COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ALTERNATIVE RATE FILING OF EASTERN ROCKCASTLE WATER ASSOCIATION, INC.	)))	CASE NO. 2014-00385

NOTICE OF FILING OF COMMISSION STAFF REPORT

Notice is hereby given that, in accordance with the Commission's Order of December 9, 2014, the attached report containing the findings of Commission Staff regarding the Applicant's proposed rate adjustment has been filed in the record of the above-styled proceeding. Pursuant to paragraphs 2 and 4 of the Commission's December 9, 2014 Order, all parties are required to file written comments regarding the findings of Commission Staff no later than March 11, 2015.

Aaron D. Greenwell for

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

DATED FEB 25 2015

cc: Parties of Record

STAFF REPORT

ON

EASTERN ROCKCASTLE WATER ASSOCIATION, INC.

CASE NO. 2014-00385

Eastern Rockcastle Water Association, Inc. ("ERWA") provides water service to approximately 604 customers residing in Rockcastle and Jackson counties, Kentucky.[1] On November 3, 2014, ERWA tendered an application to the Commission pursuant to 807 KAR 5:076 requesting to adjust its water service rates. After correction of a deficiency, the application was deemed filed on November 20, 2014. ERWA also requested to revise its non-recurring charge for meter reading in a separate application filed through the Commission's tariff filing system on October 1, 2014. Pursuant to an Order issued on November 25, 2014, ERWA's application to revise its meter reading charge was suspended and considered a part of ERWA's application to increase its water service rates.

The requested water service rates would increase the monthly cost of 5,000 gallons of water purchased through a 5/8-inch x 3/4-inch meter from $52.95 to $67.06, an increase of $14.11, or 26.64 percent. ERWA's requested rates would increase its annual revenues by $77,402, or 28.25 percent. ERWA provided financial exhibits with its application in support of the requested increase that were based on the test year ended December 31, 2013. These exhibits are shown below in condensed form.

[1] *Annual Report of Eastern Rockcastle Water Association, Inc. to the Public Service Commission for the Calendar Year Ended December 31, 2013 ("2013 Annual Report")* at 12 and 53; Application at 37 and 59.

Overall Revenue Requirement and Required Revenue Increase

Pro Forma Operating Expenses	$ 304,538
Plus: Average Annual Principal	
and Interest Payments on Current Debts	53,124
Additional Working Capital	5,520
Overall Revenue Requirement	363,182
Less: Other Operating Revenue	
Interest Income	(1,030)
Non-Operating Revenue	
Revenue Required From Rates	362,152
Less: Pro Forma Present Rate Service Revenues	(278,738)
Required Revenue Increase	$ 83,414
Pecent Increase	29.93%

In its application, ERWA proposed to increase its Meter Reading Charge from the current rate of $5 to $35, an increase of $30, or 600 percent. ERWA provided a cost justification sheet for the requested increase.

Staff performed a limited financial review of ERWA's operations for the test year ended December 31, 2013, to determine the reasonableness of the requested water service rates and non-recurring charge. The scope of Staff's review was limited to determining whether operations reported for the test year were representative of normal operations. Known and measurable changes to test-year operations were identified and adjustments were made when their effects were deemed to be material. Insignificant or immaterial discrepancies were not pursued and were not addressed.

Staff's findings are summarized in this report. Ariel Turnbull reviewed the calculation of ERWA's Overall Revenue Requirement. Jason Green reviewed revenues and rate design.

Summary of Findings

1. Overall Revenue Requirement and Required Revenue Increase. By applying the Debt Service Coverage ("DSC") Method, as generally accepted by the Commission, Staff found ERWA's Overall Revenue Requirement to be $347,742 and that a revenue increase of $51,288, or 18.72 percent, above pro forma present rate revenues is necessary to generate the Overall Revenue Requirement.

2. Water Service Rates. The rates set forth in Attachment A to this report will produce revenues sufficient to recover the revenue requirement determined by Staff as set out in this report, resulting in an approximate 18.72 percent increase to ERWA's current rates. Staff increased ERWA's current general water sales rates across the board by the percentage of increase in the Staff-determined revenue requirement. The Commission has previously found that such allocation is an appropriate and equitable method to increase rates.

