COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF INTER-COUNTY RURAL ELECTRIC COOPERATIVE CORPORATION OF DANVILLE, KENTUCKY FOR AN ORDER AUTHORIZING AN INCREASE IN ITS RETAIL RATES, APPLICABLE TO ALL CONSUMERS	)	CASE NO. 9486

O R D E R

Inter-County Rural Electric Cooperative Corporation ("Inter-County") filed an application on January 31, 1986, for an adjustment of rates to increase its annual revenue by $716,690 or 6.05 percent over normalized test year operating revenue as determined herein, stating that the additional revenue was necessary for the Cooperative to maintain its financial integrity and sound operations.

Inter-County is a consumer-owned rural electric cooperative engaged in the distribution and sale of electric energy to approximately 14,955 customers in the Kentucky counties of Boyle, Garrard, Marion, Lincoln, Mercer, Casey, Washington, Larue, Taylor, Madison, Nelson and Rockcastle.

After timely notice, a hearing was held on May 8, 1986, with the Consumer Protection Division of the Attorney General's Office ("AG") as the only party to intervene in the proceeding. Based upon the adjustments, modifications and determination herein, Inter-County has been granted an increase of $294,406 or 2.49 percent over normalized test-year operating revenue as determined herein.

TEST PERIOD

Inter-County proposed and the Commission has accepted as a test period for calculating required revenue and rates the 12-month period ending October 31, 1985. In utilizing this historic test period, the Commission has given full consideration to appropriate known and measurable changes proposed by Inter-County.

VALUATION

Net Investment

Inter-County proposed a net investment rate base of $17,625,995. The following modifications have been made by the Commission:

In determining its rate base, Inter-County used a 12-month average for materials and supplies, and prepayments. The Commission has utilized a 13-month average to determine the levels to be included in the net investment as of October 31, 1985. This method was used in order to reflect the level of materials and supplies, and the level of prepayments maintained throughout the test year.

Inter-County's proposed inclusion of an allowance for working capital of 1/8 of adjusted test-year operation and maintenance expenses, exclusive of depreciation, taxes and other deductions has been accepted, but recalculated to reflect the pro forma adjustments found reasonable herein.

Based on these adjustments, Inter-County's net investment rate base for rate-making purposes is as follows:

Utility Plant-in-service	$20,865,265
Construction Work in Progress	181,629
Total Utility Plant	$21,046,894
Add:	
Materials and Supplies	$ 190,406
Prepayments	50,507
Working Capital	235,472
Subtotal	$ 476,385
Deduct:	
Accumulated Depreciation	$ 3,842,583
Customer Advances for Construction	51,258
Subtotal	$ 3,893,841
Net Investment	$ 17,629,438

Capital Structure

Inter-County reported a test-year-end capital structure of $19,515,804, consisting of $6,031,486 in equity, exclusive of Generation and Transmission Capital Credits ("GTCCs") and $13,484,318 in long-term debt. Inter-County proposed to add $642,867 to the test-year-end equity to reflect the proposed revenue and expense adjustments requested in this application. In determining rate base and capital structure, it is essential to match revenues, investment and capital based on test-year-end. The equity adjustment proposed by Inter-County goes beyond the end of the test period and should not, therefore, be included for rate-making purposes as it would create a mismatch between rate base, capital, revenues and expenses.

Inter-County proposed an adjustment of $75,504 to reduce to zero the value of the accumulated capital credits assigned it by United Utility Supply and the Kentucky Association of Electric

Cooperatives. Inter-County proposed this same adjustment in its last rate case, Case No. 8958, contending that it is doubtful that these credits will ever be paid. The Commission is not persuaded by the arguments that these credits will never be paid or that they have no value. In addition, as stated in the prior Order, the Uniform System of Accounts for Rural Electric Cooperatives, as well as generally accepted accounting principles, recognize these capital credits for financial reporting purposes. Therefore, the Commission has not accepted the adjustment proposed by Inter-County to reduce the value of these credits for rate-making purposes.

Inter-County also proposed to increase its total capitalization by $668,000 to reflect its draw down of long-term debt funds subsequent to the test year. Again, the principle of the historical test year, with matching of revenue, investment and capital, requires rejection of this adjustment. This subject is addressed further in the section on "Interest Expense" of this Order.

