

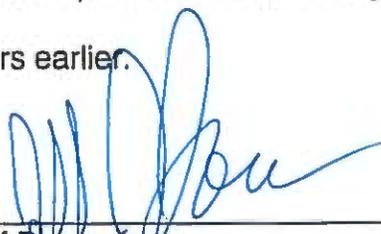
COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ALTERNATIVE RATE ADJUSTMENT FILING OF) CASE NO.
WESTERN MASON COUNTY WATER DISTRICT) 2014-00421

NOTICE OF FILING OF COMMISSION STAFF REPORT

Notice is hereby given that, in accordance with the Commission's Order of January 12, 2015, the attached report containing the findings of Commission Staff ("Staff") regarding the Applicant's proposed rate adjustment has been filed in the record of the above-styled proceeding. Pursuant to paragraph 2 of the Commission's January 12, 2015 Order, Western Mason County Water District is required to file written comments regarding the findings of Staff no later than April 7, 2015, or 14 days after the date of the filing of the staff report, whichever occurs earlier.



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

DATED MAR 24 2015

cc: Parties of Record

STAFF REPORT
ON
WESTERN MASON COUNTY WATER DISTRICT
CASE NO. 2014-00421

Western Mason County Water District ("Western Mason") provides water service to approximately 1,032 customers¹ residing in Bracken and Mason counties, Kentucky.² On December 1, 2014, Western Mason tendered an application to the Commission, pursuant to 807 KAR 5:076, requesting to adjust its water service rates through a phase-in plan. After Western Mason cured filing deficiencies, its application was accepted for filing on December 23, 2014.

Pursuant to the phase-in plan, Western Mason proposes to increase its rates in two phases. The second phase will increase annual water sales revenues over current revenues by \$237,089, or 47.82 percent.³

¹ Staff Revised Billing Analysis.

² *Annual Report of Western Mason County Water District to the Public Service Commission for the Calendar Year Ended December 31, 2013 ("2013 Annual Report")* at 12.

³ Pursuant to the proposed rate phase-in plan, Phase 1 rates would become effective immediately upon the Commission's approval and would remain in effect for one year. Phase 1 rates would increase test-year revenues by \$107,098, or 21.60 percent. Phase 2 rates would become effective upon the completion of Phase 1 rates and would remain in effect until ordered changed by the Commission. Phase 2 rates would increase Phase 1 revenues by \$129,991, or 21.56 percent. As shown in the table below, Western Mason's requested cumulative increase to test-year revenues from the phase-in plan is \$237,089, or 47.82 percent.

		Annual Water Sales Prior to Increase		Annual Water Sales Subsequent to Increase		Revenue Increase
Phase 1	\$	495,826	\$	602,925	\$	107,098
Phase 2		602,925		732,915		<u>129,991</u>
Total Revenue Increase						237,089
Divide by: Test-Year Revenue						<u>495,826</u>
Total Percentage Increase						<u>47.82%</u>

In its application, Western Mason provided financial exhibits based on the test year ended December 31, 2013, that support the requested increase. These exhibits are shown below in condensed form.

Overall Revenue Requirement and Required Revenue Increase

Pro Forma Operating Expenses	\$ 606,100 ⁴
Plus: Average Annual Principal and Interest Payments on Current Debts	<u>178,056</u>
Overall Revenue Requirement	784,156
Less: Other Operating Revenue	(51,214)
Interest Income	<u>(2)</u>
Revenue Required From Rates	732,940
Less: Pro Forma Present Rate Service Revenues	<u>(495,826)</u>
Required Revenue Increase	<u>\$ 237,114</u>
Percent Increase	<u>47.82%</u>

Staff performed a limited financial review of Western Mason's operations for the test year ended December 31, 2013, to determine the reasonableness of the requested water service rates. The scope of Staff's 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 or immaterial discrepancies were not pursued and were not addressed.

Staff's findings are summarized in this report. Ariel Turnbull reviewed the calculation of Western Mason's Overall Revenue Requirement. Sam Reid reviewed revenues and rate design.

⁴ Pro Forma Operating Expenses represent test-year Total Operating Expenses reflected in Western Mason's 2013 Annual Report and adjustments for known and measurable changes requested by Western Mason.

