COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ADJUSTMENT OF RATES OF VALLEY GAS, INC.	))	CASE NO. 89-103

O R D E R

On April 28, 1989, Valley Gas, Inc. ("Valley") filed an application for a rate adjustment pursuant to 807 KAR 5:076, the Alternative Rate Filing Procedure for Small Utilities ("ARF"). Valley did not meet the minimum requirements for an ARF filing due to its level of revenues and number of customers. However, by Commission Order dated May 18, 1989, Valley received permission to utilize the ARF procedure. The rates proposed by Valley would generate approximately $74,133 or a 31.1 percent increase in annual revenues.

On July 26, 1989, Staff issued its Report recommending an increase in annual revenues of $15,893, an increase of 6.7 percent. On August 23, 1989, Valley notified the Commission that no hearing was needed and accepted the recommendations in the Staff Report. However, Valley requested that the Commission consider several issues addressed in the Staff Report before making a final determination on the proposed rate increase.

Valley raised three specific issues in the August 23, 1989 letter. First, Valley perceived that the Staff was concerned about the amounts Valley paid in the test year to Irvington Gas

Company, Inc. ("Irvington Gas") as a management fee. Valley stated that it does not believe a monthly fee of $2,000 is unreasonable. Staff's concern dealt with the transaction between Valley and Irvington Gas, which are both owned by L. Kenneth Kasey; therefore, all transactions between the two entities are at less-than-arms-length. The Commission notes that the Staff Report recommended including the monthly management fee and, thus, fails to see any conflict between Valley's position and that of the Staff. The Commission, therefore, accepts the monthly management fee of $2,000 as reasonable to use for rate-making purposes.

The second issue raised by Valley dealt with the appropriate level of office and warehouse rental expense. Based on the terms of its service agreement, Valley paid $7,210 to Irvington Gas in the test year for office and warehouse rental. The Staff recommended an annual rent expense of $3,600. In its August 23, 1989 letter, Valley estimated it would cost approximately $5,431 annually for adequate office and warehouse space. In addition, on August 29, 1989, Valley filed a statement from a realtor in the city of Irvington concerning the cost of rented office space. After reviewing the Staff Report and the information filed by Valley, the Commission accepts Valley's estimated cost of $5,431 as reasonable for rate-making purposes.

Finally, Valley does not agree with the Staff Report recommendation to exclude for rate-making purposes test-year interest expense of $6,432 and believes that the exclusion was based on the fact that the borrowings which generated the interest expense were made from Irvington Gas. Valley explained in its August 23, 1989 letter that income from operations was not always adequate to provide necessary operating funds. Operating funds were, therefore, borrowed from Irvington Gas since it provided many services which were not reimbursed by Valley. The Commission has reviewed the Staff Report on this issue and believes that Valley has not understood the reason for the interest exclusion. The Staff stressed in its Report that the revenues from gas service should be adequate to recover the operating expenses of the utility. If revenues were deficient, it was management's responsibility to seek rate relief. The Staff further stated that, because of the use of the borrowed funds to finance past operating expenses, the interest expense on those borrowings could not be included for rate-making purposes, even if the money had been borrowed from an entity other than a commonly-owned corporation.

The Commission believes that it is clear that the exclusion of the interest expense for rate-making purposes, proposed in the Staff Report, was based on the use of the borrowed funds and not the source of those funds. The Commission has held in many cases in the past that the recovery of capital used to pay the normal ongoing operating costs of the utility constitutes retroactive rate-making. In addition, the Commission reminds Valley that under the methodology used in the Staff Report to determine Valley's revenue requirements, the inclusion of interest expense would have no effect. Using the return on net investment rate base methodology, a rate of return is applied to the net investment rate base to arrive at the required net operating income. Interest expense is not used to arrive at the net operating income; rather, interest expense is deducted from net operating income to arrive at net income. Therefore, the Commission finds that the interest expense generated from funds borrowed to meet operating expenses should be excluded and, thus, accepts the recommendation in the Staff Report for rate-making purposes.

In the August 23, 1989 letter, Valley raised two other points that should be addressed. First, Valley suggested that it should go back to the test year and change the $61,875 in notes payable to Irvington Gas to an addition to capital. Valley informed the Commission in a letter dated September 15, 1989 that its accountant had determined that Mr. Kasey no longer has any remaining tax basis in his investment in Valley. Valley has Sub-Chapter S income tax filing status. Thus, Mr. Kasey cannot reflect any tax losses incurred by Valley on his personal income tax returns. The accountant indicated that losses may be used by Mr. Kasey if he either makes an additional investment into Valley or Valley begins to generate profits. While tax and regulatory accounting practices differ in many areas, the statements by Valley's accountant indicate a concern shared by the Commission. Too often, the owners of small gas utilities will make an initial investment in the utility, and then expect that earnings are the sole source of funds to keep the utility in operation. The owners often do not realize that sometimes additional equity investment is also needed. The Commission advises Valley that, while it could convert these notes to a form of equity capital, such a conversion would not change the rate-making treatment used for Valley in this proceeding.

