

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF HILLVIEW SEWER )  
PLANT #1, INC. FOR AN ADJUSTMENT OF )  
RATES PURSUANT TO THE ALTERNATIVE ) CASE NO. 93-282  
RATE FILING PROCEDURE FOR SMALL )  
UTILITIES )

O R D E R

On August 11, 1993, Hillview Sewer Plant #1, Inc. ("Hillview Sewer") filed its application for Commission approval of proposed sewer rates. Commission Staff, having performed a limited financial review of Hillview Sewer'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 no more than 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, this case will be submitted to the Commission for a decision.

Done at Frankfort, Kentucky, this 12th day of January, 1994.

ATTEST:

Don Mills  
Executive Director

PUBLIC SERVICE COMMISSION

[Signature]  
For the Commission

COMMONWEALTH OF KENTUCKY  
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In the Matter of:

THE APPLICATION OF HILLVIEW )  
SEWER PLANT #1, INC. FOR A )  
RATE ADJUSTMENT PURSUANT TO ) CASE NO. 93-282  
THE ALTERNATIVE RATE FILING )  
PROCEDURE FOR SMALL UTILITIES )

STAFF REPORT

Prepared By: Mark C. Frost  
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Analyst, Chief  
Water and Sewer Revenue  
Requirements Branch  
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Public Utility Rate Analyst  
Communications, Water and  
Sewer Rate Design Branch  
Rates and Research Division

STAFF REPORT

ON

HILLVIEW SEWER PLANT #1, INC.

CASE NO. 93-282

A. Preface

On August 11, 1993, the Hillview Sewer Plant #1, Inc.<sup>1</sup> ("Hillview") filed its application seeking to increase its rates pursuant to the Alternative Rate Filing Procedure for Small Utilities. Hillview's proposed rates would produce an increase in its annual revenues of \$67,385, an increase of 90 percent over test period normalized revenues from rates of \$74,790.

On December 17, 1992, the Commission approved the transfer of the Hillview Sewage System Plant #1, treatment plant to Hillview.<sup>2</sup> Hillview's 1992 Annual Report was prepared by its previous owner, John Walser, and the supporting financial records are maintained at his office.

In Order to evaluate the requested increase, the Commission Staff ("Staff") chose to perform a limited financial review of Hillview's operations for the test period, the calendar year ending December 31, 1992. Mark Frost of the Commission's Division of Financial Analysis performed the limited review of the test period financial records at Mr. Walser's office on September 23, 1993 and reviewed the 1993 financial records and pro forma documentation at

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<sup>1</sup> The legal name is Hillview Sewage System Plant #1.

<sup>2</sup> Case No. 92-458, Hillview Sewerage System Plant #1, Inc. Application for Approval of the Transfer of the Hillview Sewage System Plant #1 Treatment Plant to Plant #1, Inc., Order issued December 17, 1992.

the office of Kelly King, Hillview's accountant, on October 4, 1993.

Mr. Frost is responsible for the preparation of this Staff Report except for Section B, Operating Revenue; Section D, Rate Design; and Appendix A, which were prepared by Brent Kirtley of the Commission's Division of Rates and Research. Based on the findings contained in this report, Staff recommends that Hillview be allowed to increase its revenues from rates by \$4,889.

#### 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

Account Classifications: Upon review of the 1992 Annual Report and general ledger, Staff concluded that several expenses had been misclassified. These classification errors coupled with the lack of communication between the previous and current owner, resulted in Hillview's pro forma income statement being inaccurate.

Ordinarily, the incorrect classification of operating expenses would not affect the overall determination of Hillview's revenue requirement. However, in this instance the correction of Hillview's actual and pro forma income statements will assist Staff in its preparation of the Staff Report. Therefore, Hillview's

actual and pro forma income statements would appear as set forth in Appendix's B and C to this Staff Report.

Operating Revenue

Hillview reported test-period revenue from rates of \$77,819. According to the application, there are 548 residential customers at \$11.25 per month and 3 commercial customers at \$22.51 per month. This information calculates to \$74,790 in revenue from rates. Accordingly, Staff decreased revenues from rates \$3,029. Therefore, for the purpose of this report, total test-period normalized operating revenue shall be considered to be \$74,790.

