COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

AN ADJUSTMENT OF RATES OF THE SPEARS WATER COMPANY, INC.) CASE NO. 9067

O R D E R

On May 23, 1984, Spears Water Company, Inc., ("Company") in accordance with provisions of KRS 278.190 and pursuant to 807 KAR 1:010(9), filed a petition with the Commission seeking an adjustment in its rates for water service effective June 25, 1984. The rates proposed, as reflected in the Company's billing analysis, would produce revenues from water service of $422,820 annually, an increase of $76,668 over normalized revenues produced from existing rates. This represents an increase of 22.1 percent on an overall basis. However, due to the proposal to unify the rates between the now merged Spears Water District ("District") and the Company,[1] the proposed rates will increase the revenue from the former customers of the District by 26.6 percent while the revenue from the customers of the Company will increase only 8.2 percent. The rates found reasonable herein will produce revenues of $388,208, annually, an increase of 9.9 percent on a total combined basis.

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1 Merger will be discussed in greater details later in this Order.

In order to determine the reasonableness of the proposed rates, the Commission in its Order of June 12, 1984, suspended the proposed rates, charges and classifications and deferred the application of the rates for 5 months on and after the effective date. The Consumer Protection Division of the Attorney General's Office ("AG") was the sole intervenor.

On June 27, 1984, the Company filed a motion requesting an Order for interim rate relief. The Commission, pursuant to established guidelines, held a hearing on the Company's motion for interim relief on July 26, 1984, and on August 31, 1984, the Commission in its Order denied the Company's motion for interim relief.

A hearing for the purpose of investigating the reasonableness of the Company's full petition was held October 4, 1984. All requested information has been filed.

HISTORY AND COMMENTARY

As mentioned earlier, the Company and the District are now formally merged. Merger was first proposed in Case No. 5747, Joint Application of Spears Water District and Spears Water Company, Inc., for Approval of the Lease and Sale of the Properties of Such District to Spears Water Company, Inc., and for Approval of the Charging by Spears Water Company, Inc., of the Same Rates as Heretofore Have been Charged by Such District, but the application was denied. Again merger was sought in Case No. 6464, The Joint Application of Spears Water District and the Spears Water Company, Inc., for Approval of a Lease Agreement. In an Order dated March 15, 1976, the Commission approved the joint application for the lease agreement. However, paragraph 8 of the Lease and Agreement to Purchase dated December 30, 1975, required that no sale, merger, etc., could be consummated until the bonded indebtedness of the District was met either through redemption or the placement of funds in an escrow for such redemption. On August 3, 1983, the Company, by counsel, notified the Commission by letter that paragraph 8 had been met by the funding of an escrow and that said merger was completed effective July 1, 1983. However, the letter did not state that it had been necessary for the Company to borrow $256,000 at 12.5 percent short-term in order to defease the then $385,000 of outstanding bonds of the District having an interest rate of 5-1/4 percent. The Company had not requested approval of this financing as required by the Commission's regulations.

Even now, approximately a year and a half after the financing was completed, approval of the Commission has not been requested formally, although the merits of the plan have been examined in this case. It should be noted that as a result of this financing, the merged company's debt service was significantly increased and it is the primary cause for this request of rate relief. The old District bond had approximately 23 years remaining, while the refinancing is being amortized over only 6 years. In support of the shortened amortization period, the Company has taken the position that the total debt service requirement for the shorter note is less than that of the old bonds even at the higher interest rate. The Commission finds that this contention has merit. The Commission does however advise the

Company that in future transactions the Company should more closely equate the debt service requirements of acquisitions with the useful life of these acquisitions to appropriately balance its financial needs and benefit to its ratepayers.

In this instance the shortened period of debt service does place some incremental burden on current ratepayers. The Commission has given this matter considerable attention in its determination of revenue requirements and has concluded that in the instant case full debt service coverage on the shortened period is reasonable and necessary. The Company provides good service, and the overall rates, including the incremental portion from the shortened period of debt service, are still at or below the average rates for water service for utilities of similar size and operating characteristics.

However, the Commission stresses to the Company that in the future, application for financing must be made and approved by this Commission before it is consummated, or no rate relief will be granted for unauthorized debt issues. Had the Commission taken this approach herein, the Company might have become insolvent.

