COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

ADJUSTMENT OF THE RATES OF AUXIER ROAD GAS COMPANY, INC., FOR AN INCREASE IN GAS RATES	)))	CASE NO. 9318

<u>O R D E R</u>

On March 29, 1985, Auxier Road Gas Company, Inc., ("Auxier Road") filed an application with the Commission requesting authority to increase its rates and charges for gas service rendered on and after April 19, 1985. Auxier Road included two sets of rates within its notice, interim emergency monthly rates ("emergency rates") which it proposed to implement immediately, and proposed final monthly rates ("final rates"), to be implemented upon final disposition of this case. The implementation of the emergency rates was denied by Order on May 13, 1985; however, circumstances prevented the suspension of the proposed final rates within the 20-day required period, and these rates were placed into effect by Auxier Road on April 19, 1985. On June 6, 1985, the Commission, pursuant to KRS 278.260, instituted upon its own motion an investigation into the reasonableness of the rates charged by Auxier Road and ordered this case reopened for purposes of the investigation.

The final rates proposed in the application by Auxier Road would increase its annual revenues by approximately $120,299, an increase of 24.3 percent. Auxier Road cited declining revenues due to reduced annual sales volume and decreased customer usage as the reason for the requested rate increase.

A hearing was scheduled for September 4, 1985, for the purpose of cross-examination of witnesses of Auxier Road and the intervenors. Auxier Road was directed to give notice to its customers of the proposed rates and the scheduled hearing pursuant to 807 KAR 5:011, Section 8. Motions to intervene in this matter were filed by the Consumer Protection Division of the Office of the Attorney General, and the Auxier Community Development Club. These motions were granted and no other parties formally intervened.

The hearing for the purpose of cross-examination of the witnesses of Auxier Road and the intervenors was held in the Commission's offices in Frankfort, Kentucky, on September 4, 1985, with all parties of record represented. All information requested during the hearing has been submitted.

At the September 4, 1985, hearing before any evidence was adduced, Auxier Road made an oral motion to place the burden of proof and the burden of going forward in the proceeding "upon the Public Service Commission and any intervenors or protestants at the hearing." The hearing examiner reserved the ruling on the motion for the Commission, and directed that Auxier Road file a written motion confirming its action and stating its grounds therefor. On September 16, 1985, Auxier Road filed its written motion stating that it had "existing rates presently authorized by the Commission," that the hearing was scheduled under KRS 278.260, and that "consequently, the burden of going forward <u>to</u> (sic) such hearing and the burden of proof rested...upon the Commission...to establish that the present rates lawfully in existence for Auxier Road Gas Company are unreasonable or unjustly discriminatory."

Auxier Road cited no authority for the propositions advanced, and we are not aware of any such authority. The rates now in effect are those contained in Auxier Road's application and not suspended under KRS 278.190. However, the fact that they were not suspended does not constitute approval, authorization, or adoption of these rates by the Commission. The Commission is not a party, but the forum before which this proceeding is pending. Whether this is regular rate case under KRS 278.190, or a KRS 278.260 proceeding, it is fundamental that parties establishing, defending, or opposing utility rates carry the burden of proof.

The Motion is overruled.

This Order addresses the Commission's findings and determinations on issues presented and disclosed in the hearings and investigation of Auxier Road's revenue requirement and rate design and provides rates and charges that will produce an increase in annual revenues of $52,171 above the rates in effect at the time of the filing, an increase of 11.6 percent.

COMMENTARY

Auxier Road operates as a public utility providing gas service to 35 commercial and 442 residential customers in the town of Auxier in Floyd County, Kentucky.

TEST PERIOD

Auxier Road proposed and the Commission has accepted the 12-month period ending December 31, 1984, as the test period for determining the reasonableness of the proposed rates. In using the historic test period, the Commission has given full consideration to appropriate known and measurable changes.

