COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF ELK LAKE WATER COMPANY FOR AN ADJUSTMENT OF RATES PURSUANT TO THE ALTERNATIVE RATE FILING PROCEDURE FOR SMALL UTILITIES	)	CASE NO. 93-300

O R D E R

On August 20, 1993, Elk Lake Water Company ("Elk Lake") filed its application for Commission approval of a proposed increase in its rates for water service. Commission Staff, having performed a limited financial review of Elk Lake's operations, has prepared the attached Staff Report containing Staff's findings and recommendations regarding Elk Lake's 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 21st day of December, 1993.

PUBLIC SERVICE COMMISSION

For the Commission

ATTEST:

Executive Director

COMMONWEALTH OF KENTUCKY

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STAFF REPORT

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STAFF REPORT

ON

ELK LAKE WATER COMPANY

CASE NO. 93-300

A. Preface

On August 20, 1993, Elk Lake Water Company ("Elk Lake") filed an application with the Commission seeking to increase its water rates pursuant to the Alternative Rate Filing Procedure for Small Utilities. According to Elk Lake, the proposed rates would generate an increase of 80 percent in annual revenues.

In order to evaluate the requested increase, the Commission Staff ("Staff") chose to perform a limited financial review of Elk Lake's operations for the test period, calendar year 1992. Carl Salyer Combs of the Commission's Division of Financial Analysis completed the review at Elk Lake's office on September 23, 1993. Mr. Combs is responsible for this Staff Report except for the sections on operating revenues and rate design which were prepared by Brent Kirtley of the Commission's Division of Rates and Research.

During the course of the review, Elk Lake was advised that all proposed adjustments to test-year expenses must be supported by some form of documentation, such as an invoice, or that all such adjustments must be known and measurable. Based upon the findings of this report, Staff recommends that Elk Lake reduce its annual operating revenues by $3,493.

Scope

The scope of the review was limited to obtaining information to determine whether reported 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 Revenues

Elk Lake reported water sales of $58,328 in its 1992 Annual Report. However, Elk Lake did not purchase the property until April 1, 1992. Accordingly, the water sales total is for nine months instead of twelve. Therefore, Staff conducted a billing analysis covering twelve months to determine a more accurate water sales total. The analysis resulted in water sales of $77,316. Due to a billing error, an adjustment of $530 was deducted from water sales. Other revenue consisted of $1,536 in disconnect/reconnect fees and $9,399 from availability fees. Therefore, for the purpose of this report, total normalized operating revenue shall be considered to be $87,721.

Operating and Maintenance Expenses

Elk Lake reported test-period operating expenses of $56,063 for a nine-month period (April through December, 1992) and proposed to increase that level of expense by $43,659. Staff's adjustments to test-period operations are discussed in the following sections:

Salaries and Wages

Elk Lake reported no test-year salaries and wages expense, but proposed an annual level of $54,174[1] based upon annualization of reported contractual services expense of $26,980.55 plus an adjustment of $18,200 for a full-time manager. Contractual services expense will be addressed further in its own section of this report.

During the course of the field review, Staff discovered that the manager was already employed by Elk Lake at an annual salary of $17,500. Other employees include a certified operator at an annual salary of $15,600 and a bookkeeper at an annual salary of $5,460. According to the Commission's Engineering Division, the Division of Water requires that a certified operator be on duty at the plant at all times. Based upon the foregoing information, Staff recommends that annual salaries and wages expense of $38,560[2] be included for rate-making purposes.

Employee Benefits

Elk Lake reported no test-year employee benefits expense,but proposed an annual expense of $1,405 based upon vacation pay for its three employees, plus annual Kentucky Rural Water Association ("KRWA") dues of $300. Since the three employees are already compensated for 52 weeks each year, Staff is of the opinion that those employees should not receive additional compensation during

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1 $26,980.55/.75 = $35,974 + $18,200 = $54,174

2 $17,500 + $15,600 + $5,460 = $38,560

vacation periods. Staff recommends that the portion of the proposed adjustment for annual KRWA dues be accepted and annual employee benefits expense of $300 has been included for rate-making purposes.

