

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

THE JOINT APPLICATION OF TREE-)
LINE UTILITIES, INC., D/B/A TREE-)
LINE ESTATES SEWER SYSTEM AND)
BALDWIN UNITED MORTGAGE COMPANY,)
BY COLWELL REALTY INVESTMENT,)
INC. OWNER OF TREASURE ISLAND)
EAST SEWER SYSTEM FOR APPROVAL:) CASE NO. 8934
OF SALE AND PURCHASE OF ASSETS:)
A CERTIFICATE OF CONVENIENCE AND)
NECESSITY TO CONSTRUCT: TO ISSUE)
NOTES TO FINANCE CONSTRUCTION:)
AND APPROVAL OF INCREASE OF RATES)

O R D E R

BACKGROUND

On November 8, 1983, Tree-Line Utilities, Inc., ("Tree-Line") and the Baldwin United Mortgage Company ("Baldwin") filed with the Commission a joint application seeking approval of the purchase by Tree-Line and the sale by Baldwin of the sewage collection and treatment system known as the Treasure Island East Sewer System ("Treasure Island"), serving the Caven Village Subdivision ("Caven") in Jefferson County, Kentucky. Tree-Line further requested a certificate of convenience and necessity to construct a tertiary addition to Treasure Island at an estimated cost of \$71,640; approval of the issuance of notes to finance the construction; and approval of an increase in sewage service rates. The Commission suspended the proposed rates; however, since the original filing was incomplete, the suspension period was waived

until July 6, 1984. On December 12, 1983, Baldwin and Tree-Line amended the application to reflect Baldwin's assignment of its interest in Treasure Island to Colwell Realty Investments, Inc.

A public hearing was held in this matter on June 4, 1984, in the Commission's offices in Frankfort, Kentucky. The Consumer Protection Division of the Attorney General's office was permitted to intervene and participated in the proceedings. All information requested by the Commission has been submitted.

Tree-Line requested rates which would produce an annual increase of \$29,908 to its present gross revenues. In this Order, the Commission has allowed rates to produce an increase of \$17,123.

PURCHASE AND SALE

On February 1, 1982, Baldwin and Tree-Line entered into a purchase and escrow agreement, whereby Baldwin agreed to sell Treasure Island. The Commission is of the opinion Tree-Line possesses the requisite expertise to own and operate Treasure Island and that the purchase/sale should be approved.

CONSTRUCTION AND FINANCING

Tree-Line stated in its application that the existing treatment facility meets neither the needs of the present customers nor the requirements of the Louisville and Jefferson County Health Department ("LJCHD"). Thus, Tree-Line and the LJCHD have jointly determined that tertiary treatment is essential for the proper operation of Treasure Island. The Commission is in agreement and is of the opinion that a certificate to construct tertiary facilities should be granted.

Tree-Line proposed to finance the tertiary facilities, expected to cost \$71,640,¹ in two stages. First, Tree-Line has secured a mortgage agreement, which Baldwin filed as a part of this case, to finance \$37,500 at 1-1/2 percent above the prime lending rate of the First National Bank of Louisville to be payable in 36 installments over a 3-year period. The prime lending rate of the First National Bank of Louisville on Monday, June 25, 1984, was 12-1/2 percent.

Second, Tree-Line stated the remaining capital required will be secured from Citizens Fidelity Bank ("Citizens") of Louisville Kentucky.² The amount borrowed will be approximately \$34,140 (\$71,640 - \$37,500). Tree-Line stated that it expected that this amount will be secured by a Promissory Note at 1-1/2 percent above the prime rate.³ Moreover, Tree-Line further stated that it expects to refinance the loan from Baldwin with Citizens upon completion of the tertiary addition possibly through a sale/lease back arrangement. Although Tree-Line stated that it has made preliminary negotiations with Citizens, no formal agreement had been reached by the date of the hearing⁴ in this case and none has been filed in the evidence of record.

