COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ALTERNATIVE RATE FILING OF COOLBROOK UTILITIES, LLC	))	CASE NO. 2011-00433

NOTICE OF FILING OF COMMISSION STAFF REPORT

Notice is hereby given that, in accordance with the Commission's Order of February 3, 2012, the attached report containing the findings and recommendations of Commission Staff regarding the Applicant's proposed rate adjustment has been filed in the record of the above-styled proceeding.

Jeff Derouen
Executive Director
Public Service Commission
P.O. Box 615
Frankfort, KY 40602

DATED: MAR 05 2012

cc: Parties of Record

STAFF REPORT

ON

COOLBROOK UTILITIES, LLC

CASE NO. 2011-00433

On October 31, 2011, Coolbrook Utilities, LLC ("Coolbrook") applied pursuant to 807 KAR 5:076 to increase its rates for sewer service. Using the calendar year ending December 31, 2010 as its test period, Coolbrook proposes to increase its current monthly sewer rate of $30.15 to $36.80, an increase of $6.65 or 22 percent. Coolbrook also requests authority to assess a monthly surcharge of $6.75 for a 12-month period to fund the cost of an inflow and infiltration study. The proposed surcharge will produce revenues of $35,200.

Commission Staff members Samuel Bryant and Eddie Beavers performed a limited financial review of Coolbrook's operations to determine whether test-period operating revenues and expenses are representative of normal operations and the proposed adjustments are reasonable. They did not pursue, and have not addressed in this report, insignificant or immaterial discrepancies. Where they have not expressly addressed a test-period expense, they found insufficient evidence to contest the reasonableness of that expense.

This report summarizes Commission Staff's findings and recommendations. Attachment A contains Commission Staff's recommended pro forma operating statement and sets forth its findings and recommendations regarding Coolbrook's proposed adjustments and explains its recommended adjustments to Coolbrook's test-period operating statement. Commission Staff's recommended rates are found at

Attachment B. Mr. Beavers is responsible for the pro forma revenue adjustment and the calculation of the recommended rates. Mr. Bryant is responsible for all pro forma operating expense adjustments, the revenue requirement determination, and the proposed surcharge.

Coolbrook proposes to use an operating ratio of 88 percent to determine its revenue requirement. The Commission has historically used an operating ratio approach[1] to determine revenue requirements for small, privately owned utilities.[2] This approach is used 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. For these reasons, this method should be used to determine Coolbrook's revenue requirement. Commission Staff finds that an operating ratio of 88 percent will allow Coolbrook sufficient revenues to cover its reasonable operating expenses and to provide for reasonable equity growth.

Using an operating ratio of 88 percent, Coolbrook determined that its proposed pro forma operations support a revenue requirement from base sewer rates of $192,077, which is an increase of $34,694, or 22 percent, above the normalized revenue from base sewer rates of $157,383. As shown in Table 1, Commission Staff's recommended pro forma operations and an 88 percent operating ratio result in a

---

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

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

[2] *See, e.g.,* Case No. 7553, *McKnight Utilities Co.* (Ky. PSC Nov. 13, 1979).

revenue requirement from base sewer rates of $167,236, an increase of $9,903, or 6.3 percent, over normalized revenue from rates of $157,333.

Table 1		
Operating Expenses	$	147,168
Divided by: Operating Ratio	÷	88%
Commission Staff Revenue Requirement	$	167,236
Less: Normalized Operating Revenue	-	157,333
Recommended Increase in Revenue from Rates	$	9,903

Because Coolbrook's proposed base sewer rate will produce revenue in excess of $167,236, Commission Staff recommends that it be denied. Using the recommended revenue requirement and the current number of Coolbrook's customer, Commission Staff calculates a residential rate of $32.04 per month, as shown in Table 2. Staff recommends that the Commission approve the residential rate set forth in Attachment B, as it will produce the recommended revenue requirement from rates of $167,236.

Table 2		
Total Requested/Recommended Revenue Requirement	$	167,236
Divided by: 12 Months	÷	12
Monthly Revenue Requirement	$	13,936.33
Divided by: Current Customer Level	÷	435
Monthly Rate – Rounded up to Nearest Penny	$	32.04

Coolbrook proposed a surcharge of $6.75 per month for a period of 12 months. The surcharge will generate $35,200 and Coolbrook proposes to use the surcharge proceeds to fund an inflow and infiltration study, which in its application it represents that the Kentucky Division of Water ("DOW") has required. However, Coolbrook has produced no evidence of such a requirement other than a letter in which a DOW enforcement official suggested possible terms of an Agreed Order. Coolbrook has acknowledged in response to Commission Staff's Requests for Information that no agreed order with DOW currently exists.