Operating Expenses

In its application Hillview reported actual and pro forma test period operating expenses of \$75,539 and \$116,701, respectively. The following are Staff's recommended adjustments to Hillview's actual test period operations and discussions of Hillview's proposed pro forma adjustments:

Owner/Manager Fee: Hillview paid its owner/manager a test period fee of \$9,540. Hillview's current management did not understand what the fee represented and therefore, proposed to eliminate the \$9,540 owner/manager fee from its test period operations.

Given the owner's responsibilities and duties, an owner/manager fee should be included in test period operations. The Commission has allowed sewer utilities of Hillview's size

owner/manager fees of \$2,400, which seems reasonable in this instance. Accordingly, Staff recommends the owner/manager fee be decreased by \$7,140.

Sludge Hauling: Hillview proposed a pro forma sludge hauling expense of \$6,792, an increase of \$2,215 above its test-period level. In 1993, F&W Operations began to haul 2 loads of sludge per month at a cost of \$283 per load, which is the basis for Hillview's adjustment.

Hillview's current owner, Mr. Wethington, is also the president of F&W Operations, the company that has managed and operated Hillview since its inception in February of 1987. Because Hillview and F&W Operations have common ownership, the sludge hauling fee is a less-than-arms-length transaction. Transactions that are less-than-arms-length are more closely scrutinized to insure that they do not result in unreasonable costs being passed on to the ratepayers.

To prove that the sludge hauling fee paid to F&W Operations is reasonable, Hillview provided a written estimate from James Headden Septic Tank Service. Upon comparison of the two fees, Staff determined that F&W Operations's sludge hauling fee is reasonable, and after conferring with Larry Updike and Ghasem Pour-Ghasemi of the Commission's Engineering Division, it is reasonable to expect Hillview to haul 24 loads of sludge per year on a recurring basis.

Staff recommends that Hillview's adjustment to increase sludge hauling expense by \$2,215 be accepted.

Testing: Hillview proposed a pro forma testing expense of \$2,463, an increase of \$445 above its test period level. Beckmar Environmental Laboratory increased the KPDES compliance testing fee it charged Hillview from \$145 to \$180 per month, which is the basis for Hillview's adjustment.

Staff is of the opinion that the increased fee is reasonable and an adjustment based on it would meet the rate-making criteria of known and measurable. Thus, testing expense has been increased by \$445.

Chemicals: Hillview reported test period chemical expense of \$2,223. Hillview informed Staff that the Commonwealth of Kentucky required it to install a dechlorination process at the treatment plant.

Hillview produced a written estimate from Technical Products to show that the dechlorination unit will cost \$250 and the dechlorination chemical, reducite, will cost \$2.40 per gallon. Hillview estimated that it will use approximately 715 gallons of reducite per year, which would result in an annual cost of \$1,716.

Upon consulting with Messrs. Updike and Pour-Ghasemi, it was concluded that the dechlorination unit is required and that Hillview's estimated annual cost is reasonable. Furthermore, the

dechlorinator should be depreciated over a 7 year period, which results in a depreciation expense of \$36.<sup>3</sup>

Staff recommends that chemical expense be increased by \$1,716 and depreciation expense increased by \$36.

Maintenance Supplies: Hillview proposed a pro forma maintenance supplies expense of \$3,764, an increase of \$1,500 above its test period level. During the test period, Hillview expensed the purchase of manhole rings at a cost of \$1,320. Hillview's adjustment reflects the cost to install additional manhole rings.

The purchase of a manhole ring is a capital expenditure that will benefit more than one period and therefore, should be depreciated rather than expensed. After consulting with Mr. Pour-Ghasemi, it was concluded that manhole rings should be depreciated over 10 years, which would result in a depreciation expense of \$282.<sup>4</sup>

Staff recommends that maintenance supplies expense be decreased by \$1,320 and depreciation expense increased by \$282.

Routine Maintenance Fee: Hillview proposed a pro forma routine maintenance fee of \$14,109, an increase of \$4,109 above its

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<sup>3</sup> \$250 Dechlorinator + 7-Years = \$36.

