COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

| | | |
|---|---|---|
| APPLICATION OF AIRVIEW UTILITIES, LLC. FOR RATE ADJUSTMENT FOR SMALL UTILITIES PURSUANT TO 807 KAR 5:076 | ) ) ) | CASE NO. 2014-00215 |

NOTICE OF FILING OF COMMISSION STAFF REPORT

Notice is hereby given that, in accordance with the Commission's Order of September 11, 2014, the attached report containing the findings of Commission Staff regarding the Applicant's proposed rate adjustment has been filed in the record of the above-styled proceeding. Pursuant to paragraphs 3 and 5 of the Commission's September 11, 2014 Order, Airview Utilities, LLC. ("Airview") is required to file written comments regarding the findings of Commission Staff no later than December 9, 2014.


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


DATED NOV 20 2014

cc: Parties of Record

STAFF REPORT

ON

AIRVIEW UTILITIES, LLC.

CASE NO. 2014-00215

Airview Utilities, LLC. ("Airview") provides wastewater service to approximately 199 customers[1] residing in the Airview Estates Subdivision located in Hardin County, Kentucky.[2] On June 30, 2014, Airview tendered its application for an adjustment of its rates. After Airview corrected a deficiency, its application was deemed filed on August 28, 2014. In its application Airview proposes an adjustment to its flat monthly wastewater service rate pursuant to 807 KAR 5:076. The proposed rate would increase a monthly bill from $28.45 to $42.00, an increase of $13.55, or 47.6 percent.

Airview based its application on the test-year operations ended December 31, 2013. Using operations reported for the test year, Airview determined that a revenue increase of $40,104, or 59.03 percent, is warranted. To minimize consumer rate shock, Airview proposed a rate that would increase revenue by $32,357, a 47.63 percent increase.[3]

To determine the reasonableness of the rates requested by Airview, Commission Staff ("Staff") performed a limited financial review of Airview'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

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[1] Application, p. 3.

[2] *Annual Report of Airview Utilities, LLC. to the Kentucky Public Service Commission for the Calendar Year Ended December 31, 2013* ("2013 Annual Report") at 9.

[3] Application, "Airview 2013 Pro forma."

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. David Foster reviewed the calculation of revenue requirements. Jason Green reviewed the billing analysis, reported revenues, and the method used to calculate the proposed rates.

## Summary of Findings

Based on its review, Staff determined that Airview's adjusted test-year operations support a monthly flat rate of $41.36, an increase of $12.91, or 45.38 percent, from its current rate of $28.45. Staff's calculations are shown and discussed in the remaining sections of this report.

## Pro Forma Operating Statement

The Pro Forma Operating Statement for the test year ended December 31, 2013, as determined by Staff, appears below.

| | Test Year | Adjustment | Ref. | Pro Forma |
|---|---|---|---|---|
| Operating Revenues | | | | |
| Sewer Sales Revenue | $ 68,752 | $ (2,520) | (A) | $ 66,232 |
| | | | | |
| Operating Expenses | | | | |
| Operation and Maintenance Expenses | | | | |
| Owner/Manager Fee | 9,600 | (6,000) | (B) | 3,600 |
| Sludge Hauling | 2,225 | | | 2,225 |
| Water | 5,952 | | | 5,952 |
| Other Labor, Materials, Expenses | 9,204 | 1,235 | (C) | 10,439 |
| Fuel and Power Expense | 8,917 | | | 8,917 |
| Misc. CS Expense - Chemicals | 617 | | | 617 |
| Routine Maintenance Fee | 8,400 | | | 8,400 |
| Maintenance of Collection System | 3,050 | | | 3,050 |
| Maintenance of Treatment and Disposal Plant | 23,271 | (1,120) | (D) | 22,151 |
| Maintenance of Other Plant | 1,678 | | | 1,678 |
| Customer Accounts Supervision | 184 | | | 184 |
| Uncollectible Accounts | 15,169 | (15,169) | (E) | |
| Office Supplies and Other | 599 | | | 599 |
| Outside Services Employed | 8,289 | (445) | (F) | 7,844 |
| Insurance Expenses | 1,136 | | (G) | 1,136 |
| Regulatory Commission Expenses | 1,010 | (760) | (J) | 250 |
| Miscellaneous General Expenses | 1,287 | | | 1,287 |
| Rents | 594 | 1,200 | (H) | 1,794 |
| | | | | |
| Total Operation and Maintenance Expenses | 101,182 | (21,059) | | 80,123 |
| Amortization Expense | | 2,276 | (J) | 2,276 |
| Taxes Other Than Income | 1,806 | | | 1,806 |
| Depreciation | 1,037 | (506) | (I) | 531 |
| | | | | |
| Total Operating Expenses | 104,025 | (19,289) | | 84,736 |
| | | | | |
| Net Operating Income | $ (35,273) | $ 16,769 | | $ (18,504) |

(A) Sewer Service Revenue. Airview reported test-year revenue in the amount of $68,752.[4] It proposed to reduce this amount by $813 to state pro forma present rate revenues at $67,939. Airview determined the pro forma amount by annualizing its monthly billings at present rates for 199 customers. Staff agrees with Airview's method of adjustment but does not agree with the amount.

