

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF MUHLENBERG COUNTY)	CASE NO.
WATER DISTRICT #3 FOR RATE ADJUSTMENT)	2018-00346
FOR SMALL UTILITIES PURSUANT TO 807 KAR)	
5:076)	

NOTICE OF FILING OF COMMISSION STAFF REPORT

Notice is hereby given that, in accordance with the Commission's Order of November 19, 2018, 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 November 19, 2018 Order, Muhlenberg County Water District #3 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

DATED JAN 22 2019

cc: Parties of Record

STAFF REPORT
ON
MUHLENBERG COUNTY WATER DISTRICT #3
CASE NO. 2018-00346

Muhlenberg County Water District #3 (Muhlenberg District #3) is a water utility organized pursuant to KRS Chapter 74 that owns and operates a water distribution system through which it provides retail water service to approximately 2,111 customers that reside in Muhlenberg and McLean counties, Kentucky.¹ On October 9, 2018, Muhlenberg District #3 filed an application (Application) requesting to increase its water service rates pursuant to 807 KAR 5:076. To ensure the orderly review of the Application, the Commission established a procedural schedule by Order dated November 19, 2018.

To comply with the requirements of 807 KAR 5:076, Section 9, Muhlenberg District #3 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, 2017.

Using its pro forma test-year operations, Muhlenberg District #3 determined that it could justify a revenue increase of \$220,918, or 20.7 percent, as shown in the table below.² The rates requested by Muhlenberg District #3 would increase the monthly bill of a typical residential customer by \$5.93, from \$28.65 to \$34.58, or approximately 20.7 percent.

¹ *Annual Report of Muhlenberg County Water District #3 to the Public Service Commission for the Calendar Year Ended December 31, 2017, (Annual Report)* at 12 and 48.

² Application, Revenue Requirement Calculation-Operating Ratio Method.

Pro Forma Operating Expenses	\$ 1,388,405
Divided by: Operating Ratio	<u>88%</u>
Total Revenue Requirement	<u>1,577,733</u>
Less: Other Operating Revenue	45,500
Interest Income	3,850
Wholesale Water Sales Revenue	239,013
Gain on Disposition of Utility Property	429
Interest Expense	<u>(20)</u>
Revenue Required From Retail Rates	1,288,961
Less: Pro Forma Present Retail Water Revenue	<u>(1,068,043)</u>
Required Revenue Increase	<u>\$ 220,918</u>
Percent Retail Revenue Increase	<u>20.7%</u>

To determine the reasonableness of the rates requested by Muhlenberg District #3, Staff performed a limited financial review of Muhlenberg 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. David Foster and Mike Foley reviewed the calculation of Muhlenberg District #3 Overall Revenue Requirement. Jason Green reviewed Muhlenberg's reported revenues and rate design.

SUMMARY OF FINDINGS

1. Overall Revenue Requirement and Required Revenue Increase. By applying the Operating Ratio Method, as generally accepted by the Commission, Staff found that Muhlenberg District's Overall Revenue Requirement is \$1,396,475 and that a

\$278,673 revenue increase, or 26.1 percent, to pro forma present rate revenues is necessary to generate the Overall Revenue Requirement.

2. Water Service Rates. In the Application, Muhlenberg District #3 proposed to increase all of its monthly retail water service rates evenly across the board by approximately 20.7 percent. Muhlenberg District #3 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 rate design is appropriate when there has been no evidence entered into the record demonstrating that this method is unreasonable and in the absence of a COSS. Finding no such evidence in this case, Staff followed the method proposed by Muhlenberg District #3 and allocated the \$278,673 revenue increase across the board to Muhlenberg District #3's monthly retail water service rates.

The rates set forth in the Attachment to this report are based upon the revenue requirement, as calculated by Staff, and will produce sufficient revenues from water sales to recover the \$278,673 Revenue Required from Rates, an approximate 26.1 percent increase. These rates will increase a typical residential customer's monthly water bill from \$28.65 to \$36.15, an increase of \$7.50, or approximately 26.2 percent.

