

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

THE APPLICATION OF SOUTH)
GRAVES WATER DISTRICT FOR)
(1) A CERTIFICATE OF PUBLIC)
CONVENIENCE AND NECESSITY,)
AUTHORIZING AND PERMITTING)
SAID WATER DISTRICT TO)
CONSTRUCT A WATERWORKS)
CONSTRUCTION PROJECT,) CASE NO. 8513
CONSISTING OF IMPROVEMENTS)
TO THE EXISTING WATER WORKS)
SYSTEM OF THE DISTRICT (2))
APPROVAL OF THE PROPOSED)
PLAN OF FINANCING OF SAID)
PROJECT; AND (3) APPROVAL)
OF AN ADJUSTMENT OF ITS)
WATER SERVICE RATES)

ORDER

On May 10, 1982, South Graves Water District, ("South Graves") filed an application with this Commission to increase its rates pursuant to 807 KAR 5:076, Alternative Rate Adjustment Procedure for Small Utilities ("ARF"). The requested rates would increase South Graves' annual revenues by \$41,156, an increase of 62 percent.

South Graves proposed as a part of its application to include pro forma adjustments for the effects of refinancing its long-term debt and constructing additions to its system. Therefore, the Commission required South Graves to amend its application to include a request for a certificate of

convenience and necessity and approval of the related financing.

In adopting the ARF procedure for small utilities, the Commission recognized the high costs associated with rate applications before it and initiated the simplified procedure in order to alleviate the financial burden of acquiring legal counsel and rate consultants. The Commission anticipated that in most cases a hearing would not be required and that the evidence of record would consist of the annual reports on file with the Commission, information submitted in the application form, and responses to information requests.

In this case, South Graves' amended application, which includes a request for a certificate of convenience and necessity and approval of financing, is beyond the scope of the procedures established in 807 KAR 5:076. Therefore, the Commission has processed this application under the general rate case procedure.

South Graves is seeking approval of the financing and certification of the construction of a \$125,000 waterworks project for improvements to the existing waterworks system, as set out more specifically in the summary to this Order.

This project will be financed through a \$71,000 loan and a \$54,000 grant from Farmers Home Administration ("FmHA"). The loan repayment period is to be 40 years at an interest rate of 5 percent per annum. Furthermore, due to South Graves' failure to repay the principal on its outstanding indebtedness, it has become necessary to

refinance all outstanding debt. FmHA has agreed to refinance the bonds of 1970 and 1972 at their original interest rates of 4 3/4 percent and 5 percent, respectively. However, the 1970 bond issue of \$635,000 will be refinanced in the principal amount of \$724,000 which includes outstanding principal and the interest in arrears. The 1972 bond issue of \$40,000 will be refinanced in the principal amount of \$42,500 which is calculated in the same manner as the 1970 issue.

South Graves is currently serving 605 customers in Graves County, Kentucky. Approximately 20 customers have had low pressure problems since the system was approved for construction in 1969. The construction of the pumping station and additional line will increase pressure to these customers, bringing them within the requirements of KRS 5:066, Section 6(1). It will also provide greater quantities of water needed to serve future additional customers in this area.

A public hearing in this matter was held January 13, 1983. There were no intervenors and no protests were entered.

COMMENTARY

South Graves is a nonprofit water distribution system organized and existing under the laws of the Commonwealth of Kentucky and serving approximately 605 customers in Graves County, Kentucky.

TEST PERIOD

The Commission has adopted the 12-month period ending December 31, 1981, as the test period for determining the reasonableness of the proposed rates. In utilizing the historical test period, the Commission has given full consideration to known and measurable changes found reasonable.

REVENUES AND EXPENSES

South Graves proposed several adjustments to revenues and expenses as reflected in its original application. The Commission is of the opinion that the proposed adjustments are generally proper and acceptable for rate-making purposes with the following modifications:

Electric Expense

South Graves reported actual test-period electric expense of \$4,522. In order to assess the accuracy of the reported level of expense, as well as to determine the adjusted electric expense, the Commission requested and South Graves has supplied copies of its test period electric bills from West Kentucky RECC. The total of the bills submitted reflects electric expense of \$4,507 for the test period.

South Graves proposed an adjustment to increase its electric expense by \$812. This adjustment is comprised of 2 separate parts, a 10 percent estimated increase in electric expense based upon historical experience, and an increase of \$360 to reflect the electric usage of the new pressure pumping station.

The Commission has a well-established policy of allowing only those changes which are known and measurable in determining a utility's pro forma level of expense. South Graves did not supply any information concerning an increase in rates by its electric supplier or an increase in electrical usage in support of its proposed adjustment. The Commission finds that the portion of South Graves' proposed electric adjustment relating to the 10 percent increase is neither known nor measurable and has disallowed it herein.