The Commission finds, from the evidence of record, that Inter-County's capital structure for rate-making purposes is $19,515,804 and consists of $6,031,486 in equity and $13,484,318 in long-term debt, excluding GTCC assignments in the amount of $1,392,982.

REVENUES AND EXPENSES

Inter-County proposed several adjustments to revenues and expenses to reflect current and anticipated operating conditions. The Commission finds the proposed adjustments are generally proper and acceptable for rate-making purposes, with the following modifications:

Normalized Payroll

Inter-County stated that prior to the beginning of the test period an informal review with the Rural Electrification Administration ("REA") personnel was made of the payroll distribution. The REA personnel considered the percentage of labor cost being capitalized to be high in comparison with other rural electric cooperative corporations in the state. It was determined that all of the Operations Manager's salary should be charged to operating expense accounts.

For the period of 1982 through 1984, approximately 36.13 percent of the Operations Manager's salary was charged to capital accounts. Since his duties do include supervision over construction work-in-progress,[1] the Commission is of the opinion that a portion of his salary should be capitalized. In addition, the fact that Inter-County's capitalized payroll percentage is higher than the state median, does not, alone, justify expensing all of the Operations Manager's salary.

In order to determine the portion of the Operations Manager's salary to be capitalized, the payroll distribution percentage has been recalculated. Using the 3-year average capitalized payroll percentage and the normalized test year payroll, it has been determined that $11,311 of the Operations Manager's salary should

1 Hearing Transcript, May 8, 1986, p. 12.

have been capitalized. This reduces the expensed payroll percentage from 64.32 percent to 63.50 percent.

Inter-County proposed to increase the total payroll expense by $27,580, to normalize a salary increase granted by the Board of Directors in October, 1985. The total normalized payroll for the test year is $1,379,626. By utilizing the revised expensed payroll percentage and taking into account the actual test-year expensed payroll of $859,794, the Commission has determined that the expensed payroll should be increased by $16,269 to a level of $876,063.

Uncollectible Accounts Expense

Inter-County proposed an adjustment to increase ("write-off") the Uncollectible Accounts Expense by $14,977. During December, 1984, Inter-County determined that for the period of January through November, 1984, it had provided an excessive allowance for losses on uncollectible accounts, and reduced the monthly provision percentage from .35 percent to .22 percent. In addition, Inter-County reduced the uncollectible expense account by $16,541 to reflect the decrease in the percentage for the period of January through November, 1984. Since November is the only month in this period that is in the test year, Inter-County proposed an adjustment to remove the portion of the reduction related to the period of January through October, 1984, from the test year.

The Commission is of the opinion that in determining the projected Uncollectible Accounts Expense based on the test-year gross operating revenues, the additional operating revenues granted herein should also be included. Therefore, the Commission has allowed an Uncollectible Accounts Expense of .22 percent on the total projected operating revenues of $12,143,783. As a result, the Commission has increased the Uncollectible Accounts Expense by $15,172 to a level of $26,716. This adjustment includes the reduction in the uncollectible expense account during the test year.

CADP and NCC Conversion Costs

Inter-County was under contract with the Central Area Data Processing Cooperative ("CADP") to provide computerized customer billing services. In order to have continued with CADP, Inter-County would have had to have made substantial changes during 1984 to conform with CADP's Cooperative Attached Processing System. Thus, Inter-County decided to change to Network Computing Corporation ("NCC") in April, 1985, for a lower cost per customer billed.

The cost of converting to CADP was set up by Inter-County as a deferred charge and was being amortized over an 8-year period through February, 1991. As of March 1, 1985, Inter-County determined that the balance in the deferred charge account should be amortized over the remaining 10 months of the year. Inter-County stated in the application that since the term of the CADP contract was for 28 months, from January, 1983, through April, 1985, for rate-making purposes, the original conversion costs of $7,785 should be amortized over the 28-month period.[2]

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2 Application, Exhibit J, p. 48.

