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July 30, 2008

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CERTIFICATE OF SERVICE

RE: Case No. 2007-00436
Farmdale Development Corporation

I, Stephanie Stumbo, Executive Director of the Public Service Commission, hereby certify that the enclosed attested copy of the Commission's Order in the above case was served upon the addressee by U.S. Mail on July 30, 2008.

A handwritten signature in cursive script that reads "Stephanie Stumbo".

Executive Director

SS/rs
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COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF FARMDALE DEVELOPMENT)
CORPORATION FOR AN ADJUSTMENT IN) CASE NO. 2007-00436
RATES PURSUANT TO THE ALTERNATIVE RATE)
FILING PROCEDURE FOR SMALL UTILITIES)

ORDER

Farmdale Development Corporation ("Farmdale") has applied to increase its current monthly sewer service rate of \$28 to \$42.75, an increase of 52.64 percent. By this Order, we authorize a monthly rate of \$32.60, or a 16.43 percent increase.

COMMENTARY

Farmdale, a corporation organized pursuant to KRS Chapter 271B, owns and operates subdivision sewage collection and treatment facilities that provide service to customers in the Farmdale Subdivision of Franklin County, Kentucky.¹ It is a utility subject to Commission jurisdiction.²

PROCEDURE

On October 3, 2007, Farmdale applied to the Commission for a rate adjustment pursuant to the Alternative Rate Filing Procedure for Small Utilities.³ The Commission subsequently granted full intervention to the following persons: the Attorney General of

¹ Annual Report of Farmdale Development Corporation to the Public Service Commission for the Year Ended December 31, 2006 at 8.

² KRS 278.010(3)(f); KRS 278.040.

³ 807 KAR 5:076.

Kentucky ("AG") and Marilyn and Kenny Glass. The Commission also granted 34 Farmdale customers leave to intervene as limited intervenors.

At the Commission's direction, Commission Staff conducted a limited financial review of Farmdale's operations for the calendar year ending December 31, 2006 and prepared a report of its findings and recommendations regarding Farmdale's application. On February 11, 2008, Commission Staff submitted a report of its findings and recommendations, which the Commission released to the parties. In this report, Commission Staff found that Farmdale required a revenue increase of \$8,260 and recommended that the Commission authorize a monthly rate of \$30.86.

On February 22, 2008, Farmdale filed objections to Commission Staff's findings related to the following issues: (1) owner-manager fee; (2) sludge hauling expense; (3) fuel-power expense; (4) agency collection fee; (5) interest expense; and (6) depreciation expense. Farmdale also requested an informal conference and formal hearing in this matter. No other party filed objections or otherwise commented upon the report.

Following discussions with the parties at an informal conference and review of documents that Farmdale submitted in response to the Commission Staff report, Commission Staff, on May 5, 2008, amended its report and recommended that Farmdale be authorized a monthly rate of \$31.09, which would produce total additional revenue of \$8,910. Notwithstanding these amendments, Farmdale continued to object to Commission Staff's findings and recommendations.

On June 24, 2008, the Commission held an evidentiary hearing in this matter. Testifying at this hearing were: Carroll Cogan, Farmdale's president and sole

stockholder; and Jack Kaninberg and Eddie Beavers, Commission Staff members.⁴ Following the submission of post-hearing briefs and response briefs, this matter stood submitted for decision on July 14, 2008.

DISCUSSION

As the parties have agreed generally with Commission Staff's findings regarding Farmdale's operations, and as we generally find Commission Staff's findings to be supported by the evidence of record, we shall address only the areas of disagreement in this Order.

Owner-Manager Fee

During the test period, Farmdale paid to Carroll Cogan an owner-manager fee of \$9,600.⁵ According to Mr. Cogan, this fee represents reasonable compensation for his "substantial duties and responsibilities" as manager of Farmdale's operations, his experience in operating, maintaining, and constructing sewage treatment facilities, and his qualifications as a professional engineer.⁶ Noting that the Commission has previously compared the position of owner of a sewage treatment facility to that of a water district commissioner, Mr. Cogan asserts that his duties are more numerous and complex and his responsibilities far greater than those of a water district commissioner

⁴ In lieu of Mr. Beavers appearing and adopting the contents of the Commission Staff report for which he was responsible, the parties stipulated to Mr. Beavers' testimony. Transcript at 125-126.

⁵ Farmdale's Annual Report for 2006 reflects an expense for owner-manager fees of \$9,600. See *Report of Farmdale Development Corporation, Inc. to the Kentucky Public Service Commission for the Year Ended December 31, 2006* at 9. Mr. Cogan testified that no owner-manager fees have been paid to him in the last 10 years. Prefiled Testimony of Carroll F. Cogan at 6.

