COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN ADJUSTMENT OF RATES OF THE MIKE LITTLE GAS COMPANY, INC.) CASE NO. 9535

O R D E R

On March 25, 1986, Mike Little Gas Company, Inc., ("MLG") filed an application requesting authority to increase its gas rates. The increased revenue requested was $47,246, or 14.5 percent. Based upon the determination herein, operating revenue will increase by $32,850 an increase of 11.2 percent.

A hearing was held on July 15, 1986. Kentucky-West Virginia Gas Company ("Kentucky-West") intervened.

COMMENTARY

MLG is a public utility providing gas service to 548 residential customers in Floyd County, Kentucky. The owner/operator of MLG, Mike Little, is also the owner/operator of Phelps Gas Company ("Phelps") and Elzie Neeley Gas Company, Inc. ("Elzie Neeley"). Several expenses and assets are allocated among these companies and they are therefore affiliated companies.

TEST PERIOD

MLG 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 utilizing the historical test period, the Commission has given full consideration to known and measurable adjustments found reasonable.

VALUATION

MLG proposed a net investment rate base of $124,579, which the Commission has adopted with the following modifications:

Accumulated depreciation has been reduced by $5,020 to reflect the adjustments to the reported test year amount as determined herein.

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

The $8,364 amount recorded as prepayments has been reclassified to plant-in-service to reflect the finding herein that the charges to prepayments were improperly classified.

The Commission has determined MLG's net investment rate base at December 31, 1985, to be as follows:

Gas Plant in Service	$259,953
Add: Cash Working Capital	13,512
Less: Reserve for Depreciation	143,447
Net Investment Rate Base	$130,018

Revenue Normalization/Bad Debts Expense

MLG reported test-year gas sales of $330,526; however, the amount reported was incorrect because it represents the net sales exclusive of bad debts expense. MLG expressed the position that it was correct in its treatment of reported sales revenue and that it made no difference that sales were reported net of bad debts expense, because there was no effect on net income. The Uniform System of Accounts for Gas Utilities ("USoA") requires that Bad Debts expense be recorded in Account No. 904--Uncollectible Accounts. Therefore, MLG should take steps to adjust its accounting procedures to conform.

The Commission accepts the proposed revenue normalization adjustments, except that reported revenues have been increased by $4,040 to reinstate the amount improperly deducted, and a corresponding adjustment of $4,040 has been made to increase Bad Debts expense. This results in adjusted normalized revenues of $292,996.

Cash Theft

MLG reported test year charges to Account No. 925--Injuries and Damages, of $4,345, for losses related to the theft of collections received for gas sales. MLG proposes that this loss be considered as an operating expense for rate-making purposes.

This loss should be borne by the stockholders of MLG rather than the ratepayers. The stolen funds were paid to MLG by the ratepayers for gas sales. The responsibility of protection of the funds, and thus the risk of loss, then passed to MLG. The ratepayers are not insurers of the property of MLG and cannot be expected to provide reimbursement for losses resulting from failure to adequately protect its assets. The theft of $4,345 from the offices of MLG is not an appropriate expense for rate-making purposes; this amount has, therefore, been excluded from test-year operating expenses.

Amortization Expense/Prepaid Balance

MLG reported test-year amortization expense of $3,287. This charge is a result of the incorrect disposition of balances contained in Account No. 165--Prepayments. The balance recorded in the prepayment account at December 31, 1985, is in error. These costs related to engineering costs which should have been charged to Utility Plant in Service accounts and depreciated over the service lives of the assets capitalized.

When requested to explain the existence of the $8,364 test year-end balance in the Prepaid Expense Account, MLG responded, "According to the Public Service Commission, MLG Company, Inc., is required to capitalize engineering costs and amortize over a 5-year period."[1] This response is incongruent in that items which are capitalized are not recorded as prepaids and incorrect in that the Commission has no such requirement. The Commission does, however, require utilities to capitalize not only engineering costs, but all costs of a material amount that will benefit more than one period, and depreciate such costs over the useful life of the related assets. We know of no basis for MLG's assertion that the Commission requires engineering costs to be written off over a 5-year period.

1 Response to the Commission's First Information Request, Item No. 2c.

MLG was correct in its indication that the amounts recorded as prepaids benefit more than one period and, therefore, should be capitalized. These amounts, originally charged to prepayments, along with the useful life of the asset and the associated depreciation, were as follows:

Check No. & Date	Item	Cost		Useful Life	Depreciation
5611 5/24/83	System Mapping	$ 7,500.00	(40.2%)	40	$187.50
5979 4/25/84	System Mapping	8,937.00	(47.9%)	40	223.43
6069 7/16/84	Engineering Work RE: Flood Damage	1,163.25	(6.2%)	5	232.65
6004 5/14/84	Leak Survey	1,059.25	(5.7%)	5	211.85
		$18,659.50	(100%)		$855.43

Because MLG improperly amortized the mapping costs at a 20 percent rate, amortization expense was overstated in previous years and the current balance carried on the books related to these costs is understated. For the purposes of computing revenue requirements herein, the Commission has allowed depreciation expense based upon the current balance and remaining useful life. The current balance allocable to each project was calculated by prorating the current balance of $8,364 in the ratios as indicated in the table above. Thus, the depreciation expense allowed on these projects herein is $528.