3. Non-Recurring Charges. In its application, ERWA proposed to increase its Meter Reading Charge from the current rate of $5 to $35, an increase of $30, or 600 percent. ERWA provided a cost justification sheet setting out the associated expenses incurred to provide the service in support of the requested increase. ERWA issues monthly bills to all customers based on their monthly metered usage. ERWA is transitioning to radio-read meters. At this time, approximately two-thirds of ERWA's customers have radio-read meters, which ERWA can remotely read. To reduce operating expenses, ERWA requires customers that do not have radio-read meters to read their own meters each month and report the usage. As part of its standard

operating procedure, and as allowed by 807 KAR 5:006, Section 7(5)(b), ERWA annually reads the meters of customers who read their own meters.

The proposed increased charge is made when a customer who should read his or her meter fails to report a reading to ERWA for two consecutive months, after which an ERWA employee reads the meter. The Meter Reading Charge is designed to recover the cost of this non-routine meter reading.

ERWA's tariff on file with the Commission includes the Meter Reading Charge at the current rate. The tariff does not state that certain customers are required to read their own water meter. Staff finds that ERWA should request to amend its tariff to indicate which customers are required to read their own water meter and the criteria used to determine this requirement.

4. Depreciation. At Attachment B of this report, Staff finds that the depreciable lives assigned to certain water assets should be changed for ratemaking purposes and that these lives should be used for accounting purposes in all future reporting periods. These recommended depreciable lives better match the life expectancy of ERWA's assets for the Water Division and will better match expenses to revenues. Staff further finds that no adjustment to accumulated depreciation and retained earnings should be made to account for the retroactive effect of this recommended change in accounting estimate.

Pro Forma Operating Statement

The known and measurable adjustments found appropriate by Staff are detailed in the Pro Forma Operating Statement shown below.

	Test Year	Adjustment	(Ref.)	Pro Forma
Operating Revenues				
Sales of Water	$276,628	$ 4,484	(A)	
		(15,621)	(B)	
		8,487	(C)	$273,978
Other Water Revenue		15,621	(B)	
		4,350	(D)	19,971
Total Operating Revenues	276,628	17,321		293,949
Operating Expenses				
Operation and Maintenance Expenses				
Salaries and Wages - Employees	58,164	(8,259)	(E)	49,905
Salaries and Wages - Commissioners	2,845			2,845
Employee Pensions and Benefits	11,571	3,717	(F)	15,288
Purchased Water	96,136	(13,651)	(G)	82,485
Purchased Power for Pumping	10,049	(1,427)	(G)	8,622
Materials and Supplies	11,648			11,648
Contractual Services	12,048			12,048
Transportation Expenses	12,049			12,049
Insurance	7,866			7,866
Bad Debt Expense		2,055	(H)	2,055
Miscellaneous Expense	19,322	4,484	(A)	
		(6,337)	(I)	17,469
Total Operation and Maintenance Expenses	241,698	(19,418)		222,280
Taxes Other Than Income	5,218	(1,400)	(J)	3,818
Depreciation	86,459	(28,540)	(K)	57,919
Total Operating Expenses	333,375	(49,358)		284,017
Net Operating Income	(56,747)	66,679		9,932
Interest Income	1,030			1,030
Revenues From Merchandising, Jobbing and Contract Work	1,475			1,475
Income Available to Service Debt	$ (54,242)	$ 66,679		$ 12,437

(A) Sales of Water. When reconciling ERWA's general ledger account balances to the amounts reported in its 2013 Annual Report, Staff found that the amounts reported for test-year Sales of Water and Miscellaneous Expenses are understated by $4,484. Staff increased Miscellaneous Expenses and Sales of Water by $4,484 to correct this reporting error.

(B) Other Operating Revenue. In its Annual Report, ERWA reported $276,628 in Water Sales Revenue. Staff determined that $15,621 of this amount was revenue that was realized from non-recurring charges. ERWA improperly reported this revenue with Sales of Water in its 2013 Annual Report. The Uniform System of Accounts ("USoA") requires that this revenue be reported as Other Water Revenue.[2] Staff reclassified $15,621 from Sales of Water to Other Water Revenue as required by the USoA.

(C) Billing Analysis Adjustment. ERWA's test-year revenues from water sales was stated at $276,628 in its 2013 Annual Report.[3] ERWA included in this level of revenues collections of customer payments, collections from meter tap on fees and other miscellaneous revenues. ERWA also included in its application a billing analysis which was based on actual customer water usage and derived from ERWA's electronic billing software. Staff has reviewed ERWA's billing analysis and finds that the billing analysis provided in the application is a more accurate representation of normalized test-year revenue from water sales than the amount used by EWRA. Staff increased reported test-year water sales by $8,487 to determine normalized test-year revenues from water sales.

