

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ALTERNATIVE RATE FILING APPLICATION OF) CASE NO.
MIDDLETOWN WASTE DISPOSAL, INC.) 2009-00227

ORDER

On June 19, 2009, Middletown Waste Disposal, Inc. ("Middletown") applied to the Commission for authority to adjust its sewer rates pursuant to 807 KAR 5:076, the alternative rate filing procedure for small utilities. Because of filing deficiencies, the Commission did not accept the application for filing until July 2, 2009.

Commission Staff, having performed a limited financial review of Middletown's operations, has prepared the attached report containing its findings and recommendations regarding the proposed rates. All parties should review the report carefully and submit any written comments about Staff's findings and recommendations or requests for a hearing or an informal conference no later than seven days from the date of this Order.

IT IS THEREFORE ORDERED that:

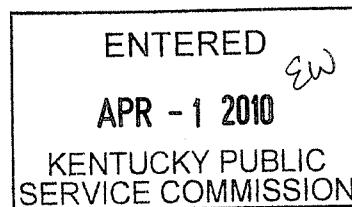
1. All parties shall have seven days from the date of this Order to submit to the Commission written comments, if any, regarding the attached Staff Report and to request a hearing or an informal conference in this matter.

2. Any party requesting a hearing in this matter shall state in its request its objections to the findings set forth in the Staff Report and provide a brief summary of testimony that it would present at hearing.

3. A party's failure to object to a finding or recommendation contained in the Staff Report within seven days of this Order shall be deemed as agreement with that finding or recommendation.

4. If no request for a hearing or an informal conference is received within the seven days, this case shall stand submitted to the Commission for decision.

By the Commission



ATTEST:

A handwritten signature in black ink, appearing to be "D. B. S.", written over a horizontal line.

Executive Director

STAFF REPORT
ON
MIDDLETOWN WASTE DISPOSAL, INC.
CASE NO. 2009-00227

Middletown Waste Disposal, Inc. ("Middletown") applied to the Commission for authority to adjust its water rates pursuant to 807 KAR 5:076, the alternative rate filing procedure for small utilities.

In order to evaluate the requested increase, Commission Staff performed a limited financial review of Middletown's operations during the test period, the calendar year ending December 31, 2008. The scope of 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.

Mark Frost and Jason Green of the Commission's Division of Financial Analysis performed the limited review. This report summarizes Staff's review and recommendations. Mr. Green is responsible for the pro forma revenue adjustment and the rate determination. Mr. Frost is responsible for all pro forma expense adjustments and the revenue requirement determination.

The comparison of Middletown's actual and pro forma operations is attached hereto as Appendix A. Based upon the recommendations and findings of Staff's limited review of the operating revenues and expenses reported in the 2008 Annual Report, and Middletown's responses to Staff's Information Request, Middletown's pro forma

operating statement would appear as set forth in Appendix B. The discussions of Staff's proposed pro forma adjustments are shown in Appendix C.

The Commission has historically used an operating ratio approach¹ to determine the revenue requirement for small, privately-owned utilities. This approach is used primarily when there is no basis for a rate-of-return determination or the cost of the utility has fully or largely been funded through the receipt of contributions. Staff finds that the operating ratio method should be used to determine Middletown's revenue requirement. Staff further finds that an operating ratio of 88 percent will allow Middletown sufficient revenues to cover its reasonable operating expenses and to provide for reasonable equity growth.

Using an 88-percent operating ratio, Middletown determined that its pro forma operations support a revenue requirement from rates of \$191,463, which is \$56,459 or 41.8 percent over Middletown's normalized revenues from rates of \$135,004.² In calculating its requested revenue requirement, Middletown used a gross-up factor of 1.22549³ to include a provision for state and federal income taxes of \$4,806.⁴

¹ Operating Ratio is defined as the ratio of expenses, including depreciation and taxes, to gross revenues.

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

² Application, Attachment A, Revenue Requirement Calculation.

³ Id.

⁴ Id. \$26,118 (Net Income Margin before Income Taxes) - \$21,312 (Net Income Margin after Income Taxes) = \$4,806.

In reviewing Middletown's income tax returns, Staff notes that Middletown chose to form as a sub-chapter S Corporation. According to the Internal Revenue Service:

S corporations are corporations that elect to pass corporate income, losses, deductions and credit through to their shareholders for federal tax purposes. Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income.⁵

Under state law, an S corporation is viewed as a separate legal entity from its shareholders and is granted the same liability protection as is afforded a shareholder of a C corporation.⁶ However, taxation of S corporations resembles that of a partnership in that there is a single income tax levied at the shareholder level.⁷ In contrast, C corporations face a double taxation; an income tax is levied at the corporate level on the net income and the shareholders pay income taxes for any dividends that they receive.⁸

The Commission has found that the income tax liability is the responsibility of the shareholder and should not be reported as an expense of the utility.⁹ Therefore, the Commission does not include a provision for income taxes in the calculation of the revenue requirement for a utility that is formed as a sub-S corporation.¹⁰ Middletown

⁵ <http://www.irs.gov/businesses/small/article/0,,id=98263,00.html>

⁶ <http://en.wikipedia.org/wiki/S-corporation>

⁷ Id.