The Company also found it necessary to borrow an additional $69,000 within the last year. Although it is impossible to directly trace the sources and uses of capital, it is certain that at least some of this $69,000 was required to pay the more than $4,000 cost of the escrow above the $256,000 specifically borrowed for this purpose and the more than $5,000 in legal and associated fees to defease the bonds. The remainder of the $69,000 was used principally for growth and expansion, although it is certain that at least some amount was required to meet other obligations of the system due to its increased debt service requirements.

ANALYSIS

TEST PERIOD

The Company has proposed and the Commission has accepted the 12-month period ending March 31, 1984, as the test period in this matter.

REVENUES AND EXPENSES

Although the Company presented no formal income statement for the test period, receipts and disbursements were provided in Exhibits B and D of its application and notice. Per Exhibit B, total operating revenues for the test period were $317,387.[2] Total operating expenses per Exhibit D were $334,016, including interest expense of $28,994. As a result, the Company had an operating income for the test period of $12,365 before interest expense. In Exhibit G-1 of its application and notice, numerous adjustments were proposed to reflect on-going conditions, the largest being water revenue stated at the level reflected in its billing analysis of $346,151, an adjustment of $37,488. As a result of this and other adjustments, the Company had an adjusted

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Water Sales	$308,663
Service Charges	2,612
Forfeited Discounts (Penalties)	4,552
School Tax	1,560
Total	$317,387

net operating income of $28,157.[3] The Commission has made the following additional adjustments to the Company's test period operations:

<u>Operating Revenue from Water Sales</u>

As stated earlier, the Company proposed to adjust its operating revenues to reflect its billing analysis, an increase of $37,488. Due to the magnitude of this adjustment, the Commission found it necessary to determine the reasonableness of such an adjustment. Realizing that revenues reflected during the test period were on a cash basis, there is a lag of at least 1 month between the billed revenue and the cash received. Therefore, billed revenue was matched with the succeeding months' receipts as reflected in Schedule 1 of this Order. This review resulted in the discovery of additional revenues of $8,368.[4] A further review of this schedule also reflected the under collection of receipts of approximately $30,600, with approximately $25,000 occurring in just the 4 months of September, December, January and February of the test period.

The Company has a policy of adjusting customer bills, particularly during the winter months, for excessive water loss

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Total Revenue	$348,763
Other Income (Penalty)	4,552
Total Expenses (including income tax)	325,158
Net Operating Income	$ 28,157

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Accrual Revenue	$317,031
Cash Revenue	308,663
Difference	$ 8,368

due to assumed leaks on the customer side of the meters. The Company's Exhibit 12 filed September 27, 1984, stated that credit adjustments for the test period were $9,396, thus supporting the under-collections for the winter months.

Further, the Company explained that $6,783 was lost due to customers leaving the system owing a final water bill. This would also result in under-collections. It should be noted that the support for this amount indicated that a substantial portion of this amount was covered by required customer deposits. However, it is most likely that these deposits were not transferred to the revenue accounts for the purpose of this filing. In addition, as a result of merger, the Company reimbursed many of the District's customer deposits to customers with a good credit history. Although this amount is undeterminable from the record, it is noted that the customer deposit balance decreased from $17,470 to $8,334 from the beginning to the end of the test period,[5] a decrease of $9,136.

Purchased water adjustments were approved for both the District and the Company during April, 1983, of 30 cents per 1,000 gallons for the Company and 29 cents per 1,000 gallons for the District. Again, the precise amount which would need to be reflected from this normalization is not known, but is estimated to be $2-4,000.[6]

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5 Notice Exhibit "C".

6 April Sales (7,000,000 approximate) X $.30 = $2,100.

As a result of the analysis described in this section, the Commission is of the opinion that, although a precise reconciliation could not be made, the revenue from water sales as reflected in the billing analysis of $346,151 is the appropriate level for the purpose of this case. Furthermore, the Commission notes that no reserve for uncollectible amounts has been proposed and therefore finds that a level of $3,500 is appropriate as it represents approximately 1 percent of gross revenues which the Commission finds is a reasonable allowance in this case.

