

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION TO REQUEST COMMISSION )  
APPROVAL FOR AN INCREASE IN FARMDALE )  
DEVELOPMENT CORPORATION SEWAGE ) CASE NO. 2006-00028  
TREATMENT PLANT'S RATE PURSUANT TO THE )  
ALTERNATIVE RATE FILING PROCEDURE FOR )  
SMALL UTILITIES )

ORDER

On January 12, 2006, Farmdale Development Corporation ("Farmdale") applied, pursuant to 807 KAR 5:076, for Commission approval of an increase in its rates for sewer service and for the assessment of a monthly surcharge for 3 years. On June 14, 2006, Farmdale amended this application to reflect its application for a temporary monthly surcharge to finance the cost of the replacement of a remote sewage lift station.<sup>1</sup> On February 26, 2007, we consolidated both applications into this proceeding to permit consideration of Farmdale's requests for surcharge and a rate adjustment in a single proceeding.

Commission Staff has performed a limited financial and technical review of Farmdale's operations and has prepared a written report containing its findings and recommendations regarding the proposed rates. By this Order, that report is made a part of the record of this proceeding and made available to the parties to this

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<sup>1</sup> Case No. 2006-00209, Application of Farmdale Development Corporation For a Certificate of Convenience and Necessity, Authority to Make Repairs and Surcharge For Same (Ky. PSC filed June 14, 2006).

proceeding. Based upon our limited review of this report, we find a procedural schedule should be established.

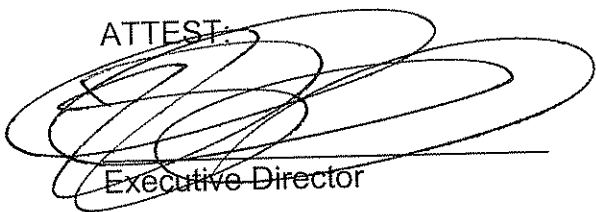
IT IS THEREFORE ORDERED that:

1. Commission Staff's written report on the proposed rate adjustment and surcharges, a copy of which is appended to this Order, is made a part of the record of this proceeding.
2. All parties shall carefully review the report and file with the Commission their written comments on the report no later than March 9, 2007. In these comments, each party shall specifically identify those findings or recommendations to which it objects. Failure to object to a finding shall be considered as an admission of that finding.
3. A hearing will be held in this matter on March 15, 2007 for the purpose of hearing evidence on Farmdale's proposed rate adjustment and proposed surcharges. Each party shall file with the Commission no later than March 9, 2007 a list of the witnesses that it intends to call at this hearing and the issues that it will present to the Commission.
4. An informal conference shall be held in this matter on March 14, 2007, beginning at 1:00 p.m., Eastern Daylight Time, to consider the possibility of settlement, the simplification of issues, and any other matters that may aid in the handling or disposition of this case.
5. Farmdale shall publish notice of the scheduled hearing in this matter in accordance with 807 KAR 5:011, Section 8(5).

Done at Frankfort, Kentucky, this 26th day of February, 2007.

By the Commission

ATTEST.

A large, complex handwritten signature in black ink, consisting of multiple overlapping loops and lines, positioned over the text 'Executive Director'.

Executive Director

STAFF REPORT  
FARMDALE DEVELOPMENT CORPORATION  
CASE NO. 2006-00028

On January 12, 2006, Farmdale Development Corporation ("Farmdale"), pursuant to 807 KAR 5:076, applied for a rate adjustment. Farmdale proposed to increase its current flat rate of \$19.05 by 81.05 percent to \$34.49, which would produce increased revenues of \$47,811. Farmdale also proposed to assess a "Monthly Construction Surcharge" of \$27.92 for 36 months to fund systems repairs and replacements of \$247,300.

After several discussions with Commission Staff regarding the need for a Certificate of Public Convenience and Necessity ("Certificate") to perform some of the requested repairs and replacements, Farmdale on June 14, 2006, applied for a Certificate to replace a remote lift station at an estimated cost of \$30,425 and a temporary surcharge to finance this cost<sup>2</sup> and amended its application in Case No. 2006-00028 for a temporary surcharge to finance the remaining repairs at an estimated cost of \$225,215. The Commission, after granting Farmdale a Certificate to construct a replacement lift station, consolidated the two proceedings to permit consideration of Farmdale's requests for surcharge and rate adjustment in a single proceeding.