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, Staff found Western Mason's Overall Revenue Requirement to be \$736,516 and that a revenue increase of \$219,265, or 44.61 percent, above pro forma present rate revenues is necessary to generate the Overall Revenue Requirement.

2. Water Service Rates. Western Mason proposes an across-the-board increase in general water sales rates of approximately 47.8 percent to be placed into effect in two phases. Western Mason has not performed a cost-of-service study to allocate the utility's costs to varying customer classifications. The Commission has previously found that an across-the-board increase is an appropriate and equitable method to increase rates in the absence of a cost-of-service study. The Commission has also previously found that a phased-in approach as proposed by Western Mason is an appropriate and equitable method to lessen the impact on the utility's customers when placing a large rate increase in effect. Given this precedent, Staff finds that an across-the-board increase and Western Mason's phased-in approach are appropriate means to allocate the increased revenue requirement.

The Phase 2 rates set forth in Attachment A to this report are based upon the revenue requirement as calculated by Staff and will produce revenues of at least \$710,738 from water sales, resulting in an approximate 44.6 percent increase to current rates.

3. Depreciation. At Attachment B of this report, Staff finds that the depreciable lives assigned to certain water assets should be changed for ratemaking purposes and that these lives should be used for accounting purposes in all future

reporting periods. These recommended depreciable lives better match the life expectancy of Western Mason's assets and will better match expenses to revenues. Staff further finds that no adjustment to accumulated depreciation and retained earnings should be made to account for the retroactive effect of this recommended change in accounting estimate.

4. Unauthorized Debt. Western Mason has an outstanding note, payable to the Bank of Maysville and with a principal balance of \$86,374, for which it did not obtain Commission approval, as required by KRS 278.300. Western Mason has the responsibility to ensure that it follows the Commission's statutes and regulations and that all statutory and regulatory approvals are obtained. Western Mason should be aware that the Commission may initiate a separate proceeding to more thoroughly investigate the possible violations of Commission statutes and regulations. If there is a determination made that there has been a willful violation of any provision of KRS Chapter 278 and 807 KAR Chapter 5, the members of the Board of Commissioners may be held accountable.⁵ As explained in further detail on page 18 of this report, this violation was a result of the Western Mason's misunderstanding of KRS 278.300. Western Mason states that it now has a clear understanding of the requirements of KRS 278.300 and will ensure that future violations will not occur.

⁵ KRS 278.990(1), Any officer, agent, or employee of a utility, as defined in KRS 278.010, and any other person who willfully violates any of the provisions of this chapter or any regulation promulgated pursuant to this chapter, or fails to obey any order of the commission from which all rights of appeal have been exhausted, or who procures, aids, or abets a violation by any utility, shall be subject to either a civil penalty to be assessed by the commission not to exceed two thousand five hundred dollars (\$2,500) for each offense or a criminal penalty of imprisonment for not more than six (6) months, or both.

The known and measurable adjustments found appropriate by Staff are detailed in the Pro Forma Operating Statement shown below.

Pro Forma Operating Statement

	Test Year	Adjustment (Ref.)	Pro Forma
Operating Revenues			
Sales of Water	\$480,954	\$ 14,872 (A)	
		(4,353) (B)	\$491,473
Miscellaneous Service Revenue	<u>51,214</u>	<u>(37,378) (C)</u>	<u>13,836</u>
Total Operating Revenues	<u>532,168</u>	<u>(26,859)</u>	<u>505,309</u>
Operating Expenses			
Operation and Maintenance Expenses			
Salaries and Wages - Employees	140,409	6,733 (D)	147,142
Salaries and Wages - Commissioners	7,200		7,200
Employee Pensions and Benefits	49,814	4,186 (E)	54,000
Purchased Water	17,936	3,137 (F)	21,073
Purchased Power for Pumping	35,476	1,987 (G)	
		(3,713) (H)	33,750
Materials and Supplies	84,850	(36,710) (I)	
		(204) (H)	47,936
Contractual Services - Accounting	14,600		14,600
Legal	268		268
Water Testing	2,666		2,666
Other	10,480		10,480
Rental of Equipment	2,159		2,159
Transportation Expenses	12,739		12,739
Insurance	12,646		12,646
Regulatory Commission Expense	1,422	250 (J)	1,672
Bad Debt Expense	18,858	(15,172) (K)	3,686
Misc. Expense	<u>98</u>		<u>98</u>
Total Operation and Maintenance Expenses	411,621	(39,506)	372,115
Taxes Other Than Income	11,198	58 (L)	11,256
Depreciation	<u>168,278</u>	<u>(18,238) (M)</u>	<u>150,040</u>
Total Operating Expenses	<u>591,097</u>	<u>(57,686)</u>	<u>533,411</u>
Net Operating Income	(58,929)	30,827	(28,102)
Interest Income	2		2
Nonutility Income	<u>12,935</u>	<u>(995) (N)</u>	<u>11,940</u>
Income Available to Service Debt	<u>\$ (45,992)</u>	<u>\$ 29,832</u>	<u>\$ (16,160)</u>