<sup>4</sup>

Test Period Manhole Rings	\$ 1,320
Pro Forma Manhole Rings	+ 1,500
Cost of Manhole Rings	\$ 2,820
Depreciation Life	+ 10-Years
Depreciation Expense	<u>\$ 282</u>



test period level. The routine maintenance fee paid to F&W Operations increased on January 12, 1993, from \$833 to \$1,176<sup>5</sup> per month, an increase of 41.2 percent.

Hillview and F&W Operations have common ownership and therefore, the routine maintenance contract is a less-than-arms-length transaction. To prove that the increased routine maintenance fee paid to F&W Operations is reasonable, Hillview provided written estimates from Andriot-Davidson and the River City Sewer Service.

Staff compared the written estimates with the F&W Operations contract and concluded that the pro forma routine maintenance fee is reasonable. Accordingly, routine maintenance fee expense has been increased by \$4,112.

Mowing: Hillview proposed a pro forma level of mowing expense of \$3,390, an increase of \$3,000 above its test period level. In 1993, Hillview paid F&W Operations a mowing fee of \$250 per month, which is the basis for its adjustment.

Upon consulting with Mr. Updike, it was concluded that based on the treatment plant lot size, a mowing fee of \$250 per month is reasonable. Furthermore, Staff determined that the lot should only be mowed 8 months per year instead of 12 months as proposed by Hillview.

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<sup>5</sup> \$14,109 Annual Fee + 12-Months = \$1,175.75.

Therefore, Staff recommends that mowing expense be increased by \$1,610<sup>6</sup>.

Uncollectible Accounts: Hillview proposed to eliminate the uncollectible account expense of \$531 from its test-period operations. Because the current owner does not expect to have delinquent customer accounts, this expense will not occur in the future. Therefore, Staff recommends that Hillview's adjustment be accepted.

Telephone and Pager: In the test period Hillview did not incur a telephone or pager expense. However, Hillview now has a telephone and pager, and is billed \$83<sup>7</sup> per month for those services.

Staff is of the opinion that the telephone and pager are ongoing expenditures that should be reflected in Hillview's operations and that the amounts billed in 1993 are reasonable. Therefore, telephone and pager expense of \$996<sup>8</sup> has been included in test period operations.

Transportation: Hillview reported test period transportation expense of \$869. In 1992 Hillview sold its trucks. Since Hillview does not own a vehicle, transportation expense will not be

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<sup>6</sup> \$250 x 8 Months = \$2,000 - \$390 = \$1,610.

<sup>7</sup> \$38 Telephone + \$45 Pager = \$83.

<sup>8</sup> \$83 x 12 Months = 996.

incurred. Therefore, Staff recommends that test period operations be reduced by \$869 to eliminate this expense.

Rent: Hillview proposed to eliminate office rent expense of \$750 from its test-period operations since the current owner does not allocate office rent to Hillview. Staff recommends that this adjustment be accepted.

Depreciation: Hillview proposed a pro forma level of depreciation expense of \$15,912, an increase of \$7,747 over the amount it reported. To document its pro forma depreciation expense, Hillview attached a copy of its 1993 depreciation schedule to the application.

As previously mentioned, Hillview was transferred to its current owner at the end of 1992. The Commission directed Hillview to file the journal entries to reflect the transfer and required the entries to be in accordance with the prescribed Uniform System of Accounts ("USoA") for sewer utilities.

The USoA for Class C and D sewer utilities required Hillview to use the following guidelines when it recorded its journal entries: (1) the original cost of plant, estimated if not known, is to be debited to the appropriate utility plant in service accounts; (2) the applicable accumulated depreciation and amortization is to be credited to the appropriate accumulated depreciation or amortization account; (3) the applicable contribution in aid of construction ("CIAC") is to be credited to

account 271, CIAC; and (4) any amount remaining is to be closed to account 108, Utility Plant Acquisition Adjustments.<sup>9</sup>

Given the above USOA requirements, Staff is of the opinion that Hillview erred in recording its general journal entries and therefore, its pro forma depreciation expense is incorrect. Based on the 1992 Annual Report and the information in Case No. 90-198, Hillview's general journal entry would be as follows:

Utility Plant In Service	\$ 445,915	
Utility Plant Acquisition Adjustment	\$ 154,165	
Accumulated Depreciation		\$ 409,576
Cash		\$ 145,000
CIAC		\$ 45,504

CIAC are cost free capital to the utility. If depreciation expense on property funded by CIAC is included for rate-making purposes it would result in a double recovery of the plant investment from the contributors, Hillview's ratepayers. Therefore, Staff recommends that depreciation on plant funded by CIAC be disallowed.

