COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

GENERAL ADJUSTMENT OF RATES OF MARYVILLE SEWERAGE SYSTEM, INC.	)))	CASE NO. 8654

O R D E R

On August 27, 1982, Maryville Sewerage System, Inc., ("Maryville") filed an application with the Commission requesting authority to increase its revenues by approximately $73,672 annually, an increase of 31 percent. Based on the determination herein the revenues of Maryville will increase by $30,161 annually, an increase of 13 percent.

A public hearing was held in this matter on January 17, 1983, in the Commission's offices in Frankfort, Kentucky. The Consumer Protection Division of the Attorney General's Office was the only party to intervene in this case.

COMMENTARY

Maryville is a privately-owned sewage treatment system serving approximately 2,076 customers in Bullitt and Jefferson Counties.

TEST PERIOD

Maryville proposed and the Commission has accepted the 12-month period ending May 31, 1982, as the test period for determining the reasonableness of the rates approved herein.

Appropriate pro forma adjustments have been included for rate-making purposes.

REVENUES AND EXPENSES

Maryville proposed several adjustments to test year operating results as reflected in the comparative income statement filed with the 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 and Gas Expense

Maryville proposed to increase actual test period electric and gas expense by $8,103. The proposed cost increase was based on information obtained from Louisville Gas and Electric Company ("LG&E") informing Maryville to expect a 20 percent increase. Pursuant to the Commission's Order dated December 17, 1982, Maryville furnished copies of electric and gas bills for each month of the test period.

The Commission takes notice that no increase in rates has been granted to LG&E although a rate request is currently pending before the Commission. Maryville filed no evidence as to any requirements for additional volumes of electricity or gas to be purchased above test year levels. Moreover, no evidence was provided that reflects that the test year usage is representative of normal operating costs. Therefore, the Commission has adjusted electric and gas expense based on the actual test year usage and the rates in effect for LG&E at the end of the test year. This determination results in an increase in this expense of $4,893. The increase includes the electric bill for Lift Station No. 1 which has been inadvertently paid by another entity in the past.

Gasoline and Truck Expense

Maryville proposed an adjustment to reduce gasoline and truck expense by $45 for the test period. When asked to provide information about this adjustment in the Commission's Order dated December 17, 1982, Maryville responded that the adjustment was made in the interest of rounding off figures. However, it was further stated in this response that due to the recently enacted 5 cent gasoline tax, gasoline expense should be increased by $250 instead of being reduced by $45. Maryville did not provide any evidence indicating that the level of gasoline prices experienced during the test year would continue, thereby requiring an additional allowance for the new gasoline tax. In fact, Mr. John A. Walser, President and Manager of the sewer system, testified on cross-examination that he understood that gasoline prices were declining currently. The Commission is of the opinion that no conclusive evidence has been presented to support the contention that the additional tax on gasoline will result in an overall increase in this expense above test year levels. Therefore, an adjustment to increase gasoline expense is not justified.

Sludge Hauling

Maryville proposed an adjustment to increase sludge hauling expense by $3,309 over actual test period results. The explanation provided for this adjustment is that the practice of dumping sludge on nearby farm land has been discontinued due to a verbal order from the Health Department, and Maryville is now required to transport sludge to the Metropolitan Sewer District ("MSD") which results in additional cost. In its Order dated December 17, 1982, the Commission requested supporting evidence as to the basis for this adjustment. The explanation provided was that additional trips to MSD will be necessary because the dumping of sludge on adjacent farms will be terminated.

Item No. 13 of the response to the Commission's Order dated November 4, 1982, stated that "uncounted trips" were made to farms and undeveloped acreage during the test period. The Commission finds that Maryville has failed to present sufficient evidence whereby a known and measurable change can be identified concerning this expense. Therefore, the Commission has determined that no adjustment shall be allowed for sludge hauling.

Maintenance - Plant and Equipment

Pursuant to the Commission's Order dated November 4, 1982, a detailed breakdown of the expenditures charged to this account was furnished. Among the items included in that breakdown was an expenditure totaling $1,277 for "new pumps for sewer plant no. 4." Based on the description of this item of expense the Commission has determined that the expensing of this item was improper and the item should be capitalized. Therefore, maintenance - plant and equipment has been reduced by $1,277 and applicable depreciation of

$255 has been added to depreciation expense for the test period to reflect depreciation of this new equipment over a 5-year period.

