

COMMONWEALTH OF KENTUCKY
BEFORE THE UTILITY REGULATORY COMMISSION

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In the Matter of:

THE APPLICATION AND PETITION OF DOWNSTREAM)
INC., FOR AN ORDER AUTHORIZING A CERTIFICATE)
OF CONVENIENCE AND NECESSITY TO OPERATE A)
SEWAGE TREATMENT FACILITY, TO HAVE RATES SET) CASE NO. 7714
FOR THE USE OF SAID FACILITY, TO BORROW)
MONEY AND TO PERFORM ANY AND ALL NECESSARY)
ACTS TO OPERATE AND MAINTAIN A SEWAGE TREAT-)
MENT FACILITY)

O R D E R

Preface

On January 25, 1980, Downstream, Inc., hereinafter referred to as the "Applicant", filed with this Commission an application seeking a Certificate of Public Convenience and Necessity authorizing the construction of a waste water collection, treatment and disposal system, approval to borrow and issue a note in the amount of \$50,000, and the approval of its proposed sewage service rates for the Fox Run Estates Subdivision in Franklin County, Kentucky.

The case was set for hearing at the Commission's offices in Frankfort, Kentucky, February 27, 1980. All parties of interest were notified and no protests were entered. At the hearing, certain requests for additional information were made by the Commission Staff. This information has now been filed, and the entire matter is now considered to be fully submitted for a final determination by this Commission.

Test Period

The Applicant's utility system is a proposed system rather than an operating system and test-year information does not exist. Estimated pro forma expenses were, therefore, utilized for the determination of revenue requirements and the rates that should produce the required revenues.

Rate Determination - General Discussion

The Commission has traditionally considered the original cost of utility plant, the net investment, the capital structure, and the going concern in the determination of fair, just and reasonable utility rates. The Commission's experiences in the establishment or adjustment of rates for sewage utilities, however, has indicated that these valuation methods are not always appropriate. This has resulted in establishment of the "Operating Ratio Method"^{1/} by this Commission for the determination of rates for sewage utilities. It is recognized, however, that there are instances where arguments can be made for the utilization of methods other than the Operating Ratio Method.

Sewage Utilities for Proposed Land Development

The Commission recognizes the inherent risks of land development: the speculative investment of capital, the speculative timetables for selling developed lots, the speculative profit margins and the time that will be required for recoupment of invested capital. Further, the construction of a sewage collection and treatment system for the purpose of providing service to future lot holders is speculative construction based on needs to be generated by land development and lot sales. During the early stages of development, the utility plant in service is usually of much greater capacity than is required by only a few lot holders. The owner of the utility property must recognize that both the operating and non-operating costs of this excess plant are costs that cannot be passed on to a few lot holders and must, therefore, be borne by the owner.

The rates for a proposed plant should be based on the estimated costs for providing service to all the lots proposed to be

^{1/} "Operating Ratio" is defined as the ratio of expenses, including depreciation and taxes to gross revenues.

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

served by the plant. This should result in a fair, just and reasonable apportionment of all the utility's costs to all lots served or to be served by the utility plant. The non-operating costs apportioned to lots still owned by the developer or the utility must be borne by the developer or utility until such time as said lots are sold. The utility is further advised that its customers should not be expected to bear all operating costs until the sale of lots has added an adequate number of customers to generate revenues equivalent to said costs from fair, just and reasonable rates.

Specific Findings in this Matter

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

1. That residential development is needed to satisfy demands for family housing in Franklin County and vicinity. That statutory requirements for the said development include requirements for the construction of sewage facilities. The Commission emphasizes, however, that the construction, financing and operating costs of the required sewage facilities should not result in unreasonable rates. Further that the Applicant for certification of said facilities is obligated to make such a determination before the beginning of construction thereon. With emphasis on these stipulations, and the qualifications inherent therein, the Commission finds that public convenience and necessity requires construction of the proposed sewage facilities for the Fox Run Estates Subdivision in Franklin County, Kentucky, as set forth in the application.