In its original application South Graves estimated that the electric usage of the pressure pumping station would be \$360 annually. However, in its reply to Item 3 of the Commission's Order of June 25, 1983, South Graves provided a new calculation of the adjustment which reflected a cost of \$287 annually. The Commission has reviewed the updated figure supplied by South Graves and concurs with the projected expense based on the revised calculation. Therefore, the Commission will allow an adjustment of \$287 to reflect the electric usage of the pumping station. The adjustment results in electric expense of \$4,794 allowed herein for rate-making purposes.

Chemicals

South Graves' operating statement for 1981 reflected \$3,620 of chemicals expense, a 42 percent increase over the expense incurred for the previous 12-month period. Upon questioning at the hearing, South Graves provided an analysis of the activity in the chemicals account for the test period

and the 12-month period preceding the test period. This analysis revealed that late in the test period South Graves made several purchases of chemicals. Because of the timing of these purchases, the Commission is of the opinion that the chemicals purchased were actually in inventory at the end of the test period and not a legitimate expense of the test period under accrual accounting methodology. Therefore, the Commission has reduced the test year chemicals expense by \$458 to exclude a reasonable amount of chemicals which should be charged to inventory in accordance with the Uniform System of Accounts for Water Utilities.

The Commission has determined the allowed chemicals expense by removing the purchases made at the end of the test period from the total purchases made during the test year and applied the most recent chemical prices from the invoices supplied to the allowed purchases.

Expenses Related to New Meters

During the test period South Graves capitalized nine new meters at a cost of \$1,032. Following questioning at the hearing, South Graves performed an investigation to check the accuracy of the capitalized costs. Through this investigation it was determined that 12 new meters were installed and the labor costs involved in the installation were not capitalized. The total meter costs for 1981 which should have been capitalized were \$3,260. Therefore, the Commission has eliminated \$2,228 from Maintenance of Meters, Account 653, which represents costs charged to this account

relating to the installation of new meters and which should have been capitalized. An adjustment has been made to depreciation expense to reflect the annual depreciation of this cost.

Salaries Expense

South Graves proposed an adjustment to salaries expense of \$1,122 based upon a 9 1/2 percent increase to its employees. Upon questioning at the hearing it was learned that South Graves at that time had not granted its employees any pay raise. It is the Commission's policy to allow only those adjustments which are known and measurable. The Commission finds that South Graves' proposed adjustment is not known and measurable and therefore, has denied the adjustment for rate-making purposes.

Depreciation Expense

The actual operating statement of South Graves for the test period reflected depreciation expense of \$20,378. In addition, South Graves proposed an adjustment of \$1,533 to reflect depreciation on the new pressure pumping station. It is the policy of the Commission to compute depreciation expense for rate-making purposes on the basis of the original cost of the plant in service at the end of the test period less contributions in aid of construction. South Graves' balance sheet reflects that the level of contributions in aid of construction at the end of the test year was \$119,357, which is approximately 15 percent of the total cost of utility plant in service. In determining the pro forma

depreciation expense, the Commission has utilized the level of plant in service at the end of the test year, adjusted for meters capitalized pursuant to this Order, exclusive of contributions in aid of construction, and the depreciation rate used by South Graves.

In addition, the Commission has included the pressure pumping station in computing South Graves' allowed depreciation expense. In so doing, the Commission recognizes that at this time South Graves has advertised and received bids for the construction of the project. The time period involved in the construction of this project is expected to be short, resulting in the facilities being placed in service shortly after the date of this Order. For these reasons, in addition to the nonrevenue producing nature of the facilities, the Commission finds it appropriate to include the pressure pumping station in the computation of South Graves' depreciation expense. After excluding depreciation associated with contributed property, the resulting depreciation expense based on straight line depreciation at a 2 1/2 percent composite rate is \$18,874.

Interest Expense

Subsequent to the filing of this case, South Graves informed the Commission that due to its inability to repay the principal on its outstanding indebtedness it had become necessary to refinance all of its outstanding debt. FmHA has agreed to refinance South Graves' two existing bond issues at the original interest rates, as well as to provide financing

for the new pressure pumping station to be constructed. However, the principal amount of the refinanced indebtedness is to include the principal and interest in arrears on the original issue. In this case South Graves' outstanding balance on the 1970 bond issue of \$635,000 will be refinanced in the principal amount of \$724,000 and the outstanding balance on the 1972 bond issue of \$40,000 will be refinanced in the principal amount of \$42,500. The financing of the new pumping station will be provided through a new bond issue in the principal amount of \$71,000 at an interest rate of 5 percent. The Commission has included annual interest expense of \$40,065 herein to reflect the annual expense based on the financing approved in this case.