Purchased Water

During the test period, the Company purchased 157,763,760 gallons of water[7] at a cost of $129,055 and billed 121,613,970 gallons. In addition, on Exhibit 14, filed October 1, 1984, the Company showed 22,411,160 gallons accounted for, but not billed, with the remainder of 13,908,630 gallons unaccounted for.

In support of the 22,411,160 gallons which were accounted for, but not billed, the Company presented an exhibit listing estimated water loss for some 70 leaks either man-made or due to deterioration. It is the opinion of the Commission that, even though these leaks were accounted for, they were not properly billed or were due to the Company's neglect and therefore are disallowed for rate-making purposes. Therefore, the Commission

7 Exhibit 11 filed September 27, 1984.

finds the allowable level of purchased water to be $117,036[8] based on an allowable water loss of 15 percent for normal deterioration, flushing, fire protection, etc. This is a reduction of $12,019.

The Commission commends the Company for its effort to account for its water and recognizes the progress made in controlling its water loss. However man-made leaks which are identifiable should be billed to the cost causer unless inappropriate for some definite reason.

Office Supplies and Expenses

During the test period, the Company had office supplies and expenses of $11,871 and proposed an additional $1,200 for computer program updates. Although the Commission is aware of the need for certain appropriate computer program updates, no supporting documentation was presented for the need of this additional programming and therefore the adjustment has been disallowed.

Furthermore, the Commission has disallowed unnecessary inter-company billing between the District and the Company of $762 as the entities are now merged.

Group Insurance

During the test period the Company had group insurance for its employees and directors totaling $7,336. A review of the supporting documentation for this amount showed that two policies

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Allowable Gallons (121,613,970 - .85)	$143,075,258
Average Costs ($129,055 ÷ 157,763,760 gallons	81.8 cents/1000
Purchased Water Cost Allowable	$ 117,036

covered costs outside the test period. Therefore, the Commission has determined the normalized level of group insurance to be \$6,684,[9] a reduction of \$652.

Property Insurance

Again, in reviewing the support for property insurance, the Commission noted that at least one of the policies covered costs beyond the test period. By normalizing, using average test period insurance, the level of property insurance found appropriate by the Commission is \$1,567,[10] a reduction of \$244.

Legal Fees

During the test period, the Company experienced legal, accounting and other fees totalling \$8,624. As discussed earlier, the two systems were merged during the test period and as a result, many of these fees represent one-time occurrences. Therefore, the Commission is of the opinion that fees resulting from the merger totalling \$5,930 should be amortized over a period of at least 10 years to reflect the period of benefit to the merged entity.

Further, the Commission found \$890 was paid to the accountant to close the books of the District. Since this expense

[9]

State Farm (\$387.41 X 12 months)	\$ 4,649
Kentucky Central (\$402.00 X 4 quarters)	1,608
Blue Cross/Blue Shield (\$88.20 X 12 months)	1,058
Subtotal	\$ 7,315
Less Employee Contributions	631
Total	\$ 6,684

[10] \$1,811 - (1/3 of 732) = \$1,567.

is non-recurring, the Commission has disallowed it for rate-making purposes. Thus legal fees has been reduced $4,227 in addition to the Company's proposed reduction of $2,000.

Finally, the Company proposed legal and other expenses totalling $5,461 for this rate case. In addition, a postage fee of $236 was later submitted. The Commission finds these fees to be reasonable; however, based on the Company's history of rate filings, this total amount of $5,697 has been amortized over 3 years for an annual amortization of $1,899.

Transportation Expense

The Company proposed to increase its transportation cost by $1,000 based on the aging of its equipment. Since this amount is only an estimate and does not meet the known and measurable criteria of the Commission, it has been disallowed for rate-making purposes.

Maintenance of Meters

In its notice, the Company stated that it was required to test its meters every 5 years and that such testing had been overlooked in the recent past. It was further stated that the last time such testing occurred, it was at a cost of $7,000. The Commission finds this estimate to be reasonable and has thus amortized this amount over 5 years for an annual level of $1,400.