[4] 2013 Annual Report, p. 25.

At the time of Staff's field visit, on August 21, 2014, Airview had 194 residential customers. By annualizing the monthly billings for 194 residential customers, Staff determined that test-year revenues should be decreased by $2,520 to $66,232.[5]

(B) Owner/Manager Fee. Airview is owned and operated by Lawrence Smither and Martin Cogan. During the test year, Airview reported an Owner/Manager fee expense of $9,600.[6] Airview proposed to reduce test-year expense by $6,000 to reflect the amount that the Commission has historically authorized for small wastewater systems.

The Commission has historically allowed small, investor-owned sewer utilities, such as Airview, recovery of a $3,600 owner/manager fee to be paid to the utility's owner for serving as its chief executive officer. In the cases of very small utilities, the fee is also considered compensation for providing additional services.[7] It is Staff's opinion that Airview's adjustment is consistent with prior Commission rulings and it accepts the decrease to test-year expenses of $6,000.

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[5] (194 x 12) x $28.45 = $66,232

[6] 2013 Annual Report, p. 27.

[7] In Case No. 2007-00397, *Application of Woodland Estates Sewage System for an Adjustment of Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC. Dec. 27, 2007), the Commission found that the $3,600 owner/manager fee awarded to Woodland Estates Sewage System, served 24 customers at the time its rate application was filed, was appropriate compensation for the owner serving as the utility's executive officer and for the owner's contribution to the utility of office space, office supplies, telephone service, billing and collection services, and bookkeeping services. In Case No. 2005-00036, *Application of Lewis Sanitation Company, Inc., D/B/A Garden Heights Sewer Division for an Adjustment of Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC Apr. 14, 2005), the Commission found that the $3,600 owner manager fee was appropriate compensation for only the owner's executive oversight of the utilities operations. In addition to the owner manger fee, the Commission allowed rate recovery for expenses that were incurred by the utility for bookkeeping services, office rent, office supplies, office utilities, and reimbursement to the owner for transportation expenses. Lewis Sanitation Company, Inc. served 108 customers at the time its rate application was filed.

(C) Other – Labor, Materials, and Expense. Airview's Kentucky Pollutant Discharge Elimination System ("KPDES") permit requires weekly testing of its effluent discharge. Microbac Laboratories' testing fee increased during the test year to $200.75 per week, or $10,439 annually, to test Airview's effluent. Based on this higher testing fee, Staff increased laboratory/testing expense by $1,235[8] to reflect the current annual cost.

(D) Maintenance of Treatment and Disposal Plant. Airview proposed to remove an expense of $1,120 it recorded for a nonrecurring repair to the collector gear drive shaft at its treatment facility. Airview requested to amortize this expense over three years. Staff agrees with the adjustment to remove the full expense from the test year, but, as discussed in Appendix B, Staff believes that the proper amortization period is seven and one-half years. Accordingly, Staff increased amortization expense, as shown in Reference Item (J), by $149.

(E) Uncollectible Accounts Expense. During the test year, Airview reported $15,169 for bad debt expense. In its Application, Airview eliminated the entire amount for ratemaking purposes, stating that "it believes the PSC will not allow its recovery in this case."[9] It did not state the basis for its position.

While bad debt expense is a cost of providing utility service for which rate recovery should be allowed, the utility bears the burden of proving that the amount requested for recovery is reasonable. As discussed in detail below, Staff finds that Airview's improper accounting methods and ineffective customer collection practices

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[8] $200.75 (Weekly Testing Fee) x 52 Weeks = $10,439 - $9,204 (Test-Period Laboratory/Testing Expense) = $1,235.

[9] Application, "Airview 2013 Proforma."

resulted in a level of test-year bad debt expense that is excessive and unreasonable and should, therefore, not be recovered through rates. Staff further finds that Airview did not provide evidence supporting a level of bad debt expense and thus, Airview's adjustment to reduce test-year bad debt expense to zero is reasonable.