Billing and Collection Expense

Maryville proposed an adjustment to increase billing expense by $345. The explanation provided for this adjustment was that Louisville Water Company ("LWC") has increased its collection fees by this amount. A letter from LWC was filed with the application which reflects that beginning May 1, 1982, LWC's joint service cost will be increased from $1.53 to $1.56. Sewer utilities which utilize the billing services of LWC pay a portion of the joint service cost based on the ratio of the sewer bill to the combined water and sewer bill. Therefore, if the water bill increased more than the sewer bill it would be possible for the amount of the joint service cost paid by the sewer utility to decrease. The Commission's Order dated December 17, 1982, requested the basis for the proposed adjustment. Maryville responded that the adjustment was based on LWC's increased collection fee. Maryville explained further that the collection fee was anticipated to increase because it was anticipated that sewer rates would increase and thus Maryville would have to pay a higher percentage of the joint service cost.

The Commission concurs with Maryville's assertion that an increase in the sewer rate would increase the billing and collection fee and typically makes adjustments in sewer utility cases to recognize this additional cost. However, in this instance the water rates to customers of LWC were increased effective January 1, 1983, according to information filed by Maryville with its application. Therefore, based on the rate increase granted to Maryville in this Order and the increase in rates by LWC, the Commission has determined that an adjustment to billing expense is not required.

Insurance

Maryville proposed to increase insurance expense by $858 over actual test period results. The adjustment was based upon the most recent insurance rates quoted. Item No. 14 of the Commission's Order dated November 4, 1982, requested documentation for the increase in rates that was quoted to Maryville. Maryville responded that the major portion of insurance expense is workmen's compensation and liability premiums which are based on payroll. Therefore, the adjustment was based on the proportional increase in payroll. However, the basis, including supporting computations, for the actual dollar amount of the adjustment was not provided although a data request specifically sought this information. The Commission is of the opinion that adjustments can be accepted only when sufficient evidence is presented so that known and measurable changes can be identified. The Commission has determined that Maryville was given sufficient opportunity to substantiate this adjustment but failed to do so. Therefore, no adjustment has been allowed to increase this expense.

Telephone Expense

An adjustment was proposed by Maryville to increase test period telephone expense by $61. The explanation provided for this adjustment was that the cost of telephone service increased during part of the test period. Copies of the monthly telephone bills were requested in Item No. 5 of the Commission's Order dated December 17, 1982. The bills reflected that telephone expense for the test period included basic local charges from South Central Bell for a mobile phone and charges from Allied Telephone Company ("Allied") for an office phone. The Commission has determined that the local monthly service charge from Allied increased by a total of $3 per month beginning in September of the test period. Therefore, an adjustment to increase telephone expense by $12 has been made to reflect this increased cost associated with the office phone.

At the hearing Mr. Walser was asked why a mobile phone was essential to Maryville's operation. He testified that the mobile phone was located in his personal automobile and when office personnel were not available to answer the office phone a call-forwarding feature connected to the phone system would automatically transfer calls to the mobile phone. Customers could call either one of two office locations concerning sewer system business and these phones were answered on a fairly consistent basis during normal business hours. The Commission requires that utilities provide customers a means to contact sewer system personnel when necessary. The ability of customers to call either of two office numbers is sufficient in this case to meet that need. The mobile phone may be convenient for sewer-related business on certain occasions. However, the Commission is of the opinion that the value of the mobile phone to the sewer operation cannot be reasonably separated from personal use and the benefit to other businesses operated by Mr. Walser. In addition, the Commission is of the opinion that the mobile phone is not reasonable and necessary to Maryville's operation and this cost should not be borne by the ratepayers. Therefore, the Commission has determined that an adjustment in the amount of $1,509 should be made for rate-making purposes to decrease telephone expense associated with the mobile phone during the test period.

These two adjustments result in adjusted test period telephone expense of $1,442.