(A) Billing Analysis Adjustment. With the application, Western Mason provided a billing analysis that was drawn from its billing software program. The billing analysis established normalized test-year revenues to be \$495,826.

(B) Sales of Water – Water Adjustment Report. Staff determined that during the test year Western Mason made adjustments in the amount of \$4,353 to customer accounts that were erroneously billed. The corresponding bill and gallon adjustments were not made in Western Mason's billing software. Staff reduced Western Mason's billing analysis provided with the application by 37 bills and approximately 976,760 gallons to determine the test-year normalized revenue from water sales of \$491,473 as shown below.

		BILLS	GALLONS	RATE/1,000	REVENUE
FIRST	2,000	12,376	21,188,700	\$27.50	\$340,340
NEXT	8,000		26,240,525	4.00	\$104,962
OVER	10,000		12,629,011	3.50	\$44,202
	Bulk Rate		469,000	4.20	\$1,970
	TOTAL	12,376	60,527,236		\$491,473

(C) Miscellaneous Service Revenue. In its general ledger, Western Mason made the test-year-end adjusting journal entry shown below. This adjustment increased account 141-Accounts Receivable and account 471.1-Miscellaneous Service Revenue by \$37,378.

	<u>Debit</u>	<u>Credit</u>
141 - Accounts Receivable	\$ 37,378	
471.1 - Miscellaneous Service Revenue		\$ 37,378

The adjusting entry was necessary to correct the Accounts Receivable balance as of December 31, 2013. The original balance was misstated due to accounting errors

that occurred when recording Water Sales Revenues and Accounts Receivable in an accounting period prior to the test year. While it was appropriate to adjust Accounts Receivable to correct this error, the adjustment to test-year Miscellaneous Service Revenue is incorrect. The accounting error should have been recorded directly to retained earnings as shown in the entry below.

	<u>Debit</u>	<u>Credit</u>
141 - Accounts Receivable	\$ 37,378	
32000 - Retained Earnings		\$ 37,378

The accounting error results in an overstatement of test-year revenue by \$37,378 and is, therefore, not appropriate. Accordingly, Staff decreased test-year Miscellaneous Service Revenue by \$37,378 to remove the effects of the adjusting entry.

(D) Salaries and Wages – Employees. During the test year, Western Mason reported \$140,409 for Salaries and Wages – Employees expense. In its application, Western Mason requested to increase this amount by \$17,526 to account for the effects of an increase to wages that became effective on March 29, 2014, and for an increase to wage rates that is anticipated to become effective on January 1, 2016.⁶ The anticipated increase has not been approved by Western Mason's Board of Commissioners.

As shown in the table below, Staff determined that the test-year expense should be increased by \$6,733 to account for the effects of the March 29, 2014 increase. An adjustment for the anticipated January 1, 2016 wage rate increase is not appropriate in this proceeding. Absent the Board of Commissioner's approval of this increase, its

⁶ Western Mason's application also indicated employees would receive a wage increase in 2015. During its review, Staff determined through conversations with Western Mason's general manager that this increase had not yet been, and was not likely to be, approved by its Board of Commissioners.

certainty is unclear. Without knowing the date the wage rate increase will become effective or the amount of the wage increase, any adjustment based upon the increase would not meet the known and measurable criteria established by 807 KAR 5:076, Section 9, and cannot be allowed.