Maintenance of Distribution Reservoirs

During the test period, the Company had $14,794 for repairs to its water tank due to the severe winter weather. Going beyond the end of the test period of March 31, 1984, the Company estimated that bills for further repairs to the tank would be an additional $10,000 and the repair to an access road to the tank site would be $4,080. Although, the Commission does not usually recognize expenditures outside the test period, it is of the opinion that it is warranted in this instance because the damage actually occurred during the test period. However, the circumstances surrounding these costs were very unusual due to the extreme cold temperature combined with a power failure which will most likely never occur again. Therefore, the Commission finds an amortization of these incurred and estimated costs over a 5-year period is reasonable with an annual amortization of $5,775, a reduction of $9,019.

Additionally, the Company stated that the tank had not been painted in some 7 years and presented an estimate of $8,200 to paint its tanks. The Commission finds the normal tank painting amortization to be 5 years and thus this cost should be amortized over that period. Thus, the annual amortization allowed by the Commission is $1,640.

<u>Directors Fees and Life Insurance</u>

During the test period, the Company booked $16,820 for directors fees and life insurance of its officers. An analysis of the support for this expenditure indicates that of this amount $9,300 was for directors fees, $7,226 for life insurance and $294 for cancer insurance for the officers of the Company. During cross-examination, the Company stated that the life insurance and cancer policies had been revised and that the new premiums were $2,640 and $346 annually. The Uniform System of Accounts for Class C Water Utilities specifically states that where the utility is the beneficiary of life insurance of officers and employees, this amount should be included outside of operating expenses not included in normal expenses considered for rate-making purposes in Account 426, Miscellaneous Income Deductions. Therefore, the Commission is of the opinion that amounts for life and cancer insurance should not be included for rate-making purposes.

FICA Taxes

The Company proposed an adjustment to employer FICA taxes in the amount of $1,336. The Commission has recalculated employer FICA tax at the approximate rate of 7 percent and finds no material change from the level of the test period. Therefore, this adjustment has been rejected.

Depreciation

The Company proposed depreciation expenses of $28,860 based on ACRS depreciation rates. In its Exhibit 20B filed September 27, 1984, the Company presented depreciation expenses of $32,953 for plant investment through the end of 1983. Adding in depreciation expense for plant items placed in service during the first 3 months of 1984, to include all of the months of the test period, total depreciation expense is $33,221.

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, less contributions in aid of construction, as ratepayers should not be required to provide recovery on that portion of the plant which has been provided free of cost. Therefore, the Commission finds the reasonable level of depreciation expense for rate-making purposes is $26,748,[11] a reduction of $2,112.

Income Taxes

The Company proposed an income tax expense of $17,000 based on proposed operations. Based on the Commission's adjusted revenues of $353,315, operating expenses of $276,506 and interest expense of $48,198 (described later) the Company's taxable income is $28,611. Therefore, the appropriate level of income taxes is $5,133,[12] a reduction of $11,867.

Based on the above adjustments, the Commission finds the reasonable net operating income to be $71,676, summarized below:

	Company Adjusted	Commission Adjustments	Commission Adjusted
Operating Revenues	$353,315	$ -0-	$ 353,315
Operating Expenses	325,158	< 43,519>	281,639
Net Operating Revenue	$ 28,157	43,519	$ 71,676

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11 Depreciation on Total Plant — $33,221
Times Non-Contributed Rates — .80515
1 - ($170,506* ÷ $875,062) = .80515
Allowable Depreciation Expense — $26,748

* This includes contributions of the District eliminated at the time of merger.

12 State Income Tax

$25,000 x .03 =	$ 750
3,611 x .04 =	144
$28,611	$ 894

Federal Income Tax

$25,000 x .15 =	$3,750
2,717 x .18 =	489
$27,717*	$4,239

*$28,611 - $894 = $27,717.

REVENUE REQUIREMENT

The Company has a debt service of $75,202, including interest expense of $34,743, on its long-term debt, and interest expense requirements on its short-term debt of $13,455 based on the level of debt in Notice Exhibit "F" and the current short-term interest rate of 13 percent. Thus, total debt requirements are $88,657. The adjusted operating revenue found reasonable earlier produces an overall debt service coverage of .81X which the Commission finds unfair, unjust and unreasonable. The Commission is of the opinion that a debt service coverage of 1.1X on the Company's long-term debt service and 1.2X on the Company's short-term debt interest requirements is fair, just and reasonable in that it will provide revenues sufficient to service the Company's debt and provide adequate cash-flow to meet its operating expenses.