2. That the construction project proposed by the Applicant consists of a 20,000 GPD extended aeration treatment plant followed by a 40,000 GPD mixed media filter unit at an estimated total project cost of \$50,256. This plant has been planned for the providing of sewage disposal services for the total proposed subdivision development of 36 single-family residential homes.

3. That the Applicant's request to finance the proposed construction by borrowing \$50,000 at an annual interest rate of eight (8) per cent should be approved.

4. That, in this instance, the determination of rates and revenue requirement should be based on the operating ratio method.

5. That the rate prescribed and set forth in Appendix "A", attached hereto and made a part hereof, is the fair, just and reasonable rate to be charged for sewage disposal services to be rendered by the Applicant in the new Fox Run Estates Subdivision of Franklin County, Kentucky.

6. That a pro forma operating ratio of approximately .88 should be realized from the revenues produced by 36 pro forma customers and the rates found reasonable herein and should provide for a reasonable pro forma return margin^{2/} in this instance.

7. That the \$33.89 monthly rate proposed by the Applicant is unfair, unjust, unreasonable and would not be in accordance with the stipulations set forth in Finding No. 1 herein and should be denied.

8. In past years when depreciation on contributed property was not a significant matter to rate making, it was traditionally included in the rate making process. Today, however, the value of contributed property is frequently more than the value of non-contributed property, and the matter of a depreciation allowance thereon is a significant matter to rate making. 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.

The Commission is of the opinion and finds that depreciation on contributed property for water and sewage utilities is not

^{2/} Return margin is the amount remaining for the payment of a return on the investment of the security holders.

justified and should not be included in rate making determinations for these utilities. The cases and decisions listed in Appendix "B", attached hereto and made a part hereof, are hereby referenced as substantiation of the Commission's position in this matter.

9. That the Applicant has filed a valid "Third Party Beneficiary Agreement" as a part of its application.

10. That the Commission, after consideration of the tabulation of pro forma revenues and expenses submitted by the Applicant concludes that these revenues, expenses and adjustments thereto can be summarized as shown in Appendix "C", attached hereto and made a part hereof. On the basis of the said Appendix "C" tabulation, the Commission further concludes that pro forma annual revenues in the amount of \$9,202 are necessary and will permit the utility to meet its reasonable pro forma expenses for providing sewage collection and disposal service to 36 customers.

11. That the Applicant should file with this Commission a duly verified document or documents (final invoices, etc.) which show the total costs for construction and all other capitalized costs (administrative, legal, engineering, etc.) within sixty (60) days of the date that construction is substantially 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 Applicant be and hereby is granted a certificate of public convenience and necessity for construction of sewage collection and treatment facilities for the Fox Run Estates Subdivision, Franklin County, Kentucky, as set forth in the Application. Further, that this certification be and is hereby qualified by the stipulations set forth herein by Finding No. 1.

IT IS FURTHER ORDERED that the Applicant be and is hereby authorized to finance construction of the proposed sewage facilities by the issuance of a \$50,000 note at an annual interest rate of eight (8) per cent. Further, that this \$50,000 in project funds shall be used only for the lawful objects as set forth in the Application.

IT IS FURTHER ORDERED that the rate set forth in Appendix "A", attached hereto and made a part hereof, be and the same is hereby fixed as the fair, just and reasonable rate of the Applicant for sewage disposal service to be provided in the Fox Run Estates Subdivision to become effective for services rendered on and after the date of this Order.


IT IS FURTHER ORDERED that the rates sought by the Applicant be and the same are hereby denied.

IT IS FURTHER ORDERED that the Applicant shall file with this Commission a duly verified document or documents regarding the total costs for this project in accordance with Finding No. 10 as previously set forth herein.

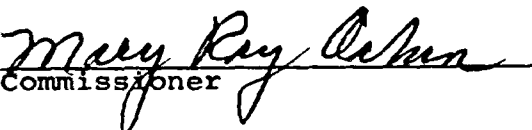
IT IS FURTHER ORDERED that the Applicant file with this Commission within thirty (30) days of the date that construction is substantially completed, its tariff sheets setting forth the rate approved herein. Further that a copy of the Applicant's Rules and Regulations for providing service to its customers shall be filed with said tariff sheets.

