

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF GREAT OAKS SANITATION	)	
COMPANY, INC. FOR A RATE ADJUSTMENT	)	CASE NO.
PURSUANT TO THE ALTERNATIVE RATE FILING	)	10485
PROCEDURE FOR SMALL UTILITIES	)	

O R D E R

PROCEDURE

On December 6, 1988, Great Oaks Sanitation Company, Inc. ("Great Oaks") applied, pursuant to Commission Regulation 807 KAR 5:076, for authority to increase its rate for sewer service. The proposed rate increase would add revenues of \$9,819 annually, an increase of 96.8 percent over total revenues in 1988.

The following parties have been permitted to intervene in this proceeding: Cindy Smith, Jana Medlin, Jane Lamb, Ron Mitchell, Richard B. Anderson, Mickie Thomason, Michael Fellowell, Barry Roberts, Shelia Clark, Mike Nolen, Stephen R. Hughes, Evert W. Tyles III, Theresa Womble, Carle Zacherett, Troy Utley, Tony York, Robin Braboy, Clifton J. Greenup, and the Utility and Rate Intervention Division of the Office of Attorney General ("AG").<sup>1</sup>

Following the filing of Great Oaks' application, Commission Staff conducted a limited review of the utility's financial

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<sup>1</sup> All intervenors, except the AG, are customers of Great Oaks. While all were individually granted intervention, their interests were represented at hearing by the AG.

records. On May 17, 1989, Commission Staff issued a report in which it recommended that Great Oaks be authorized to increase its annual revenues by \$15,997 and to assess a surcharge over a two-year period to collect \$5,416 in additional revenues.

Great Oaks accepted the recommendations of Commission Staff, but all intervenors took exceptions to them and requested a formal hearing which was held on July 18, 1989. At this hearing, testimony was given by Joretta C. Palmer, secretary of Great Oaks; Jana Medlin, Cindy Smith, Gail Yeary and Rita Hughes, customers of Great Oaks; Joe Devers and Gary Lynn Morgan, an environmental engineer and an environmental inspector, respectively, for the Natural Resources and Environmental Protection Cabinet ("NREPC"); and Mark Frost, John Geoghegan, and Larry Updike, Commission Staff members. Following the hearing, Great Oaks and the AG submitted briefs.

#### COMMENTARY

Great Oaks is a small sewage utility located in McCracken County, Kentucky. It provides sewage service to approximately 94 customers residing in the Great Oaks Subdivision. The utility began providing this service in 1979.

#### TEST YEAR

In its application, Great Oaks proposed to use the calendar year ending December 31, 1987 as the test period in this proceeding. Commission Staff subsequently proposed, and Great Oaks accepted, that the calendar year ending December 31, 1988 be used as the test period. The Commission is of the opinion that the 1988 calendar year more accurately reflects Great Oaks'

current operations and should be used as the test year in this proceeding.

## REVENUES AND EXPENSES

### Operating Revenues

Commission Staff performed a billing analysis on Great Oaks' operations for the test year and found its operating revenues to be \$10,009. As no party has challenged the results of this analysis, the Commission will adopt Commission Staff's findings as its own.

### Owner/Management Fee

Commission Staff has proposed that Great Oaks be allowed an Owner/Management fee of \$1800 to compensate the president of Great Oaks, Andrew Palmer, for his management services. According to Commission Staff, these services include "overseeing the day-to-day operations [of the utility] and insuring that the facility operates within required standards."<sup>2</sup>

Opposing the proposed adjustment, the AG argues that the record contains considerable evidence to show that plant maintenance is not being performed. The AG further argues that, because of Mr. Palmer's recent health problems, he will be unable to perform any management duties. Mr. Palmer recently suffered a stroke and is not expected to be fully recovered until July 1990. Given Mr. Palmer's absence, the AG asserts that "it can be inferred that none of the manager's duties are being performed."<sup>3</sup>

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<sup>2</sup> Commission Staff Report, page 9.

<sup>3</sup> AG's Brief, page 11.