Insurance Expense

MLG reported test year charges to Account No. 924--Property Insurance of $11,258. This amount represents MLG's portion of an insurance policy allocated among the three gas companies owned by Mike Little.

In the response to Item No. 6a of the Commission's Second Information Request, MLG stated, "Liability premium is based on gross receipts," and in response to Item No. 1 of the information requested at the July 15 hearing responded that its insurance company had instructed it to use annual sales figures as the basis for allocation. It is, therefore, apparent from the record that the most appropriate method is an allocation based upon the proportional gross operating revenues of the three affiliated companies.

At the July 15, 1986, hearing, MLG proposed an adjustment to this expense to reflect the latest insurance invoice from Hall and Clark Insurance Agency, Inc. ("Hall and Clark"). The position was advanced that the allocation should be based upon the number of customers at the rate of $2.0663 per customer per month. As stated, allocation of insurance expense should be based upon gross operating revenues. The adjustment proposed by MLG at the hearing is therefore denied.

The Hall and Clark insurance invoice dated May 17, 1986, reflects an annual premium, including tax, of $20,424.85. The 1985 gross operating revenues of the three companies, along with each company's respective percentage of the total, is as follows:

Company	1985 Operating Revenues	Percent of Total
MLG	$330,526	63.2%
Phelps	121,626	23.2%
Elzie Neeley	71,004	13.6%
	$523,156	100.0%

Applying the 63.2 percent found to be the percentage of MLG's operating revenues to the total operating revenues of the three companies, to the premium amount of this invoice results in an adjusted insurance expense for rate-making purposes of $12,908.50.

Depreciation Expense

MLG reported test-year depreciation expense of $22,062. The depreciation schedule reflects that the calculation of this amount included some assets depreciated by the Accelerated Cost Recovery System ("ACRS") method.[2] The Commission requires utilities under its jurisdiction to use depreciation methods that spread the cost of utility assets evenly over their estimated useful lives. Accelerated depreciation results in recovery of more of the cost of the asset at the beginning of its useful life and less cost near the end of its useful life. For tax purposes, of course, accelerated methods are acceptable to the Commission. MLG was asked to provide evidence as to why an adjustment should not be made to eliminate the effects of ACRS depreciation. The response was that, "Depreciation was calculated in accordance with current tax laws. The difference, if any, do[es] not warrant two

2 Application, Exhibit 1, page 3.

sets of books for this company."[3] This evidence is not sufficient to persuade the Commission to allow ACRS depreciation. MLG should take steps to assure that its accounting records are maintained in accordance with the requirements of the Commission.

The depreciation schedule further reflected that three assets had become fully depreciated during the test year. Inasmuch as the cost of these assets has been fully recovered, an adjustment has been made to exclude amounts associated with these assets. These assets and the associated test-year depreciation expense, as reflected on Exhibit 1, page 4, of the application are as follows:

Asset	Amount
A.B. Dick Billing Machine	$ 86.41
Office Furniture	367.10
Boring Machine	1,456.00
Total Adjustment	$1,909.51

Additionally, depreciation expense has been increased by $528 to reflect the depreciation associated with engineering costs improperly recorded as prepaids.

The net effect of these adjustments is to reduce reported test-year depreciation expense by $5,020, from $22,062 to $17,042. A schedule showing the derivation of this amount is provided in Appendix B to this Order.

3 Response to the Commission's Information Request No. 1, Item No. 3.

Rent Expense

MLG reported test-year rent expense of $9,450. This amount consisted of $9,000 for office and storage space, and $450 for railroad crossings.