VALUATION METHOD

Auxier Road proposed a net investment rate base of $469,062. The Commission has accepted the proposed rate base with the following modifications:

Extension of Cliff Line

Included among Auxier Road's test-year expenditures was $50,600 paid to M. Branham Construction ("Branham Construction") which represents the cost of a line to the Cliff area ("Cliff Line") for an interconnection which would allow the Kentucky/West Virginia Gas Company ("Kentucky-West") to deliver gas into the Auxier Road system. Auxier Road testified that the original intent was for Branham Construction to retain ownership of the Cliff Line, and for Auxier Road to pay a rental charge for gas delivered into the system. However, when Kentucky-West was unable to obtain Federal Energy Regulatory Commission ("FERC") approval to transmit gas to Auxier Road, thereby preventing the use of the line as planned, the line was purchased from Branham Construction by Auxier Road. The effects of this transaction on test-year financial statements were as follows: 1) Utility Plant in Service Accounts were increased by $50,600; 2) Depreciation Expense was increased by $1,453; and 3) Accumulated Depreciation was increased by $1,453.

The Commission is concerned about the manner in which this construction project was conducted. Auxier Road undertook this project without the knowledge or approval of the Commission. Auxier Road's contention that this expenditure was within the "ordinary course of business" is without merit in that its unstable financial condition makes such an expenditure very imprudent. Moreover, Auxier Road entered into this project without consideration of its commitments to purchase gas from Columbia Gas of Kentucky, Inc., ("Columbia Gas") and, by doing so, expended $50,600 for a construction project which is not now used and useful. Because this extension is not used and useful and, therefore, of no use to the ratepayers of Auxier Road, the Commission finds that inclusion of its cost is inappropriate and, therefore, has made the following adjustments to reflect this finding: 1) decrease Utility Plant in Service $50,600; 2) reduce Accumulated Depreciation $1,453; and 3) reduce Depreciation Expense $1,453.

Amortization of Extraordinary Loss

In its Order dated April 23, 1981, in Case No. 7897, Adjustment of Rates of Auxier Road Gas Company, Inc. of Prestonsburg, Kentucky, the Commission authorized the retirements of $30,882 to Account No. 182--Extraordinary Property Losses, with this balance to be amortized over a 10-year period. It is apparent from Auxier Road's December 31, 1984, balance sheet that the subsequent treatment of this property loss has not been in accordance with the Uniform System of Accounts for Class C and D Gas Companies.

Though there are slight discrepancies in the specific amounts, it is apparent from the 1981 Annual Report that Auxier

Road originally recorded the loss pursuant to the Commission's Order and in accordance with the Uniform System of Accounts. While $30,882 was the amount originally approved, $30,259 was the amount actually recorded as a property loss. As of December 31, 1984, $30,259 was still reflected as the balance in Account No. 182. Upon reviewing the 1981-1984 Annual Reports, it is apparent that Auxier Road has been amortizing this property loss by debiting Account No. 407.1--Amortization of Property Losses, and crediting Account No. 110--Accumulated Provision for Depreciation, Depletion and Amortization. The Uniform System of Accounts requires that the annual amortization of the extraordinary property loss be credited to Account No. 182. The improper accounting for the transaction has resulted in Account No. 110 being overstated by $9,556, while Account No. 182 is overstated by a like amount. Adjustments have been made herein to correct the effects of this improper accounting treatment. Auxier Road should file amended annual reports for the years 1981-1984 to reflect proper accounting for the extraordinary property loss.

Auxier Road further proposed to include $30,259 associated with the extraordinary property loss in rate base. Auxier Road contended that it had investment associated with this loss and is entitled to a return on it.[1] The Commission has consistently taken the position that a return on assets not used and useful is inappropriate and finds that Auxier Road has provided no evidence

1 Response, Item No. 14b, Commission's First Information Request, dated May 10, 1985.

as to why the Commission should deviate from this practice in this instance. To allow such treatment in this case would require current ratepayers to bear the cost of plant associated with previous service. Moreover, the inclusion of this amount was not proposed, nor was it allowed, in Auxier Road's most recent case. The Commission has, therefore, excluded amounts associated with the extraordinary property loss from rate base, but has, as in the past, allowed the amortization of the loss as an operating expense.