Bad Debt Expense

Maryville proposed an adjustment to increase bad debt expense by $346 over the cost reported for the test year. The adjustment is based upon Maryville's most recent experience, which is getting worse due to the economy. Maryville was given an opportunity to present the basis for the actual dollar amount of this adjustment in its response to Item No. 6(i) of the Commission's Order dated December 17, 1982. The response to this item referred to the 31 percent increase in this account between 1981 and 1982, and Maryville expects bad debts to increase further due to high unemployment. The

Commission is aware of the present economic climate and of the relatively high unemployment prevalent in certain areas. However, the Commission is of the opinion that this adjustment is speculative in nature and that Maryville has failed to present a known and measurable basis for adjusting this expense. Therefore, the Commission has determined that no adjustment should be made for this expense.

Operator Training Expense

Maryville proposed an adjustment in the amount of $600 for annual training necessary to recertify sewer plant operators. The cost was based on the training of three men at an estimated cost of $175 per man. Item No. 5 of the response to the Commission's Order dated November 4, 1982, contains a letter from the Kentucky Board of Certification of Wastewater System Operators that refers to 401 KAR 5:010, Section 8. This section requires that sewer plant operators must accumulate 12 hours of approved training for annual certificate renewal. Maryville has produced evidence that two training sessions were attended during the test period at a total cost of $554. Under 401 KAR 5:010, Section 8, required annual training may include various types of courses.

The Commission is aware that the Department for Natural Resources ("DNR") routinely offers training classes at various locations throughout the Commonwealth. The only fee for the DNR classes is a charge of $10 to cover the examination cost. Classes offered by other institutions may satisfy the annual training requirement but are generally more expensive. Maryville personnel attended a DNR class in Owensboro at a cost of $179, and a class at the University of Louisville sponsored by Speed Scientific School at a cost of $375 during the test period.

DNR routinely notifies sewer utilities through mass mailings of the training classes that will be available several months in advance. Mr. Walser testified that he is aware of the DNR-sponsored classes but, believing that they are not offered in the Louisville area, he chose the sessions in Owensboro. The Commission is of the opinion that DNR routinely offers training classes twice a year in the Louisville area. The Commission is aware that sewer operators have the option of attending the DNR training or training sponsored by other concerns. However, in setting rates for the future the Commission is of the opinion that ratepayers should bear only those costs which are reasonable and necessary to certify the plant operators. Therefore, the Commission has determined for rate-making purposes that the allowable training expenses for Maryville should be a total of $162 [1/] in this case. This amount includes the necessary fees and travel expenses for three employees to attend the DNR training within the Louisville area. An adjustment has been made to reduce operating expenses by $392 to exclude the additional cost incurred during the test year.

1/ 3 DNR exams at $10 each = $30; 3 renewal fees at $4 each = $12; travel, $120.

Depreciation

The depreciation schedule submitted by Maryville with the application reflects the use of an accelerated method of depreciation for book purposes for some of the assets. It is the policy of this Commission to compute depreciation expense for rate-making purposes on the basis of the straight-line method. The Commission has determined that depreciation expense for the test period has been overstated due to the use of the accelerated method. Therefore, depreciation expense has been reduced by $2,498 for the test period to reflect the use of the straight-line method of depreciation. In determining the allowable depreciation expense for rate-making purposes the Commission has computed straight line depreciation based on the net book value of plant in service and the remaining life of these assets.

Taxes Other Than Income Taxes

Effective January 1, 1983, Maryville increased employee wages by approximately 7 percent. An adjustment has not been proposed by Maryville to increase payroll taxes in connection with this pay increase. However, the Commission has determined that the employer's share of payroll taxes will increase as a result of the pay increase. Therefore, an adjustment has been made to increase payroll taxes by $578 for the test period.

Income Taxes

Maryville proposed an adjustment in the total amount of $7,000 for state and federal income taxes. However, based on the rate increase granted in this Order the Commission has determined that an adjustment in the total amount of $4,751 should be made for income taxes.

