates	1,539,196	1,526,151
Less: Pro Forma Water Sales Revenue	<u>(1,434,522)</u>	<u>(1,418,140)</u>
Increase	<u>\$ 104,674</u>	<u>\$ 108,011</u>
	<u>7.30%</u>	<u>7.62%</u>

(1) Average Annual Principal and Interest Payments. East Daviess has one outstanding note payable to the United States Department of Agriculture Rural Development ("RD") and one note payable to U.S. Bank ("Bank"). To retire these notes, East Daviess pays \$31,228 annually to RD and \$17,175 monthly to the Bank. East Daviess requested to include the total annual payments of \$237,330 in the calculation of its Overall Revenue Requirement.<sup>10</sup> Staff agrees with the requested amount.

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RD	\$ 31,228
Bank Note (\$17,175.14 x 12 Months)	<u>206,102</u>
Total Annual Loan Payments	<u>\$ 237,330</u>

(2) Additional Working Capital. The DSC method, as historically applied by the Commission, includes an allowance for additional working capital that is equal to the minimum net revenues required by East Daviess's lenders that are above its average annual debt payments. In this case, East Daviess calculated its allowance for additional working capital to be \$37,161 as follows.

	RD Note	Bank Note	Total
Annual Payment	\$ 31,228	\$ 206,102	\$ 237,330
Times: DSC Coverage Ratio	120%	115%	
Required Net Revenues	37,474	237,017	274,491
Less: Annual Payment	(31,228)	(206,102)	(237,330)
Allowance for Additional Working Capital	<u>\$ 6,246</u>	<u>\$ 30,915</u>	<u>\$ 37,161</u>

Staff agrees with the amount calculated by East Daviess for the Bank note, but not the amount for the RD note. East Daviess calculated working capital on the RD note using a 120 percent ratio as though it were an RD bond.<sup>11</sup> East Daviess's debt to RD is not bonds, but rather a note payable. Although the RD promissory note shown in East Daviess's application does not state RD's DSC ratio requirements, Staff is aware that RD generally requires a DSC ratio of 110 percent on notes payable.

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<sup>11</sup> Generally, the bond resolution, wherein a borrower and RD agree to the terms of the bonds, has two covenants that are tied to the DSC ratio. First, it states that the borrower's DSC ratio must be at least 120 percent before the borrower may issue additional parity bonds. Secondly, the resolution states that the district must charge rates for service that will generate net revenues that result in a DSC ratio of at least 120 percent.

In this instance, the 110 percent RD requirement is trumped by the higher ratio required by the Bank. The Bank requires that East Daviess maintain a "Fixed Charge Coverage Ratio" that is equal to at least 115 percent of East Daviess's average annual principal and interest payments on all debts, including the RD note.<sup>12</sup> Accordingly, Staff calculated the allowance for additional working capital to be \$35,599, as follows:

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<sup>12</sup> The U.S. Bank Loan Agreement requires that East Daviess maintain a:

"Fixed Charge Coverage Ratio as of the end of the fiscal year for the four (4) fiscal quarters then ended shall be at least 1.15:1. "Fixed Charge Coverage Ratio" shall mean (a) EBITAR minus cash taxes, cash dividends, cash distributions and Maintenance Capital Expenditures divided by (b) the sum of all required principal payments (on short and long term debt and capital leases), interest and rental or lease expense. "EBITDAR" shall mean net income plus interest expense, plus income tax, plus depreciation expense plus amortization expense plus rent or lease expense. "Maintenance Capital Expenditures" shall mean 50% of BORROWER'S depreciation expense for the period specified."

The Overall Revenue Requirement calculated by Staff results in a 148 percent Fixed Charge Coverage Ratio as calculated below:

EBITDAR	
Pro Forma Net Income	
Income Available to Service Debt at Present Rates	\$ 164,919
Plus: Revenue Increase	70,850
Less: Interest Expense, Five Year Average	<u>(57,125)</u>
Pro forma Net Income After Rate Adjustment	178,644
Plus: Interest Expense	57,125
Depreciation	<u>229,669</u>
Total EBITDAR	465,438
Less: Maintenance Capital Expenditures, 1/2 of Depreciation Expense	<u>(114,835)</u>
Total Income for Calculation of Ratio	350,604
Divide by: Average Debt Payments	<u>237,330</u>
Fixed Charge Coverage Ratio	<u>148%</u>

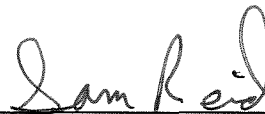
	RD Note	Bank Note	Total
Annual Payment	\$ 31,228	\$ 206,102	\$ 237,330
Times: DSC Coverage Ratio	115%	115%	
Required Net Revenues	35,912	237,017	272,929
Less: Annual Payment	(31,228)	(206,102)	(237,330)
Allowance for Additional Working Capital	\$ 4,684	\$ 30,915	\$ 35,599

Signatures




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




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Prepared by: Sam Reid  
 Manager, Communications, Water  
 and Sewer Rate Design Branch  
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ATTACHMENT A  
STAFF REPORT, CASE NO. 2013-00366  
EAST DAVIESS COUNTY WATER ASSOCIATION INC.'S  
REQUESTED RATES

5/8-inch Meter

First 2,000 Gallons  
Next 4,000 Gallons  
Next 44,000 Gallons  
All Over 50,000 Gallons

Proposed Rates

\$14.99 Minimum Bill  
5.00 per 1,000 Gallons  
3.98 per 1,000 Gallons  
3.23 per 1,000 Gallons