Further, it would not be appropriate to account for the effects of the anticipated wage increase in this proceeding had it received approval from Western Mason's board. The water service rates authorized by the Commission in this proceeding will become effective many months before the stated date of the anticipated wage increase. If an adjustment for this wage increase is included in the calculation of authorized rates, recovery of the additional wage expense would begin before the wage expense is actually incurred.

	Current Pay Rate	Regular Hours	Unused Vacation Hours	Overtime Hours (x1.5)	Pro Forma
Office Employees					
Employee 1	\$ 20.33	2,080	280	1,117	\$ 82,042
Employee 2	10.50	2,075	64	164	25,037
Field Employees					
Employee 3	14.91	2,080	64	362	<u>40,063</u>
Pro Forma Wages					147,142
Less: Test Year Wages					<u>(140,409)</u>
Increase					<u>\$ 6,733</u>

(E) Employee Pensions and Benefits. Western Mason provides health and dental insurance to its three full-time employees. Western Mason reports these costs using account 604, Employee Pensions and Benefits. In its application, Western Mason

requested to increase test-year Employee Pensions and Benefits by \$9,570. Western Mason did not provide an explanation or calculation to support this amount.

Staff determined that test-year health and dental insurance expense may be increased to \$54,000 by annualizing the most recent monthly insurance premiums paid by Western Mason. Accordingly, Staff increased test-year Employee Pensions and Benefits by \$4,186.

2014 Health Insurance Premiums	\$ 4,500
Times: 12 months	<u>12</u>
Pro Forma Health Insurance Premiums	54,000
Less: Test Year	<u>(49,814)</u>
Increase	<u>\$ 4,186</u>

(F) Increase to Wholesale Water Rate. To provide a secondary and emergency source of water supply, on January 16, 1996, Western Mason entered into a 40-year purchase water contract with Maysville Utility Commission (“Maysville”). While Western Mason does not routinely take water from Maysville, the contract has a minimum take provision of 750,000 gallons per month. During the test year, Western Mason paid the annual minimum take fee of \$17,936.

In its application, Western Mason requested to increase test-year purchased water by \$3,364 to account for an increase in Maysville’s wholesale water rate. Maysville’s current rate is \$2.3414 per thousand gallons. Staff determined that the

adjustment should be \$3,137 by applying the new wholesale rate to the contracted minimum purchase requirement.⁷

(G) Purchased Power. In its application, Western Mason requested to increase test-year purchased power by \$1,987. This amount is to account for the rate increase awarded to Kentucky Utilities Company by the Commission in Case No. 2012-00221.⁸ Staff agrees that Western Mason's adjustment properly reflects, in all material respects, the impact of the rate increase on Western Mason's test-year purchased power and has increased the test-year expense by \$1,987.

(H) Water Loss. Using information provided by Western Mason, Staff determined that Western Mason's test-year water loss was 24.91 percent,⁹ or 9.91 percent above the 15 percent allowed by 807 KAR 5:066, Section 6(3), for ratemaking purposes. As calculated below, Staff removed the cost to pump and treat water loss

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Test-Year Gallons Purchased as Required by Minimum Take (000's Omitted)	9,000
New Wholesale Rate Per Thousand Gallons	<u>\$ 2.3414</u>
Purchased Water at Wholesale Rate	21,073
Less: Test Year	<u>(17,936)</u>
Increase	<u>\$ 3,137</u>

⁸ Case No. 2012-00221, *Application of Kentucky Utilities Company for an Adjustment of Its Electric Rates* (Ky. PSC Dec. 20, 2012).

⁹

Water Produced	81,733,000
Less: Water Sold	(60,527,236)
Other Water Used	<u>(850,000)</u>
Water Loss	<u>20,355,764</u>
Water Loss Percentage	<u>24.91%</u>

that was above the allowable limit.¹⁰ Accordingly, Staff decreased test-year Purchased Power and Chemicals by \$3,713 and \$204, respectively.