To evaluate the requested monthly increase, Commission Staff performed a limited financial review of Farmdale's test period operations for the calendar year ending

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<sup>2</sup> Case No. 2006-00209, Application of Farmdale Development Corporation For a Certificate of Convenience and Necessity, Authority To Make Repairs and Surcharge For Same (Ky.PSC filed June 14, 2006).

December 31, 2005. Jack Kaninberg of the Commission's Water and Sewer Revenue Requirements Branch began the limited review with a field visit on August 21, 2006. The scope of Commission Staff's review was limited to obtaining information as to whether the test period operating revenues and expenses were representative of normal operations. Insignificant or immaterial discrepancies were not pursued and are not addressed herein. Based on its review, Commission Staff recommends a revenue increase of \$24,121, or 42.9 percent, which would result in a monthly flat rate of \$27.23 per customer, as shown in Attachment A to this report.

To evaluate the proposed surcharges, Commission Staff requested that Farmdale identify the proposed repairs and replacements and provide competitive bids from three nonaffiliated sources to support the estimate of each repair or replacement's cost. Farmdale provided incomplete bids for other projects (for example, providing bids for material costs, but not for installation costs) and failed to provide competitive bids for some projects. Farmdale also indicated that some proposed repairs had already been completed.

Perhaps most problematic was the project for "system repairs," whose cost Farmdale estimated in its original application to be \$112,560. As originally proposed, this project involved a four-page list of repair work to clean tree roots that have purportedly infiltrated Farmdale's sewer lines and to repair sewer mains. The two competitive bids provided for this work were \$29,702 and \$36,527. Based upon the wide variations in these three cost estimates, Commission Staff is unable to determine the exact nature of the work that needs to be done, to what extent it is necessary, and the reasonableness of its cost.

Commission Staff recommends that the depreciation expense associated with three already-completed projects whose costs total \$13,091 be included in pro forma revenue requirements. The first project – the replacement of diffuser drop pipes - cost \$4,103.87, which is largely consistent with the original cost estimate of \$4,120. The second project – the repair of lift station grating - cost \$647.42, which is less than the original project cost estimate of \$1,405. The third project - temporary lift station repairs - totaled \$8,340, including the \$3,101 materials cost of a new grinder pump that has been ordered but not yet installed. These costs appear to be reasonable and consistent with costs of similar projects performed by other sewer utilities.

As to the remaining proposed projects, Commission Staff finds that the projects are needed, but, due to limited information provided, cannot make any finding regarding the reasonableness of the proposed project costs and is unable to recommend an amount regarding these projects for inclusion in Farmdale's pro forma revenue requirements. A summary of these proposed projects, including major issues in question with each project, is listed in Attachment C. To include any costs related to these projects in its pro forma revenue requirements, Farmdale should provide additional evidence to support the reasonableness of its cost estimates. Because of the confusion surrounding the scope and nature of its proposed system repairs regarding tree root infiltration and broken sewer mains, Farmdale should provide a more detailed description of the nature and scope of the proposed repairs and an explanation as to the significant variance in the cost estimates for this work.

As to the replacement of a remote lift station, the Commission has issued a Certificate to Farmdale for its proposed replacement of that facility. Commission Staff

lacks sufficient information to determine the reasonable cost this facility. Farmdale estimates the cost of the facility, including installation costs, at \$30,425. The competitive bids that Farmdale provided to support its estimate, however, did not include installation costs. The only estimate of installation costs that Farmdale provides is from Mr. Larry Smither. As Mr. Smither is involved in a number of business entities with Farmdale's principal shareholders, his estimate cannot be considered as one from a non-affiliated entity. Farmdale should provide estimates of the cost of installation from non-affiliated entities to support the proposed project cost.

Assuming that the reasonable cost of the lift station replacement can be ascertained, Commission Staff proposes three options to permit Farmdale to recover the project's costs: a monthly surcharge of an amount sufficient to allow recovery over a three-year period; a monthly surcharge sufficient to allow recovery over a five-year period; and recovery through general rates through depreciation over the useful life of the replacements and other capital expenditures.

In the present proceeding, Commission Staff recommends that project costs be recovered through general rates and not through a surcharge. Commission Staff estimates that some of the proposed repairs and replacements have a useful life of up to 25 years. Accordingly, recovery through general rates in the form of depreciation expense is the most fair and equitable means of recovering the project costs. A surcharge would allow recovery of these assets in a much shorter period and require current ratepayers to absorb expenses that are more appropriately allocated to future ratepayers. Moreover, use of a surcharge requires considerable Commission resources to review the utility's conduct to ensure that proceeds are used solely for their intended

purposes and that the utility does not engage in unreasonable and potentially costly transactions with affiliated entity to the ratepayers' detriment.