Based on the accumulated depreciation and CIAC reported in its 1992 Annual Report, Hillview's utility plant has been fully depreciated for rate-making purposes. Therefore, Staff recommends that Hillview's adjustment be denied and test period operations be reduced by \$8,165 to eliminate depreciation expense on Hillview's treatment plant.

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<sup>9</sup> USOA for Class C and D Sewer Utilities, pages 19 and 20.

Rate Case Cost: At the field review, Hillview provided an invoice from its accountant showing that it cost \$1,911 to file this rate case. Staff reviewed the accountant's invoice and is of the opinion that it is reasonable. Since utilities normally do not request a rate increase every year, Commission practice has been to amortize rate case cost over a 3-year period. That would result in an amortization expense of \$637. Staff recommends that test period operations be increased by that amount.

Upon review of the invoices, Staff determined that Hillview paid its accountant \$2,925 to file its transfer case. The cost to file a transfer case is a nonrecurring expenditure that should be amortized over a 3-year period. This produces an amortization expense of \$975. Staff recommends that test period operations be increased by that amount.

Interest: Hillview proposed a pro forma interest expense of \$9,560, an increase of \$7,569 above its test period level. On February 12, 1993, Hillview's current owner purchased Hillview Sewage System Plant #1 with a \$150,000 commercial note from the Liberty National Bank and Trust Company of Louisville ("Liberty"). The note has a 1 year term, and an interest rate of 7.75 percent per annum.

Hillview is not a party to the Liberty loan agreement. Only Mr Wethington and F&W Operations are borrowers. The loan is not a liability of Hillview but it is an obligation of Mr. Wethington and

F&W Operations. Staff is of the opinion and recommends that interest associated with the Liberty loan be borne by Hillview's owner and not its ratepayers. Therefore, Hillview's proposed adjustment should be denied.

At the end of the test period, Hillview reported a balance of \$22,488 in its notes payable to associated companies. Subsequent to the filing of its application, Hillview proposed to increase its pro forma interest expense by \$1,799 based on the notes payable to associated companies and an interest rate of 8 percent per annum.

According to John Hess, Hillview's C.P.A. in 1992, the proceeds of the note payable were used for operating purposes in and prior to 1992. Staff is of the opinion that allowing the interest on debt incurred to pay Hillview's past operating expenses would constitute retroactive rate-making by requiring the current customers to pay for providing service to past customers. Thus, Staff recommends that test period operations be reduced by \$1,991 and Hillview's adjustment be denied.

Insurance: Hillview proposed a pro forma insurance expense of \$33,356, an increase of \$32,967. This adjustment represents the estimated premiums for Hillview's general liability and Mr. Wethington's life insurance.

To obtain the Liberty loan Mr. Wethington was required to acquire a \$100,000 life insurance policy and designate Liberty as beneficiary. Staff is of the opinion that Hillview's ratepayers do

not benefit from payment of the owner's life insurance premiums. As Hillview is not a signatory to the loan agreement, is not a guarantor of that loan, and did not receive any of the loan proceeds, the life insurance premium is not an expense properly charged to Hillview.

Upon review of the 1993 insurance premiums, Staff determined that Hillview's general liability insurance cost \$718 on an annual basis. Therefore, Staff recommends that insurance expense be increased by \$329.

#### Operations Summary

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

#### C. Revenue Requirements Determination

The approach frequently used by this Commission to determine revenue requirements for small, privately-owned utilities is the operating ratio. This approach is used primarily when a basis for rate-of-return determination does not exist or the utility plant investment has been depreciated or recovered through the receipt of contributions. Staff recommends the use of this approach in determining Hillview's revenue requirement.

