COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF MARTIN COUNTY WATER DISTRICT FOR AN ALTERNATIVE RATE ADJUSTMENT	)))	CASE NO. 2018-00017

NOTICE OF FILING OF COMMISSION STAFF REPORT

Notice is hereby given that, in accordance with the Commission's Order of April 30, 2018, 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 the Commission's February 20, 2018 Order, Martin County 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

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

DATE MAY 22 2018

cc: Parties of Record

STAFF REPORT

ON

MARTIN COUNTY WATER DISTRICT

CASE NO. 2018-00017

Martin County Water District ("Martin District") 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 3,243 customers residing in Martin County, Kentucky.[1] On January 16, 2018, Martin District tendered an application ("Application") to the Commission requesting to increase its water service rates pursuant to 807 KAR 5:076. The Application was considered filed as of January 22, 2018. On January 23, 2018, Martin County Concerned Citizens, Inc. ("MCCC") filed a motion to intervene. By Order dated February 2, 2018, MCCC's motion was granted.

To ensure the orderly review of the Application, the Commission established a procedural schedule by Order dated Feburary 20, 2018. On April 30, 2018, the Commission revised the existing procedural schedule to give Staff additional time to complete its report. In the cover letter to its Application, Martin District requested an expedited rate review and further requested that an emergency rate be approved while the Commission completed its review of the rate application.

Martin District based its requested rates on a historical test period that coincides with the reporting period shown in its most recent Annual Report on file with the Commission at the time it filed the Application, the calendar year ended December 31, 2016, as required by 807 KAR 5:076, Section 9.

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[1] *Annual Report of Martin County Water District to the Public Service Commission for the Calendar Year Ended December 31, 2016* ("*Annual Report*") at 12 and 48.

Martin District provided exhibits in its Application demonstrating that a 49.47 percent increase was reasonable, and requested an across the board increase to its base monthly water rates. The rates requested by Martin District would increase the monthly bill of a typical residential customer[2] by $19.76, from $39.90 to $59.66, or approximately 49.52 percent. Martin District presented financial exhibits in the Application that demonstrated how it calculated the amount of increase it could have justified. The exhibits are summarized below in condensed form.

Pro Forma Operating Expenses	$2,597,940
Plus: Average Annual Principal and Interest Payments	209,998
Additional Working Capital	38,822
Debt Service for Operational Deficit Retirement	163,187
Overall Revenue Requirement	3,009,947
Less: Other Operating Revenue	(286,066)
Interest Income	(293)
Nonutility Income	-
Revenue Required from Rates	2,723,588
Less: Pro Forma Present Rate Service Revenues	(1,822,189)
Required Revenue Increase	$ 901,399
Percentage Increase	49.47%

By Commission Order entered on March 16, 2018 ("March Order"), the Commission authorized Martin District to place into effect an interim base rate increase and a surcharge, subject to refund.[3] The Order authorized a 17.50 percent across-the-board increase to Martin District's base rates, and a Debt Service Surcharge of $4.19 per month to each customer's bill.

[2] A typical residential customer purchases 4,000 gallons of water per month through a 5/8-inch x 3/4-inch meter.

[3] Case No. 2018-00017, *Application of Martin County Water District for an Alternative Rate Adjustment* (PSC Ky. Mar. 16, 2018) Order.

To determine the reasonableness of the rates requested by Martin District, Staff performed a limited financial review of Martin District'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 to be material. Insignificant and immaterial discrepancies were not necessarily pursued or addressed.

Staff's findings are summarized in this report. Ariel Miller reviewed the calculation of Martin District's Overall Revenue Requirement. Jason Green reviewed Martin District'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 Martin District's Overall Revenue Requirement is $2,550,788 and that a $468,392 revenue increase, or 23.70 percent, to pro forma present rate revenues is necessary to generate the Overall Revenue Requirement.

