

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

NOTICE OF APPLICATION OF FERN LAKE COMPANY)
NOTICE OF FERN LAKE COMPANY PURSUANT TO)
KRS 278.180, 278.190 AND RELATED STATUTES)
AND 807 KAR 25:010, SECTION 5 THROUGH 9, AND)
RELATED SECTIONS, THAT ON DECEMBER 1, 1980,)
FERN LAKE COMPANY WILL PLACE INTO EFFECT A)
TARIFF INCREASING THE WHOLESALE COST OF)
WATER TO KENTUCKY WATER SERVICE COMPANY, INC.)

APPLICATION FOR FOLLOWING:

1. ORDER PLACING INTO EFFECT THE NEW)
TARIFF ADJUSTING ITS WHOLESALE RATES)
TO ITS SOLE CUSTOMER, KENTUCKY WATER) CASE NO. 7982
SERVICE COMPANY, INC.)

2. APPLICATION FOR AUTHORITY TO BORROW)
THE SUM OF \$1,700,000 FROM THE CITY)
OF MIDDLESBORO, KENTUCKY TO PERFORM)
REMEDIAL WORK REQUIRED BY THE BUREAU)
OF NATURAL RESOURCES, ON FERN LAKE)
COMPANY'S LAKE AND DAM IN MIDDLESBORO,)
KENTUCKY, AND TO AMORTIZE THE LOAN BY)
INCLUDING IN THE TARIFF A SURCHARGE)
ENTAILED AND ENCUMBERED FOR THE SPECIFIC)
PURPOSE OF THE DEBT SERVICE APPLIED FOR)
HEREIN)

O R D E R

On September 29, 1980, Fern Lake Company ("Applicant")
filed with this Commission its application for: (1) certifica-
tion of its proposed remedial construction work for the Fern
Lake Dam, (2) authority to borrow \$1,700,000 to finance said
construction, (3) approval to place into effect the surcharge
necessary to amortize the loan, and (4) an increase of
approximately \$50,000 in its general rate for water sold to
its sole customer, Kentucky Water Service Company, Inc.,

("Kentucky Water Service"). Said application included a notice of intent to implement the proposed rate on December 1, 1980. The Commission, in order to consider the reasonableness of the proposed rate, ordered its suspension for the five month period ending May 1, 1981.

This matter was set for hearing at the Commission's office in Frankfort, Kentucky on December 16, 1980, to consider the construction, financing and surcharge portions of the application. All parties of interest were notified of the hearing. The Division of Consumer Intervention of the Attorney General's office ("Attorney General") and Kentucky Water Service, the intervenors of record in this matter, were present and participated fully.

At the hearing, Kentucky Water Service moved the Commission for approval in the instant case of a surcharge rate clause to pass through to its customers in Middlesboro and environs any increases in the charges now being paid to the Applicant. In the alternative, Kentucky Water Service moved that the surcharge matter be assigned a case number and processed as a companion case to the instant proceeding.

The Attorney General objected to the motion on the ground that to sustain the motion would be improper procedurally as it would be the equivalent of approving a rate increase without proper application or full and complete public notice. In its interim Order issued February 27, 1981, the Commission concurred with the Attorney General's objection and found that the method proposed in the alternative motion would be proper procedurally

and would provide Kentucky Water Service the best opportunity to recover through its rate structures any surcharges imposed upon it by Applicant. Accordingly, the Commission sustained the alternative motion, and by Order dated March 5, 1981, instituted Case No. 8165, set a hearing in the matter for April 2, 1981, and ordered Kentucky Water Service to give notice of such hearing in the manner prescribed by Kentucky Revised Statutes and Commission regulations.

In addition, in its Order of February 27, 1981, the Commission granted the Applicant a certificate of convenience and necessity for the proposed remedial construction; authorized the borrowing of \$1,700,000, at an interest rate not to exceed 12% per annum, to finance the proposed construction; authorized the Applicant to place into effect, on the first billing rendered after the borrowing, a monthly surcharge to be used solely for the purpose of servicing the loan; and ordered the current monthly surcharge of \$1,793.40 to cease upon the implementation of the surcharge approved in the instant case.

