

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

NOTICE BY SANICO, INC. TO)
INCREASE ITS SEWAGE RATES)
AND FOR APPROVAL TO FINANCE) CASE NO. 8773
PLANT ADDITIONS)

O R D E R

On February 18, 1983, Sanico, Inc., ("Sanico") filed an application with the Commission requesting an increase in rates for sewage treatment service rendered on and after March 10, 1983. The proposed rates would increase annual revenues by \$19,465 annually, an increase of 111 percent. On February 22, 1983, the Commission suspended the proposed rate increase until August 10, 1983, in order to conduct public hearings and an investigation into the reasonableness of the proposed rates. A hearing was set for June 23, 1983, and Sanico was directed to give notice to its customers of the proposed rates and the scheduled hearing pursuant to 807 KAR 5:025, Section 7.

On April 1, 1983, Sanico filed a motion requesting an interim increase in rates sufficient to produce additional revenues of \$4,432 during the 5 months from April 1983 to August 1983. The request for an interim increase in rates was denied by the Commission in its Order of April 27, 1983.

Motions to intervene in this matter were filed by the Consumer Protection Division in the Office of the Attorney

General ("AG"), the City of Maysville ("City"), and two residential customers, Mrs. Stanley C. Wiggins and Mrs. William J. Peterson. These motions were granted and no other parties formally intervened.

The hearing for the purpose of cross-examination of witnesses was held in the Commission's offices in Frankfort, Kentucky, on June 23, 1983. Briefs were filed as ordered and the information requested during the hearing has been submitted.

This Order addresses the Commission's findings and determinations on issues presented and disclosed in the hearing and investigation of Sanico's revenue requirements and its need for financing of additions to utility plant. The Commission has determined herein that Sanico requires an increase in annual revenues of \$2,428.

COMMENTARY

Sanico is a privately-owned utility providing water service and sewage treatment service in Mason County, Kentucky. Sanico provides sewage treatment service to 56 residential customers and water and sewage treatment service to a 51-unit apartment complex which is owned by the stockholders of Sanico. Since November 1981 Sanico's sewer system has been connected to, and its sewage has been treated by, the sewage treatment system of the City of Maysville, Kentucky.

TEST PERIOD

Sanico proposed and the Commission has accepted the 12-month period ending December 31, 1981, as the test period for determining the reasonableness of the proposed rates. In utilizing the historic test period the Commission has given full consideration to appropriate known and measurable changes.

REVENUES AND EXPENSES

For the test period Sanico had a net operating loss from sewage operations of \$3,440. Sanico proposed several pro forma adjustments to revenues and expenses to reflect more current and anticipated operating conditions. The Commission is of the opinion that the proposed adjustments are generally proper and acceptable for rate-making purposes with the following modifications:

Administrative and General Salaries

During the test year Sanico charged \$1,200 to expense for administrative and general salaries which was the amount allowed in its most recent rate case, Case No. 8083, Adjustment of Sewer Rates of Sanico, Inc., of Maysville, Kentucky. In this proceeding Sanico has requested that it be allowed to increase this amount by \$2,800 to \$4,000 to provide compensation for its president and a part-time clerical worker. Neither of these people performs any physical maintenance work nor Sanico's billing and

accounting. These duties are all handled under contracts with outside persons at a base cost of \$2,400 annually, excluding materials and supplies.

Sanico described the duties these part-time employees perform; however, no records are maintained showing the amount of time either employee contributed to Sanico's sewer operations. Sanico offered no objective basis for the proposed \$2,000 compensation for each employee.

The Commission is of the opinion that Sanico has failed to support its requested level of expense for administrative and general salaries and has provided little information to assist the Commission in making a determination as to a reasonable level of expense. Therefore, the Commission will allow \$1,800 for administrative and general salaries which is the level of expense normally allowed for small, investor-owned sewer utilities which operate without full-time employees. Inasmuch as Sanico meets these criteria, the Commission is of the opinion that this is a reasonable level of expense and has made an adjustment of \$600 to reflect this increase above the test year expense.