The test-year expense represents 22.06 percent[10] of Airview's test-year revenues, an unusually high rate. Staff identified various actions that Airview may take to better control this expense in future reporting periods. First, $13,093 of the test-year expense represents the write-off of accounts receivable that were earned and reported as revenue in accounting periods prior to the test year. These uncollectible accounts should not have been expensed during the test year. They should have been expensed in the same years that the revenues were earned and the accounts receivable were reported to properly match revenues and expenses. Proper accounting would reduce the test-year expense by $13,093. In future reporting periods, Airview should ensure that bad debt expenses are reported in the appropriate accounting period.

Second, although Airview's tariff includes a provision and charge for the disconnection of service for nonpayment, Airview is not currently disconnecting service for non-payment. It has allowed some unpaid account balances to accumulate to over $1,000. Airview should enforce the disconnection provision of its tariff. This would significantly reduce uncollectible accounts. To further reduce uncollectible accounts,

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|---|---|
| Bad Debt Expense | $ 15,169 |
| Divide by: Test-Year Revenue | 68,752 |
| Percentage | 22.06% |

Airview should collect customer deposits that are equal to two monthly sewer service fees as allowed by its tariff on file with the Commission.

Finally, Airview stated that customers who occupy rental property are a major contributor to the high level of uncollectible accounts. It explained that customers often vacate rental property with unpaid balances before service can be disconnected. Placing all sewer service accounts in the name of the property owner instead of the renter would significantly reduce Airview's uncollectible accounts. While Airview cannot deny service to a renter, it may request to amend its tariff on file with the Commission to include the following language: The utility recommends that a property owner place service in his/her name to avoid the sewer service disconnection and the property's being subject to a reconnection charge.

(F) Outside Services Employed. During the test year, Airview reported outside services employed of $8,289, including $4,300 for bookkeeping services. Airview proposes an increase of $500 to more accurately reflect bookkeeping expenses. During its review, Staff determined that Linda Wood is responsible for Airview's monthly bookkeeping duties. Included in Ms. Wood's monthly bookkeeping duties are the processing of bill payments, preparing and mailing monthly bill statements, and receiving customer service phone calls on a daily basis. Ms. Wood stated that during heavy rain events or emergency situations, she will receive phone calls late at night or early in the morning. At the time of its review, Staff determined that Ms. Wood is presently paid $400 a month or $4,800 per year. Staff believes this is appropriate and agrees with Airview's adjustment of $500.

Staff eliminated $944.95 paid to Mr. Smither. In proceedings involving similar-sized sewer utilities, the Commission has consistently found $3,600 to be reasonable compensation for the performance of the duties performed by the owners of such systems. As that amount is being recognized in part (B), Owner/Manager Fee, this additional compensation should be removed.

The net decrease to Outside Services Employed is $445 ($945–$500).

(G) Insurance Expense. Airview participates in a group general liability policy that includes five other companies. The policy was provided by Westfield Insurance Co. and paid for by Covered Bridge Utilities, Inc.[11] During the test year, Airview reported $1,136 as its allocated share of the policy's annual premium. In its application, Airview stated that the test-year amount should be "increased by $3,864 to reflect the estimated cost of liability insurance coverage (quote to be provided), which Airview could not afford in the past. Airview will purchase this insurance if the PSC indicates this cost will be included in the revenue requirement in its final decision in this case."[12]

As of the date of this report, Airview continues to receive general liability insurance coverage through the group plan. Airview has not demonstrated that this group policy is inadequate or what additional coverage would be provided by purchasing supplemental insurance. Finding that the amount allocated to Airview for the group policy during the test year is reasonable, in all material respects, Staff finds that no adjustment to the test-year amount is warranted.

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[11] The officers and directors of Airview are also the officers and directors of Covered Bridge Utilities, Inc.

[12] Application, "Airview 2013 Pro forma."

(H) Rent. Airview proposes to increase its test-year operating expenses by $1,200 to reflect its share of the office rent. Airview currently shares an office with the other businesses owned by Mr. Smither in Crestwood, Kentucky. The $100 per month represents Airview's allocation of the costs associated with the office, which include: landline telephone; Internet connection; computer; fax machine; printer; copy machine; and filing cabinets. In reviewing the benefits received by Airview in sharing the office with affiliated companies, Staff believes that the fee is reasonable and that the Commission should accept Airview's proposed adjustment.

(I) Depreciation Expense. Airview proposes to reduce its test-year depreciation expense by $1,037. In its application, Airview states that it is not requesting any depreciation expense on historical plant in this case. Airview's current owners were not given a fixed asset schedule to support a depreciation expense when they acquired Airview. Airview further states that, pursuant to Annual Reports on file with the Commission, the historical plant has been 100 percent contributed. Staff agrees with this adjustment and reduced depreciation expense by $1,037.