Cash Working Capital

Auxier Road proposed to include a cash working capital allowance of $20,456, based on its proposed operating statement. The Commission has reduced this amount to $17,988 in order to allow 1/8 of the adjusted operating and maintenance expenses less purchased gas found appropriate herein.

Depreciation Reserve

The Commission has reduced Auxier Road's reported year-end depreciation reserve by $11,012 to reflect the adjustments found appropriate herein. This amount consists of reductions of $9,559 to correct the improper accounting treatment of the extraordinary loss and $1,453 to remove depreciation associated with the Cliff Line.

Thus the Commission has determined Auxier Road's net investment rate base to be as follows:

Utility Plant	$582,037
Prepayments	2,332
Working Capital	17,988
Subtotal	$602,357
Less:	
Accumulated Depreciation	$145,848
Customer Advances for Construction	8,651
Cliff Line Extension	50,600
Subtotal	$205,099
Net Investment Rate Base	$397,258

REVENUES AND EXPENSES

Auxier Road reported a net loss of $42,612 for the test period. In order to reflect current operating conditions, Auxier Road proposed numerous adjustments to revenues and expenses resulting in an adjusted net loss of $104,797. The Commission is of the opinion that the proposed adjustments are generally proper and acceptable for rate-making purposes with the following modifications:

Normalized Revenue

Auxier Road proposed a temperature adjustment of $8,931, which decreases the normalized revenue to $443,700. In making this adjustment, Auxier Road used an average rate based on the proposed revenue. As the temperature adjustment is an adjustment to the normalized revenues, the Commission is of the opinion that the rates used to calculate the temperature adjustment should be the same as the rates that produce the normalized revenue. Therefore, the Commission has used the Over 1 Mcf rate of $7.267 and changed the temperature adjustment to $7,260 and reduced normalized revenues to $445,411.

Purchased Gas

Auxier Road proposed adjustments to reduce purchased gas expense by $38,498. This proposed adjustment consisted of a $33,453 adjustment to normalize gas costs based on the wholesale rate of $4.951 which was in effect at the time of the filing, and a $5,045 temperature adjustment. The Commission has accepted the temperature adjustment as proposed. The Commission does not concur, however, with the methodology used to determine the normalized cost of gas. In determining the purchased gas adjustment, Auxier Road's calculation was based upon test-year Mcf sales rather than Mcf purchases. The Commission is of the opinion, and Auxier Road concurred at the hearing, that gas purchases should be used as the basis for normalizing purchased gas costs rather than gas sales. Therefore, the Commission has calculated an adjustment of $30,119[2] based upon Mcf purchases per Columbia Gas invoices and the wholesale rate in effect at the time of the filing, which has been included herein for rate-making purposes.

The aforesaid adjustments result in a decrease to test-period purchased gas expense of $35,165.

Depreciation Expense

As previously discussed, all costs associated with the installation and purchase of the Cliff Line have been eliminated

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Mcf Purchases	61,791
Wholesale Rate	$ 4.951
	$305,927
Test Year	336,046
	$ 30,119

for rate-making purposes. The Commission has reduced operating expenses by $1,453 to reflect the elimination of $1,453 in test-year depreciation associated with the Cliff Line.

Salaries, Wages and Benefits

Auxier Road proposed an adjustment to increase operating expenses by $12,532 to reflect the return to full-time employment of its maintenance man, Dennie Ousley. This adjustment, coupled with test-year total compensation of $67,997 for all employees, results in proposed total compensation of $80,528. This compensation is distributed among three full-time employees, two part-time employees, and a non-employee director.

