COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF EAST CLARK COUNTY WATER DISTRICT FOR A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY, APPROVAL FOR FINANCING AND FOR ADJUSTMENT TO RETAIL RATES	)	CASE NO. 92-343

O R D E R

On August 28, 1992, East Clark County Water District ("East Clark") filed its application for Commission approval of its proposed construction, financing and increased water rates. Commission Staff, having performed a limited financial review of East Clark's operations, has prepared the attached Staff Report containing Staff's findings and recommendations regarding the proposed rates. All parties should review the report carefully and provide any written comments or requests for a hearing or informal conference no later than 15 days from the date of this Order.

IT IS THEREFORE ORDERED that all parties shall have 15 days from the date of this Order to provide written comments regarding the attached Staff Report or requests for a hearing or informal conference. If no request for a hearing or informal conference is received, then this case will be submitted to the Commission for a decision.

Done at Frankfort, Kentucky, this 25th day of February, 1993.

PUBLIC SERVICE COMMISSION

Robert M. Davis

For the Commission

ATTEST:

Don Mills

Executive Director

COMMONWEALTH OF KENTUCKY

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STAFF REPORT

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STAFF REPORT

ON

CLARK COUNTY WATER DISTRICT

CASE NO. 92-343

A. Preface

On August 14, 1992, the East Clark County Water District ("East Clark") submitted its application with the Commission seeking a Certificate of Public Convenience and Necessity ("Certificate") to construct a $1,348,800 waterworks improvement project, for approval for its lease financing plan and its proposed rate increase. However, the application was not considered filed until August 28, 1992. East Clark's proposed rates would produce an increase in its annual revenues of $102,868, an increase of 25 percent over test-period normalized revenues from rates of $410,209.

By Interim Order dated September 16, 1992, the Commission granted East Clark's requested Certificate and approved its proposed lease financing plan. In order to evaluate the requested rate increase, the Commission Staff ("Staff") chose to perform a limited financial review of East Clark's operations for the test-period, the calendar year ending December 31, 1991. Mark C. Frost of the Commission's Division of Financial Analysis performed the limited review on November 30, 1992 and December 2, and 9, 1992.

Mr. Frost is responsible for the preparation of this Staff Report except for Section B, Operating Revenues; Section D, Rate Design; and Appendix A, which were prepared by Brent Kirtley of the Commission's Rates and Research Division. Based on the findings contained in this report, Staff recommends that East Clark be allowed to increase its annual revenues from rates by $154,457.

Scope

The Scope of the review was limited to obtaining information as to whether the test-period operating revenues and expenses were representative of normal operations. Insignificant or immaterial discrepancies were not pursued and are not addressed herein.

B. Analysis of Operating Revenues and Expenses

Operating Revenue

East Clark reported test-year revenue of $280,328 in its 1991 Annual Report. Staff's billing analysis supports this revenue amount to within a 1 percent degree of error, which is the accepted standard for rate-making purposes. The application indicates that expansion will provide for an additional 256 customers at an average of 5,000 gallons per month. This results in an additional $96,768 in revenue from sales of water. Therefore, for the purposes of this report, normalized test-year revenue shall be considered to be $377,096.

Operating Expenses

In its application, East Clark reported actual and pro forma test-period operating expenses of $303,180 and $295,114, respectively. The following are Staff's recommended adjustments to East Clark's actual test-period operations and discussions of East Clark's proposed pro forma adjustments:

<u>Salaries and Wages</u>: East Clark proposed a pro forma level of salaries and wages expense of $87,246, an increase of $24,965 above its test-period level. This adjustment is based on hiring two new employees and granting all of East Clark's employees a 5 percent wage increase in 1992.

During the test-period East Clark employed a manager, bookkeeper, and maintenance supervisor. An additional maintenance employee was hired on March 2, 1992 and an office clerk was hired on May 5, 1992. In January 1993, East Clark dismissed its manager and bookkeeper. An interim manger has been hired and East Clark is in the process of finding a permanent replacement. Because its accountant will perform the bookkeeping duties, East Clark is unsure as to when or if its bookkeeping position will be filled.