1 Application, page 2.

2 Ibid., page 3.

3 Ibid.

4 Transcript of Evidence ("T.E."), June 4, 1984, pages 30 and 31.

The Commission is of the opinion that Tree-Line's proposed financing of the tertiary facilities should be approved. However, if the terms and conditions with Citizens differ significantly from those anticipated by Tree-Line, Tree-Line should advise the Commission immediately of the amendment to this case.

RATE DETERMINATION

Test Period

For the purpose of determining the reasonableness of the proposed rate, the 12-month period ending December 31, 1982, has been accepted as the test period.

Revenues and Expenses

Tree-Line showed a net loss on its books for the test period of \$13,811. Tree-Line proposed several pro forma adjustments to its test period operating revenues and expenses to more accurately reflect current operating conditions. The Commission finds these adjustments reasonable and has accepted them for rate-making purposes with the following exceptions:

Revenue Normalization

For the test period Tree-Line showed operating revenue of \$14,418. An examination of Tree-Line's customer billing procedures revealed that its three commercial customers were being billed incorrectly. The Bank of Louisville was overbilled by \$108, McDonald's was underbilled by \$484, and Hillview Square Shopping Center was overbilled by \$1,988. In addition, the analysis also reflected that test period revenues should be increased due to the shopping center not paying its bill during

1982. In May of 1983, Tree-Line settled with the shopping center but the revenue of \$4,000 from the shopping center was not recorded as operating revenue for 1982. Therefore, Tree-Line's actual test period revenues have been normalized in the total amount of \$4,370, for total test period operating revenue of \$18,788, to reflect the actual revenue that should have been recorded.

Sludge Hauling

In response to a Commission request for information relative to reported test-year sludge hauling expense, Tree-Line amended its application to reflect a revised proposed adjustment from \$2,205 to \$1,920.⁵ In response to a Commission request to provide support for this revised adjustment, Tree-Line submitted a calculation indicating that Metropolitan Sewer District ("MSD") was increasing its dumping fee by \$28.⁶ Tree-Line additionally included charges of \$12 for profit and overhead. It is the Commission's finding that Tree-Line should be allowed to flow through additional costs associated with the increase in the MSD dumping fee; however, the additional charges for overhead and profit are not appropriate for rate-making purposes. It is the Commission's opinion that the current charge per load of \$120 should be increased by \$28 to reflect the higher charge by MSD. No evidence has been provided to show that the hauling fee of \$86

⁵ Response to Commission's Order, filed January 24, 1984, Item 3.

⁶ Response to Commission's Order, filed May 1, 1984, Item 1.

per load does not provide sufficient coverage of actual costs for overhead and profit to the sludge hauling company. Since a principal owner of CFS is also the owner of Tree-Line, the Commission finds the acquisition of these services to be less than an arms-length transaction and will therefore disallow the profit and overhead component of this cost.

Though only approximately 4 loads of sludge were hauled during the test year, in calculating the annual adjustment, Tree-Line based its calculation on 12 loads of sludge hauled per year.⁷ In support of this level of loads hauled, Tree-Line submitted invoices indicating that 10 loads of sludge were hauled during 1983. It is the Commission's opinion that 12 annual loads is reasonable for this utility based on the age of the plant and other factors. Based on this, the normal annual level of sludge hauling expense appropriate for rate-making purposes is \$1,776.⁸

Chemicals

Tree-Line booked \$610 in chemicals expense for the test period which included \$200 for drum deposits. Drum deposits are refundable and are not an operating expense. Therefore, the Commission has denied this portion of Tree-Line's test period expenses.

Maintenance of Collection and Treatment System

During the test period Tree-Line booked \$3,213 in maintenance of the collection and treatment system. An analysis

⁷ Ibid.