Amortization of Treatment Plant

In November 1981, Sanico's sewage collection system was connected to the sewage treatment system of the City and Sanico discontinued operation of its sewage treatment plant. In this proceeding Sanico requested authorization to record the extraordinary retirement of the treatment plant and

amortize the undepreciated cost of the plant of \$7,862 at December 31, 1981, over a period of 5 years. Sanico's treatment plant began operation in 1972 and was being depreciated over a 20-year life, to continue through 1991. Sanico did not offer any substantive support for the proposed 5-year amortization period, nor, in calculating its adjustment, did Sanico consider the reduction to the undepreciated cost of the treatment plant resulting from the additional depreciation of \$749 charged to expense in calendar year 1982. This additional depreciation expense reduces the undepreciated cost of the treatment plant to \$7,113.

Sanico has made little effort to sell its treatment plant to any other utilities or derive any salvage value from it in some other manner. The Commission is hopeful that some value can be obtained from this plant to reduce the cost Sanico and its customers must bear for this facility. The Commission is of the opinion that the undepreciated cost of the treatment plant should be amortized over the remaining 9 years of its 20-year service life. The Commission is also of the opinion that the retirement of the treatment plant and the reduction of plant in service should reflect, for rate-making purposes, a proportionate decrease to contributions in aid of construction. As discussed elsewhere in this Order, the Commission finds \$70,392, or 56 percent, of Sanico's plant to be contributed. A uniform application of this percentage to all plant in service reflects \$3,983 as

the contributed portion of the undepreciated cost of the treatment plant. The resulting non-contributed portion of the treatment plant's undepreciated cost is \$3,130.

Inasmuch as the cost of the portion of the treatment plant that is contributed was not recoverable through rates while the plant was operating, there is no basis for charging that cost to the ratepayers now that the plant has been retired. Therefore, while the annual amortization of the undepreciated cost of the treatment plant is \$790, for rate-making purposes the Commission has made an adjustment to increase operating expenses by only \$348 which reflects the amortization of the non-contributed portion of the treatment plant's undepreciated cost.

Amortization of Extraordinary Maintenance

On Exhibit 2, Schedule 9, of its application, Sanico reported extraordinary maintenance expense of \$4,978 during 1982 for major repairs to its lift station pumps, which it proposed to amortize over a 5-year period. In response to the Commission's data requests Sanico provided the invoices in support of its maintenance charges. All invoices totaled \$4,180 for maintenance work and reflected \$516 for finance charges. At the hearing Sanico attempted to show that all invoiced maintenance work resulted in an expense of \$4,715; however, Sanico's rate consultant, Mr. Dell Coleman, was unable to reconcile this amount with the \$4,180 expense previously reported and shown in the invoices.

The Commission is encouraged by the work Sanico has performed as it seems to have greatly alleviated the operational problems previously experienced with the lift stations; however, \$4,180 is the only amount that has been sufficiently supported to be acceptable for rate-making purposes. The Commission is of the opinion that a 5-year amortization period, as was proposed, is appropriate for this type of expense and has made an adjustment of \$836 to reflect this expense for rate-making purposes.

Treatment and Disposal Costs

During the test year, Sanico's sewage was treated by the City for 2 months. In calendar year 1982, the City treated Sanico's sewage for the entire year at a cost of \$6,678. Sanico proposed an adjustment to increase its test year treatment and disposal cost by \$6,024 to \$6,678 to reflect a full year's cost for the treatment of its sewage by the City. However, Sanico did not take into consideration the increased cost for sewage treatment service implemented by the City in 1982 nor did it exclude the penalties it incurred during 1982 for late payment of its bills from the City. The net effect of eliminating late payment penalties in the amount of \$63 and normalizing the 1982 expense based on the City's current rate of \$1.12 per thousand gallons is to increase treatment and disposal cost to \$6,898. Therefore, the Commission has made an adjustment of \$6,244 to reflect the level of expense currently being incurred by Sanico for sewage treatment and disposal.

Rate Case Expense

Sanico proposed an adjustment of \$2,589 to amortize over 3 years its projected costs of \$4,500 for professional services incurred in relation to this proceeding as well as costs incurred for Case No. 8083. Mr. Coleman testified that the entire cost of \$3,266 from Case No. 8083 was included in the proposed adjustment because it was unclear to him whether the Commission had provided for amortization of that expense in Sanico's prior case. In Case No. 8083 the Commission allowed the recovery of \$1,500 in rate case expense to be amortized over 3 years as was requested by Sanico.