An adjustment based on East Clark's current employee level would meet the rate-making criteria of known and measurable. Therefore, Staff recommends that wages and salaries expense be adjusted to reflect the two new employees and the elimination of the bookkeeping position.

Upon review of the payroll records, Staff noted that in 1991 and 1992 East Clark granted its employees wage increases of 9 and 10 percent, respectively. East Clark informed Staff that the wage increases reflected a cost of living raise plus an additional 5 percent.

Given the current economic conditions, Staff is of the opinion that 9 and 10 percent wage increases are excessive. East Clark failed to show that its employee salaries are inadequate or to otherwise justify its proposed wage levels. However, Staff is of the opinion that a 5 percent increase would not be excessive.

Based on wages increases of 5 percent in 1991 and 1992 and the two new employees hired in 1992, Staff determined that East Clark's pro forma salaries and wages expense would be $74,088.[1] Therefore, salaries and wage expense has been increased by $11,807.

Employee Pensions and Benefits: East Clark proposed a pro forma level of employee pensions and benefits expense of $20,234, an increase of $7,246 above its test-period level. This adjustment reflects the cost of the benefits for the new maintenance employee and estimated cost increases for health insurance and pensions premiums of 3 and 4 percent, respectively.

Upon review of the general ledger, Staff noted that in 1992 East Clark's health insurance and pension premiums had increased to $2,020 per month or $24,240 annually. East Clark informed Staff that the change in its staff will have no foreseeable affect on its health insurance and pension premiums.

An adjustment to reflect East Clark's increased premiums would meet the rate-making criteria of known and measurable and

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[1]

	1991 Beginning Salary	Pro Forma Salaries 1991	Pro Forma Salaries 1992
Manager	$ 27,600	$ 28,980	$ 30,429
Office Clerk	-0-	-0-	10,584
Maint. Supervisor	$ 20,400	$ 21,420	22,491
Maint. Employee	-0-	-0-	+ 10,584
Pro Forma Salaries & Wages			$ 74,088

therefore, Staff recommends that the increased cost be reflected in test-period operations. Accordingly, employee pensions and benefits expense has been increased by $11,252.

Purchased Water: East Clark proposed a pro forma level of purchased water expense of $110,395, an increase of $18,840 above its test-period level. The proposed construction project will provide service to 256 additional customers. However, East Clark's adjustment is based on 200 new customers, average test-period customer usage of 5,000 gallons per month, and the current wholesale rate charged by its supplier, the City of Winchester ("Winchester").

In its billing analysis, Staff projected that East Clark would sell an additional 15,360,000 gallons per year based on the projected 256 additional customers and average customer usage of 5,000 gallons. Using this and test-period line loss of 13.65 percent,[2] Staff determined that East Clark would purchase an additional 2,378,084 Cubic Feet[3] per year. To be consistent with the operating revenue adjustment recommended herein, Staff is of the opinion that purchased water expense should be increased to

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[2]

Test-Period Purchased Water	9,977,800	Cu. Ft.
Water Sales 65,668,800 Gal + 7.48 =	- 8,779,251	Cu. Ft.
Unaccounted for Water	1,198,549	Cu. Ft.
Water Sales	+ 8,779,251	Cu. Ft.
Test-Period Line Loss	13.65%	

[3]

5,000 Gal x 256 Cust. x 12-Months =	15,360,000	Gallons
Line Loss Reciprocal	+ 86.35%	
Purchased Water Inc. - Gal.	17,888,072	Gallons
Cu. Ft. Conversion Factor	+ 7.48	
Purchased Water Inc. - Cu. Ft.	2,378,084	Cu. Ft.

the opinion that purchased water expense should be increased to reflect the increase in annual water purchases of 2,378,084 Cubic Feet.

Effective December 1, 1992, Winchester increased its wholesale water rate from 93¢ to 96¢ per 100 cubic feet. Since, an adjustment based on Winchester's increased water rate would meet the rate-making criteria of known and measurable, Staff recommends that purchased water expense be adjusted to reflect this increased cost.