In Auxier Road's last case, Case No. 8768, Adjustment of the Rates of Auxier Road Gas Company, Inc., for an Increase in Gas Rates, the Commission expressed its concern about the levels of total compensation and established a reasonable level of wages, salaries and benefits of $57,997.[3] Auxier Road attempted to demonstrate that its proposed wages were in conformity with wage levels found reasonable in previous cases through the testimony of its consultant, Mr. A. F. Humphries, and Auxier Road's Exhibit 5 prepared by him. This exhibit purported to show that the Consumer Price Index ("CPI") had increased 59 percent from July 1980 through January 1985, while proposed compensation, in relation to the amount found reasonable in Case No. 7897, would represent an increase of a lesser amount and, thus, proposed wages were

3 Case No. 8768, Commission's Order dated September 16, 1985, p. 6.

reasonable. This argument is not valid because the index used by Mr. Humphries measured the increase in the cost of natural gas only. There would be no reason to expect a direct correlation between the cost of natural gas and compensation. Therefore, the Commission rejects this proposed proof that wages are reasonable.

The Commission does, however, agree with the basic idea of Mr. Humphries that wage levels should not increase at a rate significantly ahead of the general level of inflation. This is the trend throughout the economy and the Commission sees no reason why an exception should be made in this instance. As mentioned above, the Commission found $57,997 as the reasonable level of compensation in Auxier Road's most recent case. Auxier Road's proposed level of $80,528 represents an increase of over 38.8 percent; the inflation rate during this same time period (June 1983-August 1985) as measured by the CPI was only 8.5 percent.[4] In determining the reasonable wage level to be used for rate-making purposes in this case, the Commission has applied the increase in the CPI to the level of wages found reasonable in Case No. 8768. This results in a pro forma wages, salaries and benefits level of $62,926. The $67,997 test-year compensation level has therefore been reduced by $5,071.

<u>Amortization of Arrearages</u>

Auxier Road proposed an adjustment to amortize $76,530 in arrearages owed to Columbia Gas and the Department of Local Government ("DLG") over a 2-year period for rate-making purposes.

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4 CPI - June 1983 = 298.1; CPI - August 1985 = 323.5.

Auxier Road stated that the amortization of the arrearages should be allowed because they were expenditures of the company under the direction of the management and that management has done a good job in the last several years and will probably continue to do so in the future.[5] The Commission is of the opinion that such treatment of the arrearages is inappropriate because these amounts were accrued due to the failure of Auxier Road to properly service its debts in the past when rates were designed to produce sufficient revenues to meet these obligations. The ratepayers provided the funds to meet these debts on a current basis, and to now allow amortization of the arrearages would result in double recovery from the ratepayers for the same debt. If, as Auxier Road contends, rates were not sufficient to meet these obligations, then it was incumbent upon it to immediately petition the Commission for higher rates. The Commission has consistently upheld the view that recovery of past operating losses through current rates is inappropriate, and has been presented no persuasive evidence of why these losses should be recovered in this instance. Therefore, no adjustment for the amortization of arrearages has been allowed herein for rate-making purposes.

Telephone Expense

Auxier Road maintains two telephone lines in an office that consists of only two employees. In the last case, the Commission disallowed the cost of one of the phones and has had no persuasive

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5 Transcript of Evidence ("T.E."), p. 99, dated September 4, 1985.

evidence presented to it in this proceeding that demonstrates that circumstances now require two lines. Therefore, the Commission has excluded the approximate annual cost of one telephone line, which reduces operating expenses by $632. The Commission encourages Auxier Road to consider less expensive alternatives to having two separate lines, such as one line and an extension.

Interest on Long-Term Debt

Auxier Road proposed an adjustment to reflect interest expense of $21,773 based upon interest payments scheduled to be made during the fiscal year ending October 31, 1985, as listed within the amortization schedule of the loan agreement with DLG. The Commission is of the opinion that, in order to maintain proper matching between capitalization and operating expenses, interest expense for rate-making purposes should be based upon the debt outstanding at the end of the test year, exclusive of the portion currently due, as reflected by the amortization schedule. The Commission, therefore, has adjusted interest expense by $5,764 to reflect total allowable interest on long-term debt of $21,719.[6]