(D) Nonrecurring Charges – Meter Reading Charge. As previously discussed in this report, Staff found that ERWA's request to increase its meter read fee should be

[2] USoA for Class A/B Water Districts and Associations, at 92-93.

[3] Test-year revenues were inappropriately stated at $278,738 in ERWA's Application at ARF Form 1, Attachment RR-DC.

approved. Staff determined that the increase in fees will increase test-year revenues by $4,350.[4] Staff increased test-year revenues by this amount.

(E) Salaries and Wages. During the test year, ERWA employed an office manager and operator for whom it reported Salaries and Wages – Employee expense $58,164. As calculated and explained below, Staff found that this amount should be decreased by $8,259 to account for changes to the test-year wage rates paid to these two positions.

The office manager was hired on November 1, 2012. On February 1, 2013, her wage rate increased from $9 per hour to $10 per hour upon completion of a 90-day probationary period. Staff calculated the office manager's pro forma wages by applying the new wage rate to the hours worked by the office manager during the test year.

Additionally, on June 1, 2014, ERWA replaced the operator who was employed during the test year. The new operator is expected to work the same hours annually as the former operator; however, his wage rate of $14 per hour is less than that of the former operator. To account for this wage rate reduction in pro forma operations, Staff applied the new operator's wage rate to the test-year hours worked by the former operator.

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Test Year Revenue	$ 725
Times: Percentage Increase to Fee	600%
Increase in Revenue	$ 4,350

The calculation of Staff's adjustment to test-year wages is shown below:

	Current Pay Rate	Regular Hours	Overtime Hours (x1.5)	Pro Forma
Office Manager	$ 10.00	2,005	80.80	$ 21,262
Operator	14.00	1,970	50.63	28,643
Pro Forma Wages				49,905
Less: Test Year				(58,164)
Adjustment				$ (8,259)

(F) Employee Pensions and Benefits. During the test year, ERWA paid health insurance benefits for its two employees in the amount of $11,571. Subsequent to the test year, ERWA's health insurance premiums increased. Staff calculated pro forma health insurance expense to be $15,288 using the 2014 premiums. Staff increased test-year Employee Pensions and Benefits by $3,717 as shown below:

2014 Health Insurance Premiums	$ 1,274
Times: 12 months	12
Pro Forma Health Insurance Premiums	15,288
Less: Test Year Health Insurance	(11,571)
Adjustment	$ 3,717

(G) Water Loss. Using information provided by ERWA, Staff determined that ERWA's test-year water loss was 29.20 percent[5], or 14.20 percent above the 15 percent allowed for ratemaking purposes by 807 KAR 5:066, Section 6(3). As calculated below, Staff removed the costs to purchase and pump water loss that was above the allowable limit.

	Test Year	Times: Excess Water Loss Percentage	Decrease
Purchased Water	$ 96,136	-14.20%	$ (13,651)
Purchased Power	10,049	-14.20%	(1,427)

(H) Bad Debt Expense. Although ERWA did not report bad debt expense for the test year in its 2013 annual report on file with the Commission, it requested rate recovery in its application of the $26,193 reported for bad debt expense in its 2013 audit report. A portion of this amount represents the write-off accounts receivable that were earned and reported as revenue in accounting periods prior to the test year. These uncollectible accounts should not have been expensed during the test year. To properly match revenues and expenses, they should have been expensed in the same years in which the revenues were earned and the accounts receivable were reported. The

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Water Purchased		31,148,106
Less:	Water Sold	(21,052,200)
	Water Used for Flushing	(1,000,000)
Water Loss		9,095,906
Water Loss Percentage		29.20%

amount of bad debt expense attributable to test-year revenues could not be determined. Generally, Staff has found that a utility with effective customer deposit and collection policies will realize bad debts that range from .5 percent to 1 percent of retail sales to residential and small commercial customers.[6] Staff increased test-year expenses by $2,055[7] to restate bad debt expense at .75 percent of test-year revenue from water sales.

(I) Miscellaneous Expenses Capitalized. Staff removed $6,337 from miscellaneous expenses that was reported for the cost to replace lines and a new pump. Depreciation on these capital expenditures was included in Staff's calculation of pro forma depreciation expense.

(J) Taxes Other Than Income – Payroll Taxes. Below, Staff calculated ERWA's pro forma payroll taxes by multiplying the total taxable wages by the payroll tax rate. Staff decreased payroll tax expense by $1,400.