Based on Winchester's wholesale water rate of 96¢ per 100 cubic feet, the increased purchases of 2,387,763 cubic feet, and actual test-period water purchases of 9,977,800 cubic feet, Staff has calculated a pro forma purchased water expense of $118,616.[4] Accordingly, purchased water expense has been increased by $27,061.

<u>Electric</u>: East Clark proposed a pro forma electric expense of $7,000, an increase of $1,145 above its test-period level. East Clark's construction project includes the installation of a tank and control valve station. This adjustment reflects the average electric cost East Clark incurred to operate its existing tank and control valve station during the test period.

In evaluating pro forma adjustments, Staff utilizes the rate-making criteria of known and measurable. A pro forma adjustment

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Test-Period Purchased Water	9,977,800	Cu Ft
Increase due to New Customers	+ 2,387,763	Cu Ft
Pro Forma Purchased Water	12,365,563	Cu Ft
Times: Winchester's Rate	x .0096¢	
Purchased Water Exp.	$ 118,709	

based either on increased usage or costs would normally constitute a known and measurable adjustment. An adjustment to electric expense based on either the manufacturer's or an engineering estimate of the kilowatt hours a piece of equipment will operate and the present kilowatt hourly rate would meet this criteria. However, numerous factors (i.e., equipment age, and size) which affect electric usage make it virtually impossible to predict future usage based on historical averages. Furthermore, East Clark failed to show the relationship between its existing equipment and the equipment to be installed. Staff is of the opinion that this adjustment fails to meet the rate-making criteria of known and measurable and therefore, recommends that it be denied.

Upon review of the invoices, Staff determined that the actual electric expense was $6,240, a difference of $385 above the amount East Clark reported. Accordingly, electric expense has been increased by $385.

Operating Supplies and Maintenance: East Clark proposed a pro forma operating supplies and maintenance expense of $9,723, a decrease of $14,151 below its test-period level. This adjustment reflects the removal of inventory build-up that occurred in the test period.

East Clark was informed that all pro forma adjustments must be documented (e.g., invoice or contract) in order to meet the rate-making criteria of known and measurable. East Clark was requested and failed to provide documentation to support its adjustment and therefore, Staff recommends that it be denied.

Based on a review of the accountant's work papers and East Clark's general ledger, Staff noted that test-period materials and supplies expense was overstated by $8,281.[5] To rectify this overstatement, operating supplies and maintenance expense has been decreased by $8,281.

Upon review of East Clark's invoices, Staff determined that the following expenditures are capital in nature:

Bluegrass Fire & Equip. - Air Mask & Case	$ 1,395
RAK Industries - Truck Signs	$ 1,539
Ditch Witch - Purchased in 1990	$ 2,168

After consulting with the Commission's Engineering Division, it was determined that the ditch witch should be depreciated over 10 years and the air mask and truck signs should be depreciated over 5 years. Therefore, operating supplies and expenses has been decreased by an additional $5,102 and depreciation expense increased by $804.

Upon review of the general ledger, Staff noted that water testing fees of $826 were misclassified as operating supplies and maintenance. Ordinarily, the incorrect classification of the testing fees would not affect the overall determination of East Clark's revenue requirement. However, these fees have been

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[5]

Operating Supplies & Maintenance	$ 25,372
Year-End-Adjusting Entries	- 9,779
Actual Operating Supplies & Maint.	$ 15,593
Reported Operating Supplies & Maint.	- 23,874
Overstatement	$ 8,281

included in the calculation of pro forma testing expense. Accordingly, repairs and maintenance expense has been decreased by an additional $826. The total of these three adjustments to operating supplies and maintenance results in an adjustment to decrease this account by $14,209.

Office: East Clark proposed a pro forma level of office expense of $15,055, an increase of $1,964 above its test-period level. This adjustment reflects East Clark's estimate of the additional postage, bill forms, and computer paper that it will purchase due to the additional customers.