Staff's adjusted operations provide Hillview with an operating ratio of 93.75 percent.<sup>10</sup> Combined with Hillview's requested increase of \$67,385 the result is an operating ratio of 49.32 percent.<sup>11</sup>

Hillview requested an operating ratio of 88 percent. Staff is of the opinion that this operating ratio would allow Hillview sufficient revenue to cover its operating expenses, and to provide for reasonable equity growth. An operating ratio of 88 percent results in a revenue requirement of \$79,680.<sup>12</sup> Therefore, Staff recommends that Hillview be allowed to increase its annual operating revenues by \$4,890.<sup>13</sup>

#### D. Rate Design

In its application, Hillview filed a schedule of present and proposed rates that did not include any changes in rate design. Staff agrees that the current rate structure should not be altered. The recommended rates will generate \$79,680, satisfying the

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<sup>10</sup>  $\$70,118 + \$74,790 = 93.75\%$ .

<sup>11</sup>  $\$70,118 + (\$74,790 + \$67,385) = 49.32\%$ .

<sup>12</sup>

Adjusted Operating Expenses	\$ 70,118
Operating Ratio	+ 88%
Required Operating Revenue	<u>\$ 79,680</u>


<sup>13</sup>

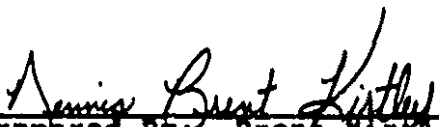
Recommended Operating Revenue	\$ 79,680
Normalized Operating Revenue	- 74,790
Recommended Revenue Increase	<u>\$ 4,890</u>



operating revenue from rates requirement. Therefore, Staff recommends the rates in Appendix A be approved for sewer service.

E. Signatures

  
Prepared By: Mark C. Frost  
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Analyst, Chief  
Water and Sewer Revenue  
Requirements Branch  
Financial Analysis Division

  
Prepared By: Brent Kirkley  
Public Utility Rate Analyst  
Communications, Water and  
Sewer Rate Design Branch  
Rates and Research Division

APPENDIX A  
TO STAFF REPORT CASE NO. 93-282

The Staff recommends the following rates be prescribed for customers of Hillview Sewer Plant #1, Inc.

Single Family	\$ 12.00 per month
Multi-Family	\$ 9.00 per month
Commercial	\$ 24.00 per month

APPENDIX B  
TO STAFF REPORT CASE NO. 93-282  
CORRECTION OF HILLVIEW'S ACTUAL OPERATIONS

	<u>1992 Annual Report</u>	<u>Expense Corrections</u>	<u>Corrected Actual</u>
Operating Revenue:			
Residential Flat Rate	\$ 77,819	\$ -0-	\$ 77,819
Operating Expenses:			
Owner/Manager Fee	\$ -0-	\$ 9,540 *	\$ 9,540
Labor & Exp - Treatment Sys:			
Sludge Hauling	4,577	-0-	4,577
Utility Expense - Water	7,101	-0-	7,101
Other - Testing & Garbage	11,715	< 9,697 >**	2,018
Electric	14,845	-0-	14,845
Chemicals	2,223	-0-	2,223
Misc. Supplies & Exp:			
Treatment & Disposal	2,264	-0-	2,264
Routine Maintenance	-0-	10,000	10,000
Maint. Treatment & Disposal	5,270	< 693 >**	4,577
Maint. Other - Mowing	-0-	390 **	390
Agency Collection Fee	3,281	-0-	3,281
Uncollectible Accounts	531	-0-	531
Admin. & General Salaries	9,540	< 8,340 >*	1,200
Office Supplies & Other Exp	104	-0-	104
Outside Services - Accounting & Legal	3,076	< 1,200 >*	1,876
Insurance	389	-0-	389
Transportation	869	-0-	869
Rents	750	-0-	750
Depreciation Expense	8,165	-0-	8,165
Amortization Expense	-0-	-0-	-0-
Taxes Other Than Income	840	-0-	840
Total Operating Expenses	\$ 75,540	\$ -0-	\$ 75,540
Net Operating Income	\$ 2,279	\$ -0-	\$ 2,279
Other Deductions:			
Interest Expense	1,991	-0-	1,991
Net Income	\$ 288	\$ -0-	\$ 288

\* Reclassification of the owner/manager fee of \$9,540 and the bookkeeper/secretary fee of \$1,200.

