

COMMONWEALTH OF KENTUCKY  
BEFORE THE UTILITY REGULATORY COMMISSION

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In the Matter of

THE APPLICATION AND PETITION OF THE )  
FARMDALE DEVELOPMENT CORPORATION, INC. )  
FOR AN ORDER AUTHORIZING SAID CORPORA- )  
TION TO REVISE RATES, ISSUED NOTES, ) CASE NO. 7539  
CONSTRUCT AND PERFORM ACCOUNTING )  
PROCEDURES. )

ORDER

Preface

On August 9, 1979, Farmdale Development Corporation, the Applicant, filed with this Commission its duly verified application seeking authority to revise rates, issue notes, construct and perform accounting procedures and established October 1, 1979 as the proposed effective date of the rate revision.

The Commission, in order to determine the reasonableness of the Applicant's proposed rates, ordered their suspension for a five month period beginning on October 1, 1979.

The case was set for hearing at the Commission's offices in Frankfort, Kentucky, September 28, 1979, for direct testimony by the Applicant and was continued on October 15, 1979 and on January 14, 1980 for cross-examination. The Consumer Protection Division of the Attorney General's Office intervened in the matter. Requests for information were made at the hearings. This information has been filed and the entire matter is now considered to be fully submitted for a final determination.

Test Period

For the purpose of determining the reasonableness of the proposed rates, the twelve month period ending May 31, 1979, has been utilized as the "Test-Year." Adjustments, where found significant and reasonable have been made to reflect current operating conditions.

Rate Determination

While the Commission has traditionally considered the original cost of utility plant, the net investment, the capital structure and the cost of reproduction as a going concern, in determining fair,

just, and reasonable rates, its experience in the establishment or adjustment of rates for sewage utilities has indicated that these valuation methods are not always appropriate. Sewage utilities are unique to the extent that the cost of facilities has usually been included in the cost of the individual lot. The owner or operator of the utility is, in many instances, the developer of the real estate and title may have change hands prior to the effective date of Commission jurisdiction (January 1, 1975). Further, the Commission has found that the books, records, and accounts of these operations are, for the most part, incomplete, so as to make impossible the fixing of rates on the above methods of valuation. Therefore, the Commission is of the opinion that the "Operating Ratio"<sup>(1)</sup> method should be utilized for the establishment or adjustment of rates for sewage utilities although it is recognized that there may be instances where this method would not be valid.

Findings in This Matter

The Commission, after consideration of all evidence of record and being advised, is of the opinion and finds:

1. That by Order entered May 30, 1979, in Case Number 7427, the Commission granted a Certificate of Public Convenience and Necessity, authorizing the construction of a treatment plant addition and sewage collection lines.
2. That the Applicant plans to finance the additional plant facilities by borrowing \$150,000 at an interest rate of prime plus two points.
3. That the Applicant's proposed redistribution of balance sheet accounts is acceptable with the exception that Sewage Plant depreciation should be at an annual rate of 5% rather than 10%.
4. That in this instance, the determination of rates and revenues requirements should be based on the operating ratio method.

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(1) Operating ratio is defined as the ratio of expense, including depreciation and taxes to gross revenues.

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

5. That the existing rate of the Farmdale Development Corporation produced revenues of \$16,450 from an average of 168 customers receiving sewage disposal services during the test year. Further, that the addition of \$63 interest income resulted in total revenues of \$16,513. Further, that the District's expenses of \$29,391 for this period resulted in a test year deficit of \$12,878.

6. That the rate as prescribed and set forth in Appendix "A", attached hereto and made a part hereof, should produce gross annual revenues of \$26,333 from 211 customers and is the fair, just, and reasonable rate to be charged for sewage services rendered by Farmdale Development Corporation to customers in its service area.

7. That an operating ratio of approximately .88 will result from the revenues produced and should provide a reasonable return margin<sup>(2)</sup> in this instance.

8. That the rate proposed by the Applicant is unfair, unjust, and unreasonable in that it would produce revenues in excess of those found reasonable herein and should be denied.

9. That while traditionally depreciation on contributed property for rate-making purposes has been allowed, it has not been a matter of great significance in past years. The value of contributed property in currently operating water and sewage utilities, however, is frequently more than the value of investor financed property. Further, it is common practice for a builder or developer to construct water and sewage facilities that add to the value and salability of his subdivision lots and to expense this investment cost in the sale price of these lots or, as an alternative, to donate these facilities to a utility company.

It is also recognized that many residential and commercial developments in metropolitan areas are served by privately-owned sewage systems. Further, that federal guidelines will require the incorporation of these sewage systems into a regional comprehensive sewer district at such time as connecting trunk lines are made available. Further, that to permit the accumulation of a depreciation

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(2) Return margin is the amount remaining for the payment of a return on the investment of the security holders.

reserve on contributed property that is to be abandoned would not, in our our opinion, be in the public interest.