	Test Year	Times: Excess Water Loss Percentage	Decrease
Purchased Power	\$ 37,463	-9.91%	\$ (3,713)
Chemicals	2,061	-9.91%	\$ (204)

(l) Materials and Supplies – New Meters. In its general ledger, Western Mason made the following test-year-end journal entry:

	<u>Debit</u>	<u>Credit</u>
620 - Materials and Supplies	\$ 34,014	
151 - Inventory		\$ 34,014

This adjusting entry increased Materials and Supplies expense and decreased inventory by \$34,014.

The entry was made to account for a reduction of inventory that was used to install radio-read meters during the test year. Staff agrees with the entry to Account 151, Inventory, but disagrees that this amount should be charged to Account 620, Materials and Supplies expense. Instead, it should have been capitalized and charged to account 101, Utility Plant in Service.

Also, Staff found that an additional \$2,696 was included in Materials and Supplies expense that was related to the radio-read meters. Staff removed the total amount related to radio-read meters, \$36,710, from Materials and Supplies expense

¹⁰ No adjustment was made to Purchased Water. Since Western Mason did not take water from Maysville during the test year, the water loss adjustment will not affect Purchased Water.

and capitalized the cost of the meters in its depreciation adjustment shown in Reference Item (M).

(J) Regulatory Commission Expense. During the 2013 session of the Kentucky General Assembly, legislators passed House Bill 1, now codified as KRS 65A, which requires that all Special Purpose Government Entities (“SPGE”) register annually with the Department for Local Government and pay an annual registration fee. The amount of the annual registration fee is calculated by a tier system that changes based on the amount of annual revenue an SPGE reports for the previous year.

Pursuant to KRS 65A, Western Mason is considered a SPGE. During the test year, Western Mason incurred a SPGE fee of \$250 based on its 2012 annual revenue. It reported the fee using account 667, Regulatory Commission Expense. Future SPGE fees will be based on revenue subsequent to this rate case proceeding, which will exceed \$500,000. At this level of revenue, Western Mason’s SPGE fee will increase to \$500. Accordingly, Staff increased test-year Regulatory Commission Expense by \$250, to reflect a total SPGE fee of \$500. In its application, Western Mason improperly requested to increase the test-year fee by \$500, the full amount of the pro forma expense.

(K) Bad Debt Expense. Western Mason reported \$18,858 for test-year bad debt expense. As explained below, Staff found that this amount includes bad debts that should have been expensed in prior accounting periods and is, therefore, overstated. Staff found that the test-year amount should be reduced to \$3,686 in pro forma operations to allow recovery of a reasonable amount of bad debt expense.

Western Mason’s financial statements are audited annually by an independent Certified Public Accountant (“CPA”). As part of these audits, all customer accounts

receivables are reviewed by the CPA, with guidance provided by Western Mason, to determine the probability of their collection. When the cumulative total of uncollectible accounts is deemed significant, they are removed from customer accounts receivable subsidiary ledger and reported as Bad Debt Expense. When the total uncollectibles are not significant, they are not removed but, are carried forward to the next year.

Western Mason's method of accounting has two primary flaws. First, accounts receivable are not written off in the year that they are earned, resulting in a mismatch of revenues to expenses. Second, this method results in large fluctuations from year to year in the amounts that are reported as Bad Debt Expense. For example, Western Mason reported no bad debt expense in each of the four years immediately preceding the test year, but reported \$18,858 during the test year. While Western Mason confirmed that the test-year amount includes accounts receivables that were billed in prior periods as well as during the test year, it stated that it does not maintain records in sufficient detail to readily determine the years in which the receivables were billed and that the amount of the expense that is attributable to the test year is unknown.

