

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF JONATHAN CREEK WATER )  
DISTRICT FOR AN ALTERNATIVE RATE ) CASE NO.  
ADJUSTMENT ) 2017-00323

NOTICE OF FILING OF COMMISSION STAFF REPORT

Notice is hereby given that, in accordance with the Commission's Order of September 21, 2017, 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 the Commission's September 21, 2017 Order, Jonathan Creek Water District is required to file written comments regarding the findings of Commission Staff no later than 14 days from the date of this report.



Gwen R. Pinson  
Executive Director  
Public Service Commission  
P.O. Box 615  
Frankfort, KY 40602

DATE NOV 30 2017

cc: Parties of Record

STAFF REPORT  
ON  
JONATHAN CREEK WATER DISTRICT  
CASE NO. 2017-00323

Jonathan Creek Water District (“Jonathan Creek”) is a water utility district organized pursuant to KRS Chapter 74 that owns and operates a water distribution system through which it provides retail water service to approximately 2,408 customers in Marshall County, Kentucky.<sup>1</sup> On August 3, 2017, Jonathan Creek tendered an application (“Application”) to the Commission requesting to increase its water service rates pursuant to 807 KAR 5:076. Jonathan Creek’s Application was deemed filed on August 3, 2017. To ensure the orderly review of the Application, the Commission established a procedural schedule by Order dated August 16, 2017. On September 21, 2017, the Commission entered an Order amending the procedural schedule in order to permit Commission Staff (“Staff”) additional time to complete the Staff Report on Jonathan Creek’s Application.

As required by 807 KAR 5:076, Jonathan Creek based its requested rates on a historic test period that coincides with the reporting period shown in its most recent Annual Report on file with the Commission, the calendar year ended December 31, 2016. Jonathan Creek presented financial exhibits in its Application demonstrating a rate increase that increases annual water sales revenues by \$98,843, an 11.35 percent

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<sup>1</sup> *Annual Report of Jonathan Creek Water District to the Public Service Commission for the Calendar Year Ended December 31, 2016 (“Annual Report”)* at 12 and 48.

increase to test-year water sales revenues of \$871,166. The exhibits are summarized below in condensed form.

Pro Forma Operating Expenses	\$ 879,386
Plus: Average Annual Debt Payments	115,016
Additional Working Capital	<u>          -</u>
Overall Revenue Requirement	994,402
Less: Other Operating Revenue	(24,073)
Interest Income	<u>          (320)</u>
Revenue Required From Rates	970,009
Less: Pro Forma Present Rate Revenue	<u>          (871,166)</u>
Required Revenue Increase	<u>    \$    98,843</u>
Percent Increase	<u>          11.35%</u>

To determine the reasonableness of the rates requested by Jonathan Creek, Staff performed a limited financial review of Jonathan Creek’s test-year operations. 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 material. Insignificant and immaterial discrepancies were not necessarily pursued or addressed.

Staff’s findings are summarized in this report. David Foster reviewed the calculation of Jonathan Creek’s Overall Revenue Requirements. Eddie Beavers reviewed Jonathan Creek’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, Staff found that Jonathan Creek’s Overall Revenue Requirement is \$990,723 and that a \$95,164 revenue increase, or 10.92 percent, to pro forma present rate revenues is necessary to generate the Overall Revenue Requirement.

2. Water Service Rates. In the Application, Jonathan Creek proposed to increase all of its monthly water service rates evenly across the board by approximately 11.35 percent. Jonathan Creek has not performed a cost-of-service study (“COSS”). The Commission has previously found that the allocation of a revenue increase evenly across the board to a utility’s current rate design is appropriate when there has been no evidence entered into the record demonstrating that this method is unreasonable and in absence of a COSS. Finding no such evidence in this case, Staff followed the method proposed by Jonathan Creek and allocated the \$95,164 revenue increase Staff found warranted evenly across the board to Jonathan Creek’s current monthly water service rates.

Shown in the Attachment to this report are the monthly water service rates calculated by Staff. These rates will increase a typical residential customer’s monthly bill from \$29.12 to \$32.31, an increase of \$3.19, or 10.95 percent.