Subsequent to the test year, Airview added an effluent pump to increase efficiency at its treatment facility, the cost of which it proposed be amortized as a nonrecurring charge. It removed the cost of the pump from the Maintenance of Treatment and Disposal Plant account, but included the labor required to install the pump in its Amortization Expense account.

Staff agrees that the pump and its installation is a nonrecurring event; however, the cost of the pump and its installation cost should be recorded as a capital asset for which the cost should be recovered through Depreciation Expense. Staff removed the costs of the pump and the installation of the pump from the Maintenance of Treatment and Disposal and the Amortization Expense accounts and included the amounts in Utility Plant in Service. As discussed in Appendix B, Staff recommends that the cost of this improvement be depreciated over seven years. The calculation for the depreciation of these assets is shown below.

| | | Cost | Asset Life | | Annual Depreciation Expense |
|---|---|---|---|---|---|
| Utility Plant in Service - Depreciation | | | | | |
| Effluent Pump | $ | 1,017 | 7 | $ | 145 |
| Plant Upgrade | | 2,699 | 7 | | 386 |
| Depreciation Expense | | | | $ | 531 |

(J) Amortization Expense. Airview renewed its KPDES permit on February 1, 2014. The total cost of the renewal fee was $3,700. The new permit expires five years from its origination date. Airview paid $760 of the permit's fee during the test year, which it reported to account 928, Regulatory Commission Expenses.

The KPDES permit renewal fee is a regulatory asset that should be amortized over its five-year life. Accordingly, Staff removed the amount paid during the test year from account 928 and increased Amortization Expense by $740, one-fifth of the total renewal expense.[13]

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|---|---|---|
| KPDES Renewal Fee | $ | 3,700 |
| Divide by: Five Years | | 5 |
| Annual Amortization Expense | $ | 740 |

Airview also requested recovery of $4,000 for the three-year amortization of the $12,000 estimated expense to be incurred to prepare, file and adjudicate the application in this proceeding. Airview's rate case cost comprises a consultant fee of $3,000, and anticipated legal fees of $9,000. Staff finds that the fees are reasonable, with the exception of the estimated legal fees, for which no invoices have been provided and no legal fees have been incurred. Accordingly, Staff finds that only the consulting fees should be amortized in this proceeding.

The consulting fees are considered to be an intangible regulatory asset. Generally, the Commission amortizes an intangible regulatory asset or liability identified in a rate proceeding over the anticipated life of the utility rates approved in that proceeding when there is no evidence to support an alternative amortization period. That life is generally based on the frequency of the utility's historic rate filings. Airview's last rate case was filed in 2003, making the frequency of it filing rate applications eleven years. This would suggest that an 11-year amortization period may be appropriate; however, it is Staff's opinion that the rates approved in this proceeding will likely become obsolete after five years, due to changes that will likely occur to Airview's cost of service during this time. Accordingly, absent a more reasonable amortization period, Staff amortized rate case expense over a five-year period. This requires a $600 increase to test-year expenses.[14]

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|---|---|---|
| Consultant Fee | $ | 3,000 |
| Divide by: Five Years | | 5 |
| Annual Amortization Expense | $ | 600 |

Lastly, subsequent to the test year, Airview performed an overhaul to its clarifier rake system gear at a total cost of $5,899. Airview requested that this repair be treated as a regulatory asset in this proceeding that is amortized over a three-year period. Staff agrees that amortization of this post-test-year repair is appropriate in this proceeding, but it disagrees with Airview's proposed three-year amortization period. As discussed in Appendix B, Staff finds that the appropriate amortization period is seven and one half years. Accordingly, Amortization Expense was increased by $787.[15]

As shown below, Staff calculated total pro forma amortization expense to be $2,276.

| | | Cost | Asset Life | | Annual Amortization Expense |
|---|---|---|---|---|---|
| Regulatory Asset - Amortization | | | | | |
| Test-Year Expenditures | | | | | |
| Repair Collector Gear Drive Shaft | $ | 1,120 | 7.5 | $ | 149 |
| KPDES Application Fee | | 750 | 5 | | 150 |
| Post-Test-Year Expenditures | | | | | |
| KPDES Permit | | 2,950 | 5 | | 590 |
| Consultant Fee | | 3,000 | 5 | | 600 |
| Gear Repair | | 5,899 | 7.5 | | 787 |
| Amortization Expense | | | | $ | 2,276 |

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| | | |
|---|---|---|
| Capital Improvement | $ | 5,899 |
| Divide by: Five Years | | 7.5 |
| Annual Amortization Expense | $ | 787 |