⁶ Post-Hearing Brief of Farmdale Development Corporation at 2. For a listing of Mr. Cogan's responsibilities, see *id.* at 4.

and that he should therefore be entitled to a much greater level of compensation than that of a water district commissioner.⁷

Commission Staff testified that the owner-manager fee should be limited to \$6,000 annually.⁸ It bases its recommendation on previous Commission findings that the duties of a sewer treatment facility owner are comparable to those of a water district commissioner and that the maximum salary for a water district commissioner is \$6,000.⁹

Concurring with the Commission Staff's position, the AG argued that Farmdale had failed to demonstrate the reasonableness of the current owner-manager fee of \$9,600. He asserted that "Farmdale is run through the use of outside services" and that the persons providing these services are well compensated.¹⁰ He further asserted that Commission Staff's use of a water district commissioner salary was a reasonable proxy for an owner-manager fee and the duties of a water district commissioner were at least as complex and demanding as those of an owner of a sewage treatment facility.

As Farmdale's owner-manager fee is not the result of an arm's-length transaction, Farmdale must demonstrate by substantial evidence that the fee is

⁷ Post-Hearing Brief of Farmdale Development Corporation at 5-6.

⁸ Transcript at 134.

⁹ KRS 74.020(6). The maximum salary for a water district commissioner is generally \$3,600 annually. A water district commissioner, however, may be permitted an annual salary of \$6,000 if he completes a minimum of six hours of water district management training approved by the Commission. Considering an owner with management experience to be the same as a water district commissioner who attends the required hours of instruction, Commission Staff asserts a maximum salary of \$6,000 is appropriate. See *Commission Staff Report*, Attachment A at Note B.

¹⁰ AG Brief at 14.

reasonable.¹¹ Farmdale has failed to make such demonstration. The record is devoid of any evidence as to the actual time that Mr. Cogan has expended performing duties on behalf of the sewer utility. The utility has contracted most operational and management duties to outside parties.¹²

As to Farmdale's argument that its owner's duties and responsibilities are equivalent to those of a water district's board of commissioners and its owner is therefore entitled to a compensation amount equal to that paid to that board, we have previously considered and rejected that argument.¹³ As shown in Table I below, which compares the salaries and responsibilities of several water district commissioners to that of Farmdale's owner, an owner-manager fee of \$9,600 is neither supportable nor reasonable but appears excessive.

¹¹ See, e.g., Case No. 9136, The Application of Prairie Facilities Inc., d/b/a Prairie Village Sewer System for an Adjustment of Rates Pursuant to the Alternative Procedure for Small Utilities (Ky. PSC Mar. 22, 1985).

¹² For example, a private accounting firm prepares Farmdale's annual report to the Commission. Transcript at 45. A bookkeeper maintains its accounting books and records. *Id.* at 105-106. Farmdale contracts with outside parties to operate and maintain the sewage treatment facility. *Id.* at 60. It further contracts with Martin G. Cogan to review its monthly discharge monitoring reports and to advise and coordinate with Farmdale's facilities operators regarding the necessary actions to maintain compliance with its discharge permit. *Id.* at 60-61. See also Answer of Farmdale Development Corporation to Commission Staff's First Data Request, Item 15.

¹³ See Case No. 1997-00456, Application of Farmdale Development Corporation for a Rate Adjustment Pursuant to the Alternative Rate Filing Procedure for Small Utilities (Ky. PSC Oct. 9, 1998) at 3 ("Farmdale is a relatively small utility that should require minimal attention from the owner-manager since routine maintenance, repairs, sludge hauling, billing and collection, and bookkeeping are all contracted services.").

TABLE I¹⁴

Utility	Customers	Operating Revenues	Operating Expenses	Total Assets and Other Debits	Number of Commissioners	Commissioner Salary
Elkhorn Water District	520	\$ 234,362	\$ 221,164	\$ 696,166	3	\$1,200
Farmdale Water District	2,438	\$ 566,890	\$ 600,651	\$ 2,532,374	3	\$3,600
Jessamine-South Elkhorn Water District	2,416	\$ 1,527,908	\$ 993,993	\$ 796,923	5	\$6,000
Northeast Woodford County Water District	964	\$ 506,433	\$ 491,872	\$ 1,872,473	3	\$6,000
Northern Kentucky Water District	80,027	\$34,120,264	\$20,284,389	\$296,323,055	7	\$6,000
Peaks Mill Water District	1,071	\$ 381,664	\$ 300,513	\$ 3,745,464	3	\$3,600
South Woodford County Water District	2,513	\$ 692,025	\$ 685,073	\$ 2,540,046	3	\$3,600
US 60 Water District	2,073	\$ 843,739	\$ 552,448	\$ 6,451,440	5	\$3,150 ¹⁵
West Shelby Water District	1,852	\$ 1,107,938	\$ 820,201	\$ 9,936,395	3	\$6,000
Farmdale Development Corporation	241	\$ 53,273	\$ 95,877	\$ 187,159	1	\$9,600