The actual test-year amortization expense of the CADP conversion costs was $4,866. Inter-County proposed to reduce this amount by $1,530 to conform with what it considered proper rate-making treatment.[3]

During the period of March through September, 1985, Inter-County incurred $20,378 in expenses to convert to NCC. Inter-County is amortizing the NCC conversion costs over the life of the 5-year contract beginning with April, 1985. Inter-County proposed to include in the test year 7 months of the NCC conversion costs amortization expense for the period of April through October, 1985.

Since the CADP conversion costs were fully amortized as of December 1985, the Commission is of the opinion, and Inter-County agreed,[4] that for rate-making purposes the actual test year CADP conversion costs amortization expense should be excluded and a full year of the NCC conversion costs amortization expense should be included. This would provide a correct matching of revenues and expenses in future periods. Therefore, the Commission has excluded $4,866 of the CADP conversion costs amortization expense while including $4,076 of NCC conversion costs amortization expense.

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Actual test period amortization	$4,866
Less:	
Corrected test period amortization ($7,785 ÷ 28 months X 12 months)	3,336
	$1,530

4 Hearing Transcript, May 8, 1986, pp. 47-49.

Fringe Benefits

Inter-County proposed an adjustment to reflect an increase in the level of fringe benefits by $5,728. To determine this adjustment, Inter-County normalized the costs of coverage under the benefit plans which were in effect during the test year, based on the rates effective January 1, 1986, and salaries and wages which became effective November 1, 1985.

Inter-County distributed the normalized fringe benefits upon the estimated amounts for Account 923 - Outside Services and Account 930.3 - Director's Fees and Expenses. The remainder of the normalized fringe benefits were allocated to Account 107 - Construction Work In Progress and Account 926 - Employees Pension and Benefits at 29.53 percent and 70.47 percent, respectively. The Commission agrees that the projected labor costs associated with Account 923 - Outside Services and Account 930.3 - Director's Fees and Expenses, should be used to determine the normalized Fringe Benefits Expense adjustment. However, the revised payroll distribution percentages should be used to allocate the remainder of the fringe benefits to Account 107 - Construction Work In Progress and Account 926 - Employees Pension and Benefits. Since the revised payroll distribution percentages reflect the correct amount of payroll expensed and capitalized, and over half of the fringe benefits are based upon wages and salaries, it is deemed reasonable by the Commission to utilize the revised payroll distribution percentages to determine the adjustment to fringe benefits. The net effect of normalizing the fringe benefits distributing the costs over the estimated amounts for Account 923

- Outside Services and Account 930.3 - Director's Fees and Expenses, and allocating the remainder to Account 107 - Construction Work In Progress and Account 926 - Employees Pension and Benefits results in a decrease of $16,313 to expensed Fringe Benefits.

<u>Directors Fees and Expenses</u>

Inter-County incurred $53,716 in Directors fees and expenses during the test period. Inter-County increased the monthly board meeting fee and the Committee meeting fee for the Directors during the test year. Due to the normalization of these fees, an increase of $2,525 is deemed reasonable by the Commission.

The Commission is aware that non-profit cooperatives must have dedicated and competent directors at the board level, and includes the actual expenses incurred in attending these meetings for rate-making purposes. However, no showing has been made that the payment of per diem fees to directors for attending industry-associated meetings other than its own board meetings advance these objectives. Therefore, it is the Commission's opinion that $7,600 incurred for fees paid to directors for attending industry-associated meetings other than its own board meetings should not be included for rate-making purposes.

During the test year Inter-County paid $1,382 in fees and expenses to Elvin Langford, a retired Director. Since there is no provision in Inter-County's By-Laws for payments to retired Directors, it is the Commission's opinion that this amount should be excluded for rate-making purposes. Therefore, due to the aforementioned items, the test-year directors fees and expenses have been reduced by $6,457 to a level of $47,259.

