

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ADJUSTMENT OF THE RATES OF PHELPS)
GAS COMPANY, INC. PURSUANT TO THE)
ALTERNATIVE RATE ADJUSTMENT) CASE NO. 9515
PROCEDURE FOR SMALL UTILITIES)

O R D E R

On February 21, 1986, Phelps Gas Company, Inc., ("Phelps") filed an application with the Commission requesting authority to increase its gas rates. This application was filed pursuant to 807 KAR 5:076, Alternative Rate Adjustment procedure for small utilities ("ARF"). Phelps stated that the requested increase was necessary because the operating margins over the past years have shown a loss, customer usage has declined, and the number of customers have declined. The amount of increased revenue requested by Phelps was \$22,473, an increase of 19.02 percent over normalized operating revenues as determined herein. Based upon the determination herein, Phelps' operating revenue will increase by \$11,453, an increase of 9.7 percent.

A hearing was not requested in this matter, and in accordance with the provisions of the ARF, no hearing was conducted. The decision of the Commission is based upon information contained in the application, written submissions, annual reports, staff reports and other documents on file in the Commission's offices.

COMMENTARY

Phelps operates as a public utility providing gas service to 213 residential customers in the town of Phelps in Pike County, Kentucky.

TEST PERIOD

Phelps proposed and the Commission has accepted the 12-month period ending December 31, 1985, 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.

Staff Audit Report Adjustments

In the course of its investigation in this case, the Commission staff performed a limited audit to verify reported test-year expenses and determined what accounting or classification changes might be appropriate. The Commission's objective was to substantially reduce the need for written data requests, thus reducing the expense to Phelps. The staff audit report of Phelps' financial operations for the calendar year 1985 was filed as a part of the record in this case on May 20, 1986.

The Commission hereby adopts the findings of that report to be used for rate-making purposes herein.

On May 30, 1986, Phelps filed comments regarding the audit report. These comments were addressed by the Commission staff in an appendix to the Commission's Order dated June 24, 1986. The comments filed by Phelps raised no substantive issues and neither those comments nor the staff's response affected the determinations herein.

The Commission has made additional adjustments to the test year, as determined in the audit report, based upon the following findings of fact to reflect more normal and current operating conditions:

VALUATION

Net Investment

Phelps proposed a net investment rate base of \$25,355. The Commission has adopted Phelps' proposed net investment rate base with the following modifications:

Accumulated depreciation has been reduced by \$705 to reflect the finding in the audit report that test-year depreciation expense was overstated by that amount.

Working capital of 1/8 of operation and maintenance expenses, exclusive of depreciation, taxes and other deductions, has been calculated based upon the adjusted pro forma operation and maintenance expenses found reasonable herein.

An adjustment of \$600 has been made to increase working capital to reflect the test year end balance of prepayments.

With these adjustments, Phelps' net investment rate base for rate-making purposes is as follows:

Gas Utility Plant in Service	\$76,775
Add:	
Prepayments	600
Cash Working Capital	4,986
Less:	
Reserve for Depreciation	<u>57,831</u>
Net Investment Rate Base	<u>\$24,530</u>

Interest on Notes Payable to Mike Little

In its application, Phelps proposed an adjustment of \$4,510 to reflect interest expense associated with a \$41,000 note payable to Mike Little.¹ This note apparently consolidates into a single note several notes dating back to January 27, 1983.² Interest expenses related to these notes payable have never been charged to the operations of Phelps in the annual reports filed with the Commission.

Phelps states that the amounts were borrowed to pay operating expenses and to have done a leak survey and line repairs.³ The lack of plant additions in recent years suggests that the amounts were applied primarily for non-capital purposes. The Commission is of the opinion that interest on debt to pay past operating losses is not an appropriate expense for rate-making purposes. The Commission has taken the position that it is the utility's responsibility to seek timely rate relief when necessary rather than to finance losses through incurrence of debt and burden the ratepayers with the subsequent debt-service. To allow the recovery of debt resulting from past operating losses would constitute retroactive rate-making.

As justification for inclusion of this interest expense Phelps states "There is no reason to not permit interest on notes

¹ Application, p. 2.

² 1985 Annual Report, p. 2.

³ Response to Commission's Information Request, Item No. 3.

for rate purposes. Interest on debt is an appropriate expense."⁴ To the contrary, the methodology proposed by Phelps for determination of rates, return on rate base, excludes interest expense as a rate-making item except as it may affect income taxes. Interest expense is a below-the-line item. The Commission, in accordance with the return on rate-base methodology, finds that the interest on notes payable to Mike Little, or any other interest, unless justified, shall not be permitted for rate-making purposes. The \$4,510 adjustment is therefore disallowed.

