COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF MUHLENBERG COUNTY WATER DISTRICT (A) FOR A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY (1) APPROVING THE CONSTRUCTION OF NEW PLANT FACILITIES; (2) APPROVING THE ISSUANCE OF CERTAIN SECURITIES; AND (3) AUTHORIZING ADJUSTMENT OF WATER SERVICE RATES AND CHARGES; AND (B) FOR AN ORDER APPROVING THE MERGER OF MUHLENBERG COUNTY WATER DISTRICT AND MUHLENBERG COUNTY WATER DISTRICT - GRAHAM UNDER THE TERMS OF KRS 74.363 AND THE APPLICATION OF ESTABLISHED RATES OF MUHLENBERG COUNTY WATER DISTRICT TO THE CUSTOMERS OF MUHLENBERG COUNTY WATER DISTRICT - GRAHAM	)	CASE NO. 9539

O R D E R

IT IS ORDERED that:

1. The Staff Audit Report for Muhlenberg County Water District ("Muhlenberg") and Muhlenberg County Water District - Graham ("Graham") attached hereto as Appendix A shall be included as a part of the record in this proceeding.

2. Muhlenberg and Graham shall have until the close of business on August 22, 1986, or within 2 weeks from the date of this Order, whichever is later, to file written comments concerning the contents of Appendix A.

Done at Frankfort, Kentucky, this 7th day of August, 1986.

PUBLIC SERVICE COMMISSION

Richard D. Heman Jr.
Chairman

Vice Chairman

Commissioner

ATTEST:

Executive Director

APPENDIX A

REPORT ON LIMITED AUDIT

OF

MUHLENBERG COUNTY WATER DISTRICT

AND

MUHLENBERG COUNTY WATER DISTRICT - GRAHAM

PREFACE

On March 28, 1986, Muhlenberg County Water District ("Muhlenberg") filed an application requesting (1) a certificate of public convenience and necessity approving the construction of new plant facilities, (2) approval of the issuance of certain securities, and (3) authorization for the adjustment of water service rates and charges. Muhlenberg also requested an Order approving the merger of Muhlenberg and Muhlenberg County Water District - Graham ("Graham") under the terms of KRS 74.363 and the application of established rates of Muhlenberg to the customers of Graham. The addition of the Graham customers should generate approximately $56,755 annually at the existing rates. The proposed rates would generate $426,364 annually in additional revenues for the merged system.

On May 14, 1986, the Commission staff issued its first information request in the case. While Muhlenberg and Graham did address the issues, several questions still remained. Because of the complexity of this case, due to the merger request, and in order to expedite its processing, the Commission staff chose to perform an audit, limited in scope, on the operations of

Muhlenberg and Graham. The audit was conducted by Isaac Scott of the Division of Rates and Tariffs on July 7-9, 1986, at Muhlenberg's business office in Greenville, Kentucky.

SCOPE

The scope of this audit was limited to determining whether or not the test-year operating expenses, as reported by Muhlenberg and Graham in the unaudited statement of income for the year ended December 31, 1985, were accounted for in accordance with the Uniform System of Accounts for Water Utilities ("USoA") and were related to the test year. The workpapers of Muhlenberg's and Graham's CPA, Charles R. Lewis, ("CPA") were reviewed. Discussions were held with the CPA's representative, Mark MacIntosh, and Rebecca Wright, Muhlenberg's office superintendent, concerning the financial policies and procedures of the two districts, as well as answering related questions concerning accounting treatments.

FINDINGS

Under the terms of a contract between Muhlenberg and Graham, Muhlenberg has been managing, controlling, and serving Graham since October 1, 1984. This contract was the solution to the financial problems experienced by Graham during the early 1980's. While Graham retained its own commissioners, all other district functions were assumed and performed by Muhlenberg. From an accounting standpoint, the personnel of Muhlenberg have kept the financial transactions of Graham separate from those of Muhlenberg's.