The AG's argument fails to consider continuity of management. Someone must continue to manage the utility, to oversee its operations, to deal with local and state regulatory officials, to ensure that plant maintenance is being performed and that the company's financial affairs are handled. In Mr. Palmer's absence, his wife and Great Oaks' secretary, Joretta Palmer, has assumed some of those duties. In addition, Great Oaks has received management assistance from the Purchase Area Development District.

The Commission believes that a management fee is the appropriate means to ensure that utility's management is properly compensated. In previous cases involving small sewer utilities, the Commission has determined that \$1800 is the appropriate level for such fee. Accordingly, it finds that the proposed adjustment of \$1800 for an owner/management fee should be allowed.

#### Water Expense

During the test period, Great Oaks incurred a purchased water expense of \$282. This amount includes late payment penalties. Commission Staff has recommended that this expense be reduced by \$66. This recommendation is based on the annualization of the minimum monthly charge for water of \$18 assessed by Great Oaks' water supplier.<sup>4</sup> The Commission finds that the proposed adjustment is reasonable and should be accepted.

#### Testing Expense

Great Oaks has proposed an adjustment of \$756 to test-period

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<sup>4</sup> \$18/month x 12 months = \$216.

operations for discharge analysis.<sup>5</sup> This analysis is performed monthly on effluent from the sewage treatment plant to ensure the plant is operating within the requirements of its KDPES permit. Commission Staff, after reviewing written estimates for the discharge analysis, recommended that the proposed adjustment be accepted. The AG urges the Commission to condition acceptance of this proposed adjustment upon the submission of proof of testing.

The Commission is of the opinion that the proposed adjustment is known and measurable and should be allowed. Under the terms of its KDPES permit, Great Oaks must perform the discharge analysis. Failure to perform such analysis may result in loss of its KDPES permit and closure of the treatment plant. The testing, therefore, is a valid expense. As to the AG's concerns that testing will actually be performed, the Commission notes that Great Oaks is currently under a court order to perform such testing.<sup>6</sup> It believes, furthermore, that NREPC, the agency responsible for the issuance of KDPES permits and the enforcement of the water pollution statutes, will take all necessary steps to ensure that Great Oaks complies with the law.

#### Chemical Expense

Great Oaks has proposed to increase its test-period expenses by \$1,800 for the cost of chlorine. During the test year, it incurred no expenses for chemicals. Based upon representations by Mr. Palmer that three 150 pound cylinders of chlorine gas were

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<sup>5</sup> 12 months x \$62.50/monthly = \$756 annually.

<sup>6</sup> Transcript of Evidence ("T.E."), page 27.

required each month for a recently purchased gas chlorinator, Commission Staff recommended that the proposed adjustment be accepted.

At the hearing, Mrs. Palmer testified that Great Oaks' sewage treatment plant uses liquid, not gaseous, chlorine to treat its effluent.<sup>7</sup> She was unable to estimate the amount of liquid chlorine used. Mr. Devers testified that, depending upon the amount of sewage being treated, the plant could use from one to six gallons of chlorine daily in its treatment process.<sup>8</sup> Mr. Updike of Commission Staff concurred with this estimate.<sup>9</sup> The AG has stipulated that the current retail cost of liquid chlorine in the Paducah area is 65.3 cents per gallon.<sup>10</sup>

The Commission finds that Great Oaks' proposed adjustment for chemical expense should not be accepted. An adjustment, however, is required to adequately reflect the cost of liquid chlorine. Based on an estimated usage of three gallons of chlorine daily, the Commission has determined that Great Oaks' allowable chemical expense should be \$715.<sup>11</sup>

#### Electricity

During the test period, Great Oaks incurred electricity expense of \$5,009. Excluding late payment penalties and credits

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7 Id. at 82.

8 Id. at 168.

9 Id. at 245.

10 AG's Brief, page 8.

11 3 gallons/day x \$.6531/gallon x 365 days/year = \$715/year.

received from its electricity supplier, Jackson Purchase Electric Cooperative Corporation ("Jackson Purchase"), Great Oaks' actual expense for electricity expense during the test period was \$4,017.