While the AG and Commission Staff rely upon our historical use of a water district commissioner's salary in determining the reasonableness of a sewer utility's owner-manager fee, we have not established a strict rule regarding the level of this expense. To the contrary, the reasonableness of the fee will depend on the circumstances of the particular utility, to include its owner's responsibilities and duties,

¹⁴ The information contained in Table I is found in the financial and statistical reports that water and sewer utilities are required to file with the Commission annually. See 807 KAR 5:006, Section 3(1). Of the 9 water districts listed in Table I, four provide service in Franklin County. Northeast Woodford County Water District and South Woodford County Water District operate in Woodford County, Kentucky. West Shelby Water District operates in Shelby County, Kentucky. Jessamine-South Elkhorn Water District operates in Jessamine County, Kentucky. Mr. Cogan referred to those water districts in his testimony. See Prefiled Testimony of Carroll F. Cogan at 5; Transcript at 53. To add further context, we have added information regarding Northern Kentucky Water District, the Commonwealth's largest water district.

¹⁵ US 60 Water District reported varying levels of compensation for its commissioners. We have used the highest reported salary level.

and the size and complexity of the sewer utility's operations. A water district commissioner's statutory salary serves as a starting point for analysis.

In the present case, the utility has failed to demonstrate that its owner-manager has duties that are greater or more extensive than those imposed upon an individual water district commissioner. It has further failed to demonstrate that Mr. Cogan's workload is significantly heavier or more complex and demanding than that required of an individual water district commissioner. Given the relatively small size of Farmdale's operations and the limited demands placed upon its owner as a result of his significant use of contractors, we find that an owner-manager fee in excess of \$6,000 is unreasonable. Accordingly, the Commission has disallowed the test period fee of \$9,600 and will allow a fee of \$6,000 only for rate-making purposes.

Sludge Hauling Expenses

Farmdale reported a test period sludge hauling expense of \$5,450. Commission Staff has questioned whether this level of expense reflects normal operations. It contends that, when compared to preceding and succeeding years, the test period level is unusually high.¹⁶

¹⁶ Farmdale reported the following sludge hauling expense levels for the period from 2002 to 2007:

Year	Amount
2002	\$2,360
2003	\$1,120
2004	\$1,120
2005	\$2,600
2006	\$5,450
2007	\$4,250

See Amended Commission Staff Report, Attachment A at Note A.

Farmdale opposes any adjustment to the test period expense level. It argues that prior to 2006 the sludge was not being wasted on a regular basis and, as a result, the sewage treatment facility was not operating in an effective or efficient manner. To correct these problems, Farmdale argues, it retained a new operator who wasted sludge on a more frequent basis. Farmdale also contends that its 2007 expense level does not reflect the cost of two loads of sludge that were hauled at no charge during Farmdale's repair of its treatment facilities. If the cost of these loads were reflected in the 2007 expense level, the test period level would not appear unusual or abnormal.¹⁷

Concurring with Commission Staff, the AG argues that the test period expense level is not reflective of normal operations and should be adjusted downward to \$3,441 based upon actual monthly sludge hauling expense since the end of the test period. Describing the two loads which Farmdale seeks to include in 2007 sludge hauling expense levels as an attempt to artificially inflate actual levels, the AG argues against any consideration of their cost as inappropriate.

Based upon our review of the record, we find that the 2006 level of sludge hauling expense is not reflective of normal operations. Changes in the plant operator and repairs that have been performed on the plant have rendered the use of the test period expense level inappropriate, and the actual expense level incurred in calendar year 2007 is more reflective of normal ongoing operations.¹⁸ Accordingly, we find that a reasonable pro forma sludge hauling expense is \$4,250.

¹⁷ Post-Hearing Brief of Farmdale Development Corporation at 2.

¹⁸ We further find that no adjustment should be made to the 2007 calendar year expense level to reflect the two loads that Martin Sanitation hauled at no separate charge. We agree with the AG's assessment that these loads were related to the repair work and should not be considered.