2. Water Service Rates. Martin District proposed to increase its current water service rates by approximately 49.47 percent evenly across-the-board. Martin District has not performed a cost-of-service study ("COSS"). The Commission has previously found that an across-the-board increase is an appropriate and equitable method of cost allocation in the absence of a COSS. Staff finds that an across-the-board increase to all rate classes is the appropriate means to allocate the increased revenue requirement. The rates set forth in Attachment A of this report are based upon

the revenue requirement as calculated by Staff and will produce sufficient revenues from water sales to recover the $2,550,788 Revenue Requirement determined by Staff, an approximately 23.70 percent increase. These rates will increase a typical residential customer's monthly water bill from $39.90 to $49.37, an increase of $9.47, or approximately 23.73 percent.

3. Depreciable Lives. In this report, Staff finds that the current depreciable lives assigned to some of Martin District's assets should be revised for ratemaking purposes. Any depreciable lives approved by the Commission in this proceeding for ratemaking purposes should be used by Martin District for all future accounting and reporting purposes. No adjustment to accumulated depreciation or retained earnings should be made to account for the effect of this change in accounting estimate.

4. Surcharge. In this report, Staff finds that an increase to base rates of 23.67 percent is required in order to generate Martin District's Overall Revenue Requirement. In the March Order[4] the Commission authorized Martin District to implement a debt service surcharge of $4.19 per customer, per month. This debt surcharge is to continue and Staff has included in the Attachment to this Report the surcharge authorized in the March Order.

Pro Forma Operating Statement

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

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[4] *Id.* at 13.

	Test Year	Adjustment	(Ref.)	Pro Forma
Operating Revenues				
Sales of Water	$ 1,941,891	$ 34,146	(A)	
			(B)	
			(C)	$ 1,976,037
Other Water Revenues	106,066		(C)	106,066
Total Operating Revenues	2,047,957	34,146		2,082,103
Operating Expenses				
Operation and Maintenance Expenses				
Salaries and Wages - Employees	555,390	(6,360)	(D)	
		(63,206)	(E)	485,824
Employee Pensions and Benefits	296,755	(116,935)	(F)	
		(17,945)	(G)	161,875
Purchased Water	24,603		(C)	
		(12,147)	(H)	12,456
Purchased Power for Pumping	373,353		(C)	
		(184,324)	(H)	189,029
Chemicals	115,033	(56,792)	(H)	58,241
Materials and Supplies	156,069	(17,640)	(D)	138,429
Contractual Services	214,221			214,221
Rent	59,212			59,212
Transportation Expense	75,334			75,334
Insurance	69,115			69,115
Regulatory Commission Expense	3,000			3,000
Bad Debt Expense	67,543			67,543
Miscellaneous Expense	40,341			40,341
Total Operation and Maintenance Expenses	2,049,969	(475,349)		1,574,620
Taxes Other Than Income	46,496	(2,898)	(E)	43,598
Depreciation	771,703	(87,953)	(I)	683,750
Total Operating Expenses	2,868,168	(566,200)		2,301,968
Net Operating Income	(820,211)	600,346		(219,865)
Interest Income	293			293
Nonutility Income	22,789	(22,789)	(J)	-
Income Available to Service Debt	$ (797,129)	$ 577,557		$ (219,572)

(A) Billing Analysis Adjustment. Martin District provided a billing analysis showing the gallons of water billed to retail customers during the test year. Applying the water service rates that were in effect during the test year to the water sales shown in the billing analysis, Staff determined that a billing analysis adjustment is appropriate that increases test-year revenues by $34,146.