Commission Staff recommends that an upward adjustment of \$1,276 be made to this expense to more accurately reflect Great Oaks' electricity consumption. In November 1988, Jackson Purchase advised Great Oaks that a meter malfunction had caused it to underbill for service to the sewer utility. To adjust for this underbilling, Commission Staff compared Great Oaks' electricity expenses for the last four months of the test period with those of the same period in 1987. It then applied this percentage change to the actual invoices for the initial months of the test period. Commission Staff took into account the effects of a rate increase granted to Jackson Purchase after the test period.<sup>12</sup> The Commission finds the methodology of the proposed adjustment to be reasonable and accepts the proposed adjustment.

#### Routine Maintenance Fee

Great Oaks reported routine maintenance fee expense of \$4500 for the test period. This expense represents a \$100 weekly fee paid to part-time maintenance personnel to operate and maintain the treatment plant. Commission Staff recommends that this expense be increased to \$5,200 based on the annualization of the weekly charge.

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<sup>12</sup> Case No. 10277, Jackson Purchase Electric Cooperative Corporation for Permission to Flow Through a Wholesale Rate Increase Filed before the Kentucky Public Service Commission by Big Rivers Electric Corporation, Docket No. 10265.

The AG strongly opposes Commission Staff's recommendation and has suggested that the test-year expense be adjusted downward. The AG's witness, Mr. Devers, testified at the hearing that the current fee was excessive and that qualified persons were available to perform maintenance at a lower fee. The AG has urged that Great Oaks "be required to show what efforts have been made to employ some of these operators known by Mr. Devers to receive less for the same work" before any maintenance fee is allowed into Great Oaks' rates.<sup>13</sup>

Managers of a utility are presumed to act in good faith. "In the absence of a showing of inefficiency or improvidence, a court will not substitute its judgment for theirs as to the measure of a prudent outlay." West Ohio Gas Co. v. Pub. Util. Comm'n, 294 U.S. 63, 72 (1935). The AG has failed to show any inefficiency or improvidence. Furthermore, the selection of employees is a matter totally within management's discretion. The Commission cannot dictate whom a utility must employ. Accordingly, the Commission accepts the Commission Staff recommendation.

#### Other Maintenance Expense

Great Oaks incurred other maintenance expenses of \$867 during the test year. As proof of these expenses, it presented cancelled checks made payable to Jerry Cornwall, its former plant operator. Mr. Cornwall allegedly purchased small maintenance items and was then reimbursed by Great Oaks.<sup>14</sup> The utility was unable to

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<sup>13</sup> AG's Brief, page 7.

<sup>14</sup> T.E., page 213.



produce any receipt to substantiate approximately half of Mr. Cornwall's purchases. The AG urges that these undocumented purchases be disallowed.

The AG's argument runs counter to the presumption of managerial good faith. Although receipts for the purchases are lacking, expenses were actually incurred. The utility asserts that the purchases in question were for needed maintenance items. Considering the small amount involved and the AG's failure to present any evidence to show any improper action on the utility's part, the Commission is of the opinion that the full expense should be allowed.

#### Transportation Expense

Great Oaks reported transportation expense of \$488 for the test period, representing the annual costs of automobile insurance and taxes. During its investigation, Commission Staff was advised that use of the automobile in question was evenly divided between Mr. Palmer's law practice and Great Oaks. Although no evidence was presented to Commission Staff to support the proposed allocation, Staff considered \$244, one half of the test-year expense, to be a reasonable estimate of the associated transportation expenses and recommended that amount be included for rate-making purposes.

The evidence of record fails to support either Great Oaks' expense or Commission Staff's recommendation. The automobile is owned by Mr. Palmer, not Great Oaks. Taxes and insurance are the responsibility of an automobile's owner. Neither Great Oaks nor Commission Staff has presented any evidence on the use of the

automobile for Great Oaks' matters. Accordingly, this expense is disallowed.