Payroll Taxes

Inter-County proposed an adjustment of $3,139 to normalize payroll taxes for an approximate 3.2 percent increase in payroll effective November 1, 1985. Inter-County expensed 68.28 percent of the payroll taxes during the test period. However, in determining this ratio the payroll taxes associated with the storm damage and computer conversion costs were included. In addition, Inter-County reclassified the capitalized portion of labor charged to transportation clearing and stores, and vacation and sick leave for purposes of determining the expense percentage of the payroll taxes. Since the storm damage costs and the computer conversion costs were capitalized for payroll purposes, it is the Commission's opinion that these costs should also be capitalized for purposes of allocating payroll taxes. Due to insufficient information, it is the Commission's opinion that the reclassification of the labor costs, and vacation and sick leave has not been justified as the proper treatment for purposes of determining the payroll taxes expense percentage. It is the Commission's opinion that the payroll taxes allocation percentages should approximate the payroll distribution percentages. Due to the information contained in this case, it is the Commission's opinion that the revised payroll distribution percentages should be used to allocate the payroll taxes.

The normalized payroll taxes for the test year are $108,215 while the actual test-period payroll taxes were $103,618. The

Commission has determined that the expensed portion of the payroll taxes should be decreased by $2,033 to a level of $106,717 based upon the revised payroll distribution expense percentage of 63.5 percent.

Other Deductions - Benefits for Directors' and Employees' Spouses

During the test year Inter-County incurred expenses for the benefit of directors' and employees' spouses in the amount of $2,295 and $1,579, respectively. Inter-County stated that it strongly encourages the participation of spouses of directors and management employees so that they know the problems and issues which their spouses face. In addition, Inter-County is of the opinion that participation by the spouses enables them to converse with member-customers about these problems and issues.[5]

The Commission is aware that the spouses of the directors and management employees do converse with member-customers and that it could be beneficial to have these spouses informed about problems facing the cooperative, but no evidence has been presented that these benefits are being derived by the incurrence of directors' and employees' spouses expenses. Therefore, the Commission has excluded for rate-making purposes the expenses incurred for the benefit of directors' and employees' spouses in the amount of $3,874.

5 Response to Commission's Information Request No. 3, dated April 28, 1986, Exhibit 42, pp. 1-2.

Other Deductions - Contributions

During the test period, Inter-County charged $955 to Account 426.1 - Contributions. Inter-County, in response to the Commission's Information Request No. 2,[6] stated that $299 was improperly classified and should have been charged to Account 913 - Advertising Expense as promotional items.

While the Commission understands that the contributions in the amount of $656 may be good for community relations, they are not related to the provision of reliable electric service to the member-customers of Inter-County.

Under 807 KAR 5:016, Section 4, promotional advertising is disallowed for rate-making purposes. The Commission finds that the rates charged consumers for utility services should reflect only the cost of providing those services. Therefore, the Commission has excluded both the $656 of contributions and the $299 of promotional advertising for rate-making purposes herein.

Interest Expense

Inter-County proposed an adjustment of $24,359 to normalize interest expense on long-term debt outstanding at the end of the test period and to reflect the interest on loan funds of $668,000 drawn down 3 months after the close of the test year.

The Commission put Inter-County and all other electric cooperatives under its jurisdiction on notice in Case No. 8778[7]

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6 Response to Commission's Information Request No. 2, dated March 25, 1986, Exhibit 23, pp. 1-3.

7 Case No. 8778, Adjustment of Rates of Salt River Rural Electric Cooperative Corporation, dated October 24, 1983.

that, in future rate proceedings, it would reconsider its past practice of allowing the interest on debt drawn down subsequent to the end of the test period.

Generally, the Commission's past practice of allowing the interest on debt drawn down after the end of the test year results in a mismatch of revenues and expenses because no adjustments have been made to update revenues and expenses for additional customers or to reflect the income from additional funds available for investment.

Inter-County stated in its application that of the total against which funds were drawn, $592,799 represented construction which was revenue producing during the entire test period. In addition, of the remaining $75,201 of work orders against which the draw was made only $40,414 represented new customer services which became revenue producing during November, 1984. Inter-County also stated that the proceeds of the draw would be quickly expended, resulting in no interest income from investing the funds. Inter-County argues that since the construction was completed and in service for practically the entire test year, the interest expense on the debt related to that construction should be included for normalization purposes.[8]

The Commission recognizes that the use of a nistorical test year coupled with the construction and financing practices of cooperatives, creates some degree of mismatching of capital, revenues, and investments. However, the proposed adjustment to

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8 Application, Exhibit J, pp. 6-7.

interest expense would worsen, rather than improve, this mismatch. Inter-County's adjusted test-year-end capitalization exceeds its rate base by $1,886,365, and if the Commission were to increase Inter-County's capitalization to reflect the additional long-term debt drawn down after the test year, the disparity between the rate base and the capital structure would be even greater.