(B) Reduction in Water Sales. In its Application, Martin District requested to decrease metered water sales by $91,056 due to what it states is a decline in coal mining, related suppliers, and other businesses in the area. More specifically, Martin District requested to decrease water sales by 4.76 percent, the annualized difference between the first nine months of the calendar year ended December 31, 2017 and the test year. During Staff's limited financial review, Martin District was asked to provide specific documentation regarding major customers that were part of the reduced usage between the test year and 2017. Martin District was unable to provide documentation of any specific customers or other evidence that supported its claim. Without evidence of a major customer that has either greatly reduced its usage or has closed entirely, an adjustment to water sales would not be appropriate. Any gross adjustment to move revenues to a different period would be a violation of the matching principle, as there would be a mismatch of revenues and expenses in pro forma operations. Therefore, Staff has not included this adjustment to water sales revenue in pro forma operations.

(C) Contract with Prestonsburg. In its Application, Martin District requested to decrease Water Sales for Resale by $62,792, increase Other Revenues by $180,000, decrease Purchased Water by $24,603, and decrease Purchased Power by $21,640, in order to reflect changes to Martin District's operations as a result of a tank lease agreement with the city of Prestonsburg. As of the date of this report, the contract for the lease agreement remains unsigned and negotiations are still pending. Accordingly, the actual details of the contract remain unknown and are not measurable for ratemaking purposes. Therefore, Staff has not included any adjustments in relation to the contract with Prestonsburg in pro forma operations.

(D) Tap Fees. In its Application, Martin District made an adjustment in the amount of $24,000 to reflect expenses associated with the installation of 24 new meter connections in the test year. This amount was split between salaries and wages expense of $6,360 and materials and supplies expense of $17,640. Staff agrees with the proposed adjustment and has included the reduction in operation and maintenance expenses and corresponding capitalization adjustment to depreciation in pro forma expenses.

(E) Employee Wages. Subsequent to the test year, Martin District experienced changes in its employee staffing levels. Martin District's business manager retired in March of 2018, and was replaced with a general manager who was hired at a negotiated salary of $9,000 per year. In addition, Martin District has one less employee than it had in the test year. Staff calculated pro forma salaries and wages expense and payroll taxes based on current staffing levels, and to reflect the effects of a reduction in overtime hours as explained below, resulting in a reduction of $63,206 and $2,898 respectively.

	Current Pay Rate	Regular Hours	Overtime Hours (x1.5)	Pro Forma
General Manager	Salaried			$ 9,000
Distribution Supervisor	Salaried			48,012
Meter Reader	Salaried			24,515
Meter Reader	Salaried			14,656
Plant Operator	$ 19.27	2,080	426	52,395
Plant Operator	17.83	2,080	698	55,754
Plant Operator	16.00	2,080	122	36,208
Plant Operator	15.00	2,080	19	31,628
Distribution	14.35	2,080	398	38,415
Distribution	13.38	2,080	291	33,671
Distribution	11.38	2,080	253	27,989
Distribution	11.38	2,080	235	27,682
Distribution	11.38	2,080	88	25,173
Office Manager	11.22	2,080	9	23,489
Office Clerk	10.38	2,080	3	21,633
Office Clerk	10.38	2,080	24	21,964
Total Pro Forma Wages				492,184
Less: Test Year Wages				(555,390)
Adjustment				$ (63,206)

Overtime Wages.

During the test year, Martin District experienced a high level of overtime hours in its Plant and Distribution operations. Staff believes that the current level of overtime compensation for its field employees is directly correlated to the high amounts of water loss that Martin District is experiencing, necessitating frequent line repairs, and the number of hours required to operate the plant. Therefore, in the table above, Staff reduced the level of overtime hours attributable to Martin District's field employees in its pro forma calculation by the percentage of excess water loss calculated in Item (H) of this report.[5]

Payroll Taxes.

Staff recalculated the amount of pro forma payroll taxes to reflect the changes in salaries and wages calculated above. As a result, Staff reduced Taxes Other than Income by $2,941 as shown in the calculation below.