Absent the actual test-year bad debt expense, Staff found that pro forma bad debt expense should be set at \$3,686 for Western Mason, based on the level of bad debt expense generally experienced by other water districts. Staff has found that a water utility with effective customer deposit and collection policies will realize annual bad debt expenses that range from .5 percent to 1 percent of water sales revenue billed to residential and small commercial customers.¹¹ By applying the mid-point of this range to Western Mason's pro forma present-rate water sales revenues, Staff

¹¹ Case No. 2012-00433, *Application of West Carroll Water District for an Adjustment in Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities*, Staff Report on West Carroll Water District (Ky. PSC Jan. 29, 2013).

determined that \$3,686 is a reasonable level of bad debt expense to be recognized for ratemaking purposes by Western Mason. Accordingly, the test-year expense was reduced by \$15,172. Staff's calculations are shown below:

Pro Forma Water Sales Revenue	\$ 491,473
Times: .75 Percent	<u>0.75%</u>
Pro Forma Bad Debt Expense	3,686
Less: Test Year Bad Debt Expense	<u>(18,858)</u>
Decrease	<u>\$ (15,172)</u>

(L) Taxes Other Than Income – Payroll Taxes. Below, Staff calculated Western Mason's pro forma payroll taxes by multiplying the total taxable wages by the payroll tax rate. Accordingly, Staff increased payroll tax expense by \$58.

	Pro Forma
Total Wages Subject to Payroll Taxes	\$ 147,142
Times: Tax Rate	<u>7.65%</u>
Payroll Tax Expense	11,256
Less: Test Year	<u>(11,198)</u>
Adjustment	<u>\$ 58</u>

(M) Depreciation. Western Mason reported \$168,278 for test-year depreciation expense. It proposed to reduce this amount by \$18,073, restating the pro forma expense to \$150,200. This adjustment was made for ratemaking purposes to account for changes to the depreciable lives assigned to Transmission and Distribution Mains.

Staff reviewed all the lives assigned to Western Mason's assets used. A summary of this review is found at Attachment B of this report. Based on this review,

Staff determined that Western Mason's test-year depreciation should be decreased by \$18,238, as calculated below:

Asset	Original Cost	Staff Useful Life	Pro Forma
Transmission and Distribution Mains	\$ 2,747,220	62.5	\$ 43,956
Meters and Meter Installations	321,514	45	7,145
Communication Equipment	130,124	10	13,012
Transportation Equipment	9,000	7	1,286
New Meters (See Reference Item I)	36,710	40	<u>918</u>
Pro Forma			66,316
Less: Test-Year Depreciation on Assets Listed in the Adjustment			<u>(84,554)</u>
Decrease			<u>\$ (18,238)</u>

(N) Nonutility Income. During the test year, Western Mason provided contracted billing and collection services to the Western Mason Sanitation District ("WMSD") in return for a flat fee of \$995 per month for this service. Staff found that billing service revenue reported by Western Mason includes 13 monthly fees instead of 12. Staff decreased Nonutility Income by \$995 to eliminate the extra month.

Overall Revenue Requirement and Required Revenue Increase

Staff applied the DSC method as generally accepted by the Commission to calculate Western Mason's Overall Revenue Requirement. 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;¹² 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 Western Mason's and Staff's calculation of their Overall Revenue Requirement and Required Revenue Increase is shown below:

	Western Mason	Staff	
Pro Forma Operating Expenses	\$ 606,100	\$ 533,411	
Plus: Average Annual Principal and Interest on Current Debts	178,056	169,254	(1)
Additional Working Capital		<u>33,851</u>	(2)
Overall Revenue Requirement	784,156	736,516	
Less: Other Operating Revenue	(51,214)	(13,836)	
Interest Income	(2)	(2)	
Non-Operating Revenue		<u>(11,940)</u>	
Revenue Required From Rates	732,940	710,738	
Less: Pro Forma Present Rate Service Revenues	<u>(495,826)</u>	<u>(491,473)</u>	
Required Revenue Increase	<u>\$ 237,114</u>	<u>\$ 219,265</u>	
Percent Increase	<u>47.82%</u>	<u>44.61%</u>	

¹² 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).

(1) Average Principal and Interest Payments. Western Mason currently has outstanding indebtedness payable to Rural Development of the Department of Agriculture of the United States of America ("RD"), the Kentucky Infrastructure Authority ("KIA"), and the Bank of Maysville. In its Application, Western Mason requested recovery of the principal and interest payments due in 2013 to these entities.