Inter-County stated in the application that management delayed the requisition for funds as long as possible, based upon economics of operations.[9] If Inter-County had drawn the funds earlier, additional income would have resulted due to temporary cash investments of either the funds of the loan or the operating reserves used to fund the construction. If the Commission were to allow the adjustment to interest expense proposed by Inter-County, a further adjustment should be made to recognize the additional income on the additional funds available for investment.

Without recognizing the increased income from additional temporary cash investments, the inclusion of the post test-period interest expense in the determination of revenue requirements would result in excessive rates for Inter-County's customers. Such a revenue requirement determination would be inconsistent with the matching concept applied to other utilities regulated by this Commission and would result in discriminatory rate-making practices. Therefore, the Commission is of the opinion that the proposed adjustment to include interest on loan funds drawn down subsequent to the end of the test period should not be included

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9 Ibid., p. 7.

herein. The Commission has included in its determination of Inter-County's revenue requirements the annual interest expense based on the balance of long-term debt outstanding at the end of the test period which results in a decrease of $9,041 from the amount of actual test period expense.

The effect of the accepted pro forma adjustments of Inter-County's net income is as follows:

	Actual Test Year	Pro Forma Adjustments	Adjusted Test Year
Operating Revenues	$11,842,634	$ 6,743	$11,849,377
Operating Expenses	10,735,786	11,476	10,747,262
Operating Income	$ 1,106,848	$<4,733>	$ 1,102,115
Interest on Long-Term Debt	755,359	<9,041>	746,318
Other Income/ <Deductions> Net	96,115	-0-	96,115
NET INCOME	$ 447,604	$ 4,308	$ 451,912

REVENUE REQUIREMENTS

According to Inter-County's financials filed with its application, the rate of return on Inter-County's net investment rate base established herein for the test period was 6.28 percent. Inter-County requested rates that would produce a rate of return of 10.07 percent and a Times Interest Earned Ratio ("TIER") of 2.4X. Inter-County stated that these earnings levels were requested in order to build equity and have some funds for construction purposes, instead of financing all future construction with borrowings.

Inter-County's TIER for the test year was 1.59X and was 1.70X and 1.73X for the calendar years 1983 and 1984, respectively.

After taking into consideration the pro forma adjustments in this case, Inter-County would achieve a 1.60X TIER without an increase in revenues. Inter-County's equity to total asset ratio is 30.9 percent based on the capital structure approved herein. Inter-County's Debt Service Coverage ratio for the test year and calendar years 1983 and 1984 was 1.68X, 1.68X and 1.77X, respectively. All of these ratios are calculated on the reported earnings of Inter-County, exclusive of the GTCCs assigned by East Kentucky Power Cooperative, Inc.

In 1984, Inter-County was granted a rate of return of 8.2 percent, which provided a TIER of 2.15X. Recognizing the lowering of interest rates and the overall improvement in economic conditions, the Commission has lowered the rates of return allowed in certain cases involving other utilities under its jurisdiction. Recent decisions involving electric cooperatives have resulted in allowed TIER levels of 2.00X reflecting the Commission's general trend of reducing rates of return and TIER.

As previously noted, Inter-County stated that the Board of Directors determined the amount of the increase needed to be $716,000, which results in a TIER of 2.4X based upon Inter-County's adjusted test year. It was stated in the application that this amount of increase will provide some funds for construction. By utilizing an adjusted historical test period, the Commission includes in the determination of revenue requirements projected operating expenses allowing for known and measurable changes to operations and maintenance expenses. Thus, the pro forma operating expense should be representative of expected future operating costs. In the determination of revenue requirements, the Commission also allows a return which is expressed by the TIER in this case. In support of the requested increase in revenues and the resulting TIER, Inter-County has noted the need for funds to cover anticipated operating costs, to provide for a portion of anticipated construction costs, and to provide equity. Inter-County did not provide any evidence which would show that an allowed TIER of 2.00X would provide an insufficient level of cash flow to achieve its requirements for normal expansion and improvements. Therefore, the Commission finds that the contentions of Inter-County in support of the 2.40X TIER are not valid.