Commission Staff recommends that, should the Commission authorize the assessment of a monthly surcharge, such authorization be permitted only if restrictions are placed upon the use of surcharge proceeds and strict reporting requirements mandated. At a minimum, any surcharge proceeds should be deposited and maintained in a separate account and should be used solely for the repairs and replacements that Farmdale set forth in its application. Farmdale should be required to submit quarterly reports on the collection and disbursement of surcharge proceeds. Any unauthorized use of the surcharge proceeds, moreover, should terminate the authority to collect the surcharge and result in the immediate refund of all collected proceeds with interest.


Commission Staff notes that Farmdale has also requested interest expense of 10 percent per annum associated with the proposed projects. Commission Staff lacks sufficient information to make any favorable recommendation upon this request. The utility has not identified a specific cost for the proposed projects, a lender who will provide the necessary financing, or the length of time for repayment of any loan. The utility, furthermore, has yet to apply for Commission authorization to borrow any funds. KRS 278.300 requires such authorization. In light of the uncertainty surrounding the cost of the proposed projects and their financing arrangements, Commission Staff is unable to make any recommendations regarding pro forma interest expense and has excluded it from its calculation of the required revenue requirement. To justify the inclusion of such interest expense in revenue requirements, Farmdale should provide

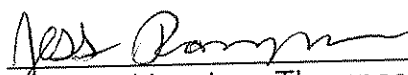


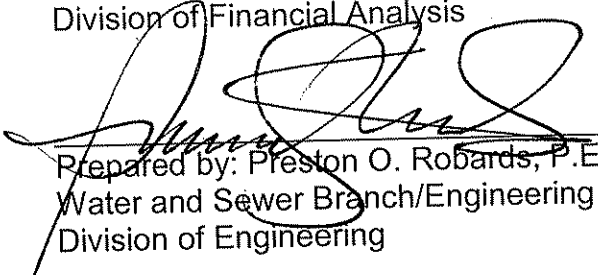
detailed evidence as to the amount, terms, conditions, and reasonableness of any proposed financing.

Jess Thompson is responsible for all revenue adjustments and the calculation of the proposed rates. Jack Kaninberg is responsible for the determination of the revenue requirement. Preston Robards is responsible for the determination of the need for the proposed construction and the associated costs. Based on the recommendations herein, Commission Staff recommends the rates set forth in Attachment B to this report.

Signatures

  
Prepared by: Jack Kaninberg  
Financial Analyst, Water and Sewer  
Revenue Requirements Branch  
Division of Financial Analysis

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

  
Prepared by: Preston O. Robards, P.E.  
Water and Sewer Branch/Engineering  
Division of Engineering

ATTACHMENT A  
STAFF REPORT CASE NO. 2006-00028  
PRO FORMA INCOME STATEMENT

Farmdale Development Attachment A	2005	Farmdale Adjusted	Staff Adjustment	Ref.	Staff Adjusted
Revenue	\$53,979	\$53,979	2,257	A	\$56,236
Owner/Manager fee	\$9,600	\$9,600	(\$6,000)	B	3,600
Sludge Hauling	\$2,600	2,600	0		2,600
Water Cost	\$3,413	3,413	0		3,413
Other – Labor, Material, & Exp.	\$5,314	7,800	0		7,800
Fuel/Power for Pumping	\$15,303	15,303	0		15,303
Chemicals	\$2,552	\$2,552	0		2,552
Routine Mt. Fee	\$8,598	9,720	0		9,720
Mt.-Collection Sewer System	\$1,635	\$1,635	0		1,635
Mt. Of Treatment & Disposal	6,277	6,277	(2,114) (105)	C	4,058
Mt. of Other	1,818	1,818	(\$230)	D	1,588
Agency Collection Fee	8,097	8,097	0	E	8,097
Office Supplies and Other	584	584	0		584
Outside Serv. Employed	2,665	2,665	(\$825)	F	\$1,840
Insurance Expense	581	581	0		581
Regulatory Commission Expense	500	250	0		250
Transportation Expense	0	0	0		0
Miscellaneous Expense	143	143	(\$66)	G	77
Rents	600	600	0		600
<i>Total Sewer O&amp;M</i>					64,298
Depreciation Expense	22	22	\$423 \$2,780	H	\$3,225
Amortization Expense	0	3,167	(\$1,000)	I	2,167
Taxes OT Income	1,024	1,024	0		1,024
<b>Total Operating Expense</b>	<b>\$71,326</b>	<b>\$77,851</b>	<b>(\$7,137)</b>		<b>\$70,714</b>
Interest Expense	0	\$13,323	(\$13,323)	J	0
<i>Total Expense</i>	<i>\$71,326</i>	<i>\$91,174</i>	<i>(\$20,460)</i>		<i>\$70,714</i>
<i>Net Income</i>	<i>(\$17,347)</i>	<i>(\$37,195)</i>	<i>\$22,717</i>		<i>(\$14,478)</i>