⁸ Id.

⁹ Case No. 2006-00271, Application of Cow Creek Gas, Inc. for Authority to Adjust Its Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities (Ky. PSC Jun. 8, 2006).

¹⁰ Id.

has not presented any evidence in this proceeding that would persuade Staff to deviate from this prior Commission position. Staff's recommended pro forma operations and an operating ratio of 88 percent result in a revenue requirement from rates of \$152,458, an increase of \$15,308 or 11.16 percent over Staff's normalized revenue from rates of \$137,150.

Operating Expenses	\$	129,966
Divided by: Operating Ratio	÷	88%
Sub-total	\$	147,689
Add: Interest Expense	+	4,769
Recommended Revenue requirement	\$	152,458
Less: Normalized Operating Revenue	-	135,004
Increase in Revenue from Rates	\$	15,308

Because the rates proposed by Middletown will produce an annual revenue that is greater than the revenue requirement determined reasonable herein, Staff recommends that the Commission deny Middletown's proposed rates. The rates calculated by Staff are an across the board percentage increase in current rates of 9.78 percent. Staff further recommends that the Commission approve the rates set forth in Appendix C, as they will produce its recommended revenue requirement from rates of \$150,568.

In June 1997, Middletown established a flat residential sewer rate of \$15.00 per customer.¹¹ In establishing its residential rate, Middletown informed the Commission by letter that it "would use the lowest single family rate found in Jefferson County" in the

¹¹ Middletown's response to the Commission Staff's Initial Information Request, Item 1(a).

belief that this would result in a reasonable rate that was lower than any other rate being charged in Jefferson County.¹²

In response to Middletown's November 23, 1994 letter, the Commission informed Middletown that its proposal to base the residential rate on the lowest single-family rate found in Jefferson County was "not satisfactory."¹³ The Commission added that the "Kentucky Revised Statutes require utility rates to be based on the fair, just and reasonable cost of providing service."¹⁴ Middletown was directed to file a rate application using the "Alternative Rate Filing for small utilities" ("ARF") and was also informed that Staff would be available to provide assistance to Middletown if requested.¹⁵

On May 14, 1997, Middletown requested Staff assistance in preparing an ARF application, stating that:

We previously received the necessary forms and that Mark C. Frost of your staff has been working on the necessary data. We are now ready to accept the residential customers and need this alternative rate form.¹⁶

On May 29, 1997, the Commission acknowledged receipt of Middletown's request and issued a letter listing the information that Staff would need in order to

¹² Id. Item 1(b), the November 23, 1994 Letter from Middletown to Larry Updike of the Commission's Engineering Division.

¹³ Middletown's response to the Commission Staff's Second Information Request, Item 10, the December 8, 1994 letter from Don Mills, the Commission's Executive Director, to Middletown.

¹⁴ Id.

¹⁵ Id.

¹⁶ Id. May 14, 1997 Letter from Middletown to Don Mills.

provide the requested assistance.¹⁷ A completed ARF application was sent to Middletown that established a residential rate, but Middletown did not file the ARF application with the Commission.¹⁸

In response to Staff's inquiry regarding prior Commission authorization of the residential rate, Middletown states:

There was no formal proceeding wherein the Commission authorized Middletown to charge the \$15.00 per month residential rate. Middletown worked with the PSC Staff over the course of more than 4 years to establish a reasonable rate.¹⁹

According to KRS 278.160(2), "No utility shall charge, demand, collect, or receive from any person a greater or less compensation for any service rendered or to be rendered than that prescribed in its filed schedules, and no person shall receive any service from any utility for a compensation greater or less than that prescribed in such schedules." Given that Middletown has not complied with the statute requirement that all rates be included in a utilities tariff, Staff recommends that the Commission begin an investigation into Middletown's alleged violation of KRS 278.160.

In response to Staff's inquiry regarding prior Commission authorization of the notes payable to L&L Enterprises and the Stockholder loan, Middletown states that there has not been a proceeding wherein the Commission has authorized Middletown to

¹⁷ Id. May 29, 1997 Letter from Don Mills to Middletown.

¹⁸ Id. Attachment to the May 6, 2009 letter from Rick Dahlgren, Middletown's accountant, to Sam Reid of the Commission's Financial Analysis Division.