A review of Muhlenberg's and Graham's accounting systems revealed that the financial records were not maintained in accordance with the USoA as required by the Commission. The CPA prepared the 1985 Annual Reports for the districts in accordance with the USoA by making a series of account adjustments. The workpapers for those adjustments were reviewed as part of the limited scope audit. The test year expenses reported by Muhlenberg and Graham were, except for minor exceptions, for that specific period.

Following is a discussion of recommended adjustments and other audit issues relating to the test-year operating expenses for each district:

MUHLENBERG

Regulatory Commission Expense - Account No. 928

Muhlenberg recorded $4,779 as regulatory commission expense. The charges primarily reflected the expenses for trips to the Commission for hearings and conferences during 1985, and the cost of leak survey work. In Muhlenberg's last rate case, Case No. 9262, they were instructed to establish a deferred debit on their balance sheet for the total commission expenses and amortize the balance over a 3-year period. No such amortization was included in the charge of $4,779.

While reviewing the expenditures of Muhlenberg, two additional charges were identified which should have been included in this category. First, a charge of $104 for postage to mail documents required for the Commission hearings was classified as Account No. 923 - Outside Services Employed. Second, charges totaling $671 for publishing notices required for the rate case were classified as Account No. 930 - Miscellaneous General

Expense. It was also noted that no charges from Muhlenberg's attorney or CPA were classified as regulatory commission expense. The limited scope of this audit did not provide for a detailed review of the attorney's and CPA's charges to determine if any should have been classified as regulatory commission expense.

Due to the limited nature of this audit and the unavailability of all the necessary information, adjusting accounting entries have not been prepared or a restatement of the balance sheet developed. However, Muhlenberg should establish a deferred debit on its balance sheet of at least $5,556, representing the known regulatory commission expenses and include any related attorney or CPA fees. This balance should then be amortized over a 3-year period, as instructed in Case No. 9262. The balance in the regulatory commission expense account has been reduced $2,928 to reflect the first year amortization of the deferred debit.

Taxes Other Than Income Taxes - Payroll Taxes - Account No. 408

A total charge of $25,925 was recorded as Taxes Other Than Income Taxes for 1985. Of that total, $22,682 were for payroll taxes. A review of the account revealed that charges totaling $4,248, representing the back payment of the 1983 liability, were included. Such a transaction actually should be treated as a prior period adjustment to retained earnings. Due to the limited scope of this audit, the necessary adjusting entries and a restated balance sheet have not been developed. However, Muhlenberg should make the necessary adjustments to the retained earnings account to reflect the 1983 tax liability payment in 1985.

The expense account has been reduced $4,248 to reflect the adjustment.

Accounting for Graham Contract Work and Reimbursements

During the test year, Muhlenberg provided certain services to Graham under the terms of their contract of October 1984. These services included the services of Bobby Oldham who worked on the Graham system, securing computer services for customer billings, office supplies, and postage. These charges were initially charged to the respective Muhlenberg account. When reimbursement from Graham was received, it was classified on Muhlenberg's books as miscellaneous revenue. At year end, the reimbursement was reclassified by reversing the entry to miscellaneous revenue and reducing the expenditures in the Muhlenberg account originally charged. The salary charges of Bobby Oldham were completely removed from Muhlenberg's accounts and recorded in Graham's. It should be noted that any item purchased exclusively for Graham was recorded in Graham's accounts and did not appear in the Muhlenberg records.

The methods utilized by Muhlenberg are inadequate for the accounting of the services and reimbursements resulting from the Graham contract. Expenses related to the contract are recorded with the normal operating and maintenance expenses of Muhlenberg. Likewise, reimbursement revenues are not recognized as contract income. During the audit, it was observed that Muhlenberg had not allocated any of their operating and maintenance expenses to Graham while it was clear such an allocation should have been performed. While the limited nature of this audit did not provide for an itemized breakdown of each account, the reviews performed indicate that these Muhlenberg accounts could be overstated due to a lack of proper expense allocation:

a. Transmission and Distribution Expenses - Operation Supplies and Expenses - Account No. 641.

b. Customer Accounts Expenses - Accounting and Collecting Labor - Account No. 902.

c. Administrative and General Expenses - Administrative and General Salaries - Account No. 920.

d. Administrative and General Expenses - Outside Services Employed - Account No. 923.