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[6] Case No. 2012-00433, *Application of West Carroll District for an Adjustment in Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC Jan. 29, 2013).

[7]

Pro Forma Present Rate Revenues	$	273,978
Times: .5 percent allowance		0.75%
Pro Forma Adjustment	$	2,055

	Pro Forma
Total Wages Subject to Payroll Taxes	$ 49,905
Times: Tax Rate	7.65%
Payroll Tax Expense	3,818
Less: Test Year	(5,218)
Adjustment	$ (1,400)

(K) Depreciation. Although ERWA reported $86,459 for test-year depreciation expense in its 2013 annual report on file with the Commission, it did not request rate recovery of this amount in its application. As explained below, Staff determined that ERWA's 2013 depreciation expense as reported in its 2013 annual report should be reduced by $28,540 to account for the changes proposed by Staff to the useful lives assigned by ERWA to certain asset account groups. Staff included the adjusted amount, $57,919, in ERWA's pro forma operations to allow for recovery through rates of an allowance for working capital that may be used to fund system renewals and replacements.[8]

In its 2013 Annual Report, ERWA calculated test-year depreciation expense by dividing the plant's original cost by its estimated useful life. A summary of Staff's review

[8] The Kentucky Supreme Court has held that the Commission must permit a water district to recover its depreciation expense through its rates for service to provide internal funds to be used for renewing and replacing assets. *See Public Serv. Comm'n of Kentucky v. Dewitt Water Dist.*, 720 S.W.2d 725, 728 (Ky.1986). Although a water district's lenders require that a small portion of the depreciation funds be deposited annually into a debt reserve/depreciation fund until the account's balance accumulates to a required threshold, neither the Commission nor the Court requires that revenues collected for depreciation be accounted for separately from the water district's general funds or that depreciation funds be used only for asset renewal and replacement. The Commission has recognized that the working capital provided through recovery of depreciation expense may be used for purposes other than renewal and replacement of assets. *See* Case No. 2012-00309, *Application of Southern Water and Sewer District for an Adjustment in Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC Dec. 21, 2012).

of the estimated useful lives is found at Attachment B of this report. To account for the effects of the changes to the lives recommended in Attachment B, and to account for the lines and new pump capitalized by Staff, Staff decreased depreciation by $28,540 as shown below.

Asset	Original Cost	Staff Useful Life	Pro Forma
Services	$ 63,963	40	$ 1,599
Transmission and Distribution Mains	3,312,286	62.5	52,997
New Line	3,798	62.5	61
New Pump	2,539	20	127
Pro Forma			54,783
Less: Test-Year Depreciation on Assets Listed in the Adjustment			(83,323)
Decrease			$ (28,540)

Overall Revenue Requirement and Required Revenue Increase

Staff applied the DSC method as generally accepted by the Commission to calculate ERWA's Overall Revenue Requirement for the Water Division. This method allows for recovery of: 1) cash-related pro forma operating expenses; 2) recovery of depreciation expense, a non-cash item, to provide working capital; 3) the average annual principal and interest payments on all long-term debts, and 4) working capital that is in addition to depreciation expense.

A comparison of ERWA's and Staff's calculation of their Overall Revenue Requirement and Required Revenue Increase for the Water Division is shown below:

	Eastern Rockcastle	Staff
Pro Forma Operating Expenses	$ 304,538	$ 284,017
Plus: Average Annual Principal		
and Interest Payments on Current Debts	53,124	53,104
Additional Working Capital	5,520	10,621
Overall Revenue Requirement	363,182	347,742
Less: Other Operating Revenue		(19,971)
Interest Income	(1,030)	(1,030)
Non-Operating Revenue		(1,475)
Revenue Required From Rates	362,152	325,266
Less: Pro Forma Present Rate Service Revenues	(278,738)	(273,978)
Required Revenue Increase	$ 83,414	$ 51,288
Pecent Increase	29.93%	18.72%

1. Average Principal and Interest Payments. ERWA currently has outstanding bonds payable to the United States Department of Agriculture Rural Development ("RD"). In its Application, ERWA requested recovery of the principal and interest payments due in 2013 on all bonds that were used to finance the cost of water system improvement projects. Staff applied the three-year average of the bond principal and interest payments in the calculation of ERWA's Overall Revenue

Requirement. Staff calculated the average to be $53,104 using the annual payments that will begin on January 1, 2015.[9]