¹⁹ Id. Item 1(c).

obtain either loan.²⁰ According to KRS 278.300(1), “No utility shall issue any securities or evidences of indebtedness, or assume any obligation or liability in respect to the securities or evidences of indebtedness of any other person until it has been authorized so to do by order of the commission.” Commission approval is not required for debt which is payable in less than two years so long as it is not renewed for a period that exceeds in the aggregate six years from the issuance date of the original debt.²¹

Given that the note to L&L Enterprises is for a 15-year term,²² and the stockholder loan originated in 2000, it is Staff’s belief that Middletown was required to obtain prior Commission authorization before it obtained either loan. Staff recommends that the Commission in its investigation into Middletown’s alleged violation of KRS 278.160, also investigate Middletown’s alleged violation of KRS 278.300. Staff also recommends that the Commission include Middletown’s shareholders as parties to the investigation.

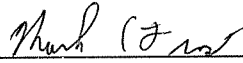
²⁰ Middletown’s Response to the Commission Staff’s Initial Information Request, Items 15(b).

Middletown’s Response to the Commission Staff’s Second Information Request, Items 3(c).

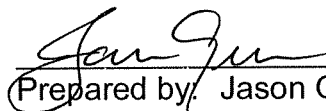
²¹ KRS 278.300(8) states, “This section does not apply to notes issued by a utility, for proper purposes and not in violation of law, that are payable at periods of not more than two (2) years from the date thereof, or to like notes, payable at a period of not more than two (2) years from date thereof, that are issued to pay or refund in whole or in part any such notes, or to renewals of such notes from time to time, not exceeding in the aggregate six (6) years from the date of the issue of the original notes so renewed or refunded.”

²² Annual Report of Middletown to the Public Service Commission of the Commonwealth of Kentucky for the Calendar Year Ended December 31, 2008 (“2008 Annual Report”) at 6.

Signatures



Prepared by: Mark C. Frost
Financial Analyst, Water and Sewer
Revenue Requirements Branch
Division of Financial Analysis



Prepared by: Jason Green
Manager, Communications, Water and
Sewer Rate Design Branch
Division of Financial Analysis

APPENDIX A
 STAFF REPORT CASE NO. 2009-00227
 MIDDLETOWN'S REQUESTED
 PRO FORMA INCOME STATEMENT

Account Titles	Actual Operations	Pro Forma Adjustments	Pro Forma Operations
Operating Revenues	\$ 137,909	\$ (2,905)	\$ 135,004
Operating Expenses:			
Operation & Maint. Exp:			
Owner/Manager Fee	\$ 14,400	\$ (8,400)	\$ 6,000
Treatment System - Sludge Hauling	7,149	0	7,149
Fuel & Power Expense	28,152	2,711	30,863
Chemicals	1,142	0	1,142
Misc. Sup & Exp - Treat. and Disp.	11,590	0	11,590
Routine Maintenance Fee	7,980	0	7,980
Internal Supervision & Eng.	0	5,400	5,400
Maint. - Collection Sewer System	16,848	(16,848)	0
Maint. - Pumping System	76,025	(57,641)	18,384
Maint. - Treatment & Disposal	1,005	0	1,005
Maint. - Other Plant	3,525	0	3,525
Administrative & General	0	5,400	5,400
Office Supplies	776	0	776
Outside Services Employed	15,921	(2,442)	13,479
Insurance	9,972	0	9,972
Transportation	2,605	(2,100)	505
Miscellaneous	7,812	(6,316)	1,496
Rents	1,200	1,200	2,400
Total Operation & Maint. Exp.	\$ 206,102	\$ (79,036)	\$ 127,066
Depreciation	18,478	(18,478)	0
Amortization	0	25,825	25,825
Taxes Other than Income Tax	3,395	0	3,395
Income Taxes - Utility Operations	175	(175)	0
Total Operating Expenses	\$ 228,150	\$ (71,864)	\$ 156,286
Net Operating Income	\$ (90,241)	\$ 68,959	\$ (21,282)
Other Deductions:			
Interest - Long-Term Debt	9,059	0	9,059
Net Income	\$ (99,300)	\$ 68,959	\$ (30,341)