3/4-inch Meter

First 3,000 Gallons  
Next 3,000 Gallons  
Next 44,000 Gallons  
All Over 50,000 Gallons

\$19.99 Minimum Bill  
5.00 per 1,000 Gallons  
3.98 per 1,000 Gallons  
3.23 per 1,000 Gallons

1-inch Meter

First 6,000 Gallons  
Next 44,000 Gallons  
All Over 50,000 Gallons

\$34.99 Minimum Bill  
3.98 per 1,000 Gallons  
3.23 per 1,000 Gallons

1 1/2-inch Meter

First 10,000 Gallons  
Next 40,000 Gallons  
All Over 50,000 Gallons

\$50.91 Minimum Bill  
3.98 per 1,000 Gallons  
3.23 per 1,000 Gallons

2-inch Meter

First 20,000 Gallons  
Next 30,000 Gallons  
All Over 50,000 Gallons

\$90.72 Minimum Bill  
3.98 per 1,000 Gallons  
3.23 per 1,000 Gallons

Wholesale Water Rates

Southeast Daviess Water District

\$1.55 per 1,000 Gallons

Leak Adjustment Rate

\$2.20 per 1,000 Gallons

ATTACHMENT B  
 STAFF REPORT, CASE NO. 2013-00366  
 EAST DAVIESS COUNTY WATER ASSOCIATION, INC.  
 ENGINEERING DIVISION'S  
 ANALYSIS OF ASSET SERVICE LIVES

Historically, the Commission has relied on the National Association of Regulatory Utility Commissioners Study of Depreciation Practices for Small Water Utilities ("NARUC Study"), dated August 15, 1979, to evaluate the reasonableness of a utility's depreciation practices. This study outlines expected service life ranges for various asset groups designed, installed, and maintained in accordance with good water works practices. Typically, an adjustment is made when the Commission finds that a utility is proposing to use a service life that falls outside of this range while service lives falling within these ranges are generally accepted.


In the following table, Engineering Staff has identified the account classifications for which the utility's current service lives are not consistent with the service lives contained in the NARUC Study. The table shows the utility's current service lives and Engineering Staff's recommended reasonable and appropriate service lives based on a review of information contained in the record of this case.

Asset Classification	Current	Change Requested by Utility	Staff Recommended	NARUC Study
Equipment-Pumping, 311	10-50		20	20
Meters, 331	20-50		40	35-45
Office Furniture and Equipment, 340	5-10		22.5*	20-25
Structures-General Plant, 319-339	20-30		37.5	35-40
Transportation Equipment, 341	5		7	7
Transmission and Distribution Mains	50	62.5	62.5	50-75

*\*Office Furniture and Equipment group 340 includes computer and software line items for which the NARUC Study does not contain any service life recommendations. Excluding computer and software line items, the rest of the assets in this group should be depreciated to 22.5-year life cycles.*

Absent any specific and verifiable evidence supporting alternative service lives, Engineering Staff finds that service lives based on the NARUC Study, as shown in the above table, are reasonable and appropriate.

Prepared January 31, 2014

  
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 George W. Wakim, P.E.  
 Manager, Water and Sewer Branch

ATTACHMENT C  
 STAFF REPORT, CASE NO. 2013-00366  
 EAST DAVIESS COUNTY WATER ASSOCIATION INC.  
 STAFF BILLING ANALYSIS

Billing Analysis for: EAST DAVIESS COUNTY WATER ASSOCIATION			
Test Period From: Jan. 1 - Dec. 31, 2012			
CURRENT RATES			
Meter Size	Bills	Gallons Sold	Revenue
5/8 inch	52,272	227,684,913	\$1,324,820.38
1 inch	268	8,138,030	32,524.38
1.5 inch	68	5,177,900	18,241.05
2 inch	170	8,175,923	33,502.26
Wholesale	12	6,286,063	9,051.93
Fire Protection	0	0	0.00
Totals	52,790	255,462,829	\$1,418,140.00

5/8" x 3/4" METER- REVENUE BY RATE INCREMENT					
		BILLS	GALLONS	RATE	REVENUE
FIRST	2,000	52,272	90,657,888	\$13.97	\$730,239.84
NEXT	4,000		92,090,215	4.66	429,140.40
NEXT	44,000		43,114,770	3.71	159,955.80
OVER	50,000		1,822,040	3.01	5,484.34
	TOTAL	52,272	227,684,913		\$1,324,820.38

1" METER- REVENUE BY RATE INCREMENT					
		BILLS	GALLONS	RATE	REVENUE
FIRST	6,000	268	1,160,540	\$32.61	\$8,739.48
NEXT	44,000		3,975,220	3.71	14,748.07
OVER	50,000		3,002,270	3.01	9,036.83
	TOTAL	268	8,138,030		\$32,524.38

1 1/2" METER- REVENUE BY RATE INCREMENT					
		BILLS	GALLONS	RATE	REVENUE
FIRST	10,000	68	424,500	\$47.45	\$3,226.60
NEXT	40,000		1,009,600	3.71	3,745.62
OVER	50,000		3,743,800	3.01	11,268.84
	TOTAL	68	5,177,900		\$18,241.05

2" METER- REVENUE BY RATE INCREMENT					
		BILLS	GALLONS	RATE	REVENUE
FIRST	20,000	170	2,316,505	\$84.55	\$14,373.50
NEXT	30,000		2,131,300	3.71	7,907.12
OVER	50,000		3,728,118	3.01	11,221.64
	TOTAL	170	8,175,923		\$33,502.26



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