Miscellaneous Nonoperating Income

During the test period South Graves reported \$107 of miscellaneous nonoperating income. This income relates to a tax that the Graves County Board of Education ordered all utilities to collect. The tax was subsequently declared to be invalid and the utilities were required to refund the amount collected. The \$107 reported as miscellaneous income represents tax which could not be refunded due to taxpayers moving without leaving a forwarding address. Since this presumably will not be a recurring item, the Commission has removed this income for rate-making purposes.

Other Interest Expense

The actual operating statement of South Graves for the test period reflected other interest expense of \$229. In

response to questioning at the hearing South Graves provided an analysis of this account. This analysis revealed that \$209 related to a 6-month term loan made and repaid during the test period. As there is no current obligation, the Commission has removed the \$209 for rate-making purposes. This results in other interest expense of \$18 which is reasonable in comparison to the other interest expenses incurred by South Graves over the previous 5 years.

The Commission finds that South Graves' adjusted test period operations are as follows:

	<u>Actual Test Period</u>	<u>Pro Forma Adjustments</u>	<u>Adjusted Test Period</u>
Operating Revenues	\$ 68,081	\$ -	\$ 68,081
Operating Expenses	62,775	(3,655)	59,120
Operating Income	<u>\$ 5,306</u>	<u>\$ 3,655</u>	<u>\$ 8,961</u>
Other Income	130	(107)	23
Other Deductions	31,674	8,411	40,085
Net Income	<u><u>\$ (26,238)</u></u>	<u><u>\$ (4,863)</u></u>	<u><u>\$ (31,101)</u></u>

REVENUE REQUIREMENTS

The Commission is of opinion that the adjusted operating loss is clearly unjust and unreasonable. Further, the Commission is of the opinion that the proposed rates should be approved as the revenues of \$109,261 generated by the proposed rates will improve South Graves' financial position. However, the Commission is concerned that while the rates requested by South Graves and approved herein will improve financial position, they are inadequate to produce a 1.2 debt service coverage, the debt service coverage required in South Graves mortgage agreement. Moreover, South Graves' financial

position may be further improved by future growth, but the Commission is of the opinion that South Graves will be unable to continue operating for an extended period of time at these rates.

The financing allowed herein includes a \$71,000 loan and a \$54,000 grant from FmHA. Of this financing, \$50,000 has been designated by FmHA to pay routine operating and maintenance expenses in order to help South Graves attain financial stability. The Commission, in establishing South Graves' revenue requirements, has considered and included all routine operating and maintenance expenses found reasonable. The rates granted herein will provide sufficient working capital for South Graves to pay its routine operating and maintenance expense, service its debt and provide sufficient funds for contingencies. Further, approval of the use of \$50,000 for working capital purposes would in effect amount to allowing this utility to finance its current operations. The funds needed to pay current operating expenses should in all but the most extreme cases be provided through rates rather than external sources. The Commission is of the opinion that funds obtained from outside sources, such as grant and debt funds, should be used solely to finance needed expenditures outside the ordinary recurring expenditures of the utility.

Therefore, the Commission finds that South Graves and its customers alike would be better served if the funds initially designated for use to finance daily operations were used as needed to extend the system and improve service to its existing users as well as to finance major repairs and

contingencies. Therefore, the Commission finds that South Graves should place the funds designated for daily operations in a reserve account and restrict the use of those funds to the financing of improvements, extensions, major repairs and contingencies.

OTHER ISSUES

The Commission in the course of this proceeding has thoroughly reviewed all information and exhibits that have been filed in this case regarding South Graves' request for approval of construction, financing and revised rates. In addition, the Commission has reviewed the annual reports of South Graves. The Commission is particularly concerned with what it perceives as a lack of responsiveness on the part of the management of South Graves.

The Commission has noted that South Graves has suffered substantial net losses every year since it began operations in 1971. The losses have been of such magnitude that as of December 31, 1981, South Graves had a deficit retained earnings balance of \$254,530 and was seriously in arrears on the current principal and interest payments on its long-term debt necessitating the refinancing of all outstanding debt. Moreover, prior to this case, in the approximately 12 years that South Graves has been in operation it had never appeared before this Commission seeking rate relief.

The Commission is concerned about the impact of this inaction on the financial condition of South Graves. Clearly, had South Graves sought timely rate relief, the costly

refinancing of all its long-term debt could have been avoided. The responsibility to maintain South Graves' financial integrity rests solely with its management; no other individual, group or agency can or should act for it. In this case the Commission can find no reasonable explanation for the inaction of South Graves and urges its management to execute its responsibility to maintain the financial integrity of the district in the future so as to assure the customers of South Graves a dependable and safe water supply.

SUMMARY

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

1. Public convenience and necessity require that the construction proposed in the application and record be performed and a certificate of public convenience and necessity should be granted.