APPENDIX B
STAFF REPORT CASE NO. 2009-00227
STAFF'S RECOMMENDED
PRO FORMA INCOME STATEMENT

Account Titles	Actual Operations	Pro Forma Adjustments	Ref	Pro Forma Operations
Operating Revenues	\$ 137,909	\$ (759)	(a)	\$ 137,150
Operating Expenses:				
Operation & Maint. Exp:				
Owner/Manager Fee	\$ 14,400	\$ (10,800)	(b)	\$ 3,600
Treatment System - Sludge Hauling	7,149	(4,990)	(c)	2,159
Fuel & Power Expense	28,152	2,712	(d)	30,864
Chemicals	1,142	0		1,142
Misc. Sup & Exp - Treat. and Disp.	11,590	7,280	(e)	18,870
Routine Maintenance Fee	7,980	0		7,980
Internal Supervision & Eng.	0	0	(b)	0
Maint. - Collection Sewer System	16,848	(16,848)	(f)	0
Maint. - Pumping System	76,025	(61,676)	(g)	14,349
Maint. - Treatment & Disposal	1,005	0		1,005
Maintenance - Other Plant	3,525	0		3,525
Administrative & General	0	0	(b)	0
Office Supplies	776	0		776
Outside Services Employed	15,921	(2,442)	(h)	13,479
Insurance	9,972	(3,506)	(i)	6,466
Transportation	2,605	(2,605)	(j)	0
Miscellaneous	7,812	(6,316)	(k)	1,496
Rents	1,200	0	(l)	1,200
Total Operation & Maint. Exp.	\$ 206,102	\$ (99,191)		\$ 106,911
Depreciation	18,478	(16,391)	(m)	2,087
Amortization	0	17,573	(n)	17,573
Taxes Other than Income Tax	3,395	0		3,395
Income Taxes - Utility Operations	175	(175)	(o)	0
Total Operating Expenses	\$ 228,150	\$ (98,194)		\$ 129,966
Net Operating Income	\$ (90,241)	\$ 97,425		\$ 7,184
Other Deductions:				
Interest - Long-Term Debt	9,059	(4,290)	(p)	4,769
Net Income	\$ (99,300)	\$ 101,715		\$ 2,415

APPENDIX C
STAFF REPORT CASE NO. 2009-00227
STAFF'S PRO FORMA ADJUSTMENTS

a. Normalized Operating Revenues. In its 2008 Annual Report, Middletown reported test-period revenue from rates of \$137,909.¹ Applying the current tariffed rates to the test-period billing information for its commercial customers and eliminating sales tax, Middletown calculated normalized revenue from commercial customers of \$113,404. Middletown developed its normalized revenue from residential customers of \$21,600 by applying the \$15 per month flat residential rate to the end-of-period customer level. Middletown is proposing to decrease operating revenues of \$137,909 by \$2,909 to reflect its proposed normalized operating revenues of \$135,004.

Using Middletown's test-period customer usage information and end-of-period customer level, Staff calculates normalized operating revenue of \$137,150. Therefore, Staff recommends that the Commission reduce test-period operating revenue of 137,909 by \$759 to reflect its normalized revenue of \$137,150.

b. Owner/Manager Fee. Middletown proposes to increase its owner/manager fee expense of \$14,400 by \$2,400 to a pro forma level of \$16,800.² The reported test-period owner/manager fee expense is comprised of a \$3,600 payment to its President, Paul Lichtefeld, and a \$10,800 payment to Middletown's Treasurer, Donald Lorenz.³ To support the annual fee paid to Mr. Lorenz, Middletown claims that he is responsible for the oversight of the day-to-day operations and for providing various

¹ 2008 Annual Report at 8.

² Application, Attachment A, Adjustment B, Owner/manager Fee Expense.

³ Id.

engineering services.⁴ Middletown proposes to increase the annual fee paid to Mr. Lichtefeld from the test-period level of \$3,600 to \$6,000 to “properly compensate him for the duties and responsibilities of maintaining the sewer plant.”⁵

In response to Staff interrogatories, Middletown provided a listing of the duties its owner/managers performed in the test period; but it was unable to document the number of hours either Mr. Lorenz or Mr. Lichtefeld spent performing those duties.⁶

Middletown’s only concern is that:

The Commission establish a fair, just, and reasonable revenue requirement in this case - including a reasonable level of overall compensation that allows Middletown to retain the human resources needed to meet the challenges it will face in the future.⁷

Middletown states that Mr. Lorenz conducts annual inspections of the plant and property and that he supervises the maintenance of all lines and the lift stations.⁸ However, Middletown admitted that it was unaware that its main lift station required “significant repairs and significant expenditures” until it hired Advanced Paving & Construction Company, Inc. to begin the cleanup and minor pump repairs in March 2006.⁹ As previously mentioned, Middletown has been charging its residential

⁴ Id.

⁵ Id.

⁶ Middletown’s Response to the Commission Staff’s Initial Information Request, Items 5-6.

⁷ Id. Item 6.

⁸ Id. Item 5.

⁹ Id. Item 9.

customers a rate that the Commission has not authorized and is not included in Middletown's tariffs that are on file with the Commission.

In a case¹⁰ involving Shadow Wood Sewer Service ("Shadow Wood"), a sewer of comparable size to Middletown,¹¹ the Commission stated that, "[a]n owner/manager is responsible for overseeing the daily operations of the system and monitoring the ongoing litigation, for a small sewer system such as Shadow Wood that does not constitute full-time employment." In that proceeding, the utility did not present any convincing evidence to suggest that its operations differ significantly from those of others to require greater administrative oversight and a larger administrative salary. The Commission found that an owner/manager fee of \$3,600 is consistent with the level of expense awarded other small, privately owned sewer treatment utilities and that a \$3,600 fee is a reasonable and adequate level of compensation for all appropriate duties performed by Shadow Wood's management in a normal year of operations.