#### Administrative and General Salaries

Commission Staff recommends that administrative and general salaries be adjusted upward by \$2,320 to reflect salaries for a part-time secretary and bookkeeper. The part-time secretary and bookkeeper were employed by both Great Oaks and Mr. Palmer's law firm. Both performed billing functions, maintained financial records, prepared financial statements, and performed various other office duties. Commission Staff argued that a portion of these persons' salaries, approximately 20 percent, should be allocated to Great Oaks to accurately reflect the costs of doing business.

The Commission agrees that some allocation should be permitted. Since the issuance of the Commission Staff Report, Mr. Palmer has become ill and his law office has been closed. The part-time secretary is no longer employed. Mrs. Palmer, who served as bookkeeper for both the utility and the law firm, continues to maintain the utility's records. Accordingly, the Commission is of the opinion that the administrative and general salaries expense should be adjusted upward to \$1,440 to reflect solely the bookkeeper's salary.

#### Miscellaneous General Expense

Commission Staff recommends that Great Oaks' expenses be adjusted upward by \$319 to reflect office electricity expense. Great Oaks was operated out of Mr. Palmer's law office. It incurred no office overhead costs. All were directly assumed by

the Palmers. Based upon the portion of office time which Mr. Palmer allocated to managing Great Oaks, Commission Staff has reasoned that approximately 20 percent of the office electricity expenses should be allocated to Great Oaks. Since the test year ended, Mr. Palmer's law office has closed and Great Oaks is now operated out of the Palmer home. No evidence about the electricity expense at this new location is found in the record. Accordingly, the Commission is of the opinion that no adjustment should be made to this expense.

Operating Statement Summary

In summary, the Commission is of the opinion and finds Great Oaks' operating statement to be as follows:

	Test-Year <u>Actual</u> \$10,009	<u>Adjustments</u> \$ 0	Test-Year <u>Adjusted</u> \$10,009
Operating Revenues			
Operating Expenses			
Owner/Management Fee	0	1800	1800
Sludge Hauling Expense	0	0	0
Water Expense	282	<66>	216
Other Labor and Materials	0	756	756
Chemicals	0	715	715
Electricity	5,009	1,276	6,285
Routine Maintenance	4,500	700	5,200
Other Maintenance	867	0	867
Postage	191	109	300
Printing	24	0	24
Past Due Collection	179	0	179
Administrative & Gen. Salaries	80	1,360	1,440
Transportation Expense	488	<488>	0
Miscellaneous General	56	0	56
Rent	0	1,251	1,251
Depreciation	6,530	<6,110>	420
Taxes Other than Income	132	50	182
Total	<u>\$18,338</u>	<u>\$1,353</u>	<u>\$19,691</u>
Net Operating Income			
Exclusive of Provision for Income Taxes	<u>\$&lt;8,329&gt;</u>	<u>\$&lt;1,353&gt;</u>	<u>\$&lt;9,682&gt;</u>

## REVENUE REQUIREMENTS DETERMINATION

The approach frequently used by the Commission to determine revenue requirements for small, privately-owned utilities is the calculation of an operating ratio. This approach is used primarily when no basis for a rate-of-return determination exists or where the cost of utility plant has fully, or largely, been recovered through the receipt of contributions, either in the form of grants or donated property.

The Commission has determined that Great Oaks needs additional annual operating income of \$13,077 based on an 88 percent operating ratio and the appropriate state and federal income taxes.<sup>15</sup> An 88 percent operating ratio should result in a net cash flow of \$3,190 and provide sufficient operating revenues for Great Oaks to meet its operating expenses and provide for reasonable equity growth in the future.<sup>16</sup>

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<sup>15</sup>  $\$19,691 + 85.29439 \% \text{ (Inclusion of Income Taxes)} = \$23,086.$