Fuel/Power for Pumping

Farmdale reported actual fuel/power costs of \$19,150 for the test period. Arguing that the test period level is not reflective of normal operations, Commission Staff recommended a reduction to the 2005 calendar year level of \$15,303. It notes that the test period expense level is significantly higher than reported levels for 2005 and 2007¹⁹ and the projected 2008 expense level.²⁰ Based upon our review of the record, we find that the test period expense level does not appear representative of normal operations and that the 2005 calendar year level should be used for rate-making purposes.

Farmdale proposes that, in the event that the 2005 expense level is used, it be permitted to recover as a non-recurring expense the difference between the test period level and the 2005 calendar year level, or \$3,847.²¹ Arguing that the proposal amounts to retroactive rate-making, the AG opposes it. We agree with the AG that recovery of the difference constitutes retroactive rate-making and deny the proposed adjustment.

Farmdale further proposes that the test period expense level be adjusted to reflect proposed adjustments in the rates of its retail electric supplier. Blue Grass Energy Cooperative has applied to the Commission for authority to increase its rates by 9 percent.²² The Commission has yet to issue a decision on this application. As no

¹⁹ Farmdale reported fuel/power for pumping expense of \$14,504 for calendar year 2007.

²⁰ Farmdale projects fuel/power for pumping expense of \$15,325 for calendar year 2008. Post-Hearing Brief of Farmdale Development Corporation at 9.

²¹ Prefiled Testimony of Carroll F. Cogan at 10.

²² Case No. 2008-00011, Application of Blue Grass Energy Cooperative for an Adjustment of Its Rates (Ky. PSC filed April 11, 2008).

change in its electric rates has yet occurred and the extent of such increase, if any, cannot now be ascertained, the proposed adjustment to test period fuel/power expense fails to meet the criteria of known and measurable and must be denied.

Maintenance of Other Plant Facilities

Farmdale reported maintenance of other plant facilities of \$1,540 for the test period. It paid this amount to a contractor to mow the grass surrounding the utility's sewage treatment facilities for 7 months of the test period.

Commission Staff recommends that the level of this expense be reduced to \$1,008 to reflect unreasonable costs related to Farmdale's use of a Louisville contractor. Commission Staff asserts that the Louisville contractor assessed a much higher rate to Farmdale than to its other utility customers because of travel expenses.²³ It further asserts that, as the service provided is not unique and does not involve any specialized skill or training, a contractor within the local area could be located to perform the services at a much lower cost. Commission Staff proposes that the test year expense level be adjusted to reflect the contractor's monthly rate as of 2004.

Farmdale has offered no explanation for its continued use of a contractor who is located a significant distance from its facilities where the service provided is not of a specialized or unique nature. It has further failed to demonstrate why the use of a local contractor is unreasonable or would not result in lower costs. Based upon the evidence of record, we find that Farmdale has failed to demonstrate that the test period expense level is reasonable, and we have reduced this level to \$1,008 for rate-making purposes.

²³ See *Commission Staff Report*, Attachment A at Note G; Transcript at 141, 171-174. See also Case No. 2006-00028, Application to Request Commission Approval for an Increase in Farmdale Development Corporation Sewage Treatment Plant's Rate Pursuant to the Alternative Rate Filing Procedure for Small Utilities (Ky. PSC Feb. 26, 2007), *Commission Staff Report*, Attachment A at Note D.

Agency Collection Fee

Farmdale reported a test year agency collection fee of \$7,991 and proposes an adjustment to increase this expense by \$14,943 for a pro forma expense of \$22,934. It asserts that its billing and collection arrangement with Farmdale Water District ("Farmdale District"), which requires the payment of a 15-percent collection fee, and its recent rate increase and proposed rate increase require the adjustment.

Commission Staff and the AG argue that the proposed adjustment and Farmdale's current collection method are unreasonable. Commission Staff testified that the proposed fee "is far higher than that of other jurisdictional utilities around the state who list Agency Collection Fees in their PSC annual reports."²⁴ The AG and Commission Staff contend that Farmdale has failed to pursue reasonable billing and collection alternatives and that its recovery of agency collection fee expense should be limited to \$8,097, the level of expense that Farmdale incurred in calendar year 2005.

Responding to these arguments, Farmdale asserts that its current arrangement with Farmdale District is reasonable and effective. It notes that, because the sewer charge is included on Farmdale District's bills and Farmdale District refuses to accept payments that do not cover the full billed amount, Farmdale District may effectively

²⁴ See *Commission Staff Report*, Attachment A at Note H.

terminate a customer's water service for failure to pay his or her sewer charges.²⁵ Given that termination of sewer service is both costly and problematic, termination of water service is extremely effective in dealing with delinquent payments. The arrangement, it further asserts, allows it to accurately and expeditiously identify any changes in customers.