As previously mentioned, East Clark was informed that all pro forma adjustments must be documented in order to meet the rate-making criteria of known and measurable. East Clark provided Staff with calculations of its adjustment but did not provide the requested supporting documentation. Therefore, Staff recommends that this adjustment be denied.

Upon review of the general ledger, Staff noted that East Clark incurred postage expense of $1,644 in the test period. Unlike electric expense, there is a direct relationship between postage expense and the number of customers served. Therefore, an adjustment to postage expense based on the increase in customers would meet the rate-making criteria of known and measurable.

Based on East Clark's billing analysis, test-period postage expense of $1,644 and 256 additional customers, Staff determined that test-period postage expense should be increased by $641.[6] Therefore, office expense has been increased by that amount.

Upon further review of the general ledger and the accountant's workpapers, Staff determined that test-period office expense had been understated and should have been recorded at $14,841. Accordingly, office expense has been increased by an additional $1,750, resulting in a total adjustment to this account of $2,391.

Rent: East Clark proposed to eliminate its office rent expense of $508 from its test-period operations. East Clark has constructed a new office and therefore, this expense will not occur in the future. Staff recommends that East Clark's adjustment be accepted.

Insurance: East Clark proposed a pro forma level of insurance expense of $10,168, an increase of $1,326 above its test-period level. As previously mentioned, East Clark is in the process of constructing a storage tank and service mains. This adjustment is based on the additional premium that East Clark will incur due to its plant construction.

East Clark provided a price quotation from its insurance agency to document that its insurance premium will increase by $1,326 due to its plant construction. Since an adjustment based on the increased premium would meet the rate-making criteria of

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[6]

$1,644 + 7,876 Test-Period Bills =	$ 0.2087
256 Customers x 12-Months =	x 3,072
Pro Forma Postage Adjustment	$ 641

known and measurable, Staff recommends that East Clark's adjustment be accepted and that insurance expense be increased by $1,326.

Upon review of the 1992 invoices, Staff noted that East Clark's insurance premiums are $6,657, a difference of $2,185 from the amount East Clark reported in the test period. Since the 1992 premiums represent East Clark's on-going insurance cost, Staff is of the opinion that they should be reflected in test-period operations. Accordingly, insurance expense has been decreased by $2,185. The cumulative effect of the two adjustments to this account results in a decrease of $859 in pro forma expenses.

Transportation: East Clark proposed a pro forma level of transportation expense of $4,881, an increase of $362 above its test-period level. East Clark is adding 23 miles and 256 customers to its existing system. This adjustment reflects East Clark's estimated increase in gasoline costs that will result from its plant additions.

As with office expense, East Clark provided the calculation but did not provide the requested supporting documentation. Therefore, Staff recommends that this adjustment be denied.

Regulatory Commission: East Clark proposed to include a regulatory commission expense of $192 to reflect its anticipated Public Service Commission Assessment.

Using the normalized revenue recommended herein of $377,096 combined with the current Assessment rate of 1.4330¢ per $1,000 of revenue, the Public Service Commission Assessment would be $540.

Accordingly, East Clark's test-period operations have been increased by this amount.

Chemical Analysis: East Clark proposed a pro forma level of chemical analysis of $1,168, an increase of $338 above its test-period level. This adjustment is based on additional chemicals that East Clark will purchase due to its increased water sales.

As with office and transportation expenses, East Clark provided the calculation but did not provide the requested supporting documentation. Further, East Clark failed to show that there is a direct relationship between the number of customers served and its chemical cost which was the basis for its calculation. Staff is of the opinion that this adjustment fails to meet the rate-making criteria of known and measurable and therefore, recommends that it be denied.

Testing: East Clark pays Commonwealth Technology a quarterly fee of $225 for trichaleomethanes testing and a monthly fee of $22 for bacteria coliform testing. The annualization of these fees results in a normalized testing expense of $1,164.[7] Accordingly, test-period operations have been increased by this amount.