Revenue Requirement	\$23,086
Less: Normalized Revenues	<u>&lt;10,009&gt;</u>
Increase Needed	<u>\$13,077</u>
<sup>16</sup> Revenue Requirement	\$23,086
Less:	
Adjusted Expenses	19,691
State and Federal Taxes	625
Add:	
Depreciation	420
Net Cash Flow	<u>\$ 3,190</u>

## SURCHARGE

In its report, the Commission Staff recommended that Great Oaks be authorized to assess a monthly surcharge to collect \$5,416 in additional revenues. The proceeds of this surcharge were to be earmarked for the purchase of a foam control pump and two backwash pumps for the sewage treatment plant. Commission Staff opined in its report that these improvements were needed in order for Great Oaks to provide adequate service.

The AG strongly opposed the surcharge and argues this equipment is not required. NREPC's evidence was that the foam control pump was "not real necessary to the operation of the treatment, but that the backwash pump was required."<sup>17</sup> Commission Staff, although noting that the plant was designed to have a foam control pump, conceded that it was not necessary to the plant's operation.<sup>18</sup> Following the hearing, the AG submitted an inspection report which stated that the backwater pumps had been tested by the plant's former operator and found to be in working order.

In view of these facts, the Commission finds that the surcharge is not required and should not be authorized.

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<sup>17</sup> T.E., page 162.

<sup>18</sup> T.E., page 251.

## QUALITY OF SERVICE

Although this case concerns the reasonableness of Great Oaks' proposed rate, considerable attention has been directed toward the quality of its service. Several ratepayers testified at the hearing about poor plant maintenance and instances of sewage bypass. NREPC submitted evidence of Great Oaks' failure to maintain its plant or comply with the water pollution laws. Commission Staff has also acknowledged that Great Oaks' treatment plant has not been operated properly.

The AG has, in a thinly disguised manner, urged the Commission to consider quality of service in rendering its decision. Unfortunately, the Commission may not. "The rate making process is to provide for the utility a reasonable profit on its operations so that its owners may achieve a return on investment. Such matters are purely those of a financial nature . . . [T]he quality of service is not germane to the normal, time-tested factors that go into the determination of a proper rate for the services rendered by a utility." South Central Bell v. Utility Reg. Comm'n, Ky., 637 S.W.2d 649, 653 (1982). Hence, the Commission must focus exclusively on financial matters.

This limitation on its rate-making powers does not render the Commission totally powerless to protect ratepayers. Commission regulations prescribe certain operating and maintenance standards to which all sewer utilities must adhere. Failure to comply with these regulations subjects a utility to possible penalty. Great Oaks is hereby placed on notice that failure to comply with these regulations will result in proceedings for the imposition of such

penalties. To ensure its compliance with those regulations monthly inspections of Great Oaks' facilities will be conducted. While these steps may not totally resolve the existing service problems, they will, hopefully, create an incentive for improvement.

#### SUMMARY

After consideration of the evidence of record and being otherwise sufficiently advised, the Commission is of the opinion and finds that:

1. The rate in Appendix A, attached hereto and incorporated herein, is the fair, just, and reasonable rate for Great Oaks and will produce gross annual revenues of approximately \$23,086. This rate will allow Great Oaks sufficient revenues to meet its operating expenses and provide for future equity growth.

2. The rate proposed by Great Oaks in its application will produce revenues less than those found reasonable herein and should be denied.

IT IS THEREFORE ORDERED that:

1. The rate in Appendix A is approved for service provided by Great Oaks on and after the date of this Order.

2. The rate proposed by Great Oaks in its application is denied.

3. Within 30 days of the date of this Order, Great Oaks shall file with the Commission its revised tariff sheets setting out the rate approved herein.

Done at Frankfort, Kentucky, this 5th day of October, 1989.

PUBLIC SERVICE COMMISSION

  
Chairman

  
Vice Chairman

  
Commissioner

ATTEST:

Executive Director



APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC  
SERVICE COMMISSION IN CASE NO. 10485 DATED 10/05/89

The following rate is prescribed for the customers in the area served by Great Oaks Sanitation 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.

Flat Rate \$20.41