

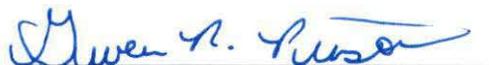
COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF HERRINGTON HAVEN ) CASE NO.  
WASTEWATER COMPANY, INC. FOR AN ) 2017-00311  
ALTERNATIVE RATE ADJUSTMENT )

NOTICE OF FILING OF COMMISSION STAFF REPORT

Notice is hereby given that, in accordance with the Commission's Order of October 5, 2017, 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 the Commission's October 5, 2017 Order, Herrington Haven Wastewater Company, Inc. is required to file written comments regarding the findings of Commission Staff no later than 21 days from the date of this report.



Gwen R. Pinson  
Executive Director  
Public Service Commission  
P.O. Box 615  
Frankfort, KY 40602

DATED DEC 19 2017

cc: Parties of Record

STAFF REPORT  
ON  
HERRINGTON HAVEN WASTEWATER COMPANY, INC.

CASE NO. 2017-00311

Herrington Haven Wastewater Company, Inc. (“Herrington Haven”) provides wastewater service to approximately 20 customers<sup>1</sup> residing in the Woodlawn Estates Subdivision in Garrard County, Kentucky.<sup>2</sup> On July 24, 2017, Herrington Haven tendered an application (“Application”) for an adjustment of its rates. By letter dated July 31, 2017, the Commission notified Herrington Haven that the Application was rejected as deficient. On August 18, 2017, Herrington Haven filed its response to the filing deficiencies. On August 29, 2017, Herrington Haven was notified that the Application remained deficient. On September 11, 2017, Herrington Haven filed further responses to the filing deficiencies, and its Application was deemed filed on September 11, 2017. To ensure the orderly review of the Application, the Commission established a procedural schedule by Order dated October 10, 2017. In its Application, Herrington Haven proposes an adjustment to its flat monthly wastewater service rate pursuant to 807 KAR 5:076.

Herrington Haven based its Application on the test-year operations ended December 31, 2016. Using operations reported for the test year, Herrington Haven determined that a revenue increase of \$3,141, or 36.88 percent, is warranted.<sup>3</sup> The

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<sup>1</sup> Application at 3.

<sup>2</sup> *Annual Report of Herrington Haven Wastewater Company, Inc. to the Kentucky Public Service Commission for the Calendar Year Ended December 31, 2016* (“2016 Annual Report”) at 9.

<sup>3</sup> Application, ARF FORM 1 – ATTACHMENT BA-FR – SEPTEMBER 2011, Billing Analysis – Flat Rates at 1.

proposed rate would increase a monthly bill from \$35.49 to \$48.58, an increase of \$13.09, or 36.88 percent.

To determine the reasonableness of the rates requested by Herrington Haven, Commission Staff (“Staff”) performed a limited financial review of Herrington Haven’s test-year operations. The scope of the 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 material. Insignificant or immaterial discrepancies were not necessarily pursued or addressed.

Staff’s findings are summarized in this report. David Foster reviewed the calculation of revenue requirements. Sam Reid reviewed the billing analysis, reported revenues, and the method used to calculate the proposed rates.

#### Summary of Findings

Based on its review, Staff determined that Herrington Haven’s adjusted test-year operations support a monthly flat rate of \$49.66, an increase of \$14.17, or 39.92 percent, from its current rate of \$35.49. Staff’s calculations are shown and discussed in the remaining sections of this report.

#### Pro Forma Operating Statement

The Pro Forma Operating Statement for the test year ended December 31, 2016, as determined by Staff, appears below.

	Test Period Operations	Pro Forma Adjustments	Ref.	Pro Forma Operations
Operating Revenues:				
Sewer Sales Revenue	\$ 8,624	\$ (106)	(A)	\$ 8,518
Operating Expenses:				
Operation & Maintenance Expenses:				
Owner/Manager Fee	3,600			3,600
Collection System		1,200	(B)	1,200
Treatment System - Sludge Hauling	1,050			1,050
Other Labor, Materials and Expenses	1,200			1,200
Chemicals	340	-	(C)	340
Purchased Power	1,078	15	(D)	1,093
Uncollectible Accounts	425			425
Office Supplies	898			898
Miscellaneous Supplies		-	(C)	0
Total Operation & Maintenance Exp.	8,591	1,215		9,806
Depreciation	595			595
Taxes Other Than Income Taxes	87			87
Income Tax Expense	175			175
Total Operating Expenses	9,448	1,215		10,663
Net Operating Income	\$ (824)	\$ (1,321)		\$ (2,145)

(A) Sewer Service Revenue. In its Application, Herrington Haven proposed to increase test-year revenues of \$8,517 by \$2,286 to state pro forma present rate revenues at \$10,803.<sup>4</sup> Test year revenues should be stated from the annual report for the immediate past year on file with the Commission and should be \$8,624.<sup>5</sup> Herrington Haven did not provide an explanation or show the calculations to support the Application's test year revenues and the proposed adjustment.