Electricity

Elk Lake proposed to increase reported test-year electric expense of $2,371 by $791 based upon annualization of the reported amount which represents nine months (April through December, 1992) of usage. Since Elk Lake had available electric bills for the first three months of 1993, Staff chose to use those bills in order to have a full twelve-month period for review. Based upon that review, Staff recommends that annual electric expense of $3,540 be included for rate-making purposes.

Chemicals Expense

Elk Lake proposed to increase reported test-year chemicals expense of $3,410 by $1,137 based upon annualization of the reported amount. Staff's Engineering Division is of the opinion that the proposed increase is reasonable. Staff, therefore, recommends that annual chemicals expense of $4,547 be included for rate-making purposes.

Materials and Supplies Expense

Elk Lake proposed to increase reported test-year materials and supplies expense of $6,259 by $2,086 based upon annualization of the reported amount. Staff is of the opinion that it is appropriate to annualize expenses which are incurred on a monthly or other regular basis such as rent, electricity, and chemicals. Based on past experience, Staff is of the opinion that purchases of materials and supplies vary so much from month to month or period to period that annualization of this type of expense is not appropriate. Therefore, Staff recommends inclusion of annual materials and supplies expense of $6,259 for rate-making purposes.

Contractual Services

Elk Lake reported test-year contractual services expense of $26,981, but proposed an annual expense of $3,000 based upon an estimated amount for engineering fees.

During the course of the field review, Staff learned that the reported amount of $26,981 consisted of salaries and wages expense of $26,521 and only $460 in actual contractual services expense.

As mentioned previously, proposed adjustments must be known and measurable and not based entirely upon estimates. Therefore, Staff recommends that the proposed annual expense of $3,000 for estimated engineering fees be denied.

Since Elk Lake incurred test-year contractual services expense of $460, Staff recommends inclusion of annual contractual services expense of $460 for rate-making purposes.

Rent Expense

Elk Lake reported no test-year rent expense, but proposed an annual expense of $2,400. Subsequent to the field review, a copy of an agreement between the Elk Lake Property Owners Association ("ELPOA") and Elk Lake was provided to Staff, reflecting lease of office space for $200 monthly. The agreement was signed by the ELPOA president and Elk Lake's chairman. As this proposed adjustment is known and measurable, Staff recommends that it be accepted and annual rent expense of $2,400 has been included for rate-making purposes.

Transportation Expense

Elk Lake reported test-year transportation expense of $1,772 and, rather than proposing an adjustment solely to transportation expense, combined reported test-year miscellaneous expense of $2,231 with the reported amount for transportation expense and proposed to annualize the total of the two amounts.

As mentioned previously in the section on materials and supplies expense, Staff is of the opinion that expenses which do not recur on a regular basis should not be annualized. While gasoline purchases may be fairly steady, vehicle maintenance expenses may fluctuate significantly from period to period. If gasoline purchases could have been clearly separated from other reported transportation expenses, Staff would recommend that the gasoline expense alone be annualized. However, since that was not the case, Staff recommends that the portion of the proposed adjustment related to transportation expense be denied and has included annual transportation expense of $1,772 for rate-making purposes.

Insurance Expense

Elk Lake proposed to increase reported test-year insurance expense of $2,628 by $5,805 based in part on an adjustment of $4,700 to provide health insurance for its manager. While conducting the field review, Staff requested that Elk Lake provide a quote from an insurance agent. According to information submitted by Elk Lake from John J. & Thomas R. Schiff & Company, Inc., an insurance agency in Cincinnati, Ohio, the annual cost for Elk Lake would be $3,299. Therefore, Staff recommends inclusion of annual insurance expense of $3,299 for rate-making purposes.

Miscellaneous Expense

Elk Lake reported test-year miscellaneous expense of $2,231. As mentioned previously, Elk Lake proposed to annualize this expense in combination with transportation expense. As with transportation expense and other expenses that do not recur on a regular basis, Staff is of the opinion that expenses of a miscellaneous nature are not appropriate to annualize. Therefore, Staff recommends that Elk Lake's proposed adjustment be denied and that annual miscellaneous expense of $2,231 be included for rate-making purposes.