Reserve - Plant Replacements

Maryville proposed to increase operating expenses by $20,000 to establish a reserve account for the purpose of funding future major expenditures. Mr. Walser testified that the proposed annual deposit to the fund was based on an estimate of future expenditures for major items. The Commission is of the opinion that the estimate proposed by Maryville is speculative in nature and that the forecasting of future expenditures fails to meet the criteria of known and measurable changes. In addition, the Commission is of the opinion that ratepayers should not bear costs when a need has not been demonstrated for acquisitions nor should ratepayers bear the cost for proposed acquisitions when the item has not yet been purchased by the utility. Therefore, the Commission has denied the proposed cost of establishment of a reserve account for rate-making purposes in this case.

Based on the allowed pro forma adjustments, Maryville's test period and adjusted operating statement appears as follows:

	Actual 5/31/82	Pro forma Adjustments	Adjusted Test Year
Operating Revenue	$234,128	-0-	$234,128
Operating Expenses	218,644	11,108	229,752
Operating Income	$ 15,484	$(11,108)	$ 4,376
Interest Income	91	(91)	-0-
Interest Expense	30,971	(16,412)	14,559
Net Income	$(15,396)	$ 5,213	$(10,183)

REVENUE REQUIREMENTS

Maryville presented no evidence in this case on its required rate of return. On the pro forma operating statement, Maryville indicated that its requested net income was 11.8 percent of proposed operating revenues, and made reference, in its explanation for a proposed reserve account, to the Commission's policy of using the operating ratio [2/] to determine revenue requirements for sewer utilities. No evidence was presented by Maryville on its required reserve margin or the appropriate operating ratio.

In determining revenue requirements of utilities within its jurisdiction the Commission has primarily used four methods to derive the allowed earnings. These methods are: (1) rate of return on net investment or capital; (2) debt service coverage; (3) times interest earned ratio; and (4) operating ratio. The method used most frequently for determining the revenue requirements of sewer utilities is the operating ratio. The Commission has used this method due to the unusual capital structure of sewer utilities, the difficulty in arriving at a fair value of investment for rate-making purposes, and the relatively small capital cost in comparison to plant investment. The operating ratio generally allowed for sewer utilities has been in the range of 88 percent although in past cases operating ratios of 93.5% and higher have been granted. In the last case approving rates for Maryville, 88 percent was the allowed operating ratio. The Commission has reviewed the

2/ $\text{Operating Ratio} = \dfrac{\text{Operating Expenses + Depreciation + Taxes}}{\text{Gross Revenue}}$

evidence of record in this case and finds that the operating ratio method should be used in determining the revenue requirements of Maryville.

In establishing the appropriate operating ratio for a utility, the Commission must consider factors such as the amount of investor-supplied equity capital and the risk associated with that investment, the availability of funds from external sources for expansion and improvements, the required level of internal funds for expansion, improvements and repayment of debt, the required level of reserves for contingencies, and a reasonable surplus.

In this instance the owners of Maryville have made very little investment in the utility. Total equity capital at the end of the test year was a deficit $12,667 with $1,000 of common stock and $(13,667) in unappropriated retained earnings. The availability of funds from outside sources to finance capital needs is demonstrated by the long-term debt and notes payable outstanding, and no evidence has been presented that would reflect that external funds would not be available to Maryville when required for expansion and improvements. Moreover, the Commission has denied, in the preceding section of this Order, a proposed adjustment to provide funds to establish a reserve for repairs and replacements because no evidence was provided to reflect the necessity of these funds.

Therefore, the determination of a reasonable level of earnings, and the expectation that those earnings can be achieved are the primary concerns in establishing a reasonable operating ratio for Maryville. The Commission is of the opinion that the erosion of earnings should not be a critical factor in this determination because the Commission has allowed numerous adjustments to the historical test year operating expenses to reflect known and measurable changes, thus rendering the pro forma operating expenses representative of expected future operating costs. Moreover, the current economic climate should not produce significant inflationary pressure on the adjusted operating expenses allowed in this case.

The Commission is of the opinion that an 88 percent operating ratio would produce excessive cash reserves and should not be used in this instance. The Commission finds that a more reasonable operating ratio for Maryville would be 92 percent. 3/ This operating ratio will provide net operating income of $34,537 which will be sufficient to service Maryville's debt and provide a reasonable surplus for equity growth. This level of net income will provide a 1.2 debt service coverage which has been allowed in other sewer and water cases by this Commission.