<sup>4</sup> Application, ARF FORM-1 ATTACHMENT SAO-S SEPTEMBER 2011, Schedule of Adjusted Operations-Sewer Utility at 1.

<sup>5</sup> 2016 Annual Report at 25.

Herrington Haven has 20 residential customers.<sup>6</sup> Annualizing the monthly billings for 20 residential customers, Staff determined test-year normalized revenues to be \$8,518,<sup>7</sup> which is \$106 less than the \$8,624 revenues reported in Herrington Haven's 2016 Annual Report.

(B) Owner/Manager Fee – Certified Operator Fee. Herrington Haven is owned and operated by Melvin Price. During the test year, Herrington Haven reported an owner/manager fee expense of \$3,600.<sup>8</sup> Herrington Haven proposed to increase the test-year owner/manager fee expense by \$1,200 in order to provide additional compensation for Mr. Price for having maintained his certified operator license.

The Commission has historically allowed small, investor-owned sewer utilities, such as Herrington Haven, recovery of a \$3,600 owner/manager fee to be paid to the utility's owner for serving as its chief executive officer. In the cases of very small utilities, the fee is also considered compensation for providing additional services.<sup>9</sup> Additionally, pursuant to 401 KAR 5:010, Section 1, Herrington Haven is required to

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<sup>6</sup> *Id.*, ARF FORM 1 ATTACHMENT BA-FA-SEPTEMBER 2011, Billing Analysis – Flat Rates at 1.

<sup>7</sup>  $(20 \times 12) \times \$35.49 = \$8,518$

<sup>8</sup> 2016 Annual Report, p. 27.

<sup>9</sup> In Case No. 2007-00397, *Application of Woodland Estates Sewage System for an Adjustment of Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC. Dec. 27, 2007), the Commission found that the \$3,600 owner/manager fee awarded to Woodland Estates Sewage System, which served 24 customers at the time its rate application was filed, was appropriate compensation for the owner serving as the utility's executive officer and for the owner's contribution to the utility of office space, office supplies, telephone service, billing and collection services, and bookkeeping services. In Case No. 2005-00036, *Application of Lewis Sanitation Company, Inc., D/B/A Garden Heights Sewer Division for an Adjustment of Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC Apr. 14, 2005), the Commission found that the \$3,600 owner/manager fee was appropriate compensation for only the owner's executive oversight of the utilities operations. In addition to the owner/manager fee, the Commission allowed rate recovery for expenses that were incurred by the utility for bookkeeping services, office rent, office supplies, office utilities, and reimbursement to the owner for transportation expenses. Lewis Sanitation Company, Inc. served 108 customers at the time its rate application was filed.

retain an operator that is certified by the Kentucky Division of Water. As stated previously, Mr. Price acts as Herrington Haven's licensed operator. The \$1,200 proposed adjustment is consistent with the level of the contract operator fees approved by the Commission for other small sewer systems and is, therefore, reasonable. Finding that the new fee is reasonable, Staff removed the \$1,200 adjustment Herrington Haven included in the Owner/Manager Fee and reclassified this amount to the Collection System account to comply with the accounting requirements of the Uniform System of Accounts ("USoA").<sup>10</sup>

(C) Chemicals and Miscellaneous Expenses. Herrington Haven proposed to increase its test-year Chemicals expense by \$1,288 to reflect the additional cost for the purchase of chemicals intended for future use.<sup>11</sup> Additionally, Herrington Haven proposed increasing Miscellaneous Supplies expense by \$149, which, during Staff's review, Herrington Haven stated was an estimated amount.<sup>12</sup>

807 KAR 5:001, Section 16(1), provides that all applications for a general rate adjustment shall be supported by either a "twelve (12) month historical test period that may include adjustments for known and measurable changes" or a "fully forecasted test period." When an applicant bases its application upon a historical test period, it must provide a "complete description and quantified explanation for all proposed adjustments with *proper support for any proposed changes* in price or activity levels, if applicable,

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<sup>10</sup> USoA for Class C and D Sewer Utilities at 115.

<sup>11</sup> September 11, 2017 Response to Deficiencies, ARF FORM 1 ATTACHMENT OME-1 SEPTEMBER 2011, Sewer Operations and Maintenance Expenses, References, Item 2.

<sup>12</sup> *Id.*, Item 3.

and other factors that may affect the adjustment,"<sup>13</sup> or a statement explaining why the required information does not exist and is not applicable. That support should include, at a minimum, documentary evidence to demonstrate the certainty of some expected change or event.<sup>14</sup>

Further, in a prior decision the Commission made the following finding regarding budgetary adjustments in a historical rate case:

While such projections may be acceptable when an applicant bases its application upon a forecasted test period, they are not when the basis for the proposed rate adjustment is a historical test period. Assuming arguendo that the projections were permissible support for Hardin District's application, the utility's failure to produce the calculations and assumptions used to develop these projections makes it impossible for the Commission to assess the validity and reasonableness of such projections.<sup>15</sup>

The proposed adjustments to chemicals and miscellaneous supplies do not comply with 807 KAR 5:001, Section 16(1). Herrington Haven has not provided the minimum evidence required by the Commission to demonstrate with certainty that the chemicals will be purchased or that the miscellaneous supplies expense estimate is accurate. The actual price that Herrington Haven will pay for chemicals is unknown. Further, Herrington Haven has not presented evidence that would persuade Staff that the pro forma adjustments based on financial estimates in a historical test period should be allowed.