Done at Frankfort, Kentucky, this 26th day of September, 1980.

UTILITY REGULATORY COMMISSION


Chairman

Vice Chairman


Commissioner

ATTEST:

Secretary

APPENDIX "A"

APPENDIX TO AN ORDER OF THE UTILITY REGULATORY
COMMISSION IN CASE NO. 7714 DATED SEPTEMBER 26, 1980

The following rate is prescribed for sewage disposal services rendered to all customers served by Downstream, Inc., in the Fox Run Estates Subdivision in Franklin County, Kentucky.

| <u>Type of Service Provided</u> | <u>Monthly Rate</u> |
|---------------------------------|-----------------------|
| Single-Family Residential | \$21.30 Per Residence |

APPENDIX "B"

APPENDIX TO AN ORDER OF THE UTILITY REGULATORY
COMMISSION IN CASE NO. 7714 DATED SEPTEMBER 26, 1980

A listing of cases and decisions that substantiate finding
number 8

- (1) 28 U.S.C. s 362(c) (1976).
Dealing with the Basis to Corporations in Reorganization. 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 depreciation 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 increase 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. 7714 DATED SEPTEMBER 26, 1980

In accordance with Finding No. 9, the following tabulation is the Commission's summary of the estimated annual revenues and expenses for the proposed 20,000 GPD sewage collection and treatment system when serving 36 single-family residences.

| | <u>Proforma(1)</u> <u>Requested</u> | <u>Proforma Found</u> <u>Reasonable</u> |
|---------------------------------------|--|--|
| (No. of Customers) | (36) | (36) |
| <u>Revenues:</u> | \$14,642 | \$ 9,202 |
| <u>Expenses:</u> | | |
| Management | \$ 600 | \$ 600 |
| Routine Maintenance | 1,200 | 1,200 |
| Repairs | 875 | 583(2) |
| Chemicals | 250 | 115(3) |
| Utilities | | |
| Telephone | 120 | 120 |
| Water | 240 | 240 |
| Electric | 1,200 | 1,200 |
| Billing & Collecting | 432 | 432 |
| Accounting | 360 | 360 |
| Depreciation | 2,468 | 2,468 |
| Insurance | 75 | 75 |
| Certificate Case Expense-1,500/3 yrs. | 500 | 75(4) |
| Taxes | | |
| Property | 252 | 236(5) |
| Payroll | 240 | 160(6) |
| Income | 230 | 261 |
| | <hr/> | <hr/> |
| Total Expenses | \$ 9,042 | \$ 8,125 |
| Net Income | \$ 5,600 | \$ 1,077 |

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- (1) Proforma requested revenues and expenses were taken from the Applicant's tabulation of revenues and expenses submitted as part of the application filed on January 25, 1980.
- (2) The Commission's records indicate three years to be the approximate average time span between rate adjustment cases for sewage utilities. The allowance of \$583 for "Maintenance (Repairs)" expense is based on allowing the requested \$875 for years two and three and disallowing the requested \$875 for year one as both the manufacturer's and contractor's warranties should meet both the Applicant's requirements for year one.
- (3) The Applicant's request for \$250 for chemicals has been reduced to \$115 based on previous allowances for similar sized utilities.
- (4) A three-year amortization of the \$1,500 "Certificate Case Expense" was disallowed as the Commission's Uniform System of Accounts for Sewage Utilities" require that this expense be accounted for as an "Organization Expense." Amortizing this expense over the twenty-year anticipated life of the 20,000 GPD treatment plant results in an annual allowance of \$75.00 for this expense.
- (5) An expense of \$236 was allowed for property taxes based on \$.45 per \$100 of valuation. \$.45 x \$56,000 - \$3,500 cash).
- (6) An expense of \$160 was allowed for payroll taxes based on 8.9% FICA x \$1,800.