The Commission finds that, given the high level of expense and the questionable nature of Farmdale District's termination practices,²⁶ the current arrangement does not appear reasonable. Based upon the rates that Farmdale proposes in its application, it will pay \$7.93 per month to Farmdale District for each bill collected.²⁷ With each additional increase in the monthly sewer rate, an additional 15 percent of that increase must be added to customer bills and paid to Farmdale District, though no new service is provided. Such an arrangement is unreasonable on its face.

²⁵ Transcript at 85. The Commission questions the lawfulness of this practice. Administrative Regulation 807 KAR 5:006, Section 14(1)(f) permits a utility to "terminate service at a point of delivery for nonpayment of charges incurred for utility service at that point of delivery." It does not permit a utility to terminate for service provided by another utility. See, e.g., Administrative Case No. 347, An Investigation into the Collection and Billing Practices of Privately-Owned Sewer Utilities (Ky. PSC Jan. 9, 1995) at 3 ("Commission regulations currently prohibit public water utilities from discontinuing a customer's water service for delinquent sewer bills. . . . A utility may discontinue service only for nonpayment of charges for services that it provides.") While a deviation from 807 KAR 5:006, Section 14(1) may be obtained, Commission records fail to reflect that Farmdale District has obtained such a deviation.

²⁶ *Supra* note 25.

²⁷ In contrast, the other six public sewer utilities that report an agency collection fee expense expend an average of \$0.99 per month per customer. See *Commission Staff Report*, Attachment A at Note H. This amount reflects the 15-percent collection fee assessed on Farmdale's proposed monthly sewer charge of \$42.75 and its monthly surcharge of \$9.92. This surcharge, which the Commission authorized in Case No. 2006-00028, is presently scheduled to remain in effect until March 2012.

Farmdale argues that its current arrangement is presently the only acceptable arrangement. It states that it has been unsuccessful in renegotiating its arrangement with Farmdale District and has been unable to find another entity willing to perform its billing and collection functions.

The Commission finds this argument unpersuasive. We note that Farmdale's billing and collection practices have been subject to Commission review and criticism for over 25 years. In Case No. 8102, we advised Farmdale:

The Commission is of the opinion that the fee paid to Farmdale Water District ("District") for collecting and accounting for services rendered by Applicant is excessive based on the actual costs incurred by the District and based on comparison of the expenses of other utilities with similar billing arrangements. The Commission is of the opinion that a just and reasonable fee should be based on actual costs rather than a set percentage of the bill and should further provide flexibility for change. . . .

The Commission finds the present contract not to be in the best interest of the public. For these reasons the Commission urges Applicant to renegotiate a contract representative of the amount found reasonable above.²⁸

Later in the same proceeding, we urged Farmdale to consider various options to reduce its billing and collection costs:

[I]t appears to the Commission that Farmdale has failed to consider various alternatives in arriving at its estimated cost. An alternative which would reduce the cost considerably would be quarterly or bimonthly billing rather than Farmdale's proposed monthly billing. Another alternative would be for Farmdale to compare the charges of other collection agencies with the District's charges and its own

²⁸ Case No. 8102, The Application and Petition of the Farmdale Development Corporation, Inc., for an Order Authorizing Said Corporation to Revise Rates (Ky. PSC Aug. 5, 1981) at 2-3.

projected internal costs. Neither these nor other possible alternatives were presented by Farmdale.²⁹

In Case No. 2006-00026,³⁰ Commission Staff voiced concerns about the structure of the collection arrangement and the large fee paid to Farmdale District. It noted that the Commission had previously expressed concerns about the reasonableness of billing fees paid to Farmdale District and “strongly . . . [suggested] that Farmdale consider more economical alternatives to its present billing and collection service in the future.”³¹

Despite these expressions of concerns, Farmdale has made little effort to investigate alternatives to its present billing and collection arrangements. Shortly before filing its application, Farmdale requested that Farmdale District reduce its billing and collection fee by 50 percent.³² When Farmdale District rejected this request, Farmdale took no further action until Commission Staff again voiced concerns about its billing and collection expenses. Between February and April 2008, it contacted Blue Grass Energy, Frankfort Electric and Water Plant Board, and 3 billing agencies to inquire about possible billing and collection arrangements. Farmdale has not conducted any

²⁹ Case No. 8102, *The Application and Petition of the Farmdale Development Corporation, Inc., for an Order Authorizing Said Corporation to Revise Rates* (Ky. PSC Dec. 9, 1981) at 5-6.

³⁰ Case No. 2006-00028, *Application to Request Commission Approval for an Increase in Farmdale Development Corporation Sewage Treatment Plant’s Rate Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC filed Jan. 19, 2006).