Assuming the need for an infiltration and inflow study exists, Coolbrook has offered no evidence that the proposed surcharge is necessary to finance such study. A utility will generally finance this type of expenditure through internal funds or through the issuance of debt. Recognizing that financing the proposed study through general rates is not likely, Coolbrook may borrow the funds and then seek recovery of the cost of borrowing through its general rates. Commission Staff is of the opinion that prior to the authorization of a surcharge, the utility should demonstrate reasonable efforts to obtain outside funding. Coolbrook has not done so. It has provided no evidence regarding its efforts to obtain funding. Reasonable efforts require the submission of applications to several lending institutions.

Commission Staff is also concerned regarding the effects of the proposed surcharge on the allocation of risks between utility ratepayers and the utility. The inflow and infiltration study represents a construction overhead that generally would be recovered over the useful lives of any construction projects resulting from the study. Such a major capital expenditure is funded by the utility and recovered through general rates over the utility plant's service life. Utility ratepayers pay for the expenditure as the capital asset depreciates. Coolbrook's proposed surcharge, however, requires ratepayers to pay these capital expenditures in advance before using the asset. Instead of the utility bearing the risk that the asset will be fully used, the proposed surcharge will transfer that risk to ratepayers.

The lack of a clearly defined need for the inflow and infiltration study, the absence of any evidence of efforts to obtain financing for the proposed study, and the shifting of risk from the utility to ratepayers leads Commission Staff to recommend that the proposed surcharge be denied.

Prepared by: Samuel J. Bryant, Jr.
Financial Analyst, Water and Sewer
Revenue Requirement Branch
Division of Financial Analysis

Prepared by: Eddie Beavers
Rate Analyst, Water and Sewer
Rate Design Branch
Division of Financial Analysis

ATTACHMENT A
STAFF REPORT, 2011-00433
COMMISSION STAFF
PRO FORMA INCOME STATEMENT
AND ADJUSTMENTS

Account Titles	2010 Annual Report	Pro Forma Adjustment	Ref.	Pro Forma Operations
Operating Revenues:				
Flat Rate Sewer	$ 116,892	$ 40,491	A	$ 157,383
Operating Expenses:				
Operation & Maint. Exp.:				
Owner Manager Fee	$ 7,200	$ (3,600)	B	$ 3,600
Sludge Hauling	11,713	0		11,713
Water	1,058	0		1,058
Other Labor & Materials	8,974	0		8,974
Fuel & Power Expense	27,108	(36)	C	27,072
Chemicals	6,775	0		6,775
Routine Maintenance Fee	17,600	1,600	D	19,200
Maint. Collection System	7,592	0		7,592
Maint. Treatment & Disp.	6,019	0		6,019
Maint. Other Plant	42,452	(25,912)	E	16,540
Agency Collection Fee	17,534	0	F	17,534
Office Supplies & Other	208	0		208
Outside Services	4,189	0		4,189
Insurance Expense	900	4,878	G	5,778
Rate Case Expense	1,968	(1,968)	H	0
Misc. General Expense	358	0		358
Rent	0	1,200	I	1,200
Total O&M expenses	$ 161,648	$ (23,838)		$ 137,810
Depreciation Expense	6,957	(3,105)	J	3,852
Amortization Expense	0	890	K	890
Taxes Other Than Income	4,616	0		4,616
Total Operating Expenses	$ 173,221	$ (26,053)		$ 147,168
Net Operating Income	$ (56,329)	$ 66,544		$ 10,215

A. Operating Revenues. Coolbrook proposes to increase its operating revenues from sewer rates by $40,491 to reflect the effect of the rate increase that was granted in Case No. 2010-00314 on June 6, 2011.[5] Coolbrook reports that during the test period it provided sewer service to 435 customers. Applying the rates authorized in

[5] Case No. 2010-00314, *Alternative Rate Filing of Coolbrook Utilities, LLC* (Ky. PSC Jun. 6, 2011).

Case No. 2010-00314 to the test-period level of customers of 435 results in normalized revenue of $157,383, which is $40,491 above the reported test-period level of $116,892. Accordingly, Commission Staff recommends that the Commission accept Coolbrook's proposed adjustment.