Second, Valley commented on the Staff's rejection of its review of surrounding utilities' rates as a basis of determining the rates for Valley. The Commission reminds Valley that the rates charged by a regulated gas utility should reflect only the costs of that utility, no more or no less. While comparison of the rates charged by other surrounding utilities may be useful for some purposes, it does not constitute a basis from which the appropriate rates for Valley can be determined.

After a review of the record in this proceeding, the Commission finds that the rate-making recommendations contained in the Staff Report are reasonable, with the exception of the office and warehouse rental expense. The Commission has reviewed the Staff Report and adopts the use of the return on net investment rate base as the reasonable methodology to use in determining the revenue requirements of Valley. The Commission has determined that Valley's net investment rate base is $77,887, which reflects the increase in rent expense allowed herein. The Commission finds that the 10 percent rate of return on net investment rate base as recommended in the Staff Report is reasonable for Valley. The application of the return on net investment rate base produces an increase in revenues of $17,749, an increase of 7.4 percent over normalized test-year operating revenues. In determining this increase, the Commission has also included an adjustment to the assessment, pursuant to KRS 278.150, as was recommended in the Staff Report. The Commission believes this increase in revenues will provide adequate rates to allow Valley to have sufficient cash flow to meet its operating expenses and provide for reasonable equity growth.

In its Report, the Staff addressed three issues which relate to compliance and accounting practices at Valley. The Report also contained proposals and recommendations on how to resolve these issues. The Commission has reviewed the proposals and recommendations and has made the following determinations:

1. Compliance with Financial Audit. The Staff examined Valley's compliance with an audit issued on September 21, 1987 by the Financial Audit Branch of the Commission. The Staff noted areas where Valley had not complied with the audit recommendations. The Commission finds that the original recommendations of the financial audit were reasonable and should be implemented. Valley should provide the Commission with an explanation on how it intends to implement the remaining recommendations.

2. Compliance with Approved Tariff. The Staff reviewed Valley's tariff sheets currently on file with the Commission. Five specific problem areas were identified in this review and were outlined in the Staff Report. The Staff recommended that Valley take the necessary steps to correct the identified tariff problems and possibly contact the appropriate section of the Commission's Rates and Tariffs Division for assistance. The Commission finds that the recommendation of the Staff Report is reasonable and should be adopted.

3. Transactions with Irvington Gas. The Staff reviewed Valley's service agreement with Irvington Gas and noted several areas where the agreement needed to be reviewed and revised. The

Staff also noted that the present agreement did not disclose how the charges were determined or what cost allocation methods were used. The Staff recommended that the agreement be reviewed and revised accordingly and that any revision would require that the basis for all charges and the allocation methods be properly documented. The Commission finds that this recommendation is reasonable and should be adopted.

SUMMARY

The Commission, after consideration of the evidence of record and being otherwise sufficiently advised, finds that:

1. The recommendations and findings contained in the Staff Report are supported by the evidence of record, are reasonable, and are hereby adopted as the findings of the Commission in this proceeding, subject to the exception noted herein, and are incorporated by reference as if fully set out herein.

2. Valley should be granted rates which would produce additional operating revenues of $17,749.

3. The rates in Appendix A, attached hereto and incorporated herein, are the fair, just, and reasonable rates for Valley and will produce gross annual operating revenues of $259,339. These rates will allow Valley sufficient revenues to meet its operating expenses, service its debt, and provide for future equity growth.

4. Within 60 days from the date of this Order, Valley should take the necessary steps to correct tariff problems identified during the Staff's review. Valley may contact the appropriate section of the Commission's Rates and Tariffs Division for assistance.

IT IS THEREFORE ORDERED that:

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

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

3. Within 60 days from the date of this Order, Valley shall file with this Commission a detailed explanation of how it plans to implement the remaining recommendations of the Financial Audit Report, dated September 21, 1987.

4. Within 60 days from the date of this Order, Valley shall file with this Commission a detailed explanation of the results of its review of the service agreement with Irvington Gas, and if revisions are made, file a copy of the revised service agreement, including the necessary supporting information identified in this Order and the Staff Report.

Done at Frankfort, Kentucky, this 9th day of November, 1989.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

ATTEST:

Commissioner

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 89-103 DATED 11/09/89

The following rates and charges are prescribed for the customers served by Valley Gas, 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 date of this Order.

CURRENTLY EFFECTIVE BILLING RATES

Rates:

All Mcf	$4.1731 Per Mcf
Customer Charge	$3.40 Per Month

Minimum Charge:

$3.40 Per Meter Per Month