³¹ Case No. 2006-00028, *supra*, *Commission Staff Report* (Feb. 26, 2007), Attachment A at Note D.

³² Letter from Robert C. Moore, Counsel for Farmdale Development Corporation, to Berl Robinson, Chairman, Farmdale Water District (July 25, 2007).

systematic inquiry into possible billing and collection agencies³³ and has not published any requests for proposals for billing services or conducted any analysis into performing those services itself.

Farmdale has acted in an unreasonable manner by failing to undertake reasonable efforts to consider alternative billing and collection services and to study the possibility of performing such services. Accordingly, we find that the proposed adjustment to test period expense levels should be denied. We further find that recovery of agency collection fee expenses should be limited to Farmdale's 2005 expense level of \$8,091.

The Commission places Farmdale on notice that in any future rate proceeding it will be required to demonstrate the reasonableness of its agency collection fee expense and to show that it has undertaken reasonable efforts to develop an alternative to its present collection methods, including the conducting of its own billing and collection.

Interest Expense

Farmdale proposes to increase test period interest expense by \$7,013 to reflect interest on a 5-year promissory note to Old National Bank in the amount of \$150,000 and a one-year renewable note to National City Bank in the amount of \$25,000. Proceeds of the 5-year note are intended to finance certain capital improvements on Farmdale's sewage collection and treatment facilities. Farmdale used the proceeds of the one-year note to pay operating expenses, including legal bills, accounting fees, and

³³ Describing its efforts as "substantial," Farmdale notes that it contacted the 3 billing service providers listed in the Frankfort Yellow Pages. Post-Hearing Brief of Farmdale Development Corporation at 12. Given Farmdale's use of contractors located outside of Frankfort for other services, such as mowing and plant operations, its failure to contact billing service providers in the Louisville and Lexington areas is difficult to understand.

other expenses. Opposing recovery of the interest expense associated with the one-year note, Commission Staff and the AG argue that such recovery is contrary to Commission precedent and constituted retroactive rate-making.

The Commission has long held that inclusion of interest expense for loans whose primary purpose is the financing of operating expenses would constitute retroactive rate-making.³⁴ Permitting recovery of this expense would require existing and future ratepayers to pay for service provided to prior customers. It is the utility's responsibility to monitor its financial condition and seek any necessary rate adjustment in a timely manner. As the evidence does not show that Farmdale acted in a reasonable manner to meet this responsibility and that permitting recovery of \$2,313 of interest expense related to the one-year note would be retroactive rate-making, we deny the recovery of that expense and have allowed an interest expense of \$6,283 for rate-making purposes.

³⁴ Case No. 8493, Notice of Adjustment of Rates of 4-Way Enterprises, Inc. d/b/a Coolbrook Sewage Treatment Plant to Become Effective April 20, 1982 (Ky. PSC Nov. 4, 1982); Case No. 9130, An Adjustment of Rates of Cogan Co., Inc. d/b/a Maple Grove Section 5 Sewer System (Ky. PSC Mar. 22, 1985); Case No. 9138, The Application of Windsor Facilities Inc., d/b/a Windsor Forest Sewer System for an Adjustment of Rates Pursuant to the Alternative Procedure for Small Utilities (Ky. PSC Mar. 25, 1985); Case No. 9100, An Adjustment of Rates of Tree-Line Utility, Inc. d/b/a Tree-Line Estates Sewage Treatment Plant (Ky. PSC April 26, 1985); Case No. 9303, The Application of Fordhaven, Inc., for an Adjustment of Rates Pursuant to the Alternative Procedure for Small Utilities (Ky. PSC Aug. 8, 1985); Case No. 9440, An Adjustment of Rates in the East Logan Water District and for Authority to Reamortize Existing Bonded Indebtedness (Ky. PSC May 16, 1986); Case No. 89-103, Adjustment of the Rates of Valley Gas, Inc. (Ky. PSC Nov. 9, 1989); Case No. 89-347, The Application of Hillridge Facilities, Inc. for a Rate Adjustment Pursuant to the Alternative Rate Filing Procedure for Small Utilities (Ky. PSC Sept. 17, 1990); Case No. 90-078, An Adjustment of Rates of Phelps Gas Company, Inc. (Ky. PSC Dec. 7, 1990); Case No. 97-458, The Application of Orchard Grass Utilities, Inc. for a Rate Adjustment Pursuant to the Alternative Rate Filing Procedures for Small Utilities (Ky. PSC Oct. 1998); Case No. 2005-00235, Application of Mallard Point Disposal Systems, Inc. for an Adjustment of Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities (Ky. PSC April 17, 2006).