Following the Commission's general practice, Staff set Western Mason's annual debt service requirement equal to \$169,254, the three-year average of its principal and interest payments to be made to RD and KIA beginning January 1, 2015.¹³ As explained below, Staff did not include loan payments to the Bank of Maysville in Western Mason's debt service requirement.

Western Mason requested recovery of \$8,875 for annual principal and interest payments to the Bank of Maysville on a ten-year note that originated on January 17, 2014, in the principal amount of \$86,374. Interest accrues on the note at a variable rate

13

Year	Annual Debt Payment
2015	\$ 168,188
2016	169,642
2017	169,932
Total	507,762
Divide by: 3 years	<u>3</u>
Average Annual Principal and Interest Payment	<u>\$ 169,254</u>

that is equal to the Wall Street Journal U.S. Prime Rate plus 0.750 percent, but never less than 4 percent. Western Mason's General Manager, David French, stated that this is the only note that remains outstanding from a series of notes payable to the Bank of Maysville that began in 2003, as listed below. Mr. French further stated that the proceeds from each of the notes payable were used to provide working capital when its general fund was not sufficient to meet cash needs.

Origination Date	Maturity Date	Loan Amount
October 10, 2003	October 10, 2004	\$ 45,030
February 19, 2004	April 19, 2004	20,030
October 10, 2004	October 10, 2005	45,085
December 28, 2004	December 28, 2005	88,055
January 19, 2007	January 19, 2008	78,185
January 19, 2008	January 19, 2009	74,495
January 19, 2009	January 19, 2010	70,075
January 19, 2010	January 19, 2011	70,075
January 19, 2011	January 19, 2021	67,953
January 17, 2014	January 17, 2024	86,374

Western Mason did not obtain the Commission's approval to enter into the current loan agreement with the Bank of Maysville, as required by KRS 278.300.¹⁴ Mr. French stated that Western Mason was not aware that the bank note represented a security or evidence of indebtedness that is subject to this statute. He stated that it was Western Mason's understanding that only loans used to finance major construction projects required the Commission's approval. He emphasized that Western Mason

¹⁴ KRS 278.300(1) states, "No utility shall issue any securities or evidences of indebtedness, or assume any obligation or liability in respect to the securities or evidences of indebtedness of any other person until it has been authorized so to do by order of the commission." While KRS 278.300(8) exempts debts that have a term of less than two years when certain conditions are met, the current note payable to the Bank of Maysville, having a ten-year term, is nonexempt and required the Commission's approval.

sought and received approval for all long-term debt instruments that were used to finance major capital improvement projects. During discussions with Staff, Mr. French stated that he now understands the requirements of KRS 278.300 and would ensure that Western Mason sought all necessary approvals in the future before assuming an evidence of indebtedness.

In prior cases, the Commission has disallowed rate recovery of loans when their proceeds were used to pay operating expenses, finding that such action would constitute retroactive ratemaking.¹⁵ Following the Commission's prior rulings, Staff finds that rate recovery of the bank loan should not be allowed and has excluded the bank loan's principal and interest payments from the calculation of Western Mason's revenue requirement.

Although the Phase 1 and Phase 2 rates calculated by Staff do not include recovery of the bank note, the revenue produced by these rates will be sufficient for Western Mason to repay the bank note. To explain, through application of the DSC method, as historically accepted by the Commission, Staff allowed Western Mason recovery of working capital that is above the cash needed by Western Mason to pay operation and maintenance expenses, taxes, and principal and interest on debts that are secured by the revenues of its water system. Western Mason may use this working capital for various purposes, including repaying the Bank of Maysville loan. As demonstrated below, payment of the Bank of Maysville loan from the revenue

¹⁵ See Case No. 8690, *Application of Glengarry Utilities, Inc., Glengarry Sewage Treatment Plant, for an Adjustment of Rates Pursuant to the Alternative Procedure for Small Utilities* (Ky. PSC July 8, 1983); and Case No. 9303, *Application of Fordhaven, Inc., for an Adjustment of Rates Pursuant to the Alternative Procedure for Small Utilities* (Ky. PSC Aug. 8, 1985).

generated from Staff's Phase 1 or Phase 2 rates will not result in Western Mason's falling below the minimum 120 percent DSC ratio required by Western Mason's lenders.