The Commission is, therefore, of the opinion and finds that depreciation on contributed property for water and sewage utilities is not justified and should not be included in rate-making determinations for these utilities. In support of this position and by way of substantiation, we make reference to the cases and decisions listed in Appendix "B", attached hereto and made a part hereof.

10. That the Commission, after consideration of the Applicant's estimated proforma revenues and expenses, concludes that these revenues, expenses and adjustments can be summarized as shown in Appendix "C", attached hereto and made a part hereof. On the basis of the said summary tabulation the Commission further concludes that annual revenues in the amount of \$26,333 are necessary and will permit the Applicant to meet its reasonable expenses for providing sewage collection and disposal services for customers in its service area.

11. That the Applicant has been authorized by Order dated February 28, 1980, subject to refund, to place the requested rate increase into effect for services rendered on and after March 1, 1980. Further, the rate prescribed by this Order is less than the rate proposed by the Applicant and the Applicant should refund to its customers the amount collected in excess of that which would have been collected by the rate authorized by this Order. Further, that said refund should be completed within sixty (60) days of the date of this Order and a report filed by the Applicant to substantiate that said refund has been completed.

#### Orders in This Matter

The Commission, on the basis of the matters hereinbefore set forth, and the evidentiary record in this case:

HEREBY ORDERS that the Farmdale Development Corporation be and is hereby authorized to finance additional treatment plant facilities and sewer lines with a \$150,000 bank loan at an interest rate not to exceed prime plus two points.

IT IS FURTHER ORDERED that the rates set forth in Appendix "A", attached hereto and made a part hereof be and they are hereby fixed as the fair, just, and reasonable rates of the Applicant to become effective for services rendered on and after the date of this Order to customers located in its service area of Franklin County, Kentucky.

IT IS FURTHER ORDERED that the rate set forth in the Applicant's petition be and the same is hereby denied.

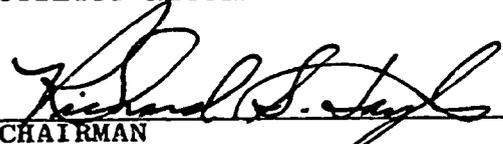
IT IS FURTHER ORDERED that the Applicant's redistribution of balance sheet accounts be and is hereby approved with the exception that Sewage Plant depreciation shall be at an annual rate of five percent (5%) rather than ten percent (10%).

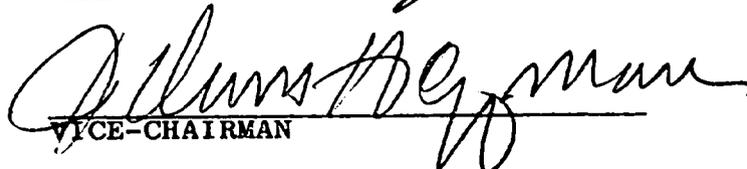
IT IS FURTHER ORDERED that any funds collected by the Applicant in excess of those authorized by this Order shall be refunded within sixty (60) days of the date of this Order and, further, that the Commission shall be notified by the Applicant as to the method and extent of the said refund, within sixty (60) days of the date of this Order.

IT IS FURTHER ORDERED that the Applicant shall file with the Commission, within thirty (30) days of the date of this Order, its revised tariff sheets setting forth the rates approved herein. Further, that a copy of the Applicant's "Rules and Regulations" for providing sewage disposal services to its customers shall be filed with said tariff sheets.

Done at Frankfort, Kentucky, this 19th day of March, 1980.

UTILITY REGULATORY COMMISSION

  
CHAIRMAN

  
VICE-CHAIRMAN

  
COMMISSIONER

ATTEST:

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SECRETARY

APPENDIX "A"

APPENDIX TO AN ORDER OF THE UTILITY REGULATORY  
COMMISSION IN CASE NO. 7539 DATED MARCH 19, 1980

The following rates are prescribed for sewage disposal services rendered by the Farmdale Development Corporation to customers located within its service area.

<u>Type of Service Provided</u>	<u>Monthly Rate</u>
Single-Family Residential	\$10.40 Per Residence
Multi-Family Residential	7.60 Per Apartment

APPENDIX "B"

APPENDIX TO AN ORDER OF THE UTILITY REGULATORY  
COMMISSION IN CASE NO. 7539 DATED MARCH 19, 1980

A listing of cases and decisions that substantiate finding  
number 8.

- (1) 28 U.S.C. s362 (c) (1976).

Dealing with the Basis to Corporations in Reorgani-  
zation. It states in part that property contributed  
by nonstockholders to a corporation has a zero basis.

- (2) Easter v. C.I.R., 338 F.2d 968 (4th Cir. 1964).