Based on the evidence of record and the reasons cited herein, the Commission has determined that a TIER of 2.00X should be granted in this case. In order to achieve this TIER, Inter-County should be allowed to increase its annual revenue by $294,406, which would result in a rate of return of 7.92 percent. This additional revenue will produce net income of $746,318, which should be sufficient to meet the requirements in Inter-County's mortgages securing its long-term debt.

REVENUE ALLOCATION AND RATE DESIGN

Inter-County proposed that the revenue allocation and rates in each tariff be increased by the percentage of increase to the normalized revenue. The Commission, being so advised, agrees with Inter-County's proposed methodology in this case and has used this methodology to develop the rates and charges in the attached Appendix A.

SUMMARY

The Commission, after consideration of 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 Inter-County and will provide net income sufficient to meet the requirements in Inter-County's mortgages securing its long-term debt.

2. The rates and charges proposed by Inter-County differ from those found reasonable herein and should be denied upon application of KRS 278.030.

3. Inter-County's proposed methodology for allocating the revenue increase is fair, just and reasonable and should be applied in this case.

IT IS THEREFORE ORDERED that:

1. The rates in Appendix A be and they hereby are approved for service rendered on and after July 24, 1986.

2. The rates proposed by Inter-County be and they hereby are denied.

3. Inter-County shall file with the Commission within 30 days from the date of this Order its revised tariff sheets setting out the rates approved herein.

Done at Frankfort, Kentucky, this 28th day of July, 1986.

PUBLIC SERVICE COMMISSION

Richard D. Hemenway
Chairman

Vice Chairman

Commissioner

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 9486 DATED 7/28/86

The following rates and charges are prescribed for the customers in the area served by Inter-County Rural Electric Cooperative Corporation. 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.

SCHEDULE 1
FARM AND HOME SERVICE*

Rate

Customer Charge	$ 5.55	Per Meter Per Month
First 500 KWH Per Month	7.645¢	Per KWH
All over 500 KWH Per Month	5.907¢	Per KWH

The Customer Charge is without KWH usage. All KWH usage is billed at rates set forth above.

The minimum monthly charge under the above rate shall be $5.55 net where 10 KVA or less of transformer capacity is required.

SCHEDULE 2
SMALL COMMERCIAL AND SMALL POWER*

Rate

Demand Charge in Excess of 10 KW Per Month $4.02 Per KW

Energy Charge

Customer Charge	$5.55	Per Meter Per Month
First 1,000 KWH Per Month	8.794¢	Per KWH
All over 1,000 KWH Per Month	6.104¢	Per KWH

The Customer Charge is without KWH usage. All KWH usage is billed at rates set forth above.

The minimum monthly charge under the above rate shall be $5.55 net where 10 KVA or less of transformer capacity is required.

SCHEDULE 4
LARGE POWER RATE (LPR)*

Rate

Maximum Demand Charge

$4.02 per month per KW of billing Demand

Energy Charge

Customer Charge	$11.10	Per Meter Per Month
First 10,000 KWH Per Month	6.145¢	Per KWH
All over 10,000 KWH Per Month	5.444¢	Per KWH

The customer charge does not allow for KWH usage. All KWH usage is billed at the above rates.

SCHEDULE 5
ALL ELECTRIC SCHOOL (AES)*

Rate

All Kilowatt Hours Per Month	5.896¢	Per Month

SCHEDULE 6
OUTDOOR LIGHTING SERVICE-SECURITY LIGHT*

Rate Per Light Per Month

Mercury Vapor Lamp 175 Watt	$6.69	Per Lamp Per Month
Mercury Vapor Lamp 200 Watt	8.15	Per Lamp Per Month

*Fuel Clause Adjustment

All rates are applicable to the Fuel Adjustment Clause and may be increased or decreased by an amount per KWH equal to the fuel adjustment amount per KWH as billed by the Wholesale Power Supplier plus an allowance for line losses. The allowance for line losses will not exceed 10% and is based on a twelve-month moving average of such losses. This Fuel Clause is subject to all other applicable provisions as set out in 807 KAR 5:056.