COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

NOTICE OF PUBLIC GAS COMPANY, INC., OF GENERAL RATE ADJUSTMENT EFFECTIVE MAY 12, 1986	)))	CASE NO. 9565

O R D E R

On April 21, 1986, Public Gas Company, Inc., ("Public") filed an application with the Commission requesting authority to increase its gas rates. Public stated that the requested increase was necessary because the costs of operation had increased since its last rate case and to attain a fair rate of return to preserve its financial integrity. Public had initially requested an increase in revenues of $87,024; however, this was revised to $84,600 after the settlement of its most recent purchased gas adjustment ("PGA"), Case No. 8186-J. The revised requested increase of $84,600 was an increase of 20.6 percent over normalized operating revenues as determined herein.

Public gave notice in this application that the proposed rates would be in effect on and after May 12, 1985. In its Order of April 29, 1986, the Commission suspended the proposed rates for 5 months beginning on the effective date of May 12, 1986.

Public filed a motion for emergency rate relief and approval of a Commission-directed refund plan on July 18, 1986. Public stated that its credit and operations would be materially impaired and damaged if the proposed rates were not made effective immediately. Public also stated that due to the refund ordered in Case No. 8186-J, it was in no position to make the refund unless the proposed rates were made effective. The Commission issued an Order on August 6, 1986, denying the motion and rejecting the refund plan; the issue of a refund plan was incorporated into the present case.

Based upon the determination herein, Public's operating revenues will increase by $36,726 annually, an increase of 9.0 percent over normalized operating revenues as determined herein.

On September 18, 1986, a hearing was conducted with all parties of record in the matter present. There were no intervenors.

COMMENTARY

Public operates as a public utility providing gas service to approximately 490 customers in the city of Jackson, Kentucky.

TEST PERIOD

Public 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 historical test period, the Commission has given full consideration to appropriate known and measurable changes.

VALUATION

Net Investment

Public proposed a net investment rate base of $282,179. The Commission has adopted Public's proposed net investment rate base with the following modification:

Working capital of one-eighth of operation and maintenance expenses, exclusive of natural gas purchases, depreciation, taxes, and other deductions, has been calculated based upon the adjusted pro forma operation and maintenance expenses found reasonable herein.

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

Utility Plant in Service		$308,308
ADD:		
Prepayments	$ 2,712	
Materials and Supplies	13,037	
Working Capital	12,982	
Subtotal		28,731
DEDUCT:		
Accumulated Depreciation		61,686
Net Investment Rate Base		$275,353

During the processing of this case, and subsequent to the public hearing held on September 18, 1986, the Commission staff found that the entries recorded on the books of Public upon its divestiture from Pan Bowl Production Gas Company ("Pan Bowl") in 1979 were not prepared in accordance with the Uniform System of Accounts Prescribed for Natural Gas Companies Subject to the Provision of the Natural Gas Act, Class C and D ("USoA").[1] Consequently, the investment rate base of Public may be in error. In fairness to Public, since the issue was not thoroughly explored in this case, the Commission will utilize the rate base developed from the test-year-end balance sheet, as modified and indicated

[1] Natural Gas Act, Title 18, Subchapter F, Part 204.

above. However, the Commission intends to explore this matter in another proceeding in the near future.

REVENUES AND EXPENSES

Normalized Sales Revenues

Public's normalized sales revenue for the test year, based on its most recent PGA, Case No. 8186-J, was $408,334.

Natural Gas Purchases

In the 1985 Annual Report filed by Public, the unaccounted for gas represented 6.5 percent[2] of total gas purchases. The Commission does not allow for rate-making purposes line losses in excess of 5 percent of total purchased volumes. Therefore, based on test period purchases of 77,354 Mcf and the average price per Mcf of $3.8799, the Commission has determined $295,301 in annual purchased gas expense to be fair and reasonable for rate-making purposes.

Management Services Provided by PATS Service Company

During the months of January through May of the test year, Public employed the management services of PATS Service Company ("PATS"). For these services PATS was paid a total of $24,655.