In response to the Commission's request, made at the hearing, Sanico submitted invoices for the work performed by counsel and Mr. Coleman in this proceeding. These invoices reflected total billings for this case in the amount of \$6,237 with anticipation of additional billings by counsel of \$500. Such amounts are not without precedent; however, they are unusual for a utility the size of Sanico, with \$17,500 in annual revenues and only 57 customers. The cost of this case alone, amortized over 3 years as proposed by Sanico, would cost each residential customer nearly two dollars per month.

The Commission is of the opinion that none of the additional expense for Case No. 8083 should be borne by Sanico's ratepayers. The rates currently in effect reflect the cost of \$1,500 which was requested in the earlier case. Sanico alone is responsible for its failure to request and adequately document the level of expense incurred for the

prior case, and as such, the Commission finds no compelling reason to require Sanico's customers to bear this cost retroactively as if it were resulting from the current case.

The cost of the current case has been documented by Sanico's counsel and rate consultant; however, little has been provided regarding the details of the work performed. Sanico should be concerned about the costs incurred in connection with this case and the minimal documentation provided in support of these costs. The Commission is concerned that Sanico will be less interested in these matters if it is allowed to pass the full amount of these costs on to its ratepayers. Inasmuch as the rate increase granted herein and the resulting increase in operating margins will inure to the benefit of Sanico's consumers and shareholders, the Commission is of the opinion that the cost of this rate case should be shared by Sanico's consumers and shareholders. An equal sharing of the invoiced costs of \$6,237, amortized over 3 years, results in an annual rate-making expense of \$1,040. This amount should allow Sanico an adequate recovery of its rate case expenses and, at the same time, provide an incentive to hold down such expenses in the future.

Easement - Connection Charge

In its application, Sanico requested recovery of \$29,321 for an easement purchased from Sanico's President, Mr. James Breslin, and then conveyed to the City. Sanico proposed to amortize this amount over 30 years with annual

finance charges of 13 percent on a loan from Mr. Breslin. This transaction was in conjunction with the connection of the Sanico system to the City's sewer system, which required the City to cross Mr. Breslin's property adjacent to Sanico's treatment plant.

Throughout this proceeding Sanico maintained that the City required a connection fee of \$29,321 to connect Sanico to the City's sewer system and, in lieu of payment of this fee, Sanico conveyed an easement to the City valued at the same \$29,321 as the connection fee. The City claimed that Sanico's use of the amount of \$29,321 was inappropriate for the easement or connection fee and that no connection fee was charged Sanico.

In support of its position, Sanico filed a bid tabulation sheet for the City's connection work which reflected an amount of \$29,321. The City's engineer, Mr. Larry New, testified that this amount reflected work in addition to the work on Mr. Breslin's property and that the work performed on Mr. Breslin's property cost much less than the total of \$29,321. Sanico presented no other documentation of the value of the easement or the requirement by the City of a connection fee. The City maintained that there never was a connection fee charged to Sanico due to the conditions of the Housing and Urban Development ("HUD") grants which funded the City's extension and connection work. The apartment complex served by Sanico is a federally-subsidized HUD project which the City contends was

required to be connected to its sewer system as a condition of receiving the grant funds. The City further contends that the conditions of the HUD grants prohibited it from charging Sanico a connection fee.

The Commission finds little evidence in support of Sanico's position. The bid tabulation does not establish the alleged connection fee and the promissory note from Sanico to Mr. Breslin for the purchase of the easement does not represent an arms' length transaction. From the evidence of record, the Commission is of the opinion that an easement was conveyed to the City, but that no value was assigned to said easement, and that no tap-on fee was required by the City to connect Sanico to its sewer system. Therefore, the Commission will not include in its determination of revenue requirements any amount for the purchase or amortization of the easement conveyed to the City.