A further hearing to consider the rate portion of the application was held on April 7, 1981, with all parties being present. At the hearing, certain requests for additional information were made by the Commission staff. This information has been filed as a part of the record and the entire matter is now considered to be submitted for final determination.

TEST PERIOD

For the purpose of testing the reasonableness of the proposed rates, the Commission has adopted the twelve-month period ended July 31, 1980. Adjustments, when proper and reasonable, have been included to more clearly reflect current operating conditions.

VALUATION METHOD

Applicant proposed as its valuation method to use the sole stockholder's investment in the stock of the Applicant less the value of the non-utility property for a total of \$580,200. The Commission, after consideration of this alternative, finds that the proposed valuation is as of October 1978, more than 18 months prior to the end of the test period, and further that such method is not conclusive as to the value of the property devoted to providing utility service. The Commission will, therefore, use the operating ratio method as the basis in determining the water rates for the Applicant as prior Commission experience with water utilities indicates that the results of this method have been reasonable and fair to both owners and ratepayers. The formula used in computing the operating ratio is as follows:

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

REVENUES AND EXPENSES

Applicant's actual income statement for the twelve months ended July 31, 1980, showed operating expenses (excluding the debt service of \$21,521 on the current loan) of \$45,668. From this actual expense the Commission has excluded income taxes of

\$516 to reflect the state and federal income tax rates in effect at the end of the test year.

Moreover, Applicant proposed several pro forma adjustments to its income statement. The Commission is of the opinion that these adjustments are generally proper and has accepted them for rate-making purposes with the following exceptions:

1. Applicant has proposed to consider interest and dividend income of \$1,912 as operating revenues for rate-making purposes rather than as a below-the-line income item. As this income is derived from investments purchased with earnings derived from utility operations, the Commission is of the opinion that the ratepayers are entitled to benefit from these revenues. Therefore, the inclusion of this revenue has been accepted. Further, based on information furnished by the Applicant on April 21 and 29, 1981, the Commission has included an additional \$720 of interest income accrued during the test period.

2. The Applicant proposed an adjustment for rate case expenses of \$5,455. As the actual test year expenses included rate case expenses of \$11,045, the proposed adjustment would reflect the inclusion in the adjusted test year operations of the entire estimated rate case expenses of \$16,500 connected with this application. The Applicant failed, however, to provide detailed information to support its estimated rate case expenses. Therefore, the Commission has reduced these estimated expenses to \$8,250 as it is of the opinion that this is a more reasonable level of expenses for a case of this nature and complexity. The breakdown of the allowable expenses

is as follows:

Accounting	\$ 1,000
Engineering	3,000
Legal	3,750
Financial	<u>500</u>
Total	\$ 8,250

Based on the record in Cases No. 6971 and 7292, both of which have been incorporated by reference herein, \$9,000¹ of rate case expense from these prior proceedings should be included in operating expenses for rate-making purposes.

In addition, in accordance with policy and historic experience with water utilities, the Commission has amortized the allowable rate case expenses for this proceeding over a three-year period for an annual allowance of \$2,750. As a result, adjusted test year operations should include an allowance for rate case expenses of \$11,750. Therefore, Applicant's proposed adjustment has been reduced by \$4,750 to \$705.

3. Testimony at the hearing of April 7, 1981, and additional information filed April 21, 1981, disclosed that the Applicant's taxes other than income taxes have increased by approximately \$3,000 over the actual test year figures. In order to provide recognition of the current operating conditions, the Commission has likewise made an upward adjustment of \$3,000 to this expense.

¹ Reflects annual allowance for amortization, over a three-year period, of total rate case expenses of \$27,000 from Cases No. 6971 and 7292 as shown on Exhibit 1, p. 3 of 7 and Exhibit 1, p.3 of 5, respectively.

4. The Commission has determined, based on the adjusted income statement, that Applicant should be allowed a provision for income taxes of \$11,018² and has adjusted operating expenses accordingly.