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<sup>13</sup> 807 KAR 5:001, Section 16(4) (emphasis added).

<sup>14</sup> See Case No. 2001-00211, *The Application of Hardin County Water District No. 1 for (1) Issuance of Certificate of Public Convenience and Necessity; (2) Authorization to Borrow Funds and to Issue its Evidence of Indebtedness Therefor (3) Authority to Adjust Rates; and (4) Approval to Revise and Adjust Tariff* (Ky. PSC Mar. 1, 2002) at 7.

<sup>15</sup> *Id.* at 8.

For these reasons, Staff finds that Herrington Haven’s proposed budgetary adjustments to reflect the \$1,288 annual cost of chemicals and the \$149 estimate for miscellaneous supplies expense should be denied.

(D) Purchased Power. In its Annual Report, Herrington Haven reported \$1,078 for purchased power. During Staff’s review, it was discovered that Herrington Haven actually incurred \$1,093 for purchased power expense. Accordingly, Staff increased purchased power expense by \$15.

Determination of Allowable Net Operating Income (“NOI”)

Staff calculated Herrington Haven’s allowable NOI using the operating ratio method as historically accepted by the Commission.<sup>16</sup> Pursuant to this method, the allowable NOI is calculated by dividing pro forma operating expenses, less the Income Tax Expense, by 88 percent and subtracting operating expenses from the result. Using this method, Staff calculated Herrington Haven’s allowable NOI to be \$1,430, as shown below.

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<sup>16</sup> An operating ratio measures the difference between operating revenues and operating expenses. It is defined by the following equation.

$$\text{Operating Ratio} = \frac{\text{Operation \& Maintenance Exp. + Depreciation + Taxes}}{\text{Gross Revenues}}$$

The Commission has found that the operating ratio is a reasonable and necessary alternative to the rate-of-return method for calculating the allowable NOI for small sewer investor-owned utilities. Specifically, it has found that the rate-of-return method cannot be used because there is “no basis” upon which to determine a rate of return for these utilities. (See Case No. 95-236, *Application of Thelma Waste Control, Inc. for a Rate Adjustment Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC. Apr. 15, 1996) at 6.) Further, it has found that the operating ratio method is appropriate when plant investment is low and operating expenses are high. (See Case No. 7982, *Notice of Application of Fern Lake Company* (Ky. PSC. Aug. 27, 1981) at 3.)

Operating Expenses	\$ 10,488
Divide by: Operating Ratio	<u>88%</u>
Operating Revenues	11,918
Less: Operating Expenses	<u>(10,488)</u>
Allowable NOI	<u>\$ 1,430</u>

Calculation of Overall Revenue Requirement  
And Required Revenue Increase

To recover all pro forma operating expenses and to generate the allowable NOI, Herrington Haven requires overall revenue of \$11,918. As shown below, a \$3,400 revenue increase, or 39.92 percent, is necessary to produce the overall revenue requirement.

Operating Expenses	\$ 10,488
Allowable NOI	<u>1,430</u>
Revenue Requirement	11,918
Less: Pro Forma Present Rate Revenues	<u>(8,518)</u>
Required Revenue Increase	<u>\$ 3,400</u>
Percentage	<u>39.92%</u>

Rate Calculated by Staff

Herrington Haven's current rate design is a flat monthly rate of \$35.49 per single-family residential customer. Herrington Haven proposes to continue the current rate design and to recover the requested revenue requirement by increasing the amount of the flat monthly rate. Staff agrees with Herrington Haven's rate design. Using Staff's revenue requirement of \$11,918, Staff determines the flat monthly rate to be \$49.66.<sup>17</sup>

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<sup>17</sup> \$11,918 (Revenue Requirement) ÷ 12 (Months) ÷ 20 (Customers) = \$49.66

APPENDIX  
STAFF REPORT, CASE NO. 2017-00311  
HERRINGTON HAVEN WASTEWATER COMPANY, INC.

Monthly Rates

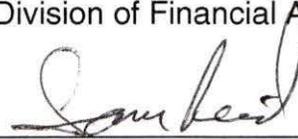
Single Family Residential – Residential Flat Rate	\$49.66
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Signatures



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Prepared by: David P. Foster  
Financial Analyst, Water and Sewer  
Revenue Requirements Branch  
Division of Financial Analysis



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Prepared by: Sam Reid  
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