Financing of Proposed Plant Additions

As part of its application Sanico requested approval of financing for the replacement of its existing single-phase lift station pumps with three-phase pumps at both of its lift stations. Sanico later amended its request to include only the replacement of the 2 pumps at one lift station at a cost of \$17,747, including installation and the cost of a three-phase electrical hook-up.

Sanico maintained that the replacement of the pumps was necessary to comply with requirements of the Kentucky Cabinet for Natural Resources ("CNR"); however, Sanico's only

documentation for this alleged requirement was a letter from CNR indicating that formal approval of the project was not required since little construction was actually involved. Sanico offered no other evidence to prove the need for the new pumps nor did it contest the testimony of Mr. New that the old pumps are currently performing adequately and have been for several months.

The replacement of the two pumps would increase Sanico's annual expense, including depreciation, interest and principal, by approximately \$7,000, as compared to the test year expense of approximately \$1,000 for maintenance of pumps. The Commission is cognizant of the operational problems Sanico has experienced in the past with its pumping system, but these problems and the correction thereof cannot be addressed without considering the cost of the proposed action or possible alternatives. The record does not indicate that Sanico has considered either.

While the new pumps may improve the physical operation of the lift station, Sanico has failed to show that the improvement justifies its cost. In setting rates, the Commission must determine a reasonable level of expense reflective of prudent expenditures by the utility. The record contains no information that reflects that the old pumps have not worked adequately since the major repair work performed during 1982 at a cost of \$4,180. Considering the level of cost that would accompany the installation of new pumps, and the extensive work just completed on the old pumps,

the Commission is of the opinion that the proposed plant additions and the financing thereof are not in the best interests of Sanico's consumers at the present time and, therefore, should be denied. Accordingly, none of the costs for the proposed plant additions have been included herein for rate-making purposes.

Maintenance of Pumping System

During the test year Sanico incurred \$1,038 in expense for maintenance of pumps. In conjunction with the proposed replacement of its existing pumps, Sanico had proposed an adjustment to reflect the elimination of the test year maintenance expense. In the preceding section the Commission denied the financing of the new pumps that Sanico proposed to install and indicated that Sanico should continue to operate using its existing pumps. Continued use of the existing pumps should result in continued maintenance expense; therefore, the Commission has not accepted Sanico's proposed adjustment and has included the test year expense for rate-making purposes.

Depreciation Expense

During the test year Sanico's depreciation expense per books was \$4,917. For rate-making purposes, Sanico adjusted this amount to \$4,332 based on the remaining service lives established in Case No. 8083 for Sanico's utility plant in service. Sanico proposed to reduce depreciation expense by \$1,779 to reflect the retirement of the treatment plant and full depreciation of the pumps. Sanico also proposed to

increase depreciation expense by \$2,009 to reflect the addition of the new pumps. The Commission has accepted these adjustments with the exception of the additional expense for the new pumps, which is discussed elsewhere in this Order. These accepted adjustments result in annual depreciation expense of \$2,553 on plant in service of \$106,690.

Sanico proposed an additional adjustment to reduce depreciation expense for rate-making purposes by \$1,464 to exclude depreciation on contributed property of \$40,568. The Commission, in Case No. 8083, determined the amount of Sanico's contributed property to be \$70,392, which included the lines and other facilities added to the system to serve the Jersey Ridge Apartments. These facilities were transferred to Sanico from JPB, Inc., the firm which developed and constructed the apartment complex in 1978. Since 1980, when the assets were transferred, Sanico has offset this addition to plant in service with an increase in equity capital. Sanico contends that, inasmuch as Mr. Breslin was the sole stockholder in JBP, Inc., the transfer consisted of a stockholder's contribution to capital.

The Commission finds Sanico's argument to be unpersuasive. The transfer of the assets was not reflected on Sanico's books until 2 years after construction was complete and was never formally documented. The assets were never the property of any firm or individual other than Sanico or JPB, Inc. The common ownership of Sanico and JPB, Inc., does not establish that the transfer of assets

represents an addition to equity capital. The donation of property to Sanico from a separate legal entity represents a contribution in aid of construction in which Sanico has no investment or recoverable cost. Therefore, the Commission finds \$70,392 to be the amount of Sanico's contributed property. For rate-making purposes the Commission has reflected a reduction to contributions in aid of construction in proportion to the reduction to plant in service caused by the retirement of the treatment plant. This results in \$59,882, or 56 percent, of the \$106,990 remaining plant in service being treated as contributed property, the cost of which is not recoverable through rates. Accordingly, the Commission has reduced gross depreciation expense of \$2,553 by 56 percent for rate-making purposes, which requires a downward adjustment of \$1,430 and results in depreciation expense allowed for rate-making purposes of \$1,123.