Pro Forma Wages	$	492,184
Times: 7.65%		7.65%
Pro Forma Payroll Taxes		37,652
Less: Test Year		(40,550)
Adjustment	$	(2,898)

(F) Retirement Expense Adjustment Pursuant to GASB 68. Martin District reported test-year employee pension expense in the amount of $198,974. Martin District 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, Martin District is 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 Martin District

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Field Employee Overtime Hours	4,998
Times: 49.37 Percent	49.37%
Total Hours to be Reduced	2,468
Less: Total Overtime Hours	(4,998)
Total Allowed Hours	(2,530)

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,[6] 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, 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 Martin District's actual test-year CERS contributions totaled $82,039. Accordingly, Staff decreased employee pension and benefits expense by $116,935, to reflect what was actually paid in the test year.

(G) Employee Benefits. Martin District reported $97,781 in the test year for amounts Martin District paid on behalf of its employees for the cost of providing health, dental, vision, and life insurance benefits to all full-time employees.

Martin District currently pays 100 percent of the monthly premiums for all employees' health, dental, vision, and life insurance. 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 the total salaries and fringe benefits. The Commission is placing greater emphasis on evaluating employee's 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

[6] 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.

not meet those criteria. Factoring in for the preceding, and accounting for other pro-forma adjustments, Staff determined the net adjustment to Martin District's test-year employee benefits expense should be decreased in the amount of $17,945 to reflect the most recent monthly premiums and a reduction based on the average employee contribution rates for health insurance and dental insurance as shown below.

Type of Premium	Current Monthly Premium	Times: Average Employee Contribution Rate	Monthly Premium Adjustment	Pro Forma Monthly Premium
Health Insurance	$ 7,961	21%	$ (1,672)	$ 6,289
Dental Insurance	381	60%	(229)	152
Life Insurance	143			143
Vision Insurance	68			68
Total Pro Forma Monthly Premium				6,653
Times: 12 Months				12
Total Annual Pro Forma Premium				79,836
Less: Test Year				(97,781)
Adjustment				$(17,945)

(H) Expenses Attributable to Water Loss. In its Annual Report, Martin District reported water loss of 64.37 percent.[7] 807 KAR 5:066, Section 6(3), limits water loss to 15 percent for ratemaking purposes unless an alternative level is found reasonable by

[7] Annual Report at 56.

the Commission.[8] As shown below, Staff calculated the cost to purchase, pump, and treat excess water loss to be $253,263.

	Test Year	Times: Excess Water Loss Percentage	Decrease
Purchased Water	$ 24,603	-49.37%	$ (12,147)
Purchased Power	373,353	-49.37%	(184,324)
Chemicals	115,033	-49.37%	(56,792)

Accordingly, Staff removed the amounts attributable to excess water loss in pro forma operations.

(I) Depreciation. In its Application, Martin District adjusted the lives of certain assets that appear on Martin District's depreciation schedule for the year ended December 31, 2016. Staff agrees that the adjustments made to the lives in its Application accurately represent, in all material respects, the appropriate lives to be assigned to those assets. Therefore, Staff decreased Depreciation Expense by $87,953, the amount calculated in Martin District's Application.

(J) Gain on Disposition of Utility Property. During the test year, Martin District realized a gain on the sale of utility property that would not normally occur during the normal course of business. In its Application, Martin District requested to remove from its pro forma the amount of the sale. Staff agrees with this adjustment and has

[8] 807 KAR 5:066, Section 6(3), states: "Unaccounted-for water loss. Except for purchased water rate adjustments for water districts and water associations, and rate adjustments pursuant to KRS 278.023(4), for rate making purposes a utility's unaccounted-for water loss shall not exceed fifteen (15) percent of total water produced and purchased, excluding water used by a utility in its own operations. Upon application by a utility in a rate case filing or by separate filing, or upon motion by the commission, an alternative level of reasonable unaccounted-for water loss may be established by the commission. A utility proposing an alternative level shall have the burden of demonstrating that the alternative level is more reasonable than the level prescribed in this section."

therefore included the reduction of income in the amount of $22,789 in pro forma operations.