Depreciation Expense

Elk Lake reported test-year depreciation expense of $8,162 based on its investment inclusive of contributed property. Staff has calculated depreciation on contributed property of $3,705 based on reported contributions of $158,000 and Elk Lake's composite depreciation rate of 2.34 percent.[3] Staff is of the opinion that depreciation expense should not be included on plant that was paid for with contributions from rate payers rather than with owners' capital. Therefore, Staff recommends that depreciation expense associated with contributed property of $3,705 be excluded for rate-making purposes.

Elk Lake proposed to recover the cost of the following items of equipment and other capital improvements through its rates:

Item	Cost
Scales for chlorine room	$ 1,258
Seal chlorine room	350
Water pump	3,200
Motor for pressure pump station	300
Repair of reservoir overflow	843
Repair of water tower overflow	200
Install 12 distribution blow-outs	1,800
Pressure pump station	7,500
Pressure recorder	320
Chlorine gas mask	422
	$16,193

The Commission's Engineering Division is of the opinion that the expenditures are warranted and that the cost should be depreciated over five years. Therefore, Staff recommends that annual depreciation expense of $3,239[4] related to those items and improvements be included for rate-making purposes. Combined with the aforementioned recommendation of a reduction of $3,705 to reported test-year depreciation expense, Staff recommends inclusion

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[3] $8,162 (Reported Depreciation Expense) / $348,099 (Utility Plant per Annual Report) = 2.34 percent

[4] $16,193 (Cost of equipment and other improvements) / 5 years = $3,239

of total annual depreciation expense of $7,696[5] for rate-making purposes.

Amortization Expense

Elk Lake reported no test-year amortization expense, but proposed to amortize estimated rate case expense of $3,500 over three years. When informed that only rate case expense actually incurred would meet the standard of known and measurable, Elk Lake filed a copy of a letter from its attorney stating that his fee for filing this case is $2,500. Staff agrees that three years is an appropriate period over which to amortize rate case expense and, therefore, recommends inclusion of annual amortization expense of $833[6] for rate-making purposes.

Taxes Other Than Income Tax

Elk Lake proposed to increase reported test-year taxes other than income tax expense of $2,249 by $1,895 based upon increased Federal Insurance Contributions Act ("FICA") taxes attributable to the proposed increase in salaries and wages expense. Based upon annual salaries and wages expense of $38,560 recommended previously in this report and the current FICA rate of 7.62 percent, Staff recommends inclusion of annual taxes other than income tax expense of $2,938[7] for rate-making purposes.

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5 $8,162 - $,3,705 + $3,239 = $7,696

6 $2,500 (Rate Case Expense Incurred) / 3 years = $833

7 $38,560 (Recommended Annual Salaries and Wages Expense) * 7.62 percent (The Current FICA Rate) = $2,938

Interest on Long-Term Debt

Elk Lake reported test-year interest expense on long-term debt of $14,680 and proposed an annual expense of $18,619. According to Elk Lake, proceeds of a loan for $205,000 from Peoples Bank and Trust of Owenton, Kentucky were used for purchase of the utility. A copy of the promissory note, dated April 4, 1992 was provided by Elk Lake showing that the debt was to be amortized over a period of 120 months at an annual interest rate of 9.4 percent.

According to KRS 278.300 (1), "No utility shall issue any securities or evidences of indebtedness, or assume any obligation or liability in respect to the securities or evidences of indebtedness of any other person until it has been authorized so to do by order of the commission." Upon review of Case No. 92-070,[8] Staff determined that Elk Lake did not request or receive Commission authorization to incur the aforementioned debt. Therefore, Staff recommends that annual interest expense on long-term debt be excluded for rate-making purposes.