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Unaccounted for Gas	5,059 Mcf
Natural Gas Purchases	77,364 Mcf
Percentage Unaccounted for Gas	6.5392%

This charge was allocated among the following accounts:

Account No.	Account	Amount
761	Mains and Service Labor	$14,515
901	Meter Reading Labor	3,629
902	Accounting and Collecting Labor	3,629
767	Maintenance of Lines	2,169
903	Customer Accounts - Supplies and Expenses	723
		$24,665

At the hearing, the President of Public, Edmund Vachon, stated that PATS was not hired for any other services during the test year and would not be utilized in the future by Public.[3] Thus the charges for PATS are of a non-recurring nature and have been excluded from rate-making consideration.

The services performed by PATS for Public were not covered by a written contract. The charges by PATS represent 17.5 percent of the test-year gas expenses, exclusive of natural gas purchases. Good business practices would advise that such an arrangement be in writing. The Commission advises Public to begin utilizing written agreements in these situations.

Salaries and Wages

Public's total charges in the test year for salaries and wages was $56,487.[4] Public proposed to reduce this total by

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3 Hearing Transcript, September 18, 1986, pages 14-15.

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Mains and Service Labor	$21,447
Meter Reading Labor	7,095
Accounting and Collecting Labor	7,095
Administrative and General Salaries	20,850
	$56,487

$4,235, which represented the charges which Pan Bowl had reimbursed Public for the shared services of an office secretary. Public proposed no other adjustments to salaries and wages.

As was noted in the previous section, the total salaries and wages expense included charges from PATS. The total PATS charges applicable to salaries and wages was $21,773. Since these charges have been determined to be non-recurring, they have been deducted from the total for rate-making purposes. The combined effect of this adjustment and the one proposed by Public reduces the salaries and wages by $26,008 to a balance of $30,479.

During the test year Public employed as many as five people to work in various capacities. The earliest employment date was in mid-March, 1985. At year-end only two people were employed by Public, a secretary and a general manager. As noted earlier, Public proposed no adjustments to their salaries. The Commission is of the opinion that in fairness to Public, since the PATS expenses have been excluded, an adjustment to place salaries on an annual basis should be made.

The actual salary paid to both the general manager and the secretary were compared to the amounts reported as test year end salaries.[5] The test-year-end monthly salary for the general manager was 28.4 percent higher that the average monthly salary

5 Response to the Commission's Second Information Request, filed September 2, 1986, Item No. 6.

actually paid.[6] The test-year-end monthly salary for the secretary was 43.2 percent higher than the average monthly salary actually paid.[7] At the hearing, Mr. Vachon was asked to justify the higher test year end salaries. His explanations did not provide adequate information to support the higher levels. However, Mr. Vachon did state that a field maintenance person had been hired in early 1986 at a monthly salary of $1,100.

Public is a small gas utility. It employs a general manager who spends 70 percent of his time on administrative duties, shares a full-time secretary with another business, and utilizes an outside firm to handle all accounting and bookkeeping functions.

The Commission finds for rate-making purposes that the annualized test-year-end monthly salary of the general manager is excessive and has not been adequately supported. For rate-making purposes, the average monthly salary will be annualized. The Commission will allow the annualized salary of the new field maintenance person at the stated rate of $1,100 per month. However, given the information available, it is doubtful that Public needs the services of a secretary at this time, and therefore no allowance for a secretary has been made herein. Thus, the amount

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6	Test-Year-End Monthly Salary	$2,500	
	Average Monthly Salary - Actual	1,947	
	Difference	$ 553	28.4%
7	Test-Year-End Monthly Salary	$1,192	
	Average Monthly Salary - Actual	832	
	Difference	$ 360	43.2%

allowed for salaries and wages for rate-making purposes herein is $36,600.[8]

Uncollectible Accounts

In its application, Public proposed to increase the uncollectible accounts expense by $1,145 to $2,500. Public explained its determination of this adjustment as, ". . . management estimates that bad debt expense will approximate 1/2 of 1 percent of gross sales. This estimate is based upon $500,000 in gas sales and historical bad debts of the Company."[9] However, at the hearing, Mr. Vachon testified that in actuality the test-year-end balance of $2,500 was decided upon, and the rate and sales factors adjusted accordingly.[10]

The Commission finds that the estimate rate of 1/2 of 1 percent is a reasonable level for a company the size of Public. Therefore, applying this rate to the $452,265 gross sales for the test year produces a balance of $2,261 in uncollectible accounts expense allowed for rate-making purposes herein.