## Determination of Allowable Net Operating Income ("NOI")

Airview calculated its allowable NOI using the operating ratio method as historically accepted by the Commission.[16] Pursuant to this method, the allowable NOI is calculated by dividing pro forma operating expenses by 88 percent and subtracting operating expenses from the result. Using this method, Staff calculated Airview's allowable NOI to be $11,555, as shown below.

| | |
|---|---|
| Operating Expenses | $84,736 |
| Divide by: Operating Ratio | 88% |
| Operating Revenues | 96,291 |
| Less: Operating Expenses | (84,736) |
| Allowable NOI | $11,555 |

## Calculation of Overall Revenue Requirement And Required Revenue Increase

To recover all pro forma operating expenses and to generate the allowable NOI, Airview requires overall revenue of $ 96,291. As shown below, a $30,059 revenue increase, or 45.38 percent, is necessary to produce the overall revenue requirement.

[16] An operating ratio measures the difference between operating revenues and operating expenses. It is defined by the following equation.

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

The Commission has found that the operating ratio is a reasonable and necessary alternative to the rate of return method for calculating the allowable NOI for small sewer investor owned utilities. Specifically, it has found that the rate of return method cannot be used because there is "no basis" upon which to determine a rate of return for these utilities, Administrative Case No. 95-236, *Application of Thelma Waste Control, Inc. for a Rate Adjustment Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC. Apr. 15, 1996) at 6. Further, it has found that the operating ratio method is appropriate when plant investment is low and operating expenses are high, Case No. 7982, *Notice of Application of Fern Lake Company* (Ky. PSC. Aug. 27, 1981) at 3.

| | |
|---|---|
| Operating Expenses | $ 84,736 |
| Allowable NOI | 11,555 |
| Revenue Requirement | 96,291 |
| Less: Pro Forma Present Rate Revenues | (66,232) |
| Required Revenue Increase | $ 30,059 |
| Percentage | 45.38% |

Rate Calculated by Staff

Airview's current rate design is a flat monthly rate. The current monthly rate is $28.45 for a single family residential customer. Airview proposes to continue the current rate design and to recover the requested revenue requirement by increasing the amount of the flat monthly rate. Staff agrees with Airview's rate design. Using Staff's revenue requirement of $96,291, Staff determines the flat monthly rate to be $41.36.[17]

Signatures

Prepared by: David P. Foster
Financial Analyst, Water and Sewer
Revenue Requirements Branch
Division of Financial Analysis

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

[17] ($96,291/12 months) / 194 = $41.36

APPENDIX A
STAFF REPORT, CASE NO. 2014-00215
AIRVIEW UTILITIES, LLC

Monthly Rates

| | |
|---|---|
| Single Family Residential – Residential Flat Rate | $41.36 |

APPENDIX B
STAFF REPORT, CASE NO. 2014-00215
AIRVIEW UTILITIES, LLC

ENGINEERING DIVISION'S
RECOMMENDED AVERAGE SERVICE LIVES

Historically, the Commission has relied on Table 44, Average Service Lifetimes, Major Systems Components, Wastewater Systems, of the O&M Guide for the Support of Rural Water-Wastewater Systems by Commission on Rural Water, Chicago, Illinois, 1974, pages 246-247, to evaluate the reasonableness of a utility's wastewater 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 O&M Guide. The table shows the utility's current and Engineering staff's recommendation for the estimated service lives based on a review of information contained in the record of this case.

| Asset Classification | Current | Staff's Recommendation | O&M Guide |
|---|---|---|---|
| Effluent pump | | 7 | * |
| Clarifier rake system gear rebuilding | 3 | 7.5 | ** |

*The O&M Guide does not have a service life for effluent pumps. However, since an effluent pump is a submersible pump which operates in a similar fashion to lift station pumps, a recommended service life of 7 years appears reasonable and appropriate.

**The O&M Guide contains no specific service life recommendations for the (secondary) clarifier rake system gear equipment asset. Therefore, the utility supplemented the record of the case stating that such equipment repair should be recovered over a 3-year period due to the utility's critical need for cash flow improvement to fund increasing repair needs.

This gear system runs a dual rake system, one of which is on the surface of the clarifier acting as a skimmer and the second at the bottom of the clarifier acting as a rake for the settled sludge. The O&M Guide contains a specific service life for Grit and Sludge Handling Equipment for Primary Treatment Systems with a service life range of 5-10 years. Since this gear system is associated with handling sludge at the bottom of the secondary clarifier, Engineering Staff finds that a 7.5-year service life recommendation is appropriate, reasonable, and acceptable.

Prepared November 6, 2014

George W. Wakim

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