Table 1: Normalized Revenues		
Monthly Flat Sewer Rate	$	30.15
Multiplied by: No. of Bills	x	5220
Normalized Annual Revenues	$	157,383
Less: Reported Test-Period Revenues	-	116,892
Pro Forma Adjustment	$	40,491

B. Owner/Manager Fee. Coolbrook proposes to increase its test-period owner/manager fee from $7,200 to $15,000, an increase of $7,800. According to Coolbrook, its owner and President, Larry Smither, spent 300 hours per year on Coolbrook matters. Applying an hourly rate of $50 to the 300 annual hours, Coolbrook arrives at the requested owner/manager fee of $15,000.

The Commission has previously stated that "the reasonableness of the [owner-manager] fee will depend on the circumstances of the particular utility, to include its owner's responsibilities and duties and the size and complexity of the sewer utility's operations."[6] It further stated that, as payment of an owner-manager fee is not an arms-length transaction, the utility must demonstrate by substantial evidence that the fee is reasonable.

Coolbrook has not demonstrated that, given its operations, the fee being paid to Mr. Smither is reasonable. To support its contention that Mr. Smither spends approximately 300 hours per year managing Coolbrook's operations, it submitted a daily

[6] Case No. 2007-00436, *Application of Farmdale Development Corporation for an Adjustment in Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* at 6 (Ky. PSC Jul. 30, 2008).

activity log that covers 45 noncontiguous days outside of the test period. This log shows that during this period Mr. Smither spent 47.5 hours on Coolbrook matters. However, 12 of these hours, or approximately 25.3 percent of the noted time, was rate-case related. Compensation for this time would not be included in pro forma operating expenses because of the nature of the work and because it was incurred outside the test period.

In reviewing the log, Commission Staff is of the opinion that the duties that Mr. Smither performs do not differ significantly from those of other similarly sized sewer utilities to require greater administrative oversight and a larger administrative salary. In fact, the majority of Coolbrook's operations are performed by outside or affiliated contractors (e.g., bookkeeping, plant operations, customer billing and collection).

In proceedings involving similarly-sized sewerage treatment facilities, the Commission has consistently found $3,600 to be a reasonable amount for the owner/manager fee.[7] In the absence of any factor that distinguishes Coolbrook's operations from those entities or the duties of Coolbrook's owners from those of other utility owners, Commission Staff recommends that the Commission deny Coolbrook's adjustment to increase its owner/manager fee to $15,000 and limit the owner/manager fee in this case to $3,600, resulting in a decrease of $3,600 to operating expenses.

---

[7] Case No. 2007-00443, *South 641 Water Dist.* (Ky. PSC Dec. 20, 2007); Case No. 2008-00042, *Cedarbrook Treatment Plant* (Ky. PSC July 29, 2008); Case No. 2008-00355, *Thomas Country Estates Wastewater Treatment Plant* (Ky. PSC Oct. 24, 2008); Case No. 2008-00482, *Purchase Public Service Corp.* (Ky. PSC Mar. 24, 2009); Case No. 2008-00501, *Ledbetter Water Dist.* (Ky. PSC May 22, 2009); Case No. 2008-00506, *Powell's Valley Water Dist.* (Ky. PSC Apr. 14, 2009); Case No. 2009-00075, *Longview Land Co.* (Ky. PSC July 20, 2009); Case No. 2009-00227, *Middletown Waste Disposal, Inc.* (Ky. PSC Apr.30, 2010); Case No. 2009-00403, *Evergreen Disposal System, Inc.* (Ky. PSC July 29, 2010); Case No. 2010-00231, *Purchase Public Service Corp.* (Ky. PSC Sept. 9, 2010).

C. Fuel and Power Expense. Coolbrook proposed a total of $28,355, an increase of $1,247 over actual test-period expense. The increase was to normalize the expense for a rate increase by Coolbrook's supplier, Blue Grass Energy Cooperative Corporation ("Blue Grass"). Coolbrook states that on January 14, 2011, the Commission approved new rates for East Kentucky Power Cooperative ("EKPC"), resulting in an average increase of 4.6 percent to EKPC's distribution cooperatives. Applying the 4.6 percent to the 2010 expense of $27,108 results in Coolbrook's proposed adjustment of $1,247.

In Case No. 2010-00169,[8] the Commission granted Blue Grass an increase in its energy charge rates to pass through the increase in the wholesale power costs resulting from the rate increase granted to EKPC. The percentage methodology proposed by Coolbrook fails to accurately reflect the effect that Blue Grass's rate increase will have on Coolbrook's pro forma fuel and power expense. Applying the energy charge contained in Blue Grass's current rate schedules will result in a more accurate and reasonable adjustment.