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Annualized General Manager's Salary:	
$1,950 X 12 months	$23,400
Annualized Field Maintenance Person's Salary:	
$1,100 X 12 months	13,200
TOTAL	$36,600

9 Response to the Commission's First Information Request, filed July 1, 1986, Item No. 4e.

10 Hearing Transcript, September 18, 1986, pages 24-25.

Employee Pensions and Benefits

Public proposed no adjustment to the test-year pensions and benefits expense of $2,419, which was for medical insurance, even though the composition of the work force had changed by test-year end. Public initially indicated that the monthly insurance cost was $250 for the covered employees and that payments had been made for approximately 10 months.[11] However, in information filed by Public which was requested at the hearing, the monthly cost was stated as $403 and that level of payment had been made for approximately 6 months.[12] This information was made in the form of a statement and was not supported by billings from the insurance carrier.

In either case, an annualization of the insurance expense should be made. For rate-making purposes, the monthly charge of $250 has been utilized because of information supplied supporting that figure and the approximate time in effect. Therefore, the expense for employee pensions and benefits included herein is $3,000.

Office Rent

Public proposed an increase of $3,950 to its rent expense for offices and storage. The increase was based upon an annualization of the test-year-end monthly rent of $750. Public disclosed that

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11 Response to the Commission's First Information Request, filed July 1, 1986, Item No. 8c.

12 Information requested at the September 18, 1986, hearing, filed September 23, 1986, Item No. 5.

the rental of space was being done on a month-to-month basis under an oral agreement and that the expense in the test year had been as low as $200 per month.[13] At the hearing, Mr. Vachon stated that the higher rent was justified because it allowed the landlord a fair return on his property. The landlord is related to the owners of Pan Bowl, Public's gas supplier and the landlord's family formerly owned Public.[14]

The Commission is concerned that the rental expense increased so substantially and that there are longstanding business connections between the landlord and Public. In such case, the burden of proof is on Public to demonstrate that the price charged is fair, just, and reasonable. Public has not adequately met its burden in the present case. The Commission will therefore allow $5,050 as the total rent expense for rate-making purposes herein, which is the amount actually paid during the test year.

Depreciation and Amortization

For the test year, Public reported depreciation expense of $13,122. The depreciation schedule supplied by Public indicated that the amortization of a plant acquisition adjustment in the amount of $2,596 had been included in the schedule and the test-year depreciation expense. Therefore, the $2,596 amortization expense has been reclassified for rate-making purposes herein.

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13 Response to Commission's Second Information Request, filed September 2, 1986, Item No. 2.

14 Hearing Transcript, September 18, 1986, pages 26-29.

Further review of the schedule revealed that the assets of Public were shown at "cost" and "depreciable basis." For most of the assets placed in service on or before 1980, there was a difference in the amounts recorded as cost and depreciable basis.[15] Public stated that cost was the total amount that would be depreciated by the utility, while the depreciable basis represented the cost used to calculate depreciation expense.[16] For the pre-1980 assets, this approach was not consistently used.

Public has not adequately supported the contention that the depreciable basis should be used to calculate depreciation expense. For rate-making purposes, the asset costs will be used to calculate depreciation expense. Therefore, depreciation expense has been reduced $1,426 to reflect depreciation based on cost and reduced $2,596 for the reclassification of amortization expense, for a total expense of $9,100 for rate-making purposes herein.