The Commission realizes that the sources of capital for small utilities are limited, and that Phelps is fortunate to have the availability of owner-financing. If reasonable grounds are advanced in future proceedings, recovery of the associated interest may be allowed.

Interest on Past-Due Billings

As determined in the audit report, Phelps misclassified \$3,663 in late charges on past due billings from Columbia Gas as purchased gas expense. The audit report reclassified this amount to Account No. 431 - Other Interest Expense. The Commission has in many instances disallowed for rate-making purposes amounts related to late-payment penalties and as explained in the preceding section, under the methodology proposed by Phelps for computation of its revenue requirement, return on rate-base, interest expense is classified as a non-operating expense item and, therefore, a cost to be borne by the stockholders rather than the

⁴ ibid.

ratepayers. Only under extraordinary circumstances would interest expense be considered as an operating expense for rate-making purposes.

At the Commission's request to explain why interest expense on past-due billings should be allowed in this instance Phelps responded, "Interest is a legitimate operating expense, there is no reason to even suspect that it would not be allowed for rate purposes."⁵ The Commission finds that this is not an adequate explanation to permit deviation from the normal treatment of this expense. Therefore, this amount has not been used for the purposes of determining rates herein.

Income Taxes

In its application Phelps proposed an adjustment of \$360 for state and federal income tax expense. However, the record reflects that Phelps is a Sub-Chapter S corporation and Phelps, by its own admission, stated that income taxes should not be allowed in this instance.⁶ The proposed \$360 has, therefore, been excluded for rate-making purposes herein.

Other Taxes

Included within Phelps' 1985 reported Other Taxes expense was \$3,510 related to the 3 percent utility tax collected from customers and paid over to the Pike County school system. This collection by Phelps represents neither income nor expense and, as such,

5 Ibid., Item No. 6.

6 Ibid., Item No. 2.

has not been included in the adjusted operating statement contained herein.

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

	<u>Test Year Per Audit</u>	<u>Adjustments</u>	<u>Test Year Adjusted</u>
Operating Revenues	\$125,923	\$ <7,796>	\$118,127
Operating Expenses	<u>137,386</u>	<u><10,259></u>	<u>127,127</u>
Operating Income	<11,463>	2,463	<9,000>
Other Deductions	3,663	<3,663>	-0-
Net Income	<u>\$<15,126></u>	<u>\$ 6,126</u>	<u>\$ <9,000></u>

RATE OF RETURN

Phelps requested a rate of return on net investment rate base of 10 percent. In its most recent case, Phelps was allowed a return of 13 percent. The requested return is consistent with the lowered returns allowed by the Commission since Phelps' last case in 1982 and therefore, the Commission is of the opinion that the requested return of 10 percent is a fair, just and reasonable rate of return on net investment rate base in that it will allow Phelps to pay its operating expenses, service its debt, and provide a reasonable surplus for equity growth.

REVENUE REQUIREMENTS

The Commission has determined that Phelps needs additional annual operating income of \$11,453 to produce an overall return on net investment rate base of 10 percent. To achieve this level of

operating income, Phelps is entitled to increase its annual revenues by \$11,453 over normalized operating revenues as determined herein.

The rates and charges in Appendix A are designed to produce gross operating revenue, based upon the adjusted test year, of \$129,580.

FINDINGS AND ORDERS

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

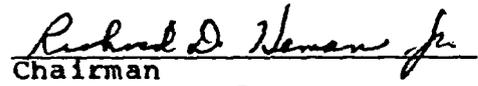
1. Phelps' proposed rates are not fair, just and reasonable and should be denied.
2. The rates and charges in Appendix A are the fair, just and reasonable rates to be charged by Phelps.

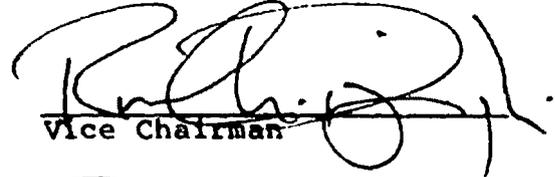
IT IS THEREFORE ORDERED that:

1. The rates in Appendix A be and they hereby are approved for service rendered by Phelps on and after the date of this Order.
2. The rates proposed by Phelps be and they hereby are denied.
3. Within 30 days from the date of this Order Phelps shall file with the Commission its revised tariff sheets setting out the rates approved herein.

Done at Frankfort, Kentucky, this 10th day of July, 1986.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Secretary

APPENDIX

APPENDIX TO AN ORDER OF THE PUBLIC SERVICE
COMMISSION IN CASE NO. 9515 DATED 7/10/86

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

RATES: Monthly

First 1 Mcf	\$8.49 Minimum Bill
Over 1 Mcf	6.19 Per Mcf

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

	<u>Commodity</u>
Columbia Gas of Kentucky, Inc.	\$4.404 per Mcf