⁸ 12 X \$148 = \$1,776.

of the individual invoices showed that, during the test period, Tree-Line made plant additions of \$1,758 to its sewer system and erroneously expensed these items. A breakdown of these items is as follows:

<u>Invoice No.</u>	<u>Date</u>	<u>Vendor</u>	<u>Amount</u>
526-2	5/26/82	Andriot-Davidson's Service Company, Inc.	\$1,434
802-3	8/2/82	Andriot-Davidson's Service Company, Inc.	\$ 324

These items will be given proper consideration by the Commission with regard to allowable depreciation expense.

Outside Services

During the test period Tree-Line incurred expenses for outside services of \$2,010. Of this amount \$250 was a payment to the law firm of Spalding, Cato, Kleine-Kracht and Ames for services rendered in review of the purchase/sale agreement discussed previously. Another payment of \$268 was paid to the law firm of McCoy, Gathright and McCoy for services rendered in the case of Baldwin versus Wilbert R. Simpson, et al. The Commission is of the opinion that the \$250 fee is properly capitalized as cost of organization and that the \$268 fee is non-recurring. The Commission is further of the opinion that both payments should properly be amortized over a 3-year period. Therefore, test period expenses have been reduced by a net amount of \$345.⁹

⁹ \$250 + \$268 = \$518 ÷ 3 years = \$173; \$518 - \$173 = \$345.

Insurance Expense

Tree-Line proposed to adjust its insurance expense by \$10 to reflect an anticipated increase. This adjustment although minor is neither known nor measurable and has been disallowed for rate-making purposes.

Depreciation Expense

Tree-Line proposed depreciation expense of \$4,776 to reflect an expected useful life of 15 years for its new tertiary sewage treatment addition. The Commission is of the opinion that 20 years more closely approximates the useful life of this tertiary plant and has therefore reduced depreciation expense for rate-making purposes by \$1,194.¹⁰

Moreover, as previously discussed the Commission finds that the capital items erroneously expensed in maintenance of sewage collection and treatment facilities should properly be depreciated. The Commission is of the opinion that the useful lives of these plant additions is 3 years and has therefore increased depreciation expense \$586.¹¹

Interest Expense

The Commission as discussed herein approved Tree-Line's proposed financing of its tertiary treatment plant addition expected to cost \$71,640. However, Tree-Line has only secured formal agreement for \$37,500 of the total cost with no

¹⁰ $\$4,776 - (\$71,640 \div 20 \text{ years} = \$3,582) = \$1,194.$

¹¹ $\$1,758 \div 3 \text{ years} = \$586.$

documentation nor formal agreement to support the balance of \$34,140. Therefore, in this Order the Commission will allow the interest expense on the \$37,500 verified by the mortgage agreement with Baldwin. The Commission using the latest prime rate of 12-1/2 percent quoted by the First National Bank of Louisville has determined that the interest expense allowable for rate-making purposes is \$5,250.¹²

Since no formal agreement has been submitted for the remainder of the financing, the Commission will not include any interest expense herein for rate-making purposes as the expense is neither known nor measurable. Should Tree-Line secure a formal agreement for the balance of the financing from Citizens and can submit said agreement within 20 days from the date of this Order, the Commission will reconsider this matter on rehearing.

Routine Maintenance Service Fee

During the test period, Tree-Line incurred routine maintenance service expenses of \$2,625. Tree-Line proposed to increase this expense by \$1,275 to \$3,900. Tree-Line stated that this increase was due solely to provide enough funds to increase the number of daily inspections of the plant per week from four to six.

The routine maintenance services are performed by Andriot-Davidson's Service Company, Inc., ("Andriot-Davidson"). The principal owner of Andriot-Davidson and Tree-Line are the

¹² $\$37,500 \times (12.5 \text{ percent} + 1.5 \text{ percent}) = \$5,250.$

same, and transactions between these entities are therefore less than arms-length. The Commission has questioned Tree-Line on the reasonableness of the less-than-arms-length fees paid to Andriot-Davidson in numerous requests and on cross-examination during the hearing in this case. The Commission after reviewing the record is of the opinion that Tree-Line has not met its burden of proof concerning the reasonableness of these charges.