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;[9] 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 Martin District's and Staff's calculations of the Overall Revenue Requirement and Required Revenue Increase using the DSC method is shown below.

[9] 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)

	Martin District	Staff
Pro Forma Operating Expenses	$2,597,940	$ 2,301,968
Plus: Average Annual Principal and Interest Payments	209,998	209,998
Additional Working Capital	38,822	38,822
Debt Service for Operational Deficit Retirement	163,187	-
Overall Revenue Requirement	3,009,947	2,550,788
Less: Other Operating Revenue	(286,066)	(106,066)
Interest Income	(293)	(293)
Nonutility Income	-	-
Revenue Required from Rates	2,723,588	2,444,429
Less: Pro Forma Present Rate Service Revenues	(1,822,189)	(1,976,037)
Required Revenue Increase	$ 901,399	$ 468,392
Percentage Increase	49.47%	23.70%

(1) Average Annual Principal and Interest Payments. Martin District currently has one outstanding bond payable to the Kentucky Rural Water Finance Corporation ("KRWFC"), one note payable to the Kentucky Infrastructure Authority ("KIA"), and a lease payable to the Kentucky Association of Counties ("KACo"). In its Application, Martin District requested recovery of the average annual principal and interest payments on these loans, which it calculated to be $209,998, based on a five-year average of the annual principal and interest payments for the years 2017 through 2021. Staff finds that the amount requested in Martin District's Application accurately represents, in all material respects, the average amount of the debt payments to be paid

by Martin District during the anticipated life of the rates authorized by the Commission in this proceeding.[10]

(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 a district's lenders that are above its average annual debt payments. In addition to depreciation expense, Martin District requested recovery of an allowance for working capital that is equal to 120 percent of its average annual debt payments for its bond and loan payable to KRWFC and KIA, respectively. Martin District did not request an allowance for working capital on its lease payments to KACo.

KRWFC requires that Martin District charge rates that produce net revenues that are at least 120 percent of its average annual debt payments. Following the Commission's historic practice, Staff agrees with Martin District's proposed recovery of its calculation for an allowance for working capital and has included it in the calculation of Martin District's overall revenue requirement.

[10] Generally, the anticipated life of a utility's service rates is based on the frequency of the utility's previous rate case filings, but is no longer than five years, since rates tend to become obsolete due to changes that will likely occur to the utility's cost of service in a five-year period. Martin District last adjusted its monthly water service rates pursuant to the application for general adjustment of existing rates procedure in 807 KAR 5:001 Section 16 in 2010. Case No. 2010-00300, *Application of Martin County Water District for Approval of a Proposed Increase in Rates for Water Service* (Ky. PSC July 16, 2010). Therefore, Staff finds that the anticipated life of the rates approved in this proceeding is five years.

Signatures

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Jason Green

Prepared by: Jason Green
Water and Sewer Branch
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ATTACHMENT

ATTACHMENT TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2018-00017 DATED MAY 2 2 2018

Monthly Water Rates

5/8 X ¾-Inch Meter				
First	2,000	Gallons	$32.79	Minimum Bill
Over	2,000	Gallons	8.29	per 1,000 Gallons
1-Inch Meter				
First	5,000	Gallons	$57.64	Minimum Bill
Over	5,000	Gallons	8.29	per 1,000 Gallons
1 ½-Inch Meter				
First	10,000	Gallons	$99.08	Minimum Bill
Over	10,000	Gallons	8.29	per 1,000 Gallons
2-Inch Meter				
First	20,000	Gallons	$181.96	Minimum Bill
Over	20,000	Gallons	8.29	per 1,000 Gallons
3-Inch Meter				
First	30,000	Gallons	$264.84	Minimum Bill
Over	30,000	Gallons	8.29	per 1,000 Gallons
4-Inch Meter				
First	50,000	Gallons	$430.60	Minimum Bill
Over	50,000	Gallons	8.29	per 1,000 Gallons
Debt Service Surcharge			$4.19/ Month	

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