In Case No. 1991-00282,¹² the Commission determined that Proctor/Davis/Ray Engineers were charging a management/operation fee of \$42,007 to Delaplain Disposal Company ("Delaplain"), an increase of 160 percent over the fee that was approved in Delaplain's prior rate case. The Commission found that a "[u]tility of Delaplain's size

¹⁰ Case No. 2001-00423, Application of Fourth Avenue Corp.-Long Corp., Joint Venture, D/B/A Shadow Wood Subdivision Sewer Service for an Alternative Rate Filing (Ky. PSC Sept. 6, 2002).

¹¹ Annual Report of Shadow Wood to the Public Service Commission of the Commonwealth of Kentucky for the Calendar Year Ended December 31, 2007 at 12. Shadow Wood is providing sanitization service to 207 Customers.

¹² Case No. 1991-00282, The Application of Delaplain Disposal Company for a Rate Adjustment Pursuant to the Alternative Rate Filing Procedure for Small Utilities (Ky. PSC Jan. 15, 1992).

should not require the services of an engineering firm in the daily management and operation.”

Upon its review of the list of duties performed by Middletown’s owner/managers, Staff believes that Middletown has failed to document the number of hours each owner/manager spends performing utility tasks and to show why it is entitled to compensation levels greater than the levels the Commission has granted other small, privately owned sewer treatment utilities. Further, it has been shown that Middletown’s shareholders are not familiar with the statutes or regulations that govern the utilities that are subject to the Commission’s jurisdiction.¹³

For the aforementioned reasons, Staff recommends that the Commission deny Middletown’s request to increase its test-period owner/manager fee by \$2,400 to a pro forma level of \$16,800. Staff further recommends that Middletown’s test-period owner/manager fee of \$14,400 be decreased by \$10,800 to allow Middletown only one owner/manager fee of \$3,600.

c. Sludge Hauling. Middletown reports a test-period sludge hauling expense of \$7,149. In reviewing the James Headden Septic Tank Service invoices, Staff discovered that, in June 2008, 29,000 gallons of sludge/sewage were removed at a cost of \$4,990. Middletown informed Staff that “the sludge, sewage, etc. was transported due to an obstruction in the system.”¹⁴ Staff believes that the 29,000 gallons that was removed in June represents a nonrecurring expenditure that should be removed from

¹³ Middletown’s alleged violations of KRS 278.160 and KRS 278.300.

¹⁴ Middletown’s Response to the Commission Staff’s Second Information Request, Item 4(a).

test-period expenses and amortized over a reasonable period. Accordingly, Staff recommends the Commission reduce Middletown's sludge hauling expense by \$4,990 to remove the amount deemed nonrecurring. The amortization of the nonrecurring costs will be discussed in a latter section.

d. Fuel and Power. Middletown proposes to increase its test-period fuel and power expense of \$28,142 by \$2,711 to a pro forma level of \$30,863.¹⁵ According to Middletown, only 11 months of electric expense was included in its 2008 Annual Report and this proposed adjustment corrects the error in its report.¹⁶ In reviewing the Louisville Gas and Electric invoices and the Louisville Water invoices, Staff notes Middletown is correct in that this expense was understated by \$2,712. Accordingly, Staff recommends the Commission increase fuel and power expense by \$2,712 to include the missing month.

e. Effluent Testing. Middletown reports a miscellaneous supplies and expense of \$11,590, which represents its annual effluent testing expense. In its February 10, 2010 filing, Middletown submitted a letter from Beckmar indicating that Middletown's permit KY0086845 requires that extra weekly analysis be performed at a cost of \$140 per week. Staff believes that an adjustment to reflect the new testing requirement meets the rate-making criteria of known and measurable. Accordingly, Staff recommends that the Commission increase miscellaneous supplies and expense by \$7,280¹⁷ to reflect the annual cost of the new effluent tests.

¹⁵ Application, Attachment A, Adjustment C, Fuel and Power Expense.

¹⁶ Id.

¹⁷ \$140 (Weekly Testing Fee) x 52 Weeks = \$7,280.

f. Maintenance - Collection Sewer System. Middletown proposes to reduce its test-period operating expenses by \$16,848 to eliminate maintenance - collection sewer system expense.¹⁸ According to Middletown, the repairs made to its collection system in 2008 were abnormally high and this level of repair expenditures is not expected to recur in the future.¹⁹ Middletown is proposing to remove these costs from test-period operating expense and to recover these expenditures over a multi-year period in amortization expense.²⁰ Upon review of the test-period invoices, Staff agrees with Middletown and recommends the Commission reduce operating expenses by \$16,848 to remove the nonrecurring expenditures. The amortization of the nonrecurring costs will be discussed in a latter section.

g. Maintenance - Pumping System. Middletown is proposing to reduce its test-period maintenance - pumping system expense by \$57,641 to remove the costs incurred to repair the lift station.²¹ According to Middletown, the lift station repairs are nonrecurring costs that should be removed from expenses and amortized over a reasonable period.²² In reviewing the test-period invoices, Staff discovered an additional \$4,035 of nonrecurring expenditures that should be removed from test-period operating expenses. To eliminate the nonrecurring expenditures that are listed in Table 2 below, Staff is proposing that the Commission reduce Middletown's maintenance -

¹⁸ Id. Adjustment E, Maintenance of Collection System Expense.