	Phase 1	Phase 2
Water Sales Revenue	\$ 591,399	\$ 711,635
Other Operating Revenue	13,836	13,836
Other Revenue	11,940	11,940
Interest Income	2	2
	<hr/>	<hr/>
Gross Revenue	617,177	737,413
Less: Operation and Maintenance Expenses	(372,115)	(372,115)
Taxes Other Than Income Taxes	(11,256)	(11,256)
Bank Loan Payment	(8,875)	(8,875)
	<hr/>	<hr/>
Net Revenues	224,931	345,167
Divide by: Average Annual Debt Payments	169,254	169,254
	<hr/>	<hr/>
DSC Ratio	133%	204%

(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 Western Mason's lenders that are above its average annual debt payments. Historically, the Commission allows a water district recovery of additional working capital that is equal to the minimum net revenues required by the district's lenders that are above the district's average annual debt payments. In this case, RD requires that Western Mason charge rates that produce net revenues that are at least 120 percent of its average annual bond payments. Following the Commission's historic practice, Staff calculated Western Mason's allowance for additional working

capital to be \$33,851, as shown below.¹⁶ Staff included this amount in the calculation of Western Mason's Overall Revenue Requirement.

Average Annual Principal and Interest	\$ 169,254
Times: DSC Coverage Ratio	<u>120%</u>
Total Net Revenues Required	203,105
Less: Average Annual Principal and Interest Payments	<u>(169,254)</u>
Additional Working Capital	<u>\$ 33,851</u>

Signatures:


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¹⁶ Inclusion of the additional working capital in Western Mason's revenue requirement is not necessary for it to earn revenues that meet the minimum DSC ratio required by its lenders. As depreciation is a noncash item, it is excluded from the ratio calculation, which is actually a measure of cash flow. As shown below, Western Mason's minimum DSC ratio is met with or without the inclusion of additional working capital.

	With Additional Working Capital	Without Additional Working Capital
Overall Revenue Requirement	\$ 736,516	\$ 702,665
Less: Operating and Maintenance Expense	(372,115)	(372,115)
Taxes Other Than Income	(11,256)	(11,256)
Bank Loan	<u>(8,875)</u>	<u>(8,875)</u>
Net Revenues	344,270	310,419
Divided by: Average Annual Debt Payments	<u>169,254</u>	<u>169,254</u>
DSC Ratio	<u>203%</u>	<u>183%</u>

ATTACHMENT A
STAFF REPORT, CASE NO. 2014-00421
RATES CALCULATED BY STAFF

Monthly Water Rates

Phase 1

First	2,000	gallons	\$ 33.10	Minimum bill
Next	8,000	gallons	4.81	per 1,000 gallons
All Over	10,000	gallons	4.21	per 1,000 gallons
Bulk Water Sales			5.05	per 1,000 gallons

Phase 2

First	2,000	gallons	\$ 39.82	Minimum bill
Next	8,000	gallons	5.79	per 1,000 gallons
All Over	10,000	gallons	5.07	per 1,000 gallons
Bulk Water Sales			6:10	per 1,000 gallons

ATTACHMENT B
 STAFF REPORT, CASE NO. 2014-00421
 WESTERN MASON COUNTY WATER DISTRICT
 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.

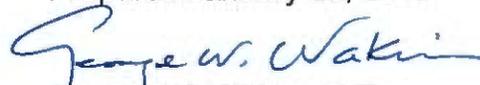
In the following table, Engineering Staff has identified the account classifications for which the utility's current service lives are not consistent with the service lives contained in the NARUC Study. The table shows the utility's current and Engineering Staff's recommended reasonable and appropriate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

Asset Classification	Current	Staff Recommended	NARUC Study
331/343 Transmission and Distribution Mains	39-40	62.5	50-75
334/346 Meters and Meter Installations	7-39	45	40-50
New Meters	*	40	35-45
341 Transportation Equipment	5	7	7
Automated Meter Reading System, Telemetry System, GPS Mapping System/Communication Equipment	20	10	10

*New meters were expensed in the test year rather than capitalized.

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, should be considered reasonable and appropriate.

Prepared January 26, 2015


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