3. Unauthorized Debt. As discussed in more detail beginning on page 11 of this report, Jonathan Creek currently has loans outstanding that are payable to Community Financial Services Bank (“Community Financial”) for which Jonathan Creek did not obtain Commission approval as required by KRS 278.300. Jonathan Creek has the responsibility to ensure that it follows the Commission’s statutes and regulations and

that all statutory and regulatory approvals are obtained. Jonathan Creek should be aware that the Commission may initiate a separate proceeding to more thoroughly investigate the possible violations of Commission statutes and regulations. If a determination is 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.<sup>2</sup>

Pro Forma Operating Statement

Jonathan Creek's Pro Forma Operating Statement for the test year ended December 31, 2016, as determined by Staff, appears below.

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<sup>2</sup> 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.

	<u>Test Year</u>	<u>Adjustment</u>	<u>(Ref.)</u>	<u>Pro Forma</u>
Operating Revenues				
Sales of Water	\$ 877,404	\$ (12,724)	(A)	
		6,486	(B)	\$ 871,166
Other Water Revenues				
Forfeited Discounts	10,150			10,150
Misc. Service Revenues	-	12,724	(A)	12,724
Other Water Revenues	1,199			1,199
Total Operating Revenues	<u>888,753</u>	<u>6,486</u>		<u>895,239</u>
Operating Expenses				
Operation and Maintenance Expenses				
Salaries and Wages - Employees	286,101	(13,300)	(C)	272,801
Salaries and Wages - Commissioners	24,400	(24,400)	(D)	-
Employee Pensions and Benefits	52,046	6,170	(E)	
		19,410	(F)	77,627
Purchased Power	68,664	(4,497)	(G)	64,167
Chemicals	12,877	(843)	(G)	12,034
Materials and Supplies	6,312	(13,300)	(C)	(6,988)
Contractual Services	307,989	(230,275)	(H)	77,714
Rental of Equipment	3,867			3,867
Transportation Expenses	21,671			21,671
Insurance	22,535			22,535
Advertising	122			122
Other	45,393			45,393
Bad Debt Expense	8,956			8,956
Miscellaneous Expense	73,170			73,170
Total Operation and Maintenance Expenses	934,103	(261,034)		673,069
Taxes Other Than Income	27,895			27,895
Depreciation	214,687	(39,944)	(I)	174,743
Total Operating Expenses	<u>1,176,685</u>	<u>(300,978)</u>		<u>875,707</u>
Net Operating Income	(287,932)	307,464		19,532
Interest Income	320			320
Income Available to Service Debt	<u>\$ (287,612)</u>	<u>\$ 307,464</u>		<u>\$ 19,852</u>

(A) Water Sales Revenue. In the Application, Jonathan Creek proposed adjustments to Water Service Revenues to remove nonrecurring charge revenues from water sales. During the test year, Jonathan Creek realized revenues from nonrecurring charges of \$12,724. Jonathan Creek improperly reported this revenue with Water Sales

Revenues in its 2016 Annual Report. The Uniform System of Accounts (“USoA”) requires that this revenue be reported as Miscellaneous Service Revenues.<sup>3</sup> Staff agrees with Jonathan Creek’s adjustment and has re-classed these revenues from Water Sales to Miscellaneous Service Revenues.

(B) Billing Analysis Adjustment. In the Application, Jonathan Creek provided a billing analysis detailing water usage and water sales revenue for the 12-month test year. Jonathan Creek adjusted water sales revenue by \$6,486 to match the billing analysis. Staff has reviewed Jonathan Creek’s billing analysis and finds that the water sales revenues of \$871,166 for all customers is an accurate representation of normalized test year water sale revenue agrees with Jonathan Creek’s adjustment. The net effect after the adjustment to the Annual Report water sales revenue of (\$12,724) to remove miscellaneous service revenues, in an increase in water sales revenue by \$6,486.