Franchise Fee

The test year figure of $6,079 for taxes other than income taxes included a $500 franchise fee paid to the City of Jackson for a 10-year franchise. At the hearing, Mr. Vachon stated that this was a one time charge and it would not recur during the 10-

15 Response to the Commission's First Information Request, filed July 1, 1986, Item No. 9.

16 Response to the Commission's Second Information Request, filed by September 2, 1986, Item No. 7.

year period.[17] The Commission is of the opinion that this transaction represents a non-recurring expense which should not be included for rate-making purposes. Therefore, the taxes other than income taxes has been reduced $500 for rate-making purposes herein.

Income Taxes

Public proposed an allowance for income taxes of $6,644. In the test year, Public had not accrued any income taxes due to its operating losses. The proposal assumed a composite income tax rate of 20 percent. Based upon the revenues allowed herein, and allowing for both federal and state income tax rates, $2,146[18] has been included, as income tax expense, for rate-making purposes.

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

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17 Hearing Transcript, September 18, 1986, page 35.

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Operating Income Required	$27,979
LESS:	
Interest on Short-Term Debt	<15,750>
Taxable Income	$12,229
Effective Tax Rate (Federal and State Combined)	.1755
TOTAL INCOME TAXES	$ 2,146

	Test Year Actual	Adjustments	Test Year Adjusted
Operating Revenues	$456,843	$<47,009>	$409,834
Operating Expenses	479,361	<62,927>	416,434
Operating Income	$<22,518>	$ 15,918	$ <6,600>
Other Deductions	13,379	2,371	15,750
NET INCOME	$<35,897>	$ 13,547	$<22,350>

RATE OF RETURN

Public requested a rate of return on net investment rate base of 15 percent. In its most recent case, Public was allowed a return of 17.6 percent. The requested return is consistent with the lowered returns allowed by the Commission since Public's last case in 1981.

At December 31, 1985, Public was financed entirely by short-term notes, which had a composite interest rate of 11.25 percent.[19] Public's requested return on net investment is based on a hypothetical capitalization of $87,474 equity and $140,000 debt. Public proposed a return on its debt of 11.25 percent and a return on its equity of 30.4 percent,[20] for an overall return on

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Total Adjusted Interest Expense	$ 15,750
Total Short-term Notes	$140,000
Composite Interest Rate	11.25%

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Total Requested Return on Capitalized Rate Base	$42,310
LESS:	
Return on Short-term Notes	15,750
Requested Return on Equity	$26,560
÷ Net Equity	87,474
REQUESTED RATE OF RETURN ON EQUITY	30.4%

capitalization of 18.6 percent.[21] In Public's last case, the allowed return on capital was 15.5 percent.

The Commission will accept the hypothetical capital structure of 38 percent equity and 62 percent debt and apply this capital structure to the net investment rate base. Moreover, the Commission will accept Public's cost of debt of 11.25 percent. However, the 30.4 percent return on equity requested by Public in its application is found to be unfair, unjust, and unreasonable. The Commission finds that a rate of return on equity of 14 percent is fair, just, and reasonable, given Public's current circumstances. This results in a rate of return on capital of 12.3 percent.[22] With this rate of return, the operating income required is $27,979,[23] which yields a return on net investment, as determined herein, of 10.2 percent.[24]

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21 Public's Application, Exhibit 2, page 1.

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Return on Debt @ 11.25%	$ 15,750
Return on Equity @ 14%	12,229
Total Return on Capitalized Rate Base	$ 27,979
Total Capitalization	$227,474
RATE OF RETURN ON CAPITAL	12.3%

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Capitalized Rate Base	$227,474
Rate of Return	12.3%
OPERATING INCOME REQUIRED	$ 27,979

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Operating Income Required	$ 27,979
Net Investment Rate Base	$275,353
RATE RETURN ON NET INVESTMENT	10.2%

In Public's last case in 1981 it was cautioned by the Commission ". . .that it must immediately take steps to correct its financial instability by seeking long-term debt financing to replace the existing short-term notes."[25] From the information available in the present case, Public has not heeded this advice. The Commission again cautions Public that it should seek long-term financing.