¹⁹ Id.

²⁰ Id.

²¹ Id. Adjustment F, Maintenance of Pumping System Expense.

²² Id.

pumping system expense by \$61,676. The amortization of the nonrecurring costs will be discussed in a latter section.

Description	Amount
Lift Station	\$ 49,251
Sludge Pump	5,030
Air Diffuser	3,360
Header Repairs	+ 4,035
Total	\$ 61,676

h. Outside Services Employed. Middletown proposes to reduce its test-period outside services employed expense of \$15,921 by \$2,442 to remove legal fees that are considered nonrecurring. Upon review of Middletown’s adjustment, Staff believes that it is reasonable and correct. Therefore, Staff recommends that the Commission accept Middletown’s adjustment to reduce its outside services employed expense by \$2,442 to eliminate nonrecurring legal fees. The amortization of the nonrecurring legal fees will be discussed in a latter section.

i. Insurance. Middletown reports a test-period insurance expense of \$9,972. In reviewing the test-period invoices, Staff determined that \$3,217²³ of the reported expense was for audits of prior periods and, therefore, should not be included as an expense in the test period. Accordingly, Staff is recommending the Commission reduce test-period insurance expense by \$3,217 to eliminate insurance premiums from prior periods.

Middletown reported a vehicle insurance premium of \$289 that is to provide coverage for a vehicle that is not registered to Middletown. Middletown claims that, “A

²³ Audit - Premium Period 07/01/06 through 07/01/07	\$ 1,650
Audit - Premium Period 07/01/07 through 07/01/08	+ 1,567
Total Cost for Prior Periods	<u>\$ 3,217</u>

vehicle is required for Middletown's management to make frequent plant visits and to fulfill oversight responsibilities."²⁴ Mr. Lorenz, the owner of the vehicle, states that this was a fee charged to Middletown for the use of his vehicle.²⁵ Middletown did not maintain a millage log to document the trips that were made to Middletown's treatment facilities.²⁶

In a previous decision, the Commission made the following finding regarding the allocated operational costs of a vehicle that was registered in the shareholder's name:

The evidence of record fails to support either Great Oaks' expense or Commission Staff's recommendation. The automobile is owned by Mr. Palmer, not Great Oaks. Taxes and insurance are the responsibility of an automobile's owner. Neither Great Oaks nor Commission Staff has presented any evidence on the use of the automobile for Great Oaks' matters.²⁷

Middletown has not presented any evidence in this proceeding that would persuade Staff to deviate from this prior Commission finding. Therefore, Staff recommends that the Commission decrease test-period insurance expense by the vehicle insurance premium of \$289 for a total recommended decrease to insurance expense of \$3,506.²⁸

²⁴ Middletown's Response to the Commission Staff's Second Information Request, Item 5.

²⁵ Id.

²⁶ Id. Item 5.

²⁷ See Case No. 10485, The Application of Great Oaks Sanitation Company, Inc. for A rate Adjustment Pursuant to the Alternative Rate Filing Procedure for Small Utilities (Ky. PSC Oct. 5, 1989) at 9-10.

²⁸ \$3,217 (Prior Period Insurance Premiums) + \$289 (Insurance Premium - Vehicle) = \$3,506.

j. Transportation. Middletown proposes to reduce its test-period outside services employed expense of \$2,605 by \$2,100 to remove the transportation reimbursement that is no longer being paid to the secretary/treasurer, Mr. Lorenz.²⁹ Upon review of Middletown's adjustment, Staff believes that it is reasonable and correct. Given that this is an expense that is no longer being incurred by Middletown, Staff recommends that the Commission accept Middletown's proposed adjustment and decrease transportation expense by \$2,100.

The remaining transportation expense of \$505 reflects reimbursements made to Mr. Lorenz for the purchases of gasoline that were made on his Chase credit card. Middletown states that, "There is no documentation supporting a cost allocation. However, a vehicle is required for Middletown's management to make frequent plant visits and to fulfill oversight responsibilities."³⁰ As with the vehicle insurance premium, Middletown has not presented any evidence in this proceeding that would persuade Staff to deviate from this prior Commission finding regarding undocumented transportation expenses. Therefore, Staff recommends that the Commission decrease test-period insurance expense by the allocated gasoline purchases of \$505 for a total recommended decrease to operating expense of \$2,605.³¹

k. Miscellaneous. Middletown is proposing to decrease test-period miscellaneous expense of \$7,812 by \$6,316 to remove the sales tax collections from

²⁹ Application, Attachment A, Adjustment I, Transportation Expense.