Intervention in Columbia Gas Case

Auxier Road proposed an adjustment to reflect the amortization of $4,542 over a 4-year period for expenses incurred for its intervention in Case No. 9003, An Adjustment of Rates of Columbia Gas of Kentucky, Inc. On a review of the record in that case, it is apparent that Auxier Road's primary purpose for

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Scheduled December 31, 1984, Balance	$423,779
Interest Rate	5.125%
	$ 21,719

intervention was to attempt to get Columbia Gas to relinquish its rights to serve Auxier Road. The record reflects that the only contributions to the case by Auxier Road were a 3-page motion for intervention and 11 transcript pages of oral testimony by Mr. Branham. The Commission supports Auxier Road's efforts to pursue every avenue possible to keep its rates low. However, Auxier Road must justify expenditures for professional services. In this instance, the Commission is of the opinion that Auxier Road provided very limited, if any, evidence of value in the Columbia Gas case and that the level of expense goes way beyond the limit of reasonableness. On this basis, the Commission is of the opinion that expenses associated with Auxier Road's intervention in the Columbia Gas rate case were of no benefit to the ratepayers and that it would, therefore, be inappropriate to allow recovery of these expenses through rates.

The Commission is in no way attempting to discourage Auxier Road from intervening in future cases. To the contrary, the Commission seeks Auxier Road's input in instances when it is able to provide evidence that would be of aid in making decisions. Even in those instances, however, expenses must be contained to what is reasonable.

Interest Income

Auxier Road proposed an adjustment to exclude all interest income for rate-making purposes. Temporary cash investments decreased from $97,134 at the beginning of the test period to $13,918 at the end. The reduction was due primarily to customer refunds, payment for an extension of mains, and transfers to working funds to meet operating expenses.

The Commission is in agreement with Auxier Road that a reduction to this revenue item is necessary; however, the record indicates that Auxier Road maintained cash investments of around $13,000-$14,000 from the end of the test year through the date of the hearing. Moreover, it is unreasonable to assume that no interest income will be generated by Auxier Road in future periods. Therefore, to determine a more reasonable adjustment, the Commission has projected interest income based upon the test-year end temporary cash investment balance of $13,918 and an interest rate of 7.47[7] percent, which results in projected interest income of $1,040.

Related Party Transactions

The Commission is concerned about the increasing level of transactions between Auxier Road and the family of its president, Mr. Estill Branham. The test-year income statement reflected payments to his wife and two daughters for payroll expenses; a brother, who is also a frequent vendor for construction, for directors fees; another brother for accounting services; and his mother, for lease payments. Auxier Road should always attempt to procure the cheapest service available without regard to family or other relationships. Less than arms-length transactions will be closely monitored by the Commission in the future and adjustments

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7 The Wall Street Journal, October 21, 1985, p. 29, Merrill-Lynch Ready Asset Trust Rate.

will be made to eliminate the effects of unreasonable payments if necessary.

Compliance with Commission Findings

A primary reason for Auxier Road's current financial condition appears to be its disregard for the findings of the Commission in past rate Orders. Among the areas where findings have been disregarded are salaries, where in the last case a reasonable level was established but actual levels remained significantly higher, and telephone expense, where Auxier Road has continued to maintain an unnecessary line contrary to the Commission's findings. By ignoring the Commission's findings and making expenditures at a higher level than found reasonable by the Commission, funds for payment to creditors have not been available, resulting in large current liabilities and arrearages. The Commission will be closely monitoring Auxier Road's operations in the future to determine whether disregard for the Commission's findings continues. Auxier Road has an obligation to conduct its operations in accordance with Commission findings, and failure to do so in the future may result in adjustments to retroactively correct the effects of violations.

The Commission, after consideration of all pro forma adjustment and applicable income tax effects, has determined Auxier Road's adjusted operating results to be as follows:

	Test Year Actual	Adjustments	Test Year Adjusted
Operating Revenues	$501,375	$< 50,470>	$450,905
Operating Expenses	521,991	< 48,315>	473,676
Operating Income	$<20,616>	$< 2,155>	$<22,771>
Other Income	28,615	< 27,575>	1,040
Other Deductions	50,611	< 29,235>	21,376
Net Income	$<42,612>	$< 495>	$<43,107>

RATE OF RETURN

Auxier Road requested a rate of return on net investment rate base of 8 percent. In its most recent case, Auxier Road was allowed a return of 7.5 percent.