According to the USoA, Muhlenberg should have accounted for all Graham contract expenses, actual and allocated, by utilizing Account No. 415 - Revenues from Merchandising, Jobbing, and Contract Work and Account No. 416 - Costs and Expenses of Merchandising, Jobbing, and Contract Work. This would have allowed Muhlenberg to collect all Graham's expenses in one account and report all reimbursements as income, thus providing appropriate disclosure in the income statements. To report these accounts in the annual report, the line items would have to be inserted under the Other Income category of the statement. Muhlenberg should make the necessary changes to report Graham's contract work in this manner. While restatement for 1985 may not be possible, it should be done for 1986.

Reclassifications

As was indicated earlier in this report, the Muhlenberg books were adjusted to achieve reporting conformity with the USoA. During the course of the audit, it was observed that several Muhlenberg accounts had been improperly classified in the USoA format.

This determination was made based on the description of the original Muhlenberg account. Two reclassification errors have already been identified in the discussion of Regulatory Commission Expenses. With the exception of those two errors, the other identified reclassifications do not change the total net loss of Muhlenberg. Due to the limited nature of this audit, only the most apparent reclassification problems were reviewed. The following reclassifications should be made to the Muhlenberg Statement of Income:

a. Account No. 474 - Other Water Revenues of $11,178 should be classified as Account No. 470 - Forfeited Discounts.

b. Account No. 421 - Miscellaneous Nonoperating Income of $475 should be classified as Account No. 474 - Gains from Disposition of Utility Property and shown on the Statement of Income as Other Operating Revenues.

c. Account No. 922 - Administrative Expense Transferred - Credit of $250 should be classified as a debit to Account No. 930 - Miscellaneous General Expenses.

d. Account No. 923 - Outside Services Employed of $104 and Account No. 930 - Miscellaneous General Expense of $671 should be classified as part of the Balance Sheet Deferred Debit account for Regulatory Commission Expense.

Non-Compliance with Tariff Rules and Regulations

During the course of this audit, it was observed that several service charges collected by Muhlenberg did not conform with the tariff rules and regulations on file with the Commission. The charges in question were:

a. Delinquent Service Charge - The approved reconnection charge is $10; Muhlenberg was charging $15.

b. Deposits - The deposit is to equal twice one average monthly water bill; Muhlenberg was charging $25 per new customer.

c. Tap-on Fees - The residential fee is $350 per meter, with no specific charge listed for commercial or industrial customers; Muhlenberg was charging $750 per meter for commercial and industrial customers.

d. An owner's/renter's charge of $15 per customer was collected; Muhlenberg has no such charge approved in their tariff rules and regulations.

Muhlenberg is reminded that only charges for services listed on their approved tariff are enforceable and any change requires an amendment to that tariff. Until that time, the approved rules and regulations are to be complied with.

MUHLENBERG SUMMARY

The following is a summary of the effect of these adjustments and reclassifications on Muhlenberg's test-year operating statement:

Acct. No.	Account Name	Test Year Reported	Staff Audit Adjustments	Test Year Adjusted
	Operating Revenues:			
461	Metered Sales to General Customers	$ 788,767	$ -0-	$ 788,767
466	Sales for Resale	60,337	-0-	60,337
470	Forfeited Discounts	-0-	11,178	11,178
471	Miscellaneous Service Revenues	5,675	-0-	5,675
474	Other Water Revenues	15,864	<11,178>	4,686
414	Gains from Disposition of Utility Property	-0-	475	475
		$ 870,643	$ 475	$ 871,118
	Operating Expenses:			
601	Purchased Water	$ 362,164	$ -0-	$ 362,164
621	Fuel/Power Purchased for Pumping	45,382	-0-	45,382
625	Maintenance of Water Pumping Plant	5,958	-0-	5,958
631	Chemicals & Analysis	5,219	-0-	5,219
640	T&D* - Operation Labor	55,099	-0-	55,099
641	T&D* - Supplies & Expenses	5,269	-0-	5,269
650	Maint. of Dist. Reserv. & Standpipes	240	-0-	240