³⁰ Middletown's Response to the Commission Staff's Second Information Request, Item 6.

³¹ \$2,100 (Reimbursements to Mr. Lorenz) + \$505 (Allocated Gasoline Purchases) = \$2,605.

operating expenses.³² Given that Middletown is simply acting as a collection agency for the state and is not incurring an expense itself, Staff recommends that the Commission accept Middletown's proposed adjustment to eliminate sales tax collections of \$6,312 from its operating expenses.

I. Office Rent. Middletown is proposing to increase test-period office rent expense of \$1,200 by \$1,200 to reflect paying Mr. Lorenz \$200 per month for the use of office space, the utilities, and office equipment.³³ To show that its pro forma monthly office rent of \$200 is lower than rent that would be paid to an outside party, Middletown provided "a survey of available office rents in the Louisville area, which shows Middletown's proposed office rent of \$200 is low in comparison."³⁴

Middletown is currently renting an office that is located on Mr. Lorenz's farm in rural Spencer County. According to Middletown, Mr. Lorenz's farm is approximately 21.25 miles from its treatment facilities in Jefferson County. Given that the payment of office rent to Mr. Lorenz is considered a less-than-arm's-length transaction, it is the utility's responsibility to justify the reasonableness of its expenses, especially when they are the result of a less-than-arm's length transaction between affiliated parties.

The offices used by Middletown in its analysis are located in urban Jefferson County in areas that are zoned for business use. It is Staff's opinion that an office located in an urban area can charge a higher rent than an office located on a rural farm.

³² Application, Attachment A, Adjustment J, Miscellaneous Expense.

³³ Id. Adjustment K, Rents Expense.

³⁴ Middletown's Response to the Commission Staff's Second Information Request, Item 9.

Further, the office location on Mr. Lorenz's farm does not provide a benefit to the utility, which is located in Middletown, Kentucky. Accordingly, Staff believes that Middletown has failed to meet its burden of proof and recommends the Commission reject Middletown's proposed adjustment to increase office rent by \$1,200.

m. Depreciation. Middletown is proposing to decrease its test-period operating expenses by \$18,478 to eliminate depreciation expenses.³⁵ Middletown claims that its proposed adjustment conforms to past Commission policy to disallow depreciation on plant funded by Contributions In Aid of Construction ("CIAC").³⁶ According to the 2008 Annual Report, 88.705 percent³⁷ of Middletown's Utility Plant In Service ("UPIS") has been funded by the receipt of cost free capital, CIAC. Accordingly, Staff is recommending the Commission decrease depreciation expense by 88.705 percent or \$16,391,³⁸ rather than to eliminate 100 percent of depreciation expense as proposed by Middletown.

n. Amortization. Middletown is proposing to increase test-period operating expenses to reflect amortization expense of \$25,825 as calculated in Table 3 below.

Descriptions	Cost	Amortization Period	Amortization Expense
Lift Station	\$ 49,251	3	\$ 16,417
Collection Lines	\$ 16,848	3	5,616
Sludge Pump	\$ 5,030	5	1,006

³⁵ Application, Attachment A, Adjustment L, Depreciation Expense.

³⁶ Id.

³⁷ $\$544,392 \text{ (CIAC)} \div \$613,712 \text{ (UPIS)} = 88.705\%$.

³⁸ $\$18,478 \text{ (Test-Period Depreciation Expense)} \times 88.705\% \text{ (Percentage of UPIS funded by CIAC)} = \$16,391$.

Air Diffuser	\$ 3,360	5	672
KPDES Permit	\$ 1,000	5	200
Legal Fees	\$ 2,442	3	814
Rate Case Cost	\$ 3,300	3	+ 1,100
Pro Forma Adj.			\$ 25,825

Middletown is requesting a three-year recovery period for the repairs made in 2008 that total \$66,099³⁹ and to recover the 2008 capital expenditures of \$8,390⁴⁰ over a five-year period. According to Middletown, it is aware that the Commission has allowed other utilities to recover significant repair and replacement expenditures on an accelerated basis by allowing the utility to collect a five-year surcharge.⁴¹ Middletown could not provide documentation to support its proposed recovery periods other than to cite two prior cases⁴² where the Commission allowed a utility to use a surcharge to fund construction/repair projects and to state that:

Middletown recognizes it would be unfair to customers to base new sewer rates upon the 2008 repairs as if they occurred annually. We therefore propose to remove them from operating expenses and spread them over a multi-year period for fair, just and reasonable rate recovery.⁴³

³⁹ Application, Attachment A, Adjustment M, Amortization Expense. \$49,251 (Lift Station) + \$16,848 (Lift Station) = \$66,099.

⁴⁰ Id. \$5,030 (Sludge Pump) + \$3,360 (Air Diffuser) = \$8,390.

⁴¹ Id.