In the Application, Muhlenberg District #3 also proposed to establish a separate rate for its wholesale customer, the city of Sacramento (Sacramento). However, considering that Sacramento is no longer purchasing water from Muhlenberg District #3, Staff finds that calculating a wholesale rate is not necessary at this time. If Muhlenberg District #3 starts selling water to a wholesale customer in the future, they are encouraged to file another application for a rate increase in order to calculate a wholesale rate.

PRO FORMA OPERATING STATEMENT

Muhlenberg District #3's Pro Forma Operating Statement for the test year ended
December 31, 2017, as determined by Staff, appears below.

	<u>Test Year</u>	<u>Adjustment</u>	<u>(Ref.)</u>	<u>Pro Forma</u>
Operating Revenues				
Total Metered Retail Water Sales	\$ 1,042,801	\$ 25,242	(A)	\$ 1,068,043
Sales for Resale	239,013	(239,013)	(B)	0
Other Water Revenues				
Forfeited Discounts	24,250			24,250
Misc. Service Revenues	20,282			20,282
Other Water Revenues	968			968
 Total Operating Revenues	 1,327,314	 (213,771)		 1,113,543
Operating Expenses				
Operation and Maintenance Expenses				
Salaries and Wages - Employees	249,348	9,583	(C)	
		(3,275)	(D)	255,656
Salaries and Wages - Officers	18,000			18,000
Employee Pensions and Benefits	151,655	(12,845)	(E)	
		(55,436)	(F)	83,374
Purchased Water	705,483	(160,689)	(G)	
		(5,077)	(H)	539,717
Purchased Power	29,561	(275)	(H)	29,286
Materials and Supplies	45,975	(3,275)	(D)	42,700
Contractual Services	44,920			44,920
Transportation Expenses	11,737	(1,800)	(I)	9,937
Insurance - General Liability & Other	18,181			18,181
Insurance - Workers Comp	3,008			3,008
Advertising	453			453
Bad Debt Expense	3,497			3,497
Miscellaneous Expenses	38,749	(731)	(J)	38,018
 Total Operation and Maintenance Expenses	 1,320,567	 (233,821)		 1,086,746
Depreciation Expense	102,378	15,362	(K)	117,740
Taxes Other Than Income	23,679	733	(L)	24,412
 Total Operating Expenses	 1,446,624	 (217,726)		 1,228,898
 Net Operating Income	 (119,310)	 3,955		 (115,355)
Gains (Losses) on Disposition of Property	429			429
Interest Income	3,850			3,850
Interest Expense	(20)			(20)
 Income Available to Service Debt	 <u>\$ (115,051)</u>	 <u>\$ 3,955</u>		 <u>\$ (111,096)</u>

(A) Billing Analysis Adjustment. Muhlenberg District #3 provided a billing analysis listing the water usage and water sales revenue for the 12-month test year in its Application. Staff has reviewed Muhlenberg District #3's billing analysis provided in the Application and finds that the water sales revenues determined by the billing analysis of \$1,068,043 for all retail customers is an accurate representation of the normalized test-year revenue from water sales; therefore, Staff has increased water sales revenue by \$25,242.

(B) Sales for Resale. During the test year, Muhlenberg District #3's wholesale customer, Sacramento, stopped purchasing water for resale from Muhlenberg District #3. As a result, Staff decreased water sales revenue by \$239,013.

(C) Salaries and Wages - Employees. Muhlenberg District #3 reported \$249,348 in wages paid to its employees. In its Application, Muhlenberg District #3 proposed to increase this amount by \$13,470 to account for staffing level changes that occurred and to remove back wages that were paid to current employees during the test year that were earned in prior years. Muhlenberg District #3 did not provide its calculation. Staff determined, based on conversations with utility personnel, that an increase of \$9,583 to Salaries and Wages – Employees was warranted to reflect the items described below.

During and subsequent to the test year, Muhlenberg District #3 experienced multiple staffing level changes. During the test year, Muhlenberg District #3's Office Manager retired. The office's billing clerk was promoted to fill the office manager's position, and an office utility clerk was promoted to the vacant billing clerk's position. Following the test year, another employee was hired to fill the utility clerk position. To

reflect the current changes to staffing levels, Staff recalculated pro forma wages based on hours worked for the test year at the current wage rates paid to Muhlenberg District #3's employees.