*Transmission and Distribution

Acct. No.	Account Name	Test Year Reported	Staff Audit Adjustments	Test Year Adjusted
651	Maintenance of Mains	4,202	-0-	4,202
653	Maintenance of Meters	1,879	-0-	1,879
901	Meter Reading Labor	30,844	-0-	30,844
902	Accounting & Collecting Labor	54,525	-0-	54,525
903	Customer Acct. - Supplies & Expenses	14,783	-0-	14,783
904	Uncollectible Accounts	3,968	-0-	3,968
920	Adm. & General Salaries	52,585	-0-	52,585
921	Office Supplies & Other Expenses	10,021	-0-	10,021
922	Adm. Expense Transferred - Cr.	250	250	-0-
923	Outside Services Employed	24,572	<104>	24,468
924	Property Insurance	12,518	-0-	12,518
926	Employee Pensions & Benefits	29,977	-0-	29,977
928	Regulatory Commission Exp.	4,779	<2,928>	1,851
930	Misc. Gen. Expenses	1,909	<421>	1,488
933	Transportation Expense	31,223	-0-	31,223
935	Maint. of General Plant	1,822	-0-	1,822
		$ 758,688	$ <3,203>	$ 755,485
403	Depreciation Expense	111,984	-0-	111,984
408	Taxes Other Than Income Taxes	25,725	<4,248>	21,477
Total Operating Expenses		$ 896,397	$ <7,451>	$ 888,946
Operating Income (Loss)		$ <25,754>	$ 7,926	$ <17,828>
Other Income:				
419	Interest & Dividend Income	$ 12,301	$ -0-	$ 12,301
421	Misc. Nonoperating Income	7,531	<475>	7,056
Other Deductions:				
427	Interest on Long-Term Debt	128,275	-0-	128,275
431	Other Interest Expense	3,454	-0-	3,454
NET INCOME (LOSS)		$<137,651>	$ 7,451	$<130,200>

GRAHAM

Transmission and Distribution Expenses - Operation Labor - Account No. 640 and Customer Accounts Expenses - Meter Reading Labor - Account No. 901

Graham chose to allocate the salary of Bobby Oldham between Account Nos. 640 and 901, on a 50/50 basis. This allocation was based on the rate used in previous years. Thus, Bobby Oldham's reported salary was $4,151 for 1985.

While reviewing these expenditures, it was discovered that the wages payable accrual, which was part of the $4,151 total, included the wages payable for January 1986. The review showed that the total salaries reported for Bobby Oldham covered 13 months. The January 1986 accrual totaled $375. In order to present only the test-year operating expenses, the $375 has been deducted from the affected accounts using the Graham allocation basis. Therefore, Operation Labor has been reduced $188 and Meter Reading Labor has been reduced $187.

Outside Services Employed - Account No. 923

Graham reported for the test year an expense of $304 as Outside Services Employed. The audit review revealed that the amount represented interest charges on an unpaid bill from Graham's former accountant. The unpaid bill had been properly reported in the 1984 Annual Report. While the interest charges were related to the Outside Services Employed account, proper USoA treatment requires this amount be recognized as an interest expense. Therefore, the $304 has been reclassified as Account No. 431 - Other Interest Expense.

Allocation of Expenses to Graham

As was previously discussed in the Muhlenberg section of this report, no allocations of expenses were made to Graham's accounts. Such allocations should have been made in order to present an accurate picture of the financial condition of Graham. While the scope of this audit was limited, and all possible allocations were not identified, the work performed indicates that allocations could and should have been made to the following Graham accounts:

a. Account No. 641 - Transmission and Distribution Expenses - Operation Supplies and Expenses.

b. Account No. 902 - Customer Accounts Expenses - Accounting and Collecting Labor.

c. Account No. 920 - Administrative and General Expenses - Administrative and General Salaries.

d. Account No. 923 - Administrative and General Expenses - Outside Services Employed.

Graham should be charged for their portion of the expenses incurred by Muhlenberg which benefit Graham. Modifications should be made to Graham's accounting procedures to reflect Muhlenberg's revised means of accounting for Graham contract work.