The owner of the office building is also the owner of MLG, who also rents space to two affiliated gas companies, Phelps and Elzie Neeley. The monthly rates charged to MLG, Phelps and Elzie Neeley are $750, $300 and $200, respectively. In response to the Commission's request to explain how the monthly rent was determined, MLG responded, "Office rent was determined by prorating space used by gas companies and customer ratio of each."[4] However, when asked to provide the calculation of this proration, the company responded, "There is no calculation per se showing the derivation of the monthly rent."[5] Further questioning at the hearing regarding the determination of rent expense was unsuccessful in establishing how the amounts of the rents are determined.[6]

The Commission also attempted to establish the reasons why the monthly rent was significantly higher for MLG relative to the charges for Elzie Neeley and Phelps; contradictions among the answers to the questions in this regard prevent the Commission from determining what MLG alleges to be the justification

4 Response to the Commission's Information Request No. 1, Item No. 6.

5 Response to the Commission's Information Request No. 2, Item No. 9a.

6 Hearing Transcript, July 15, 1986, page 18.

for its paying a higher rent. As stated above, MLG at first stated the rent was determined based upon number of customers, the implication being that because MLG has more customers, it should be charged a higher rent. Subsequently, when asked to justify why the number of customers served was an appropriate basis for determination of rent, MLG responded, "The number of customers is not the only available basis for determining rent," and cited other important factors.[7] When asked what additional assets or benefits are provided to MLG which justify a higher rent charge, it responded, "The building is located in Melvin, which is closer to the gas system of MLG; thereby providing access to a larger number of customers of the Mike Little system." The Commission does not recognize this as a valid basis for charging MLG a higher rent. The location of a company's customers would have no bearing on the rent determination in an arms-length transaction. At the hearing, MLG departed from its previous reasoning and contended that the actual basis for charging more was that it occupied more of the space than did the other two companies.[8] While this would be a valid reason, there is contradictory evidence in the record that suggests that this may not be an accurate representation of the circumstances. In reference to Item No. 9d of the Commission's Information Request No. 2, MLG was asked to explain what additional assets or benefits are provided to MLG

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7 Response to the Commission's Information Request No. 2, Item No. 9b.

8 Hearing Transcript, July 15, 1986, page 18.

which justify a higher rent charge than for companies occupying the same office space. MLG's response to that question contained no reference at all to the supposed greater amount of space occupied by it, though the question obviously solicits the information if, in fact, it is a reason. Moreover, the way assets are shifted and allocated among the companies, the best interpretation of the circumstances based upon the record is that any materials and supplies on hand are "community property" subject to use by any of the three gas companies. Trucks, personnel, a computer, office space, insurance, etc., are all shared among the companies. Additionally, the record reflects that "on hand" construction materials were used by Phelps during 1985.[9]

In a less-than-arms-length transaction the burden of proof is on the applicant to demonstrate that the price is fair, just and reasonable. The Commission is of the opinion that the $9,000 rent expense is excessive relative to the office space rented by MLG. MLG has failed to meet its burden in this instance. The Commission will therefore allow $300 as rent expense for rate-making purposes in this proceeding. This is the amount charged to Phelps, and is the higher of the rents charged to the other two gas companies occupying the same office space.

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9 Response to the Commission's Information Request No. 2, Item No. 2b.

Wages and Salaries

At the July 15, 1986, hearing, MLG proposed a $1,200 adjustment to wages and salaries to reflect $50 per month wage increases for two employees which had gone into effect on January 1, 1986.

Inasmuch as no wage increases were granted in 1985 and MLG's gross payroll compares favorably with similarly sized gas companies, the Commission will allow the $1,200 adjustment to wages and salaries.

After consideration of all pro forma adjustments, the Commission finds MLG's adjusted operating revenue to be as follows:

	Test Period Actual	Pro Forma Adjustments	Test Period Adjusted
Operating Revenues	$330,526	$<37,530>	$292,996
Operating Expenses	378,274	<65,430>	312,844
Operating Income	$<47,748>	$ 27,900	$<19,848>
Other Deductions	-0-	12,701	12,701
NET INCOME	$<47,748>	$ 15,199	$<32,549>

RATE OF RETURN

MLG requested a rate of return on net investment rate base of 13 percent. In its most recent case, MLG was allowed a return of 13 percent. However, this return is inconsistent with levels allowed in recent gas cases involving similarly sized utilities, and is also unjustified in view of the general decrease in inflation and interest rates since the rate case. The Commission is of the opinion that an appropriate rate of return on the net investment rate base should be 10 percent, which will allow MLG to pay its operating expenses, service its debt, and provide a reasonable surplus for equity growth.

REVENUE REQUIREMENTS

The Commission has determined that MLG has justified the need for additional annual operating income of $32,850 to produce an overall return on net investment rate base of 10 percent. To achieve this level of operating income, annual revenues are increased by $32,850 over normalized operating revenues, as determined herein.

The gross operating revenue of $325,846, including the increase of $32,850, is based upon operating revenues and cost of gas normalized to Purchased Gas Adjustment ("PGA") Case No. 8799-K. Additional filings, through PGA Case No. 8799-N, have since reduced operating revenues and cost of gas by $7,595. Therefore, the rates and charges in the attached Appendix A have incorporated the reduction through PGA Case No. 8799-N and are designed to produce operating revenues of $318,215.