	2018 Wages		2017 Hours		Total Salaries
	Regular	Overtime	Regular	Overtime	
Employee 1	\$12.00	\$ 18.00	2,080		\$ 24,960
Employee 2	18.16	27.24	2,080	12	38,100
Employee 3	16.77	25.16	2,080	6	35,033
Employee 4	16.77	25.16	2,080	220	40,416
Employee 5	16.77	25.16	2,080	274	41,774
Employee 6	13.39	20.09	2,080	111	30,081
Employee 7	23.35	35.03	2,080		48,568
Pro Forma Wages					\$258,931
Less: Test Year					<u>(249,348)</u>
Increase					<u>\$ 9,583</u>

(D) Capitalization of Test-Year Meter Installations. During the test year, Muhlenberg District #3 collected \$6,550 to install seven 5/8-inch x 3/4-inch meters and two 1-inch meter connections. These installations incur costs that include wages, wage overheads, transportation, equipment, and materials and supplies. The Uniform System of Accounts for Class A/B Water Systems (USoA) requires that these costs be capitalized as Utility Plant in Service and depreciated over their estimated useful lives.³ Muhlenberg District #3 incorrectly reported these costs as test-year expenses. To correct this accounting error in pro forma operations, Staff removed the amount collected for these connections from test-year expenses and included a provision for their recovery in pro

³ USoA, Accounting Instruction 19 and 33.

forma depreciation expense. Ideally, Staff would have reduced each of the expense accounts that contained installation costs by a portion of the capitalized costs, but for simplicity, Staff decreased the wages expense and the materials and supplies expense by \$3,275 each, or half of the total estimated cost. In Case No. 2015-00331, the Commission accepted Staff's finding that the expense for new tap installations be decreased by half.⁴ Using this abbreviated method does not have a material effect on the results of Staff's analysis of Muhlenberg District #3's operations.

(E) Employee Pensions and Benefits. Muhlenberg District #3 reported test-year Employee Pensions and Benefits expense of \$151,655. Staff determined Muhlenberg District #3's test-year employee pensions and the benefits expense should be decreased by \$12,845 as explained below.

Muhlenberg District #3 currently pays 100 percent of the monthly premiums for its eligible full-time 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 benefits 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, and to ensure the development of a fair, just, and reasonable rate. It has found in most cases 100 percent of employer-funded health care does not meet those criteria. Factoring in for the

⁴ Case No. 2015-00331, Commission Staff Report on McKinney Water District (filed Oct. 20, 2015)

preceding, Staff determined the net adjustment to Muhlenberg District #3's test-year health insurance expense should be a decrease of \$12,845,⁵ as shown below.

Muhlenberg District #3 currently has seven employees who have single-coverage health insurance policies and six employees with dental coverage. As shown below, Staff annualized the most recent monthly premiums paid on behalf of all full-time employees who were receiving health insurance and dental benefits at the time of Staff's review.

<u>Health and Dental Annualized Premiums</u>	
Current Premium for Full-time Employees	\$ 2,952
Times: 12 Months	<u>12</u>
Annualized	35,426
Less: Test Year	<u>(40,160)</u>
Decrease	<u><u>\$ (4,734)</u></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 and dental insurance coverage, Staff reduced Muhlenberg District #3's single-coverage health insurance premiums by 21 percent and its dental premiums by 60 percent, the national average employee contribution rate,⁶ as shown below.