In order to achieve the debt service coverage found fair, just and reasonable, the Commission has determined that the Company is entitled to a net operating income determined as follows:

Long-Term Debt Service Requirement ($75,202 X 1.1)	$82,722
Short-Term Debt Interest Requirements ($13,455 X 1.2)	16,146
Reasonable Net Operating Income	$98,868

Thus, the Company is entitled to additional revenues on an annual basis of $34,893 determined as follows:

Reasonable Net Operating Income	$98,868
Adjusted Net Operating Income	71,676
Deficiency	27,192
Retention Factor for Income Tax and Uncollectibles	.7793[13]
Additional Revenue Requirements	$34,893

The Commission does wish to apprise the Company that the additional revenue granted herein is based on the higher debt service requirements and that appropriate review will be made upon repayment of these loans and further that appropriate rate reductions may be necessary in the future.

RATE DESIGN

The Company has been operating under the auspices of two sets of rates which was the result of the approval of the lease purchase agreement with Spears Water District in Case No. 6464 dated March 15, 1976. In this instant case, the Company has proposed to consolidate the rate schedules of the former Spears Water District with its own present rate schedule. It has also proposed to increase the service charge rate. The Commission agrees.

FINDINGS AND ORDERS

1. The rates proposed by the Company will generate revenues greater than those allowed herein and should be denied upon application of KRS 278.030.

2. The rates in Appendix A are the fair, just and reasonable rates to be charged by the Company on and after the date of this Order.

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[13] $1 - [(.18 \times .96) + .04] = .7872 \times .99 = .7793$

3. The consolidation of rate schedules of the former Spears Water District and Spears Water Company, Inc., is in the best interest of the District, the Company, and their customers, and should be approved.

IT IS THEREFORE ORDERED that the rates proposed by the Company are hereby denied.

IT IS FURTHER ORDERED that the rates in Appendix A are the fair, just and reasonable rates to be charged by the Company for water service rendered on and after the date of this Order.

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

Done at Frankfort, Kentucky, this 21st day of November, 1984.

By the Commission

ATTEST:

Forest M. Skaggs

Secretary

SCHEDULE 1

Month Billed		Month Received	Amount Billed [1]	Amount Received [2]	Under-Collections
April	-	May	$ 22,459.85	$ 22,482.79	$ <22.94>
May	-	June	23,634.24	22,197.04	1,437.20
June	-	July	23,293.19	23,828.81	<535.62>
July	-	August	30,416.78	28,932.43	1,484.35
August	-	September	31,889.78	31,639.92	249.86
Sept.	-	October	35,050.15	28,360.39	6,689.76
October	-	November	33,675.31	32,121.72	1,553.59
Nov.	-	December	26,148.61	25,446.27	702.34
Dec.	-	January	28,437.78	25,599.41	2,838.37
January	-	February	33,582.80	24,652.58	8,930.22
Feb.	-	March	28,015.33	21,832.50	6,182.83
March	-	April	31,041.20	29,935.00[3]	1,106.20
Total			$347,645.02	$317,028.86	$ 30,616.16

1 Exhibit 10 filed September 27, 1984.

2 Exhibit B filed May 23, 1984.

3 Exhibit B-1 filed July 23, 1984.

APPENDIX A

APPENDIX TO AN ORDER OF THE PUBLIC SERVICE COMMISSION IN CASE NO. 9067 DATED 11/21/84

The following rates and charges are prescribed for the customers served by Spears Water Company, Inc. 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.

RESIDENTIAL SERVICE

Gallonage Block	Monthly Rates
First 2,000 gallons	$ 7.60 Minimum Bill
Next 10,000 gallons	3.10 per 1,000 gallons
Over 12,000 gallons	2.25 per 1,000 gallons

MOBILE HOME AND/OR FIELD SERVICE

Gallonage Block	Monthly Rates
First 1,000 gallons	$ 4.40 Minimum Bill
Next 11,000 gallons	3.10 per 1,000 gallons
Over 12,000 gallons	2.25 per 1,000 gallons

Service Charge	$10.00