(C) Test-Year Meter Installations. During the test year, Jonathan Creek installed 38 new 5/8-inch x 3/4-inch meter connections with an estimated total cost of \$26,600.<sup>4</sup> This estimated cost includes wages, wage overheads, transportation costs, equipment costs, and materials and supplies. The USoA requires that these costs be capitalized as Utility Plant in Service and depreciated over their estimated useful lives.<sup>5</sup>

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<sup>3</sup> USoA for Class A&B Water Districts and Associations, pages 92 and 93.

<sup>4</sup> During the test year, Jonathan Creek did not use a work order system or other method to identify the actual construction costs of new meter connections. Absent the actual costs, Staff estimated this cost to be \$26,600 by multiplying Jonathan Creek’s current \$700 tap fee for a 5/8-inch x 3/4-inch meter installation by the number of new connections installed during 2016. Staff finds that this method produces a reasonable estimate of the total test-year meter installation costs, since the tap fee represents Jonathan Creek’s average installation cost.

<sup>5</sup> USoA, Accounting instruction at 19 and 33.

In its Application, Jonathan Creek proposed to decrease Salaries and Wages, Employee Benefits, and Taxes Other Than Income expenses by total amount of \$21,740<sup>6</sup> to account for meter installation expenses. Jonathan Creek did not show the calculation of its proposed adjustment.

Ideally, Staff would have reduced each of the expense accounts that contain installation costs by a portion of the capitalized costs. For simplicity, Staff finds that Jonathan Creek's test-year wages expense and materials and supplies expense should be decreased by \$13,300 each, or one-half of the total estimated cost. In Case No. 2017-00211, the Commission accepted Staff's finding that expenses for new tap installations be decreased by half.<sup>7</sup>

(D) Salaries and Wages – Commissioners. During the test year, Jonathan Creek reported \$24,400 in payments to its Board of Commissioners. Staff requested Jonathan Creek to provide a copy of the fiscal court minutes authorizing the payment of the commissioner fees. According to KRS 74.020(6) the commissioner fees:

. . . shall be fixed by the county judges/executive with the approval of the fiscal court; in multicounty districts, it shall be fixed by the agreement between the county judges/executive with the approval of their fiscal courts.

Jonathan Creek was unable to provide the required approval from the judge/executive and the fiscal court in Marshall County, Kentucky. For this reason, Staff reduced operating expenses by \$24,400 to eliminate the commissioner fees.

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<sup>6</sup> \$16,992 (Salaries and Wages – Employees) + \$3,091 (Employee Pensions and Benefits) + \$1,657 (Taxes Other Than Income) = \$21,740

<sup>7</sup> Case No. 2017-00211, *Electronic Application of Letcher County Water and Sewer District for Alternative Rate Adjustment* (PSC Ky. Oct. 17, 2017) Staff Report on Letcher County Water District at 10.

(E) Employee Contribution for Health Insurance. Jonathan Creek reported \$52,046 for test-year Employee Pensions and Benefits expense. This amount included \$27,133 for the cost of providing health, life, dental, and vision benefits to all qualifying full-time employees.

Jonathan Creek currently pays 100 percent of the monthly premiums for its employees' and their spouses' and dependents' health insurance. Jonathan Creek also pays 100 percent of life, dental, and vision insurance premiums for all of its employees. Staff notes that in recent Orders, the Commission has made ratemaking adjustments to reduce the cost of employee benefit packages paid by some utilities when certain aspects of those benefit packages were found to be unreasonable based on a review of total salaries and fringe benefits. The Commission is placing greater emphasis on evaluating employees' total compensation packages, including both salary and benefits programs, for market and geographic competitiveness to ensure the development of a fair, just, and reasonable rate. It has found that in most cases, 100 percent employer-funded health care does not meet those criteria. Factoring in for the preceding, and accounting for other pro-forma adjustments, Staff determined the net adjustment to Jonathan Creek's test-year health insurance expense should be an increase of \$6,170,<sup>8</sup> as shown below.

Jonathan Creek currently has four employees who have single-coverage health insurance policies and one employee whose policy includes coverage for dependents.