The effect of these adjustments on net income is as follows:

	<u>Actual</u>	<u>Adjustments</u>	<u>Adjusted</u>
Revenues	\$109,336	\$ (19,714)	\$89,622
Expenses	67,189	(18,170)	49,019
Net Income	\$ 42,147	(1,544)	\$40,603

RETURN

The revenues generated by the existing rates produce an operating ratio, after accepted adjustments, of 54.7%. As the Commission is of the opinion that a fair, just and reasonable operating ratio is 88% in that it will allow the Applicant to meet its reasonable operating expenses, service its debt and provide a reasonable return to Applicant's owner, it appears that the current rates generate excess revenues. Therefore, the Commission finds that Applicant's proposed rates should be denied. Further, the Commission is giving notice to the utility as required by KRS 278.180 and is instituting a separate proceeding, Case No. 8276, requiring the Applicant to show cause, if any it can, why its rates should not be reduced.

SURCHARGE TO SERVICE DEBT

Applicant was authorized by the Commission's Order of February 27, 1981, to place into effect, on the first billing rendered after the date of the borrowing of the \$1,700,000 authorized in said Order, a surcharge to be used for the purpose of servicing its debt.

²
 [\$51,621 (taxable income) x 33.5% (composite federal and state corporate tax rate)] - \$6,275 = \$11,018.

As of this date, the City of Middlesboro has been unable to secure buyers for the proposed industrial building revenue bonds at an interest rate not exceeding 12%. Therefore, the Applicant has neither borrowed the funds nor implemented the authorized surcharge. The Commission had hoped that, by the date of its final Order in this matter, the funds would be borrowed and the exact amount of the surcharge determined so as to enable the Commission to set out the exact surcharge amount in Appendix A attached hereto. Inasmuch as this information is not available as of this date, the Commission finds the most expedient manner in which to handle this matter is to require the Applicant to notify the Commission of the exact amount of the surcharge at least 30 days prior to the proposed effective date, so as to enable the Commission to ascertain the propriety of the calculation and to allow the Applicant's sole customer, Kentucky Water Service, to file an application to adjust its rates accordingly under its approved purchased water adjustment clause.

FINDINGS AND ORDER

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

1. The rates approved in Case No. 7292 and set forth in attached Appendix A are the fair, just and reasonable rates to be charged by Applicant for water service rendered until such time as Case No. 8276 is completed.

2. The rates proposed by Applicant would produce revenues in excess of those found to be reasonable herein and therefore must be denied upon application of KRS 278.030.

IT IS THEREFORE ORDERED that:

1. The rates prescribed and set forth in attached Appendix A are hereby fixed as the fair, just and reasonable rates to be charged by Fern Lake Company until such time as Case No. 8276 is completed.

2. The rates proposed by Fern Lake Company are hereby denied.

3. Fern Lake Company shall notify this Commission of the exact amount of the authorized surcharge at least 30 days prior to the proposed effective date.

4. The Applicant shall file with this Commission, within 30 days after the date of this Order, its tariff sheets setting forth the rate approved herein.

Done at Frankfort, Kentucky, this the 23rd day of July, 1981.

PUBLIC SERVICE COMMISSION

Marlin M. Volk
Chairman

Did not participate
Vice Chairman

Don Glasgow
Commissioner

APPENDIX A

APPENDIX TO AN ORDER OF THE PUBLIC SERVICE
COMMISSION IN CASE NO. 7982 DATED JULY 23, 1981.

The following rates are prescribed for the customers served by the Fern Lake Company. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of the Commission prior to the date of this Order.

	<u>Usage</u>	<u>Monthly Rate</u>
First	41,667,000 Gallons	\$7,100.00 (Minimum Bill) [*]
Each Additional	1,000 Gallons	0.18 per 1,000 Gallons

* An additional surcharge not to exceed \$18,535 per month shall be added to the minimum bill, for the purpose of servicing a 20-year loan from the City of Middlesboro, Kentucky, in the amount of \$1,700,000, at an interest rate not to exceed 12%. This surcharge shall be computed monthly and automatically discontinued when the loan is amortized.