Other Interest Expense

Elk Lake reported no test-year other interest expense, but proposed an annual expense of $4,003. According to Elk Lake, $46,875 was borrowed from the ELPOA, no promissory note exists, and the proceeds were used for operating expenses incurred during the

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[8] Case No. 92-070, The Application of Eureka Investments, Inc. D/B/A Resort Water Company to Transfer Ownership and Assets to the Elk Lake Property Owners Association, Order issued March 30, 1992.

test period. Staff is of the opinion that allowing the interest on debt incurred to pay for past operating expenses would constitute retroactive rate-making, which is prohibited. Therefore, Staff recommends that no interest expense associated with the loan from ELPOA be included for rate-making purposes.

Interest Income

Elk Lake reported test-year interest income of $609 and proposed to annualize that amount which represented earnings for nine months. Staff is of the opinion that Elk Lake's proposal is reasonable and has included annual interest income of $812 for rate-making purposes.

Operations Summary

Based on the recommendations of Staff contained in this report, Elk Lake's operating statement would appear as follows:

	Test Period Application	Recommended Adjustments	Test Year Adjusted
OPERATING REVENUES:			
Water Sales	$ 58,328	$ 18,458	$ 76,786
Other Revenues	1,152	9,783	10,935
Total Oper. Rev.	$ 59,480	$ 28,241	$ 87,721
OPERATING EXPENSES:			
Salaries and Wages	$ -0-	$ 38,560	$ 38,560
Employee Benefits	-0-	300	300
Electricity	2,371	1,169	3,540
Chemicals	3,410	1,137	4,547
Materials & Supplies	6,259	-0-	6,259
Contractual Services	26,981	<26,521>	460
Rent	-0-	2,400	2,400
Transportation	1,772	-0-	1,772
Insurance	2,628	671	3,299
Miscellaneous	2,231	-0-	2,231
Depreciation	8,162	<466>	7,696
Amortization	-0-	833	833
Taxes Other Than Income	2,249	689	2,938

Total Operating Exp.	$ 56,063	$ 18,772	$ 74,835
OPERATING INCOME	$ 3,417	$ 9,469	$ 12,886
OTHER INCOME - Interest and Dividend	609	203	812
OTHER DEDUCTIONS - Int. Expense	14,680	<14,680>	-0-
NET INCOME	$ <10,654>	$ 24,352	$ 13,698

C. 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.[9]

This approach is used primarily when there is no basis for a rate-of-return determination or due to the fact that the cost of the utility plant has fully, or largely, been recovered through the receipt of contributions, either in the form of grants or donated property. The ratio generally used by the Commission in order to provide for equity growth is 88 percent. In this instance, the use of an 88 percent operating ratio applied to the adjusted test-year operating expense results in a total revenue requirement of

[9] Operating Ratio = Operating Expense/Operating Revenue

$85,040.[10] Therefore, Staff recommends that Elk Lake reduce its annual revenues by $3,493[11].

D. Rate Design

Elk Lake's present rate structure consists of a declining block schedule that includes three rate increments. In its application, Elk Lake filed a schedule of proposed rates that did not include any change in rate structure. Staff agrees that the current rate structure should not be altered. The normalized test-year revenue as stated has been determined as follows:

Revenue from Rates	$76,786
Normalized Other Operating Revenue	10,935
Non-Operating Income	812
Total Test-Year Revenue	$88,533
Staff Recommended Revenue Requirement	85,040
Recommended Reduction in Revenue	$ 3,493

The rates in Appendix A will generate the required operating revenue from rates of $73,293. The addition of $10,935 in normalized other operating revenue and $812 in non-operating income results in the total revenue requirement of $85,040.

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10 Adjusted Operating Expense/Operating Ratio $74,835/.88
=Revenue Requirement $85,040

11

Revenue Requirement	$ 85,040
Less: Normalized Operating Revenues	<87,721>
Normalized Other Inc. (Non-Operating)	<812>
Amount of Increase <Decrease> Required	$ <3,493>

E. Signatures

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APPENDIX A
TO STAFF REPORT CASE NO. 93-300

The Staff recommends the following rates be prescribed for customers of Elk Lake Water Company.

Schedule of Rates

First 2,000 Gallons	$18.90 Minimum Bill
Next 2,000 Gallons	2.10 Per 1,000 Gallons
Over 4,000 Gallons	1.55 Per 1,000 Gallons