⁵

Annualized Premium Decrease	\$ (4,734)
Benefit Reduction	<u>(8,111)</u>
Total Decrease	<u><u>\$ (12,845)</u></u>

⁶ 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>)

	<u>Health Insurance</u>	<u>Dental Insurance</u>	<u>Total Decrease</u>
Annual Premium Subject to Adjustment	\$ 33,704	\$ 1,722	
Times: Percentage Reduction	<u>21%</u>	<u>60%</u>	
	<u>\$ 7,078</u>	<u>\$ 1,033</u>	<u>\$ 8,111</u>

(F) Retirement Expense Pursuant to GASB 68. Muhlenberg District #3 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, Muhlenberg District #3 is required to contribute a percentage of its employee wages to CERS. In the fiscal year, beginning July 1, 2018, the CERS contribution rate was 21.48 percent.⁷ The CERS pension expense Muhlenberg District #3 reported in the test year conformed to the requirements of the Governmental Accounting Standards Board Statement No. 68 (GASB 68).

In Case No. 2016-00163,⁸ 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 Muhlenberg District #3's test-year CERS contributions totaled \$43,433. Accordingly, Staff is decreasing employee pension and benefits expense by \$55,436, as shown below.

⁷ <https://kyret.ky.gov/Employers/Pages/Contribution-Rates.aspx>

⁸ 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.

Total Pro Forma Wages	\$ 255,656
Times: 2018 CERS Contribution Rate	<u>21.48%</u>
Pro Forma CERS Contribution	54,915
Less: Test Year CERS	<u>(110,351)</u>
CERS Contribution Adjustment	<u>\$ (55,436)</u>

(G) Purchased Water Expense. As explained in Item (B) above, Staff removed the expenses incurred by Muhlenberg District #3 during the test year to purchase the water that is no longer being sold to the city of Sacramento. Staff's adjustment includes a gross-up factor to account for Muhlenberg District #3's line-loss percentage. Staff's adjustment is shown below.

Gallons Sold to the City of Sacramento During the Test Year	52,702,000
Gross up Factor to Account for Line Loss	<u>1.15932</u>
Gallons Purchased to Sell to the City of Sacramento	61,098,483
Times: Water Purchase Rate per 1000 Gallons	<u>\$ 2.63</u>
Water Purchased Expense Adjustment	<u>\$ (160,689)</u>

(H) Expenses Attributable to Water Loss. Pursuant to 807 KAR 5:066, Section (6)3, Muhlenberg District #3's water loss is limited to 15 percent for ratemaking purposes unless it can demonstrate that an alternative level is reasonable. Muhlenberg District #3 reported test-year water loss at 15.932 percent,⁹ or 0.932 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, Staff removed the expenses incurred during

⁹ Annual Report at 56.

the test year to purchase and pump the lost water that was in excess of the allowable amount, taking into account the amount of water expense reduction addressed in Item (G). Staff's calculation is shown below.

	<u>Purchased Water</u>	<u>Purchased Power</u>
Test-Year Subject to Water Loss Adjustment	\$544,794	\$ 29,561
Times: Water Loss in Excess of 15 Percent	<u>-0.932%</u>	<u>-0.932%</u>
Decrease	<u>\$ (5,077)</u>	<u>\$ (275)</u>

(I) Transportation Expense. In the test year, Muhlenberg District #3 paid its three Commissioners \$50 per month for a total annual expense of \$1,800 for vehicle allowance as compensation to attend monthly meetings and perform their duties as Commissioners. Subsequent to the test year, Muhlenberg District #3 ceased the practice.¹⁰ Staff removed the expense from test-year operations.

(J) Miscellaneous Expenses. Muhlenberg District #3 reported \$38,749 for Miscellaneous Expenses. In this account, Staff discovered reported expenses for a retirement dinner for an employee, a Christmas dinner that was held for the district's employees and their families, and Christmas gift baskets given to its employees. The costs for these expenditures was \$243, \$332, and \$156, respectively. Staff removed these expenses from test-year operations for a total decrease of \$731.