REVENUE REQUIREMENTS

The Commission has determined that Public needs additional annual operating income of $36,726 to produce an overall return on net investment of 10.2 percent. To achieve this level of operating income, Public is entitled to increase its annual revenues by $36,726 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 $446,560.

OTHER ISSUES

Refund

In PGA Case No. 8186-J, the Commission discovered that Public had failed to decrease its retail rates following a decrease in wholesale contract rates from its supplier in December 1984. Public calculated the amount of excess revenues collected from December 1984 to April 15, 1986, to be $23,814.77. On April 21,

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25 Case No. 8186, Notice of Adjustment in Natural Gas Rates of the Public Gas Company, Final Order dated November 13, 1981, page 7.

1986, Public filed a motion for emergency rate relief and proposed a refund plan. In the Commission's Order of August 6, 1986, it stated that the issue of the refund would be addressed in its Final Order in Case No. 9565.

During the hearing, Mr. Vachon requested that the refund of the overcollections be made by crediting the bills of Public's customers for a period of 12 months. The Commission finds this an acceptable request.

Compliance with the Uniform System of Accounts

During the processing of this case, these situations became known:

1. Public's contracted work from PATS and its office rental agreement were not covered by a written agreement or contract.

2. Public could not provide monthly expense information because its books are not kept on a monthly basis.

3. Several of the expenses reported in the 1985 Annual Report were not recorded in the proper account.

The Commission reminds Public that it is subject to the requirements of the USoA. Among the requirements of the USoA are the following:

a. Each utility shall keep its books of account. . .so as to be able to furnish readily full information as to any item included in any accounts.[26]

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[26] USoA, General Instructions, Item No. 2, "Records".

b. Each utility shall keep its books on a monthly basis so that for each accounting period all transactions applicable thereto. . .shall be entered in the books of the utility.[27]

Therefore, Public shall undertake the steps necessary to bring its accounting practices into conformity with the USoA. If Public continues to utilize the services of an outside accounting service, Public will be responsible for informing the service of these requirements.

Arms-Length Transactions

Two transactions were disclosed in the record in this case which appear to be less-than-arms-length in nature. One of the transactions involves Public renting vehicles from its general manager. The other instance is Public's accounting, bookkeeping, and related services being provided by a consulting firm owned by Mr. Vachon, Public's president. In both instances, Public's documentation and explanations are not completely adequate.

The Commission reminds Public that in a less-than-arms-length transaction, the burden of proof is on the applicant to demonstrate that the transaction is fair, just, and reasonable. Public should take this standard into consideration if it chooses to continue using such arrangements.

FINDINGS AND ORDERS

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

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[27] *Ibid.*, Item No. 4, "Accounting Period".

1. Public's proposed rates are not fair, just, or reasonable and should be denied.

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

3. The present accounting practices used by Public do not conform to the USoA.

4. Public should file with this Commission a refund plan setting out the details of the refund, including the time period of 12 months and the amount per Mcf to be subtracted from its customers' bills. This refund should be put into effect as soon after the date of this Order as is practicable.

IT IS THEREFORE ORDERED that:

1. The rates in Appendix A be and they hereby are approved for service rendered by Public on and after the date of this Order.

2. The rates proposed by Public be and they hereby are denied.

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

4. Within 60 days from the date of this Order Public shall file with the Commission a narrative outlining the steps it plans to take to bring its accounting practices into conformity with the USoA.

5. Within 10 days of the date of this Order, Public shall file with this Commission a refund plan to return to its customers

excess revenues of $23,814.77 over a period of 12 months to be effective with the next billing period.

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

PUBLIC SERVICE COMMISSION

Richard D. Heman Jr.
Chairman

Vice Chairman

George N. Williams
Commissioner

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 9565 DATED 10/10/86

The following rates and charges are prescribed for the customers served by Public 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. These rates reflect all rate changes through Case No. 8186-J.

RATES: Monthly

First 1 Mcf - Minimum Bill	$7.1504 Per Mcf
All Over 1 Mcf	$6.0304 Per Mcf