Taxpayers are not allowed to recoup, by means of de-  
preciation deductions, an investment in depreciable  
assets made by a stranger.

- (3) Martigney Creek Sewer Co., (Mo. Pub. Serv. Comm.,  
Case No. 17,117) (November 26, 1971).

For rate making purposes a sewer company should not  
be allowed to treat depreciation on contributed plant  
as an operating expense.

- (4) Re Incline Village General Improv. Dist., I & S 558,  
I & S 559, (Nev. Pub. Serv. Comm., May 14, 1970).

Where a general improvement district sought to in-  
crease water rates, the Commission could not consider  
depreciation expense on the district's plant because  
all of the plant had been contributed by members of  
the district.

- (5) Princess Anne Utilities Corp. v. Virginia ex rel.  
State Corp. Commission, 179 SE 2d 714, (Va. 1971).

A depreciation allowance on contributions in aid of  
construction was not allowed to a sewer company  
operating in a state following the "original cost"  
rule in determining rate base because the company  
made no investment in the property, and had nothing  
to recover by depreciating the donated property.

APPENDIX "C"

APPENDIX TO AN ORDER OF THE UTILITY REGULATORY  
COMMISSION IN CASE NO. 7539 DATED MARCH 19, 1980

In accordance with Finding No. 9, the following tabulation is the Commission's summary of the "Test Year" and projected annual revenues and expenses for the Applicant's 68,000 GPD sewage treatment plant and sewage collection system which will provide service to approximately 211 customers in Franklin County, Kentucky.

(No. of Customers)	<u>Test Year</u> <sup>(1)</sup>	<u>Pro forma</u> <sup>(1)</sup> <u>Requested</u>	<u>Pro Forma</u> <u>Found Reasonable</u>
	(168)	(207)	(211) <sup>(2)</sup>
<b>Revenues:</b>			
1. Sewage Service	\$16,450	\$44,712	\$26,333
2. Interest	<u>63</u>	<u>0</u>	<u>0</u>
<b>Total Revenues</b>	<b>\$16,513</b>	<b>\$44,712</b>	<b>\$26,333</b>
<b>Expenses:</b>			
1. Management	\$ 3,600	\$ 4,800	\$ 2,400 <sup>(3)</sup>
2. Billing & Collecting	2,468	6,706	3,950 <sup>(4)</sup>
3. Office Expenses	1,792	1,792	1,792
4. Utilities	3,340	3,808	3,808
5. Repair and Maintenance	4,374	5,391	3,336 <sup>(5)</sup>
6. Labor	1,596	1,596	1,596
7. Depreciation	12,221	9,378	2,931 <sup>(6)</sup>
8. Rate Case Expense Case No. 7427	0	1,500	0 <sup>(7)</sup>
9. Rate Case Expense Case No. 7539	0	1,500	1,500
10. Insurance	0	139	139
11. Commission Assessment	0	54	50 <sup>(8)</sup>
12. Property Tax	0	687	687
13. Income Tax	<u>0</u>	<u>1,238</u>	<u>842</u> <sup>(9)</sup>
<b>Total Expenses</b>	<b>\$29,391</b>	<b>\$38,589</b>	<b>\$23,031</b>
<b>Net Income</b>	<b>(\$12,878)</b>	<b>\$ 6,123</b>	<b>\$ 3,302</b>

(1) Test Year and Pro forma Requested expenses were taken from the Applicant's statement of revenues and expenses for the 12 month period ending May 31, 1979.

(2) Testimony by the Applicant indicated that 211 customers will be served by the existing facilities.

(3)The Commission finds that a reasonable management fee in this instance is \$2,400, based upon past management fee allowances for similar sized utilities.

(4)The amount allowed for billing and collecting is calculated as 15% of total revenues, in accordance with the Applicant's contract with the Farmdale Water District.

(5)The Repair and Maintenance expense found reasonable was determined by making two adjustments to the Test Year expense. First, \$1,718 of the \$4,374 Test Year expense was disallowed on the basis that four pump replacements during the Test Year in the amount of \$1,718 are not Repair and Maintenance expenses but rather are capital items and are thus covered through depreciation. The adjusted Test Year expense of \$2,656 (\$4,374 - \$1,718), which was for an average of 168 customers during the Test Year, was then further adjusted to account for 211 customers in the pro forma by multiplying by a factor of 211/168 to yield \$3,336.

(6)The depreciation expense found reasonable was determined by taking a straight line depreciation of all noncontributed property (two treatment plant additions) and assuming a 20 year composite life.

(7)The rate case expense for Case No. 7427, which authorized construction of additional sewer lines and a treatment plant addition, was disallowed. These expenses should be included as part of capital cost of the project.

(8)The Applicant will be assessed the minimum amount of \$50, based upon the revenues allowed.

(9)Based upon the net income allowed, the Applicant's tax liability will be \$842.