Sewer Main Survey

During the test period, Farmdale incurred an expense of \$598 to conduct a survey of manholes.³⁵ Farmdale proposes to increase this expense to \$2,700 to reflect increases in the cost of such a survey.³⁶ It bases its proposed increase upon a quote for such service from an outside vendor.³⁷ Commission Staff and the AG oppose the proposed adjustment.³⁸

The Commission finds that Farmdale has failed to provide adequate support for the proposed adjustment. The price quote contains few details about the proposed survey and does not enable us to determine whether the quoted survey is of the same nature and quality as the survey that was performed in 2006. Moreover, Farmdale has not presented additional quotes to demonstrate that the quoted price is representative of the present market. It furthermore has failed to explain why the survey cannot be

³⁵ Farmdale recorded this expense in Account 714, Maintenance of Treatment and Disposal Plant. During the test period, it recorded expenses of \$19,712 to this account. In its application, it proposed to reduce this amount by \$13,091 to remove several capital expenditures improperly classified as expenses. Commission Staff originally proposed to reduce the test period by an addition \$2,233 to remove the cost of the manhole survey (\$598) and the purchase and installation of a new motor (\$1,636). Commission Staff further proposed that the motor's purchase and installation costs be recovered through depreciation expense. See *Commission Staff Report*, Attachment A at Note F. Farmdale did not object to Commission Staff's proposal regarding the motor's costs, but objected to the removal of the cost of the manhole survey. Revising its position regarding the recurring nature of the expense, Commission Staff subsequently amended its recommendations and supported the inclusion of the \$598 in test period expenses. See *Amended Commission Staff Report*, Attachment A at Note B.

³⁶ Transcript at 20-21. See also Prefiled Testimony of Carroll F. Cogan at 11 (requesting that test period expense be adjusted to reflect an increase in total cost of the survey to \$1,000).

³⁷ Transcript at 20 and Exhibit 4.

³⁸ *Id.* at 177; AG Brief at 16.

performed under its existing contracts for services. In the absence of such evidence, we find that the proposed adjustment should be denied.

Revised Legal Fees

At the hearing, Farmdale proposed an adjustment to its legal fees to reflect total legal costs related to the current rate proceeding of \$14,046.66.³⁹ Farmdale originally proposed to increase its test period amortization expense by \$600 to reflect expected legal costs of \$3,000 amortized over a 5-year period.⁴⁰ Having reviewed the invoices to support this proposed adjustment, we find that Farmdale should be permitted to recover \$14,024.03 of these fees through its rates. Amortizing this expense over a 5-year period produces an annual expense of \$2,805.⁴¹

Summary

Based upon our review of the evidence, we find that Farmdale's adjusted test period operations are as shown in Table II below.

³⁹ Transcript at 26.

⁴⁰ Application at 12. Farmdale proposed a total adjustment of \$3,734 to test period amortization expense. Commission Staff had proposed minor revisions to Farmdale's proposal to increase proposed adjusted amortization expense to \$3,977. See *Commission Staff Report*, Attachment A at Note K; *Amended Commission Staff Report*, Attachment A at Note D.

⁴¹ This adjustment increases adjusted amortization expense to \$6,182.

TABLE II			
	Test Year	Adjustments	Pro forma
Operating Revenues			
Sewer Revenues	\$53,273	\$27,703	\$80,976
Total Operating Revenue	<u>\$53,273</u>	<u>\$27,703</u>	<u>\$80,976</u>
Operating Expenses			
Operation and Maintenance			
Owner/Manager Fee	\$ 9,600	(\$ 3,600)	\$ 6,000
Sludge Hauling	\$ 5,450	(\$ 1,200)	\$ 4,250
Water Cost	\$ 1,646	(\$24)	\$ 1,622
Other Labor, Materials & Expenses	\$ 7,485	\$ 315	\$ 7,800
Fuel/Power for Pumping	\$19,150	(\$ 3,847)	\$15,303
Chemicals	\$ 2,402		\$ 2,402
Routine Maintenance Fee	\$11,370	(\$1,650)	\$ 9,720
Maintenance of Collection Sewer System	\$ 350		\$ 350
Maintenance of Treatment and Disposal Plant	\$19,712	(\$14,726)	\$ 4,986
Maintenance of Other Plant Facilities	\$ 1,540	(\$532)	\$ 1,008
Agency Collection Fee	\$ 7,991	\$106	\$ 8,097
Office Supplies and Other Expenses	\$ 278		\$ 278
Outside Services Employed	\$ 5,709	(\$2,709)	\$ 3,000
Insurance Expense	\$ 543		\$ 543
Regulatory Commission Expense	\$ 590		\$ 590
Miscellaneous General Expenses	\$ 26		\$ 26
Rents	\$ 600		\$ 600
Total Operation and Maintenance Expense	\$94,442	(\$27,867)	\$66,575
Depreciation Expense	\$ 118	\$ 3,408	\$ 3,526
Amortization Expense	\$ 0	\$ 6,182	\$ 6,182
Taxes Other Than Income	\$ 1,142		\$ 1,142
Total Operating Expenses	<u>\$95,702</u>	<u>(\$18,277)</u>	<u>\$77,425</u>
Income Taxes	\$ 175		\$ 175
Interest Expense	\$ 893	\$ 5,390	\$ 6,283
Total Expense	<u>\$96,770</u>	<u>(\$12,887)</u>	<u>\$83,883</u>
Net Income	<u>(\$43,497)</u>	<u>\$40,590</u>	<u>(\$ 2,907)</u>