However, the Commission, after a thorough review of the routine maintenance service needs of Tree-Line, is of the opinion that the number of daily visits per week should be increased to six. Therefore, the Commission is of the opinion that the overriding consideration in this matter is the service standard and will allow the increase since this is the basis of the adjustment. The Commission however cautions Tree-Line that in future cases its burden of proof regarding the reasonableness of less-than-arms-length transactions must be met more adequately than its responses herein.

Therefore, Tree-Line's adjusted operations at the end of the test period are as follows:

	<u>Per Books</u>	<u>Adjustments</u>	<u>Adjusted</u>
Operating Revenues	\$ 14,418	\$ 4,370	\$ 18,788
Operating Expenses	25,309	790	26,099
Net Operating Income (Loss)	<u>\$(10,891)</u>	<u>\$ 3,580</u>	<u>\$(7,311)</u>
Interest Expense	2,920	2,330	5,250
Net Income (Loss)	<u>\$(13,811)</u>	<u>\$ 1,250</u>	<u>\$(12,561)</u>

REVENUE REQUIREMENTS

The Commission is of the opinion that Tree-Line's adjusted operating loss is unfair, unjust and unreasonable. The Commission

is further of the opinion that an operating ratio of 88 percent is fair, just and reasonable in that it will allow Tree-Line to meet its operating expenses, service its debt and provide a reasonable return to its stockholders. Therefore, the Commission finds that Tree-Line should be permitted to increase its rates to produce an increase in annual revenue of \$17,123,¹³ which includes Jefferson County, state and federal income taxes of \$883.

SUMMARY

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

1. Tree-Line is ready, willing and able to provide service and the purchase/sale should be approved.

2. Public convenience and necessity requires the construction of tertiary treatment facilities according to the plans and specifications filed in the evidence of record herein and should be approved.

3. The financing of the tertiary treatment plant as described herein is fair, just and reasonable and should be approved.

4. The rates proposed by Tree-line would produce revenues in excess of the revenues found reasonable herein and should be denied upon application of KRS 278.030.

5. The rates in Appendix A are the fair, just and reasonable rates to charge for sewage services rendered to

¹³ $(\$26,099 + \$883) \div 88 \text{ percent} = \$30,661 + \$5,250 - \$18,788 = \$17,123.$

Tree-Line's customers and should produce annual revenues of approximately \$35,911.

IT IS THEREFORE ORDERED that the purchase/sale be and it hereby is approved.

IT IS FURTHER ORDERED that Tree-Line is granted a certificate to construct tertiary treatment facilities in accordance with the plans and specifications filed in this case.

IT IS FURTHER ORDERED that Tree-Line's proposed financing of tertiary treatment facilities be and it hereby is approved.

IT IS FURTHER ORDERED that the rates in Appendix A be and they hereby are the fair, just and reasonable rates of Tree-Line for sewage services rendered on and after the date of this Order.

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

IT IS FURTHER ORDERED that, within 30 days of the date of this Order, Tree-Line shall file with this Commission its tariff sheets setting forth the rates approved herein and a copy of its rules and regulations for providing sewage services.

Done at Frankfort, Kentucky, this 6th day of July, 1984.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Secretary

APPENDIX A

APPENDIX TO AN ORDER OF THE PUBLIC SERVICE
COMMISSION IN CASE NO. 8934 DATED July 6, 1984.

The following rates are prescribed for the customers in the area served by Tree-Line Utilities, Inc., d/b/a Treasure Island East Sewer System located in Jefferson County, Kentucky. 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 effective date of this Order.

RATES: Monthly

Single Family Residential	\$20.90 per Residence
Multi Family Residential	15.65 per Apartment
All Other	40.00 per Residential Equivalent ¹

¹ The number of residential equivalents and/or fractional parts thereof shall be determined by dividing the customer's average monthly water consumption in gallons by 12,000 gallons. The minimum bill for this type service shall be \$40.00.