Coolbrook receives electric service at four different metering points and is billed with one rate classification, "SC-1 General Service (0-100 KW)." Applying the current energy rate[9] to Coolbrook's 2010 Kilowatt Hour Usage, Commission Staff calculates a

---

[8] Case No. 2010-00169, Application of Blue Grass Energy Cooperative Corporation for Pass-Through of East Kentucky Power Cooperative, Inc. Wholesale Rate Adjustment (Ky. PSC Jan. 14, 2011).

[9] On May 31, 2011, the Commission established a new energy rate for the SC-1 Energy Schedule. This rate supersedes the rate to which Coolbrook refers in its application. *See* Case No. 2010-00497, *An Examination of the Application of the Fuel Adjustment Clause of Blue Grass Energy Cooperative Corporation From November 1, 2008 Through October 31, 2010* (Ky. PSC May 31, 2011).

pro forma decrease to purchased power expense of $36. Accordingly, Staff recommends that the Commission deny Coolbrook's proposed adjustment and decrease purchased power expense by $36.

D. Routine Maintenance Fees Expense. According to Coolbrook, its reported routine maintenance fee expense of $17,600 only reflected 11 monthly payments and did not reflect the full cost of maintenance for the test period. To correct this error, Coolbrook proposes to increase this expense by $1,600. Commission Staff finds Coolbrook's adjustment to be correct and recommends the Commission accept the proposed adjustment.

E. Maintenance of Other Plant. Coolbrook proposes to remove capital expenditures that were incorrectly included in its test period maintenance of other plant expense. Coolbrook's proposal would reduce the test-period level of this expense from $42,452 to $16,630, a decrease of $25,912. Commission Staff agrees and recommends the Commission accept Coolbrook's proposed adjustment.

F. Agency Collection Fee. Coolbrook proposes to increase its test-period agency collection fee expense from $17,534 to $23,217, an increase of $5,683. Currently, Farmdale Water District ("Farmdale District") performs Coolbrook's customer billing and collections and charges a fee of 15 percent of the amount collected. Coolbrook determined that its requested rates would produce an agency collection fee of $28,971, $11,605 above the test-period level.[10] Coolbrook proposes to increase the agency collection fee expense by $5,638, or one-half of the $11,605 increase in billing fees that would result if the proposed rates were placed into effect. Coolbrook asserts

[10] 435 (Customers) x $37 (Requested Rate) x 12 (Months) = $193,140 x 0.15 (Agency Collection Fee) = $28,971.

that it is critical that the Commission recognize some billing and collection cost increase even if the actual increase in the fee is not totally recovered in its rates. Coolbrook asserts that its current billing and collection arrangement with the Farmdale District requires the adjustment.

This Commission has long been concerned with the high cost of the billing and collection services provided by the Farmdale District. In Case No. 2007-00436,[11] the Commission made the following finding's regarding the billing and collection fees being charged by the Farmdale District:

> The Commission finds that, given the high level of expense and the questionable nature of Farmdale District's termination practices, 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. 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.[12]

In that proceeding, the Commission denied Farmdale Development Corporation's ("Farmdale Sewer") adjustment to the agency collection fee expense to reflect the effect of the requested revenue requirement and limited Farmdale Sewer's recovery of the agency collection fee expenses to the test-period expense level of $8,091.[13] The Commission also placed Farmdale Sewer on notice that in any future rate proceeding it

---

[11] Case No. 2007-00436, *Application of Farmdale Development Corporation for an Adjustment in Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC July 30, 2008).

[12] *Id.* at 12.

[13] *Id.* at 15.

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.[14]

In this current proceeding, Coolbrook states that, given the negative collection experience of other utilities, it has not advertised for bids nor considered doing the billing and collecting activity in-house. According to Coolbrook, a competitive bidding exercise required by the Commission in Case No. 2007-00436, did not yield attractive alternatives to Farmdale District. Coolbrook claims that collections are more efficiently and effectively performed by water utilities that may terminate water service if the entire bill, including the sewer portion, is not paid.

Coolbrook has provided no studies or factual evidence to support its contention that use of a water supplier is more cost-effective. No agreement between Farmdale District and Coolbrook for the termination of water service presently exists. Moreover, Farmdale District may not discontinue water service for a customer's failure to pay a bill owed for service provided by a sewer utility without Commission approval. Farmdale has not sought such approval from the Commission. Coolbrook has been unable to show that its proposed agency collection expense is reasonable and that it has undertaken all reasonable efforts to develop an alternative. For these reasons, Commission Staff recommends that the Commission deny Coolbrook's proposed

[14] *Id.* The Commission has expressed similar concerns regarding the billing performed for Coolbrook's predecessors. *See* 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. 98-284, *The Application of 4-Way Enterprises, Inc., Coolbrook Sanitation Division For a Rate Adjustment Pursuant to the Alternative Rate Filing Procedure For Small Utilities* (Ky. PSC Mar. 25, 1999).

adjustment and increase the agency collection by $71 to reflect the level agreed to in the previous rate case.