2. The proposed construction includes the following elements: one pressure pumping station; 5,630 feet of 4" P.V.C. pipe; 100 feet of 8" casing pipe; four valve boxes; and one crushed stone driveway. The cost of this construction, according to the bids received March 3, 1983, will be approximately \$36,979.16. These bids were lower than the project engineer had estimated the cost to be; therefore, South Graves received approval from FmHA to construct future improvements with the additional \$16,320.84 in loan funds already committed to South Graves.

3. Any deviations from the approved construction which could adversely affect the water treatment facilities should be subject to the prior approval of this Commission.

4. The proposed financing, consisting of a \$71,000 loan and a \$54,000 grant from FmHA is for lawful objects within the corporate purposes of South Graves, is necessary and appropriate for and consistent with the proper performance of services to the public by South Graves, should not impair its ability to perform these services, and is reasonably necessary and appropriate for such purposes.

5. South Graves should furnish duly verified documentation of the total cost of this project including the cost of construction and all other capitalized costs (engineering, legal and administrative, etc.), within 60 days of the date that construction is substantially completed.

6. South Graves' contract with its engineer should require the provision of full-time resident inspection under the general supervision of a professional engineer with a Kentucky registration in civil or mechanical engineering. This supervision and inspection should insure that the construction work is done in accordance with the contract plans and specifications and in conformance with the best practices of the construction trades involved in the project.

7. South Graves should require the engineer to furnish a copy of the record plans and a signed statement that the construction has been satisfactorily completed in accordance with the contract plans and specifications within 60 days of the date of substantial completion of this construction.

8. South Graves should establish a reserve account and place the grant funds received from FmHA into this account to be used exclusively to finance improvements, extensions, major repairs and contingent items.

9. The rates and charges proposed by South Graves and contained in Appendix A are the fair, just and reasonable rates to be charged by South Graves in that they will produce gross annual revenue of \$109,261.

IT IS THEREFORE ORDERED that South Graves be and it hereby is granted a certificate of public convenience and necessity to proceed with the proposed construction project as set forth in the plans and specifications of record herein.

IT IS FURTHER ORDERED that any deviations from the approved construction which could adversely affect the water treatment facilities shall be subject to the prior approval of this Commission.

IT IS FURTHER ORDERED that South Graves be and it hereby is authorized to borrow \$71,000 at 5 percent interest from the FmHA over a 40-year period. Further, the project funds shall be used only for the lawful objects of South Graves as set forth in the application.

IT IS FURTHER ORDERED that South Graves shall file with the Commission duly verified documentation which shows the total costs of construction herein certificated, including all capitalized costs (engineering, legal, administrative, etc.), within 60 days of the date that construction is substantially completed.

IT IS FURTHER ORDERED that the contract between South Graves and its engineer shall require the provision of full-time resident inspection under the general supervision of a professional engineer with a Kentucky registration in civil or mechanical engineering. This supervision and inspection shall insure that the construction work is done in accordance with the contract plans and specifications and conforms to the best practices of the construction trades involved in the project.

IT IS FURTHER ORDERED that South Graves shall require the engineer to furnish the Commission with a copy of the record drawing and a signed statement that the construction has been satisfactorily completed and done in accordance with the contract plans and specifications within 60 days of the date of substantial completion of the proposed construction.

IT IS FURTHER ORDERED that South Graves shall place all funds in excess of the cost of construction of the facilities approved herein received from FmHA in a reserve account and shall restrict the use of these funds exclusively to finance improvements, extensions, major repairs and contingencies, or the early repayment of its outstanding debt obligations.

IT IS FURTHER ORDERED that the rates proposed by South Graves and contained in Appendix A be and they hereby are approved as the fair, just and reasonable rates and charges to be charged by South Graves for service rendered on and after the date of this Order.

IT IS FURTHER ORDERED that within 30 days of the date of this Order South Graves shall file its revised tariff sheets setting forth the rates approved herein and its rules and regulations governing the provision of service.

Done at Frankfort, Kentucky, this 7th day of April, 1983.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Secretary

APPENDIX A

APPENDIX TO AN ORDER OF THE PUBLIC
SERVICE COMMISSION IN CASE NO. 8513
DATED April 7, 1983.

The following rates are prescribed for the customers in the area served by South Graves Water District. 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.

Rates: Monthly

First	2,000 gallons	\$7.75 Minimum Bill
Next	3,000 gallons	3.25 per 1,000 gallons
Next	5,000 gallons	2.50 per 1,000 gallons
Next	10,000 gallons	2.00 per 1,000 gallons
Next	30,000 gallons	1.50 per 1,000 gallons
Next	50,000 gallons	1.00 per 1,000 gallons
Over	100,000 gallons	.80 per 1,000 gallons