Therefore, the Commission finds that Maryville is entitled to increase its rates to produce total revenues of $264,289 which will require an increase in revenues of $30,161 annually.

3/ According to A.J.G. Priest's Principles of Public Utility Regulation, Vol. I, p. 224, operating ratios of 92 to 96 percent are not unusual and have often been equivalent at the 92 percent level to returns of 15 percent.

ACCOUNTING RECORDS

Item No. 1 of the response to the Commission's Order dated December 17, 1982, reflects that certain development costs are being recovered through tap-on fees and from the Turnpike Water District. Item No. 4 of the additional information which was requested at the hearing reflects that $3,319 was charged to development costs between December 31, 1981, and May 31, 1982. Maryville stated that no journal entries were necessary because the amounts appeared as receipts in the cash receipts journal. The Commission is of the opinion that this procedure is not in accordance with the Uniform System of Accounts for Sewer Utilities as prescribed by this Commission. The receipts collected should be credited to Contributions in Aid of Construction (Account No. 271) and the applicable development costs transferred to the appropriate plant in service account. Therefore, the Commission has determined that Maryville should make the proper entries to correct the previous accounting treatment and all subsequent transactions should be in accordance with the Uniform System of Accounts.

The application reflects that total investment in plant by Maryville is $1,498,926. It has been established that $1,260,127 of this amount is recognized to be contributed property. However, Maryville did not include a Contributions in Aid of Construction account within the test period balance sheet. Item No. 8 of the response to the Commission's Order dated December 17, 1982, reflects that the cost of contributed utility plant is included within utility plant cost on the balance sheet. This cost was fully amortized before contribution and the amount amortized has been included within accumulated depreciation on the balance sheet. The Commission is of the opinion that this accounting practice is not in accordance with the Uniform System of Accounts. Therefore, the Commission has determined that Maryville should make the entries necessary for its records to be in accordance with the Uniform System of Accounts.

Maryville requested an adjustment in this case to recognize depreciation on costs incurred to construct a water line to sewer plant No. 4. Item No. 7 of the response to the Commission's Order dated November 4, 1982, reflects that these costs are classified as development costs. The Commission has determined that Maryville should transfer these costs to the appropriate plant in service account to reflect the proper classification of these costs.

SUMMARY

The Commission, having considered the evidence of record and being advised, is of the opinion and finds that:

1. The rates in Appendix A are the fair, just and reasonable rates for Maryville and will produce gross annual revenue sufficient to pay its operating expenses, service its debt and provide a reasonable surplus for equity growth.

2. The rates proposed by Maryville would produce revenue in excess of that found reasonable herein and should be denied upon application of KRS 278.030.

3. A portion of the accounting records maintained by Maryville are not in accordance with the Uniform System of Accounts for Sewer Utilities as prescribed by this Commission and the applicable records should be changed.

IT IS THEREFORE ORDERED that the rates in Appendix A be and they hereby are approved for service rendered by Maryville on and after February 16, 1983.

IT IS FURTHER ORDERED that the rates proposed by Maryville be and they hereby are denied.

IT IS FURTHER ORDERED that Maryville shall revise its accounting records in the areas specifically mentioned herein to be in accordance with the Uniform System of Accounts for Sewer Utilities as prescribed by this Commission.

IT IS FURTHER ORDERED that within 30 days from the date of this Order Maryville shall file with the Commission its revised tariff sheet setting out the rates approved herein.

Done at Frankfort, Kentucky, this 17th day of February, 1983.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ATTEST:

APPENDIX A

APPENDIX TO AN ORDER OF THE PUBLIC SERVICE COMMISSION IN CASE NO. 8654 DATED FEBRUARY 17, 1983.

The following rates are prescribed for the customers in the area served by Maryville Sewage System, Inc., located in Jefferson County, Kentucky. All 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.

Customer Category	Monthly Rate
Single Family Residential	$ 10.75 per residence
Commercial	21.45 per residential equivalent
Multi Family Residential	8.10 per apartment