\*\* Reclassification of the routine maintenance fee of \$10,000, the mowing fee of \$390, and the garbage expense of \$303.

APPENDIX C  
 TO STAFF REPORT CASE NO. 93-282  
 CORRECTION OF HILLVIEW'S PRO FORMA OPERATIONS

	<u>Actual Operations</u>	<u>Pro Forma Adjustments</u>	<u>Pro Forma Operations</u>
Operating Revenue:			
Residential Flat Rate	\$ 77,819	\$< 3,029 >	\$ 74,790
Operating Expenses:			
Owner/Manager Fee	\$ 9,540	\$< 9,540 >	\$ -0-
Labor & Exp - Treatment Sys:			
Sludge Hauling	4,577	2,215	6,792
Utility Expense - Water	7,101	-0-	7,101
Other - Testing & Garbage	2,018	445	2,463
Electric	14,845	-0-	14,845
Chemicals	2,223	-0-	2,223
Misc. Supplies & Exp:			
Treatment & Disposal	2,264	1,500	3,764
Routine Maintenance	10,000	4,109	14,109
Maint. Treatment & Disposal	4,577	-0-	4,577
Maint. Other - Mowing	390	3,000	3,390
Agency Collection Fee	3,281	-0-	3,281
Uncollectible Accounts	531	< 531 >	-0-
Admin. & General Salaries	1,200	-0-	1,200
Office Supplies & Other Exp	104	-0-	104
Outside Services - Accounting & Legal	1,876	-0-	1,876
Insurance	389	32,967	33,356
Transportation	869	-0-	869
Rents	750	< 750 >	-0-
Depreciation Expense	8,165	7,747	15,912
Amortization Expense	-0-	-0-	-0-
Taxes Other Than Income	840	-0-	840
Total Operating Expenses	<u>\$ 75,540</u>	<u>\$ 41,162</u>	<u>\$ 116,702</u>
Net Operating Income	\$ 2,279	\$< 44,191 >	\$< 41,912 >
Other Deductions:			
Interest Expense	<u>1,991</u>	<u>7,569</u>	<u>9,560</u>
Net Income	<u>\$ 288</u>	<u>\$&lt; 51,760 &gt;</u>	<u>\$&lt; 51,472 &gt;</u>

APPENDIX D  
TO STAFF REPORT CASE NO. 93-282

	<u>Actual Operations</u>	<u>Pro Forma Adjustments</u>	<u>Pro Forma Operations</u>
Operating Revenue:			
Residential Flat Rate	\$ 77,819	\$< 3,029 >	\$ 74,790
Operating Expenses:			
Owner/Manager Fee	\$ 9,540	\$< 7,140 >	\$ 2,400
Labor & Exp - Treatment Sys:			
Sludge Hauling	4,577	2,215	6,792
Utility Expense - Water	7,101	-0-	7,101
Other - Testing & Garbage	2,018	445	2,463
Electric	14,845	-0-	14,845
Chemicals	2,223	1,716	3,939
Misc. Supplies & Exp:			
Treatment & Disposal	2,264	< 1,320 >	944
Routine Maintenance	10,000	4,112	14,112
Maint. Treatment & Disposal	4,577	-0-	4,577
Maint. Other - Mowing	390	1,610	2,000
Agency Collection Fee	3,281	-0-	3,281
Uncollectible Accounts	531	< 531 >	-0-
Admin. & General Salaries	1,200	-0-	1,200
Office Supplies & Other Exp	104	996	1,100
Outside Services - Accounting & Legal	1,876	-0-	1,876
Insurance	389	329	718
Transportation	869	< 869 >	-0-
Rents	750	< 750 >	-0-
Depreciation Expense	8,165	< 7,847 >	318
Amortization Expense	-0-	1,612	1,612
Taxes Other Than Income	840	-0-	840
Total Operating Expenses	\$ 75,540	\$< 5,422 >	\$ 70,118
Net Operating Income	\$ 2,279	\$ 2,393	\$ 4,672
Other Deductions:			
Interest Expense	1,991	< 1,991 >	-0-
Net Income	\$ 288	\$ 4,384	\$ 4,672