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	Annualized Premium Increase	\$ 14,259
	Benefit Reduction	<u>(8,089)</u>
	Total Increase	<u>\$ 6,170</u>

As shown below, Staff annualized the most recent monthly premiums paid on behalf of all full-time employees who were receiving health benefits at the time of Staff's review.

Current Premium for Full-time Employees	\$ 2,870
Times: 12 Months	<u>12</u>
Annualized	34,440
Less: Test Year	<u>(20,180)</u>
Increase	<u>\$ 14,259</u>

Additionally, consistent with recent orders in which the Commission has reduced benefit expenses for utilities that pay 100 percent of an employee's health insurance coverage, Staff reduced Jonathan Creek's family health insurance premiums by 33 percent and the single premiums by 21 percent, the national average employee contribution rate,<sup>9</sup> as shown below.

<u>Policy Type</u>	<u>Annual Expense</u>	<u>Percentage Reduction</u>	<u>Adjustment</u>
Family	\$ 7,137	33%	\$ 2,355
Single	27,302	21%	<u>5,733</u>
Total Decrease			<u>\$ 8,089</u>

(F) Retirement Expense Pursuant to GASB 68. Jonathan Creek reported test-year employee pension expense of \$24,913. Jonathan Creek provides pension benefits and post-retirement health care benefits to its employees by participating in the County Employee Retirement System ("CERS"). As a participating member, Jonathan Creek is

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<sup>9</sup> Bureau of Labor Statistics, Healthcare Benefits, March 2017, Table 10, private industry workers. (<https://www.bls.gov/ncs/ebs/benefits/2017/ownership/private/table10a.pdf>)

required to contribute a percentage of its employee wages to CERS. In the fiscal year beginning July 1, 2016, the CERS contribution rate was 17.06 percent. The CERS pension expense Jonathan Creek reported in the test year conformed to the requirements of the General Accounting Standards Board Pronouncement No. 68 (“GASB 68”).

In Case No. 2016-00163,<sup>10</sup> Commission Staff discussed in great detail the reporting requirements of GASB 68 and how those requirements would affect a utility’s income statement and balance sheet. In that proceeding, Commission Staff found that the annual pension expense should be equal to the amount of a district’s contributions to CERS, which “historically have been fairly constant.” Staff determined that Jonathan Creek’s test-year CERS contributions totaled \$44,324. Accordingly, Staff is increasing employee pension and benefits expense by \$19,410.

(G) Expenses Attributable to Water Loss. Pursuant to 807 KAR 5:066, Section (6)(3), Jonathan Creek’s water loss is limited to 15 percent for ratemaking purposes unless it can demonstrate that an alternative level is reasonable. Jonathan Creek reported test-year water loss at 21.55 percent,<sup>11</sup> or 6.55 percent above the amount allowed, and did not attempt to demonstrate that the amount of the excess water loss is reasonable. To comply with the regulation, Jonathan Creek proposed to remove the expenses incurred during the test year to pump and treat the water loss that was in excess of the allowable amount. Staff agrees with Jonathan Creek’s adjustment. The calculations are shown below.

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<sup>10</sup> Case No. 2016-00163, *Alternative Rate Adjustment Filing of Marion County Water District* (PSC Ky. Aug. 11, 2016) Staff Report on Marion County Water District at 10-27.

<sup>11</sup> Annual Report at 56.

	<u>Test Year</u>	<u>Excess Water Loss Percentage</u>	<u>Decrease</u>
Purchased Power for Pumping	\$ 68,664	-6.55%	\$ (4,497)
Chemicals	12,877	-6.55%	(843)

(H) Contractual Services. In its Application, Jonathan Creek proposed removing expenses that were incurred from a tank rehabilitation project and window replacement in its water treatment plant. Jonathan Creek included a provision for their recovery in pro forma depreciation expense. Staff agrees with the removal of these items and has reduced test-year Contractual Services expense by \$230,275.