Bad Debt: East Clark proposed a pro forma level of bad debt expense of $1,329, a decrease of $3,986 from its test-period level. This adjustment is based on a 3-year average of this expense account. East Clark has failed to show any correlation between its

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[7]

$225 x 4-Quarters	=	$ 900
$ 22 x 12-Months	=	+ 264
Testing Expense		$ 1,164

proposed 3-year average of bad debt expense and the direct write-off method that was the basis of the test-period actual bad debt expense. Therefore, Staff recommends that East Clark's adjustment be denied.

Depreciation: East Clark proposed a pro forma level of depreciation expense of $9,459, a decrease of $47,727 from its test-period level. In its application, East Clark provided the following explanation for this adjustment: "To minimize expenses (and thereby rates), East Clark County Water District is seeking to recover in this rate case the principal on lines and storage facilities."

In order to insure East Clark's financial integrity, an appropriate amount of depreciation expense should be included in its pro forma operations. Staff is of the opinion that if depreciation expense is reduced to the level proposed, then East Clark's financial integrity would be placed in jeopardy. Further, at a meeting on January 28, 1993, two of East Clark's commissioners informed Staff that they wanted the appropriate level of depreciation expense included in pro forma operations. Therefore, Staff recommends that East Clark's adjustment be denied.

During the test period, East Clark purchased two vehicles and renovated its office. However, since the expenditures did not occur at the beginning of the year, East Clark failed to report a full year of depreciation expense. Staff has determined that depreciation expense should be increased by $5,922 to reflect the annualization of this expense and has increased depreciation expense by this amount.

In this current case, East Clark has been granted a Certificate to construct a storage tank and service mains at an estimated cost of $237,433 and $677,068, respectively. Based on review of East Clark's depreciation schedule, it was determined that the storage tank and service mains should be depreciated over 50 years, which would result in a deprecation expense of $18,290.

Since the revenues and expenses recommended herein have been adjusted to reflect the additional customers that are related to East Clark's construction project, Staff is of the opinion that depreciation expense should likewise be adjusted. Therefore, depreciation expense has been increased by an additional $18,290.

The adjustments to depreciation expense recommended in this section combined with the $806 adjustment from the section entitled "Operating Supplies and Maintenance" would result in an increase of $25,016 in pro forma expenses.

FICA: East Clark reported test-period FICA expense of $6,656. Based on the pro forma salaries and wages expense determined reasonable herein, East Clark's pro forma FICA expense would be $5,668 a difference of $988 from the amount East Clark reported. Accordingly, FICA expense has been decreased by $988.

Operations Summary

Based on the recommendations of Staff contained in this report, East Clark's operating statement would appear as set forth in Appendix B to this report.

C. Revenue Requirements Determination

The approach frequently used by this Commission to determine revenue requirements for "non-profit" water utilities is debt service coverage ("DSC"). Staff recommends the use of this approach in determining East Clark's revenue requirement.

Based on the outstanding Farmers Home Administration bonds, Staff has determined that East Clark's annual debt service is $35,436.[8] East Clark has an outstanding lease with the Kentucky Association of Counties Leasing Trust Program ("KACo") and in this proceeding its construction project will be partially funded by a similar KACo lease. Based on the existing and proposed KACo leases, East Clark's 3-year average lease payment is $137,241.[9]

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[8]

Years	1978 Issuance	1987 Issuance	Total FmHA Debt Payments
1993	$ 19,500	$ 16,104	$ 35,604
1994	$ 19,200	$ 16,036	35,236
1995	$ 18,900	$ 16,567	+ 35,467
			$ 106,307
			÷ 3 Years
			$ 35,436

[9]

	1990 Lease	Proposed Lease	Total
1993	$ 44,566	$ 93,326	$ 137,892
1994	$ 44,463	$ 92,797	137,260
1995	$ 44,354	$ 92,217	+ 136,571
			$ 411,723
			÷ 3-Years
			$ 137,241