Since Auxier Road's last case in 1983, interest rates in general have dropped and the Commission has correspondingly lowered returns allowed to jurisdictional utilities. The Commission finds no reason to deviate from this practice in this instance, but does find reasons to further support a lowering of rate of return. At this time, the stockholders have no net investment in the company. All utility plant is supported by a subsidized loan bearing an interest rate of 5.125 percent. By allowing any return at all, the Commission seeks not to compensate the stockholders of Auxier Road, for there is no equity to compensate, but rather, to allow the company to maintain a reasonable level of cash reserves and remain a financially viable company. Under present circumstances, the need for cash reserves is minimal. With a newly built system, extraordinary maintenance should be low and the record in this case reflects no plans for major construction. Therefore, the Commission is of the opinion that a fair, just and reasonable rate of return on the net

CORRECTION

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PRECEDING IMAGE HAS BEEN REFILMED TO ASSURE LEGIBILITY OR TO CORRECT A POSSIBLE ERROR

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REVENUE REQUIREMENTS

The Commission has determined that Auxier Road needs additional annual operating income of $27,808 to produce an overall return on net investment rate base of 7 percent. After the provision for taxes of $1,592, there is an overall revenue deficiency of $52,171. To achieve this level of operating income, Auxier Road is entitled to increase its annual revenues as follows:

Reasonable Net Operating Income	$ 27,808
Adjusted Net Operating Loss	22,771
Net Operating Income Deficiency	$ 50,579
Income Taxes	1,592
Additional Revenues Required	$ 52,171

The rates and charges in Appendix A are designed to produce gross operating revenue, based upon the adjusted test year of $503,076.

Revenue Allocation and Rate Design

Auxier Road proposed no change in their rate design and proposed equal distribution to the revenue increase. The Commission agrees with the revenue allocation methodology in this case.

FINDINGS AND ORDERS

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

1. The rates and charges currently in effect are excessive and unreasonable and should be reduced.

2. The rates and charges in Appendix A are the fair, just and reasonable rates to be charged by Auxier Road.

3. Auxier Road should amend its annual reports for the years 1981-1984 to reflect proper accounting for the amortization of the extraordinary property loss.

IT IS THEREFORE ORDERED that:

1. Upon application of 278.260, Auxier Road shall reduce its rates and charges to conform with Finding No. 1.

2. The rates and charges in Appendix A are the fair, just and reasonable rates to be charged by Auxier Road for service rendered on and after the date of this Order.

3. Auxier Road shall amend its 1981-1984 Annual Reports in accordance with Finding No. 3.

4. Within 30 days of the date of this Order Auxier Road shall file with this Commission its revised tariffs setting out the rates authorized herein.

5. The motion that the burden of proof in this proceeding be upon the Commission be and hereby is overruled.

Done at Frankfort, Kentucky, this 20th day of December, 1985.

PUBLIC SERVICE COMMISSION

Richard D. Heman Jr.
Chairman

Vice Chairman

George N. Williams
Commissioner

ATTEST:

Secretary

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 9318 DATED 12/20/85

The following rates and charges are prescribed for the customers served by Auxier Road Gas Company, Inc. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the effective date of this Order.

The following rates and charges have incorporated all increases and decreases in purchase gas adjustment clause cases from 8768-L through 8768-P.

RATES:	Monthly	
First	1,000 cu. ft.	$8.55 Minimum Bill
All Over	1,000 cu. ft.	7.73 per 1,000 cu. ft.

The base rate for the future application of the purchased gas adjustment clause of Auxier Road Gas Company, Inc., shall be:

	Commodity
Columbia Gas of Kentucky, Inc.	$4.551 per Mcf