⁴² Case No. 2006-00028, Application of Farmdale Development Corporation for an Adjustment of Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities (Ky. PSC April 11, 2007).

Case No. 2003-000494, Application of Airview Estates, Inc. for an Adjustment of Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities (Ky. PSC Jun 14, 2004).

⁴³ Middletown's Response to the Commission Staff's Initial Information Request, Item 9(d).

Middletown is proposing to amortize its rate case cost of \$3,300 and the nonrecurring legal fees of \$2,442 over three year periods.⁴⁴ According to Middletown, it is in the process of renewing the “KPDES permit” at a cost of \$1,000 and is proposing to amortize this fee over the life of the permit, which is five years.⁴⁵

Staff believes that it is important for a utility to match the proposed recovery period of a nonrecurring expenditure to its expected life. Failure to properly match the two periods will result in recovering costs that provide a benefit to future rate-payers from the current customer base. Staff believes that Middletown has failed to provide documentation to support its proposed amortization periods and that the requested accelerated recovery periods results in the current customers subsidizing the rates of Middletown’s future customers.

Staff is in agreement with Middletown’s request to amortize the “KPDES permit” over five years, the nonrecurring legal fees over three years and rate case costs over three years. However, since filing its application, Middletown has obtained legal counsel. In its filing dated February 19, 2010, Middletown submitted itemized invoices from its legal counsel showing that rate case cost increased from \$3,300 to \$9,400.

Using the average service life schedule issued by the Commission on Rural Water, and including the increased rate case cost, Staff calculates an amortization expense of \$17,573 as shown in Table 4 below. Staff is recommending that the Commission deny Middletown’s requested amortization adjustment and that it increase

⁴⁴ Application, Attachment A, Adjustment M, Amortization Expense.

⁴⁵ Id.

operating expense by \$17,573 to reflect the pro forma amortization expense as calculated by Staff.

Description	Cost	Amortization Life	Amortization Expense
Lift Station	\$ 49,251	7	\$ 7,036
Collection Lines	\$ 16,848	10	1,685
Sludge Pump	\$ 5,030	10	503
Air Diffuser	\$ 3,360	3	1,120
KPDES Permit	\$ 1,360	5	272
Sludge Removal	\$ 4,990	3	1,663
Legal Fees	\$ 2,442	3	814
Header Repairs	\$ 4,035	3	1,345
Rate Case Cost	\$ 9,404	3	+ 3,135
Pro Forma Adj.			\$ 17,573

o. Income Tax. Middletown reports a test-period income tax expense of \$175. As discussed earlier, Middletown is a sub-chapter S corporation and, therefore, income tax is not computed at the corporate level. Staff is recommending that test-period operating expense be decreased by \$175 to eliminate income tax expense from Middletown's pro forma operating expenses.

p. Interest. Table 5 below is a breakdown of Middleton's test-period interest expense of \$9,059.

Obligation Description	Date of Loan	2008 Interest
L&L Enterprises	03/01/1989	\$ 4,769
Citizens Union Bank	06/26/2008	1,256
Stockholder Loan	03/30/2000 ⁴⁷	+ 3,034
Total		\$ 9,059

⁴⁶ 2008 Annual Report at 6.

⁴⁷ Middletown's Response to the Commission Staff's Second Information Request, Item 3(d).

According to Middletown, the proceeds of the note payable to the associated company, L&L Enterprises, was used “to purchase the land upon which Middletown’s sewage treatment plant sits.”⁴⁸ Middletown identifies the Citizens Union Bank note as a line of credit that is being used to fund current operating expenses.⁴⁹ The proceeds of the shareholder loan was “mostly used to fund significant unforeseen repairs.”⁵⁰

Historically, the Commission has not allowed utilities to recover from the rate-payers interest on loans incurred to cover operating expenses, because it is the responsibility of the owner to monitor the utility’s financial condition and seek rate relief in a timely manner.⁵¹ Nothing has been presented by Middletown to persuade Staff that this practice should be modified. Therefore, Staff recommends that test-period interest expense be decreased by \$4,290 to eliminate interest expense for loans that were used to fund current operations.

⁴⁸ Middletown’s Response to the Commission Staff’s Initial Information Request, Item 14(c).

⁴⁹ Id.

⁵⁰ Middletown’s Response to the Commission Staff’s Second Information Request, Item 3(a).

⁵¹ 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).

APPENDIX D
STAFF REPORT CASE NO. 2009-00227
STAFF'S RECOMMENDED RATE

RATES AND CHARGES

Industrial Rates

First 20,000 Gallons	\$	88.93	Minimum Bill
Over 20,000 Gallons	\$	4.45	per 1,000 Gallons

English Station

First 7,500 Gallons	\$	33.38	Minimum Bill
Over 7,500 Gallons	\$	4.45	per 1,000 Gallons

Residential

Monthly Service Charge	\$	16.67	per month
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