(I) Depreciation. In its Application, Jonathan Creek proposed to reduce its test-year depreciation expense of \$214,687 by \$39,944.<sup>12</sup> This adjustment was the result of Jonathan Creek's proposal to adjust the lives assigned to certain assets that were outside of the life ranges found reasonable in the National Association of Regulatory Utility Commissioners' ("NARUC") publication titled Depreciation Practices for Small Utilities ("NARUC Study") and to capitalize the amount of contracted services removed from the test year expenses discussed in Item (H).<sup>13</sup>

To evaluate the reasonableness of the depreciation practices of small water utilities, the Commission has historically relied upon the referenced NARUC Study. Jonathan Creek proposed to adjust the lives of assets that were outside of the NARUC ranges to the mid-point of the depreciable life ranges. In this proceeding, Staff found no

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<sup>12</sup> Application, Schedule of Adjusted Operations.

<sup>13</sup> *Id.*, References.

evidence to support depreciable lives that vary significantly from the mid-point of the NARUC ranges, and after further review of Jonathan Creek's plant ledger, Staff agrees with Jonathan Creek's decrease to depreciation expense of \$39,944.

#### Overall Revenue Requirement and Required Revenue Increase

The Commission has historically applied a DSC method to calculate the Overall Revenue Requirement of water districts and water associations. 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>14</sup> 3) the average annual principal and interest payments on all long-term debts.

A comparison of Jonathan Creek's and Staff's calculations of Jonathan Creek's Overall Revenue Requirement and Required Revenue Increase using the DSC method is shown below.

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<sup>14</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 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).

	<u>Jonathan Creek</u>	<u>Staff</u>	<u>(Ref)</u>
Pro Forma Operating Expenses	\$ 879,386	\$ 875,707	
Plus: Average Annual Debt Payments	<u>115,016</u>	<u>115,016</u>	(1)
Overall Revenue Requirement	994,402	990,723	
Less: Other Operating Revenue	(24,073)	(24,073)	
Interest Income	<u>(320)</u>	<u>(320)</u>	
Revenue Required From Rates	970,009	966,330	
Less: Pro Forma Present Rate Revenue	<u>(871,166)</u>	<u>(871,166)</u>	
Required Revenue Increase	<u>\$ 98,843</u>	<u>\$ 95,164</u>	
Percent Increase	<u>11.35%</u>	<u>10.92%</u>	

(1) Average Annual Principal and Interest Payments. At the time of filing, Jonathan Creek had one outstanding loan payable to Community Financial that was not authorized by the Commission. KRS 278.300(1) states that 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. Accordingly, *prima facie* evidence exists that Jonathan Creek violated KRS 278.300(1). The Commission will pursue a separate action against Jonathan Creek to show cause and present evidence on its failure to adhere to the procedures of KRS 278.300(1). In instances in which it is shown that the proceeds of an authorized loan were used to pay for current operating expenses, the Commission has disallowed rate recovery, finding that such action would constitute retroactive ratemaking. Staff has determined that Jonathan Creek used the proceeds of the Community Financial loan to fund capital projects and purchase capital assets, and

therefore, finds that Jonathan Creek should be allowed rate recovery of the associated debt service.

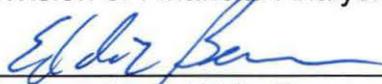
In its Application, Jonathan Creek requested recovery of the five-year average annual principal and interest payments due in 2017, 2018, 2019, 2020, and 2021 of \$115,016. Staff agrees that the \$115,016 requested by Jonathan Creek represents, in all material respects, the average annual debt payments that will be made in each year that the water rates approved by the Commission in this proceeding will remain in effect.

Signatures



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



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

ATTACHMENT

ATTACHMENT TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE  
COMMISSION IN CASE NO. 2017-00323 DATED **NOV 30 2017**

Staff Calculated Monthly Water Rates

Minimum Bills Based on Meter Size (Zero Usage)

Meter Size	Customer Charge
5/8-Inch x 3/4-Inch Meter	\$6.79 per month
1-Inch Meter	13.12 per month
1 1/2-Inch Meter	23.69 per month
2-Inch Meter	36.36 per month
3-Inch Meter	65.94 per month
6-Inch Meter	213.82 per month
All Usage	6.38 per 1,000 Gallons

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