The Attorney General has stated that a water district may only make expenditures that are consistent with its statutory purpose to furnish a water supply. "As a creature of

¹⁰ Pursuant to KRS 74.020(6), each water district commissioner receives an annual salary of not more than \$3,600, except that each water district commissioner who completes minimum training requirements may receive an annual salary of not more than \$6,000.

statute, a water district created pursuant to KRS Chapter 74 may expend funds only in keeping with its statutory purpose, or express statutory authorization.”¹¹ “To expend any part of the funds arising from fees for water services for any purpose other than those for which the district was created is to contravene the provisions contained in sections 171 and 180, State Constitution, and to do so, is illegal. The officer making such illegal expenditure subjects himself to the obligation upon the demand of any citizen who pays fees for water services to either recover from the person to whom the illegal sum was donated or to reimburse the district for the amount of the illegal donation.”¹²

(K) Depreciation. In its Application, Muhlenberg District #3 proposed to increase its test-year depreciation expense of \$102,378 by \$15,362.¹³ This adjustment was the result of Muhlenberg District #3’s proposal to adjust the lives assigned to certain assets that were outside of the life ranges in accordance with the National Association of Regulatory Utility Commissioners’ (NARUC) publication titled Depreciation Practices for Small Utilities (NARUC Study), and to include a depreciation expense for additional assets that were installed subsequent to the test year.

To evaluate the reasonableness of the depreciation practices of small water utilities, the Commission has historically relied upon the NARUC Study. Muhlenberg District #3 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 evidence to support depreciable lives that vary significantly from the mid-point of the NARUC

¹¹ OAG 92-43 (Mar. 19, 1992).

¹² 1956 OAG 36,219.

¹³ Application, References.

ranges, and after further review of Muhlenberg District #3 plant ledger, Staff agrees with Muhlenberg District #3's increase to depreciation expense of \$15,362.

(L) Taxes Other Than Income. As discussed in Item (C), Staff determined that Muhlenberg District #3's test-year employee wages will increase by \$9,583 due to changes in Muhlenberg District #3's employee staffing. Muhlenberg District #3's test-year FICA taxes will increase as a result of these changes. As calculated below, Staff determined that the increase to test-year FICA taxes will be \$733. Accordingly, Staff increased test-year Taxes Other Than Income by \$733.

Increase to Employee Wages Expense	\$ 9,583
Times: 7.65% FICA Tax Rate	<u>7.65%</u>
FICA Tax Rate Increase	<u>\$ 733</u>

Overall Revenue Requirement and Required Revenue Increase

A comparison of Muhlenberg District #3's and Staff's calculations of the Overall Revenue Requirement and Required Revenue Increase is shown below. By applying the Operating Ratio, Staff determined Muhlenberg District #3's Overall Revenue Requirement to be \$1,396,475. As shown below, a revenue increase of \$278,673, or 26.1 percent, is necessary to generate the Overall Revenue Requirement.

	Muhlenberg District	Staff
Pro Forma Operating Expenses	\$ 1,388,405	\$ 1,228,898
Divided by: Operating Ratio	<u>88%</u>	<u>88%</u>
Overall Revenue Requirement	<u>1,577,733</u>	<u>1,396,475</u>
Less: Other Operating Revenue	45,500	45,500
Interest Income	3,850	3,850
Wholesale Water Sales Revenue	239,013	0
Gain on Disposition of Utility Property	429	429
Interest Expense	<u>(20)</u>	<u>(20)</u>
Revenue Required From Retail Rates	1,288,961	1,346,716
Less: Pro Forma Present Retail Water Revenue	<u>(1,068,043)</u>	<u>(1,068,043)</u>
Required Revenue Increase	<u>\$ 220,918</u>	<u>\$ 278,673</u>
Percent Retail Revenue Increase	<u>20.7%</u>	<u>26.1%</u>

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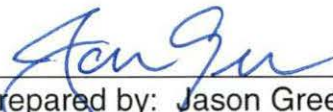
Signatures



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Division of Financial Analysis



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ATTACHMENT

ATTACHMENT TO A STAFF REPORT OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 2018-00260 DATED **JAN 22 2019**

Monthly Water Rates

First	2,000	Gallons	\$ 22.39	Minimum bill
Next	8,000	Gallons	6.88	per 1,000 Gallons
Next	10,000	Gallons	6.51	per 1,000 Gallons
Next	30,000	Gallons	6.04	per 1,000 Gallons
All Over	50,000	Gallons	5.69	per 1,000 Gallons

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