The net effect of the accepted adjustments to Sanico's test year operations is as follows:

	<u>Actual Test Year</u>	<u>Adjustments</u>	<u>Adjusted Test Year</u>
Operating Revenues	\$14,423	\$3,090	\$17,513
Operating Expenses	<u>17,863</u>	<u>(859)</u>	<u>17,004</u>
Net Income (loss)	<u>\$(3,440)</u>	<u>\$3,949</u>	<u>\$ 509</u>

REVENUE REQUIREMENTS

Sanico based its requested increase in revenue on an operating ratio methodology and requested revenue sufficient to produce a ratio of .88. In order to achieve this ratio, Sanico should be allowed to increase its annual revenue by

approximately \$2,428. This additional revenue, after the provision for income taxes of \$544, will provide for net income of \$2,393.

OTHER ISSUES

Sanico's Continued Existence

Sanico is one of at least three utilities that have been connected to the City's sewage treatment system within the past 2 years. Two others, Arnold Realty Company and Sanitation District No. 1 of Mason County have been transferred to the City. While it has no jurisdiction in this area, the Commission is of the opinion that a similar transfer of Sanico would be in the best interests of Sanico's customers.

Jurisdiction Over Sanico

At the June 23, 1983, hearing the City argued that the Commission had no jurisdiction to regulate Sanico because Sanico's existence was in violation of the Kentucky Constitution. The City's brief on this issue was filed on July 1, 1983, and Sanico's response was filed on July 8, 1983.

On May 19, 1970, the State Commissioner of Sanitation Districts, pursuant to KRS 220.080 to 220.090, established the Sanitation District No. 2 of Mason County, Kentucky ("District"). In May 1972 the District granted Sanico a perpetual franchise to operate a sewage collection and disposal system within the District's boundaries. The City claims that this perpetual franchise violates Section 164 of

the Kentucky Constitution, which limits such franchises to 20 years duration. Consequently, the City argues that Sanico's authority to operate was void ab initio rendering it incapable of being grandfathered in 1975 as a sewer utility under KRS 278.010(3)(f).

In 1974 the Kentucky General Assembly enacted KRS 278.010(3)(f), which empowered the Commission to exercise jurisdiction over sewer utilities. Certain facilities, such as those regulated by a metropolitan sewer district, were exempted from the Commission's jurisdiction. None of the exemptions is applicable to Sanico. Sanico is a corporation which controls and operates facilities in connection with the treatment of sewage for the public, for compensation. Therefore, the Commission finds that Sanico is subject to its jurisdiction. The Kentucky Court of Justice, not the Commission, is the proper forum for the City's allegations of constitutional violations. The Commission makes no findings herein for any purpose as to the validity of the contract between Sanico and the District, or the authority of Sanico to provide service in the area it now serves.

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 Sanico and will produce gross annual revenue of approximately \$19,941.

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

IT IS THEREFORE ORDERED that the rates in Appendix A be and they hereby are approved for service rendered by Sanico on and after August 10, 1983.

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

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

Done at Frankfort, Kentucky, this 11th day of August, 1983.

PUBLIC SERVICE COMMISSION

Did Not Participate
Chairman

Katherine Rendell
Vice Chairman

Don Carver
Commissioner

ATTEST:

Secretary

APPENDIX A

APPENDIX TO AN ORDER OF THE PUBLIC SERVICE
COMMISSION IN CASE NO. 8773 DATED August 11, 1983

The following rates are prescribed for all customers served by Sanico, Inc. All rates and charges not specifically mentioned herein shall remain the same as those in effect prior to the date of this Order.

Rates: Monthly

Customer Category

Residential/Apartment Rate \$ 15.50 per Month

Jersey Ridge Apartments \$795.00 per Month