Calculation of Revenue Requirement using Operating Ratio Method:

\$ 70,714	Pro forma Operating Expenses
<u>88%</u>	Operating Ratio
\$ 80,357	Revenue Requirement
<u>(\$56,236)</u>	Normalized Revenues
\$ 24,121	Recommended Revenue Increase (42.9% increase)

\$80,357 / 12 = \$6,696.42 divided by 246 customers = \$27.221 per month bill

**Explanatory Notes:**

**A. Revenues** – Normalized revenues as determined by Staff’s billing analysis.

**B. Owner/Manager Fee** – The Commission normally allows an owner/manager fee of \$3,600 to compensate the owner-manager of a small sewer utility. Consistent with this practice, Staff recommends approval of a \$3,600 owner-manager fee in this case.

**C. Maintenance of Treatment and Disposal Expenses** – Two adjustments were made to this expense. The first was to remove several expenditures that were nonrecurring and capital in nature, and to allow for their recovery over a five-year period in Depreciation Expense, as follows:

Category	Date	Amount	Life (yrs.)	Annual Amount
Equip. Repair – Quality Electric	4/18/05	\$593.28	5	
Parts – Grainger Timeclock	5/10/05	\$254.40	5	
Parts – Flow meter rollers	5/19/05	\$428.75	5	
Parts – Stevens Monitoring Floats, etc.	9/29/05	\$422.71	5	
Camden Environmental Ejector	12/2/05	\$415.00	5	
Totals		\$2,114.14	5	\$422.83

The second adjustment was to remove \$105 of fuel surcharges that were paid to Farmdale’s affiliate, Covered Bridge Utilities. It is unclear whether or not these charges will recur given fluctuating gasoline prices, and therefore these charges should not be built into permanent rates.

**D. Maintenance of Other** – Included in these expenses were grass cutting charges of \$1,238 which Farmdale pays to a Louisville contractor. This contractor’s charges increased from \$144 per month (or \$72 per cutting) in 2004 to \$170 in 2005, and increased later in 2005 to \$194 per month. The contractor’s invoices suggest Farmdale was charged almost double the amount charged to other Louisville-area utilities owned by or affiliated with Farmdale’s management, and during the field visit Farmdale personnel indicated the mowing charges increased because of higher gasoline expenses. It is reasonable to question why Farmdale’s ratepayers should pay extra for grass cutting - a non-technical service - provided from Louisville rather than from a local contractor. Therefore, Staff has reduced allowable grass cutting expenses to the 2004 charge of \$144 per month for 7 months, or \$1,008. This \$230 adjustment still allows Farmdale \$72 per mow, which is higher than the rates paid in 2006 to any of the other utilities charged by Farmdale’s grass cutting contractor.

**E. Agency Collection Fee** – Farmdale paid \$8,097 for billing and collection services during 2005. Staff recommends no adjustment to this fee, noting that in Farmdale’s last rate case in 1998 the Commission allowed an agency collection fee of \$7,780. In addition, other sewer utilities in Farmdale’s general vicinity are paying a similar billing and collection fee. However, Staff also notes that this fee, which approximates 15

percent of Farmdale's gross revenues, amounts to roughly \$2.74 per month for each of Farmdale's 246 customers. As well, the Commission in 1999 questioned the reasonableness of similar fees paid by Coolbrook Sanitation, another small sewer utility in Franklin County, and advised the utility to consider public bids or renegotiation of the terms of the billing and collection contract. Therefore, while Staff proposes no adjustment to this expense, it strongly suggests that Farmdale consider more economical alternatives to its present billing and collection service in the future.

**F. Outside Services Employed** – In 2005, Farmdale paid \$825 to Martin & Associates for monthly discharge monitoring reporting to the Kentucky Division of Water. In Farmdale's last rate case in 1998, the Commission accepted Staff's recommendation to disallow this type of fee, finding that the preparation of such correspondence is considered to be a management duty compensated by the owner-manager fee. Martin & Associates is owned by Martin Cogan, who is the son of Farmdale's owner. Consistent with that precedent, Staff in this case recommends removing the fees of \$825 paid to Martin and Associates.