Non-Compliance with Tariff Rules and Regulations

During the course of this audit, it was observed that Graham was not in compliance with their tariff rules and regulations on file with the Commission. For approximately the past 5 years, Graham has been charging water rates in excess of their approved tariff. It appears that the rates charged were the same ones proposed in Case No. 8189, filed with the Commission on March 27, 1981. On September 1, 1981, that case was dismissed without prejudice. No other adjustments to rates have been sought by Graham until the current case. The only service charge included in the Graham tariff is a tap-on fee. However, Graham has charged and collected reconnection fees at the rates charged by Muhlenberg. Graham is reminded, as was Muhlenberg, that only charges for services listed on their approved tariff are enforceable and any change requires an amendment to that tariff. Until that time, the approved tariff rules and regulations are to be complied with.

GRAHAM SUMMARY

The following is a summary of the effect of these adjustments and reclassifications on Graham's test-year operating statement:

Acct. No.	Account Name	Test Year Reported	Staff Audit Adjustments	Test Year Adjusted
	Operating Revenues:			
461	Metered Sales to General Customers	$36,697	$ -0-	$36,697
471	Miscellaneous Service Revenues	285	-0-	285
474	Other Water Revenues	600	-0-	600
		$37,582	$ -0-	$37,582
	Operating Expenses:			
601	Purchased Water	$31,479	$ -0-	$31,479
631	Chemicals & Analysis	571	-0-	571
640	T&D* - Operation Labor	2,076	<188>	1,888
651	Maintenance of Mains	53	-0-	53
901	Meter Reading Labor	2,075	<187>	1,888
903	Customer Acct. - Supplies & Expenses	1,519	-0-	1,519
921	Office Supplies & Other Expenses	18	-0-	18
923	Outside Services Employed	304	<304>	-0-
930	Misc. Gen. Expenses	59	-0-	59
933	Transportation Expense	35	-0-	35
		$38,189	$<679>	$37,510
403	Depreciation Expense	2,689	-0-	2,689
408	Taxes Other Than Income Taxes	270	-0-	270
	Total Operating Expenses	$41,148	$<679>	$40,469

*Transmission and Distribution

Acct. No.	Account Name	Test Year Reported	Staff Audit Adjustments	Test Year Adjusted
	Operating Income (Loss)	$<3,566>	$ 679	$<2,887>
	Other Income:			
421	Misc. Nonoperating Income	20	-0-	20
	Other Deductions:			
427	Interest on Long-Term Debt	3,075	-0-	3,075
428	Amortization of Debt Disc. & Expense	250	-0-	250
431	Other Interest Expense	-0-	304	304
	NET INCOME (LOSS)	$<6,871>	$ 375	$<6,496>

CONCLUSIONS AND RECOMMENDATIONS

As previously stated, the Muhlenberg and Graham financial records were not maintained in accordance with the USoA. The 1985 Annual Reports for the two districts were prepared in accordance with the USoA by the CPA. The conversion from the financial records to the Annual Reports was adequately documented and supported. The CPA is currently revising both districts' records so that they will be in accordance with the USoA. Muhlenberg, Graham, and the CPA are encouraged to continue this revision. As has been observed in this audit, conversion such as the ones prepared for Muhlenberg and Graham can lead to classification problems which later must be corrected.

It is recommended that Muhlenberg begin to account for Graham's contract work and revenues by utilizing the accounts previously discussed. This approach would not only be in accordance with the USoA, but would allow Muhlenberg to accurately record all the costs and revenues generated under this contractual relationship. It is further recommended that Muhlenberg prepare and record the necessary expense allocations for the items shared by these two districts.

Due to the limited scope of the audit, the staff did not attempt to determine the accuracy of Muhlenberg's and Graham's utility plant-in-service, or to verify the districts' test-year depreciation expense. The adjustments contained in the report do not require any restatement or correction to the plant or depreciation accounts.

Respectfully Submitted,

Isaac Scott

ISAAC SCOTT
Public Utilities Financial Analyst
PUBLIC SERVICE COMMISSION
Rates and Tariffs Division
Revenue Requirements Section