The Commission has historically used an operating ratio approach to determine revenue requirements for small, privately owned utilities.⁴² This approach is used

⁴² See, e.g., Case No. 7558, General Adjustments in the Rates of Maryville Sewage System, Inc. (Ky. P.S.C. June 27, 1980).

because no basis for rate-of-return determination exists or the cost of the utility has fully or largely been recovered through the receipt of contributions. The Commission finds that this method should be used to determine Farmdale's revenue requirements. The Commission finds that an operating ratio⁴³ of 88 percent would allow Farmdale sufficient revenues to cover its reasonable operating expenses and to provide for reasonable equity growth. An operating ratio of 88 percent results in a revenue requirement of \$94,266 and increased revenues of \$13,290 over normalized revenues from sewer

⁴³ Operating Ratio is defined as the ratio of expenses, including depreciation and taxes, to gross revenues.

$$\text{Operating Ratio} = \frac{\text{Operating Expenses} + \text{Depreciation} + \text{Taxes}}{\text{Gross Revenues}}$$

rates of \$80,976.⁴⁴ Applying the revenue requirement over 241 customers produces a monthly rate of \$32.60.⁴⁵

SUMMARY

After review of the evidence of record and being otherwise sufficiently advised, the Commission finds that:

1. Farmdale's adjusted test period revenues are \$80,976.
2. Farmdale's adjusted test period operating expenses are \$77,425.
3. Farmdale's adjusted test period depreciation expense is \$6,182.
4. Farmdale's taxes other than income taxes for the test period are \$1,142.
5. An operating ratio of 88 percent will provide Farmdale with sufficient revenues to cover its reasonable operating expenses and to provide for reasonable equity growth.
6. Based on an operating ratio of 88 percent and Farmdale's adjusted test period revenues and expenses, Farmdale should be permitted to earn revenues of \$94,266.
7. A monthly sewer rate of \$32.60 is the fair, just and reasonable rate for Farmdale and will produce annual revenues of \$94,266 based on adjusted test year revenues.

⁴⁴	Pro forma Expenses	\$77,425
	Operating Ratio	÷ .88
	Subtotal	<u>\$87,983</u>
	Plus Recommended Interest Expense	<u>\$ 6,283</u>
	Revenue Requirement	\$94,266
	Less Normalized Revenues	<u>\$80,976</u>
	Revenue Increase	<u>\$13,290</u>

⁴⁵ \$32.60 per month = \$ \$94,266 ÷ (12 months x 241 customers).

8. Farmdale's proposed rate will produce revenue in excess of that found reasonable and should be denied.

IT IS THEREFORE ORDERED that:

1. The findings contained in the Commission Staff Report, as amended, except as expressly noted in this Order, are adopted as the Commission's findings and incorporated by reference into this Order.

2. Farmdale's proposed rate is denied.

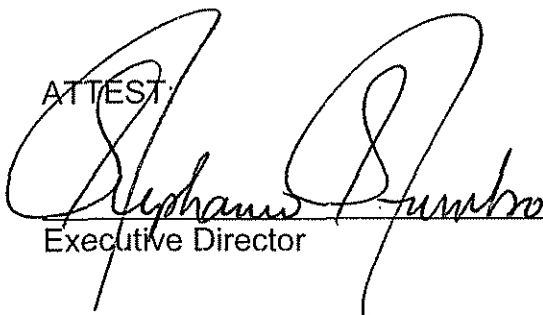
3. A monthly sewer rate of \$32.60 is approved for sewer service that Farmdale renders on and after the date of this Order.

4. Within 30 days of the date of this Order, Farmdale shall file with the Commission a revised tariff sheet setting forth the rate approved herein.

Done at Frankfort, Kentucky, this 30th day of July, 2008.

By the Commission

ATTEST:


Executive Director

Case No. 2007-00436