Motion to Impose Surcharge

On August 7, 1986, MLG moved for a $1.86 surcharge per Mcf in addition to the regularly allowed rates until arrearages of $106,000 plus interest owed to Kentucky-West are paid in full.

The presenting of the motion more than 3 weeks after the public hearing denies the Commission, and all other interested parties, the opportunity to evaluate the merits of the motion. The annual revenue generated by the proposed surcharge is 130 percent of the amount originally requested by MLG. Inasmuch as adequate notice, testimony, discovery, and cross-examination on this issue has not been incorporated in this case, the motion is denied.

Moreover, in a growing number of cases, gas utilities are failing to pay their gas bills, then request the Commission to grant surcharges or to allow the arrearages to be amortized. Nonpayment for gas purchased jeopardizes the utility's ability to provide gas service. Regardless of the propriety of granting surcharges, MLG has failed to file timely information into the record on which the Commission can rule favorably on this motion. The Commission will, therefore, deny the imposition of a surcharge in this instance. Therefore, on the basis of these considerations, the Commission denies inclusion of the amortization of delinquent gas purchases.

SUMMARY

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

1. The rates and charges proposed by MLG would produce revenues in excess of those found reasonable herein and should be denied upon application of KRS 278.030.

2. The rates of return granted herein are fair, just and reasonable and will provide for the financial obligations of MLG with a reasonable amount remaining for equity growth.

IT IS THEREFORE ORDERED that:

1. The rates and charges proposed by MLG be and they hereby are denied.

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

3. Within 30 days from the date of this Order, MLG shall file with this Commission its revised tariff sheets setting out the rates approved herein.

Done at Frankfort, Kentucky, this 17th day of September, 1986.

PUBLIC SERVICE COMMISSION

Richard D. Hemann Jr.
Chairman

Vice Chairman

Commissioner

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 9535 DATED SEPTEMBER 17, 1986

The following rates and charges are prescribed for the customers served by Mike Little 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.

RATES: Monthly

First 1 Mcf - Minimum Bill	$5.64 Per Mcf
All Over 1 Mcf	$5.4229 Per Mcf

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

	Commodity
Kentucky West Virginia Gas Company	$2.6062 per Dth

*Including $0.0135 Gas Research Institute Funding Charge

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 9535 DATED SEPTEMBER 17, 1986

Depreciation Adjustment Based on December 31, 1985, Undepreciated Balance and Remaining Useful Lives

The following items have been depreciated:

Item	12/31/85 Undepreciated Balance	Remaining Useful Life	Adjusted Depreciation Expenses
ACRS Property:			
1982 Lines & Equipment	$ 6,449.50	30-4 = 26	$ 248.06
1982 Meters	237.24	30-4 = 26	9.12
1982 Regulators	997.15	20-4 = 16	62.32
1982 Gauges & Rigid Services Appl. Unit	2,018.07	10-4 = 6	336.35
1983 Heater (2/18)	232.30	5-3 = 2	116.15
1983 Radio	776.95	5-3 = 2	388.48
1983 Tamping Machine (8/2)	1,567.50	15-3 = 12	130.63
1983 Pipes	15,079.00	30-3 = 27	558.48
1983 Radio Unit (5/31)	4,284.00	5-3 = 2	2,142.00
1984 Pipe	3,531.58	30-2 = 28	126.13
1984 Pump (2/24)	189.00	5-2 = 3	63.00
1984 Cash Register & Calculator	400.00	5-2 = 3	133.33
1984 Photocopier (4/30)	1,260.00	5-2 = 3	420.00
1984 Backhoe (5/9)	8,436.39	10-2 = 8	1,054.55
1984 Various M & E	4,009.51	5-2 = 3	1,336.50
1985 Ditch Witch	2,465.00	10-1 = 9	273.89
1985 Pipe (Jan.-July)	17,599.80	30-1 = 29	606.89
1985 Computer	4,080.00	5-1 = 4	1,020.00
1985 Ford Ranger (August)	3,750.00	3-1 = 2	1,875.00
1985 Trailer (June)	1,020.00	5-1 = 4	255.00
1985 Pipe (October)	542.38	30-1 = 29	18.70
1985 Pipe (November)	657.77	30-1 = 29	23.89
Depreciated ACRS Property			$ 11,198.47
Depreciation - Non ACRS Property on First Page of Schedule			$ 2,330.00

Item	12/31/85 Undepreciated Balance	Remaining Useful Life	Adjusted Depreciation Expenses
Depreciation - Non ACRS Property on Second Page of Schedule			$2,961.00
Depreciation - Non ACRS Property on Third Page of Schedule			$ 24.00
Total Depreciation			$ 16,513.47
ADD: Adjustment to Reflect Depreciation on Amounts Classified as Prepaids			$ 528.08
TOTAL ADJUSTED DEPRECIATION			$<17,041.55>