2. Additional Working Capital. The DSC method, as historically applied by the Commission, includes an allowance for additional working capital that is equal to the minimum net revenues required by ERWA's lenders that are above its average annual debt payments. In addition to depreciation expense, ERWA requested recovery of an allowance for working capital that is equal to 10 percent of its average annual RD bond payments. Historically, the Commission allows a water district recovery of additional working capital that is equal to the minimum net revenues required by the district's lenders that are above the district's average annual debt payments. In this case, RD requires that ERWA charge rates that produce net revenues that are at least 120 percent of its average annual bond payments. Following the Commission's historic practice, Staff calculated ERWA's allowance for additional working capital to be

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Year	Annual Debt Payment
2015	$ 53,117
2016	53,074
2017	53,120
Total	159,311
Divide by: 3 years	3
Average Annual Principal and Interest Payment	$ 53,104

$10,621, as shown below.[10] Staff included this amount in the calculation of ERWA's Overall Revenue Requirement.

Average Annual Principal and Interest	$ 53,104
Times: DSC Coverage Ratio	120%
Total Net Revenues Required	63,724
Less: Average Annual Principal and Interest Payments	(53,104)
Additional Working Capital	$ 10,621

Signatures

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[10] Inclusion of the additional working capital in ERWA's revenue requirement is not necessary for it to earn revenues that meet the minimum DSC ratio required by its lenders. As depreciation is a noncash item, it is excluded from the ratio calculation, which is actually a measure of cash flow. As shown below, ERWA's minimum DSC ratio is met with or without the inclusion of additional working capital.

	With Additional Working Capital	Without Additional Working Capital
Overall Revenue Requirement	$ 347,742	$ 337,121
Less: Operating and Maintenance Expense	(222,280)	(222,280)
Taxes Other Than Income	(3,818)	(3,818)
Net Revenues	121,644	111,023
Divided by: Average Annual Debt Payments	53,104	53,104
DSC Ratio	229%	209%

ATTACHMENT A
STAFF REPORT, CASE NO. 2014-00385
EASTERN ROCKCASTLE WATER ASSOCIATION
RATES CALCULATED BY STAFF

Monthly Water Rates

3/4-Inch Meters	
First 2,000 Gallons	$ 28.28 Minimum Bill
Over 2,000 Gallons	11.53 Per 1,000 Gallons
1-Inch Meters	
First 5,000 Gallons	$ 62.87 Minimum Bill
Over 5,000 Gallons	11.53 Per 1,000 Gallons
2-Inch Meters	
First 15,000 Gallons	$178.17 Minimum Bill
Over 15,000 Gallons	11.53 Per 1,000 Gallons
Leak Adjustment Rate	
Customers Average Monthly Bill Plus	$ 3.86 Per 1,000 Gallons
Meter Read Fee	$ 35.00

ATTACHMENT B
STAFF REPORT, CASE NO. 2014-00385
EASTERN ROCKCASTLE WATER ASSOCIATION
ENGINEERING DIVISION'S
ANALYSIS OF ASSET SERVICE LIVES

Historically, the Commission has relied on the National Association of Regulatory Utility Commissioners Study of Depreciation Practices for Small Water Utilities ("NARUC Study"), dated August 15, 1979, to evaluate the reasonableness of a utility's depreciation practices. This study outlines expected service life ranges for various asset groups designed, installed, and maintained in accordance with good water works practices. Typically, an adjustment is made when the Commission finds that a utility is proposing to use a service life that falls outside of this range, while service lives falling within these ranges are generally accepted.

In the following table, Engineering staff has identified the account classifications for which the utility's current service lives are not consistent with the service lives contained in the NARUC Study. The table shows the utility's current and Engineering staff's recommended reasonable and appropriate service lives based on a review of information contained in the record of this case.

Asset Classification	**Current**	**Staff Recommended**	**NARUC Study**
2013 New Service, 99 New Service, New Services, New Lines & Services, 02 & 03 New Services, 2011 & 2012 New Services/Services	15, 25, 39	40	30-50
Water Lines & Meters, 96 & 97 Additions, 99 & 2000 Line Extension, 05 Water Improvements, Hwy 1152 Line Relocation and 09 Line Extension/Transmission and Distribution Mains	25, 39, 50	62.5	50-75

Absent any specific and verifiable evidence supporting alternative service lives, Engineering Staff finds that service lives based on the NARUC Study, as shown in the above table, should be considered reasonable and appropriate.

Prepared January 13, 2015

George W. Wakim

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