**G. Miscellaneous Expense** – Staff recommends removing \$66 of bank service charges for non-sufficient funds and overdraft charges in Farmdale's bank accounts. Ratepayers should not be required to pay these expenses, and this rate increase should allow Farmdale sufficient funds to better manage its cash flow situation.

**H. Depreciation Expense** – Staff made two adjustments to depreciation expense. First, Staff adjusted Farmdale's pro forma depreciation expense by \$423 to allow a 5-year recovery of the nonrecurring capital charges removed from Maintenance of Treatment and Disposal Expenses. Secondly, Staff increased depreciation expense by \$2,780, using estimated useful lives as provided by Staff's Engineering Division, to allow recovery of the project costs already completed by Farmdale according to its response of December 12, 2006, to Staff's Data Request, as follows:

Projects Completed	Original Estimate	Cost per 12/12/06 Response	Useful Life (years)	Annual Depreciation
f. Replace diffuser drop pipes	\$4,120	\$4,104	3	\$1,373.33
h. Lift station grating	\$1,405	\$647	3	\$215.66
j. Temporary repairs (see CPCN)	\$8,340	\$8,340	7	\$1,191.43
<b>Totals</b>	<b>\$13,865</b>	<b>\$13,091</b>		<b>\$2,780.42</b>

**I. Amortization Expense** – Farmdale proposed Amortization Expense of \$3,167 to recover rate case expenses of \$9,500 over three years. Prior to the initial filing of this application, Farmdale's most recent rate adjustment occurred in 1998, or 8 years ago. In this case, Farmdale's rate case expenses are higher than those normally incurred in simplified alternative rate filings (ARFs), due in part to Farmdale's proposed construction and the associated surcharge. Because these construction-related matters are unusual for an ARF case, and should not be expected to recur with any regular frequency, Staff recommends adjusting the proposed Amortization Expense as follows:

	Proposed	Recommended Years	Amortization	Adjustment
CPA Original fee	\$2,000	3	\$667	
CPA Amended fee	\$2,500	5	\$500	
Legal fees	\$5,000	5	1,000	
	\$9,500 @ 3 yrs = \$3,167		\$2,167	(\$1,000)

**J. Interest Expense** – Removal of Farmdale’s proposed Interest Expense as discussed on pages 5 and 6 of the Staff Report.

ATTACHMENT B  
STAFF REPORT CASE NO. 2006-00028  
STAFF'S RECOMMENDED RATES

Monthly Sewer Rate

Flat Residential Rate

\$27.23

ATTACHMENT C  
STAFF REPORT CASE NO. 2006-00028  
PROJECT LIST

Farmdale Project List	Original Estimate	Competitive Bids	Issues
<b>No Competitive Bids Provided</b>			
b. Lagoon pump/clean	\$58,750	No alternatives provided	No competitive bids
g. Small plant maintenance	\$3,050	No alternatives provided	No competitive bids
i. Supervision	\$10,445	No mention in 12/12 data	-If some projects are allowed and others not, how much supervisory expense should be allowed for each project? -Does this include supervision for \$13,091 in projects already allowed? If so, it should be reduced. -How much supervisory expense is justified over and above annual management and operations expenses?
<b>Subtotal</b>	<b>\$72,245</b>		
<b>Competitive Bids Differ From Estimates</b>			
a. System Repairs	\$112,560	1.Martin-\$29,702 2.Pipe Eyes-\$36,682	-What is the exact scope, nature and extent of the work needed? -Are the low bids comparable to the high bid in terms of the work to be done – why is there a \$75,000+ variation? -What cost is reasonable?
d. Replace chlorine tank	\$17,225	1.Tipton-\$19,920 2.JeBe-\$10,380 uninstalled	-Only one competitive bid included installed cost.
e. Standby blower motor assembly	\$9,320	1.Tipton-\$5,498 uninstalled 2.Quality-\$3,815 uninstalled 3.Smithers-\$3,000 installation	-The two unaffiliated competitors' bids did not include installed costs. -\$6,815 cost if Smithers installs the Quality vendor's materials.
<b>Subtotal</b>	<b>\$139,105</b>		
<b>Total Project Costs Unaddressed (excluding lift station)</b>	<b>\$211,350</b>		