East Clark's adjusted operations reflect \$(111,934)[10] in income available for debt service which results in a DSC of (3.16)x[11]. The increase in rates requested by East Clark would result in income available for debt service of \$(9,066)[12] and a DSC of (0.26)x.[13]

Staff is of the opinion that a 1.2x DSC and a dollar-for-dollar coverage on the KACo lease payments, will provide sufficient revenues to allow East Clark to meet its operating expenses, pay its lease obligations, and service its debt. A DSC of 1.2x will result in a revenue requirement of \$545,966[14] and therefore, Staff recommends that East Clark be granted an increase in annual revenues from rates of \$154,457.[15]

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Net Operating Income	\$ 10,864
Add: Interest Income	+ 14,443
Subtotal	\$ 25,307
Less: Lease Payment	- 137,241
Income Available for DSC	\$ (111,934)

11 \$(111,934) ÷ \$35,436 = (3.16)x.

12

Income Available for DSC	\$ (111,934)
Requested Increase in Rates	+ 102,868
	\$ (9,066)

13 \$(9,066) ÷ \$35,436 = (0.26)x.

14

Debt Service	\$ 35,436
Recommended Coverage 0.2 x \$35,436 =	7,087
Capital Lease Payment	137,241
Adjusted Operating Expenses	+ 366,232
Revenue Requirement	\$ 545,996

15

Revenue Requirement	\$ 545,996
Normalized Operating Revenue	377,096
Other Income	- 14,443
Recommended Increase	\$ 154,457

D. Rate Design

The application filed by East Clark included a schedule of present and proposed rates and did not include a proposal to change their rate structure. Staff is in agreement that the current rate structure is reasonable and should not be altered. Any increase granted in the case has been added to the existing rate structure. The rates established in Appendix A will generate the revenue requirement of $531,553, therefore, Staff recommends the rates in Appendix A, attached hereto and incorporated herein, be approved for services rendered.

E. Signatures

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Requirements Branch
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APPENDIX A
TO STAFF REPORT CASE NO. 92-343

The Staff recommends the following rate be prescribed for customers of East Clark County Water District.

Usage Blocks	Monthly Rates
First 2,000 gallons	$19.80 Minimum Bill
Next 2,000 gallons	9.55 per 1,000 gallons
Next 3,000 gallons	7.35 per 1,000 gallons
Next 3,000 gallons	5.90 per 1,000 gallons
Over 10,000 gallons	4.45 per 1,000 gallons

APPENDIX B
TO STAFF REPORT CASE NO. 92-343

	Actual Operations	Pro Forma Adjustments	Recommended Operations
Operating Revenue:			
Water Sales	$ 280,328	$ 96,768	$ 377,096
Utility Operating Expenses:			
Operating Expenses:			
Salaries & Wages - Emp.	$ 62,281	$ 11,807	$ 74,088
Commisioner Fees	2,700	0	2,700
Pension & Benefits	12,988	11,252	24,240
Purchased Water	91,555	27,061	118,616
Electric Expense	5,855	385	6,240
Supplies & Maintenance	23,874	(14,209)	9,665
Office Expense	13,091	2,391	15,482
Rent	580	(508)	72
Insurance	8,842	(859)	7,983
Professional Fees	5,562	0	5,562
Transportation	4,519	0	4,519
Reg. Commission Exp.	0	540	540
Chemical Annalysis	830	0	830
Testing	0	1,164	1,164
Bad Debt Expense	5,315	0	5,315
Miscellaneous	30	0	30
Operating Expenses	$ 238,022	$ 39,024	$ 277,046
Depreciation	57,186	25,016	82,202
Taxes Other Than Income	7,972	(988)	6,984
Utility Operating Exp.	$ 303,180	$ 63,052	$ 366,232
Net Operating Income/(Loss)	$ (22,852)	$ 33,716	$ 10,864
Other Income & Deductions:			
Interest & Dividend Income	14,443	0	14,443
Misc. Nonutility Expenses	367	0	367
Interest Expense	60,328	0	60,328
Net Income/(Loss)	$ (69,104)	$ 33,716	$ (35,388)