G. Insurance Expense. Coolbrook proposed to increase its test-period insurance expense by $4,878 to a pro forma level of $5,778. This adjustment is supported by an invoice from Voit-Lee Insurance, Inc. Upon review of the supporting invoice, Commission Staff recommends that the Commission accept Coolbrook's proposed adjustment.

H. Rate Case Expense. Coolbrook reduced operating expenses by $1,968 to eliminate rate case expenditures that it has proposed to recover by amortizing the cost over three years. Commission Staff is of the opinion that Coolbrook is correct and recommends the Commission accept the proposed adjustment. The amortization of rate case amortization is discussed in Adjustment K, Amortization Expense.

I. Rent. Coolbrook proposes to increase its test period operating expenses by $1,200 to reflect its share of the office rent. Coolbrook currently shares an office with the other businesses owned by Mr. Smither in Crestwood, Kentucky. The $100 per month represents Coolbrook's allocation of the costs associated with the office, which include: a landline telephone; an internet connection; a computer; a fax machine; a printer; a copy machine; and filing cabinets. In reviewing the benefits received by Coolbrook in sharing the office with affiliated companies, Commission Staff believes that the fee is reasonable and that the Commission should accept Coolbrook's proposed adjustment.

J. Depreciation Expense. Coolbrook proposes to decrease its test-year depreciation expense of $6,957 by $3,105 to reflect the amount of depreciation included in the Stipulation Agreement in the previous rate case. Commission Staff finds Coolbrook's adjustment to be correct and recommends the Commission accept it as proposed.

K. Amortization Expense. Coolbrook proposes to increase operating expenses by $4,312. Approximately $1,232 of this amount purportedly reflects the amortization of rate case expenses incurred in Case No. 2010-00314. The remaining $3,090 reflects the amortization of estimated rate case expenses incurred in the current proceeding.

It is a well-settled principle of utility law that rate case expenses must be included in the costs of operation in the computation of a fair return. Coolbrook has presented no evidence to demonstrate that the rates agreed to and approved in Case No. 2010-00314 failed to include rate case expense. In Case No. 2010-0036,[15] the Commission made the following finding:

> As the settlement agreement in each proceeding is silent on this issue, we cannot assume that parties agreed to the amortization of rate case expense any more than we can assume that parties did not establish rates providing for the immediate expensing of the full rate case expense. Accordingly, we find that the AG's proposed adjustment should be accepted. Any utility that enters a settlement agreement in a rate case proceeding and wishes to amortize the rate case expense incurred in that proceeding should ensure that the settlement agreement specifically addresses the issue of rate case expenses <u>or</u> request the creation of a regulatory asset for its rate case expenses for accounting purposes.

---

[15] Case No. 2010-00036, *Application of Kentucky-American Water Company For An Adjustment of Rates Supported By a Fully Forecasted Test Year* at 46 (Ky. PSC Dec. 14, 2010).

Accordingly, Commission Staff recommends that the Commission deny Coolbrook's adjustment to include the amortization of rate case expense for Case No. 2010-00314.

Coolbrook's rate case cost is comprised of accounting fees of $2,400, postage and customer notice expenses of $270, and anticipated legal fees of $6,600. Upon review of the supporting invoices, Commission Staff finds that the fees are reasonable with the exception of the estimated legal fees which are not known or measurable. Commission Staff calculates a rate case amortization expense of $890 based upon amortizing the allowable costs of $2,670 over three years. Accordingly, Commission Staff recommends that the Commission deny Coolbrook's proposed adjustment, and instead increase operating expenses by $890.

ATTACHMENT B
STAFF REPORT, 2011-00433
COMMISSION STAFF
RECOMMENDED RATE

	RATE	
Monthly Flat Rate		$ 32.04

Honorable Robert C Moore
Attorney At Law
Hazelrigg & Cox, LLP
415 West Main Street
P.O. Box 676
Frankfort, KENTUCKY 40602

Lawrence Smither
Coolbrook Utilities, LLC
P. O. Box 91588
Louisville, KY 40291

Honorable David Edward Spenard
Assistant Attorney General
Office of the Attorney General Utility & Rate
1024 Capital Center Drive
Suite 200
Frankfort, KENTUCKY 40601-8204