COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF THE MALLARD POINT DISPOSAL SYSTEM, INC. FOR AN ADJUSTMENT OF RATES PURSUANT TO THE ALTERNATIVE RATE FILING PROCEDURE FOR SMALL UTILITIES	)	CASE NO. 94-266

O R D E R

On July 13, 1994, Mallard Point Disposal System, Inc. ("Mallard Point") filed its application for Commission approval of proposed sewer rates. Commission Staff, having performed a limited financial review of Mallard Point'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 16th day of November, 1994.

ATTEST:

Don Mills

Executive Director

PUBLIC SERVICE COMMISSION

For the Commission

COMMONWEALTH OF KENTUCKY

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STAFF REPORT

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STAFF REPORT

ON

MALLARD POINT DISPOSAL SYSTEM, INC.

CASE NO. 94-266

A. Preface

On July 13, 1994, the Mallard Point Disposal System, Inc. ("Mallard Point") filed its application seeking to increase its rates pursuant to the Alternative Rate Filing Procedure for Small Utilities. Mallard Point's proposed rates would produce an increase in its annual revenues of $61,599, an increase of 109.68 percent over test-period normalized revenues from rates of $56,160.

In Order to evaluate the requested increase, the Commission Staff ("Staff") performed a limited financial review of Mallard Point's operations for the test-period, the calendar year ending December 31, 1993. Mark Frost of the Commission's Division of Financial Analysis performed the limited review on August 23, 1994 and September 2, 1994.

Mr. Frost is responsible for the preparation of this Staff Report except for Section B, Normalized Revenue; Section D, Rate Design; and Appendix A, which were prepared by John Geoghegan of the Commission's Division of Rates and Research. Based on the findings contained in this report, Staff recommends that Mallard Point be allowed to increase its revenues from rates by $19,733.

Scope

The scope of the review was limited to obtaining information to determine 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.

Commentary

In conducting its limited field review, Staff analyzes test period invoices and canceled checks in determining a utility's appropriate level of operating expenses. However, Mallard Point did not retain its test period invoices and Mallard Point's canceled checks were not available for review. To arrive at its recommended level of operating expenses, Staff relied upon the accountant's workpapers, the copies of invoices provided by T.M. Regan, and the expense schedule provided by Kentucky Utilities Company ("KU").

B. Analysis of Operating Revenues and Expenses

Normalized Revenue

In its 1993 Annual Report, Mallard Point reported revenue from sewer service of $54,269. Mallard Point's application indicates that it has 211 customers. This number of customers would generate $56,160 in revenue annually at its current rate of $22.18, a difference of $1,891.

Operating Expenses

In its application Mallard Point reported actual and pro forma test period operating expenses of $45,001 and $106,560, respectively. The following are Staff's recommended adjustments to

Mallard Point's test period operations and discussions of Mallard Point's pro forma adjustments:

Owner/Manager Fee: Mallard Point proposed a pro forma owner/manager fee of $15,000. Mallard Point claims that its owner, Mark Smith, has not been paid for the services he has rendered. The amount of time Mr. Smith worked at the plant is the basis for this adjustment.

Although the fee is based on the hours Mr. Smith worked at the treatment plant, Mallard Point was unable to document the time or the services Mr. Smith performed. Because the routine maintenance is performed by a part-time employee and Mallard Point has a licensed plant operator, Mr. Smith's actual duties at the plant are minimal. An owner/manager fee of $15,000 is unwarranted and therefore, Staff recommends that this adjustment be denied.

An owner/manager has certain managerial responsibilities and duties and therefore, is entitled to be compensated. The Commission has allowed sewer utilities of Mallard Point's size owner/manager fees of $2,400, which seems reasonable in this instance. Accordingly, Staff recommends test period operations be increased by $2,400 to reflect inclusion of an owner/manager fee.

Testing Fee: Mallard Point proposed a pro forma testing fee expense of $1,500. The T.M. Regan invoices revealed that the actual testing expense is $1,857,[1] a difference of $357 from the amount Mallard Point proposed. Staff is of the opinion that a testing fee of $1,857 is reasonable and therefore, has increased test period operations by that amount.

Fuel & Power: Mallard Point proposed a pro forma fuel & power expense of $11,430. Mallard Point has requested a Certificate of Convenience and Necessity ("Certificate") to increase its treatment plant capacity.[2] This adjustment reflects the estimated electric cost that will result from the installation of a new pump at the expanded plant.

Mallard Point provided an estimate from the KU showing that the new pump will use 15,570 KWH per month if operated 20 hours per day, which would result in an annual cost of $5,880.[3] Although historical data does not exist to document the number of hours the pump will operate, Ghasem Pour-Ghasemi of the Commission's Engineering Division agreed with KU's estimate. Therefore, test period operations have been increased by $5,880.

1

WWTP Analysis	$ 609
Lab Fees $ 104 Monthly Fee x 12 Months =	1,248
Annual Testing Expense	$ 1,857

2 Case No. 94-267, The Petition of Mallard Point Disposal System, Inc. for Approval of a Certificate of Convenience and Necessity to Construct Sanitary Sewer Facilities and for Approval of Financing.

3 $490 Monthly LP Rate x 12 Months = $5,880.

KU provided Mallard Point with an analysis of its account activity for the period of September 1992 through March 1993. Upon review of the KU analysis, Staff determined that the annualized test period electric expense was $4,431 and therefore, electric expense has been increased by that amount.

Chemicals: Mallard Point proposed a pro forma chemical expense of $1,000. This adjustment reflects the estimated outside labor cost that will result from the proposed plant expansion.

The rate-making criteria of "known and measurable" is used to evaluate pro forma adjustments. An adjustment based on documented increased cost or usage would normally constitute a known and measurable adjustment. However, Mallard Point was unable to document its proposed chemical expense and, therefore Staff recommends Mallard Point's adjustment be denied.

Although Mallard Point listed no chemical expense in its 1993 Annual Report, Staff determined that in the test period Mallard Point incurred a chemical expense of $430. Therefore, a pro forma adjustment of $430 has been included.

Routine Maintenance Fee/Outside Services: Mallard Point did not incur a routine maintenance fee in the test period, but did propose a pro forma outside service expense of $500. This adjustment reflects the estimated outside service expense that will result from the proposed plant expansion. Mallard Point was unable to document its proposed adjustment and, therefore Staff recommends that it be denied.

To comply with a Natural Resources and Environmental Protection Cabinet requirement, Mallard Point hired a certified plant operator at a fee of $100 per month or $1,200 annually. Staff is of the opinion that the fee is reasonable and an adjustment to reflect the routine maintenance fee would meet the rate-making criteria of known and measurable. Accordingly, a pro forma adjustment of $1,200 has been made.

The invoices provided by T.M. Regan showed that in the test period Mallard Point was billed an operation and maintenance fee of $2,540. Because Mallard Point has a licensed plant operator and a part-time maintenance employee, the operation and maintenance service provided by T.M. Regan is unnecessary and would result in a duplication of services. Therefore, this fee has not been reflected in test period operations.

Internal Supervision: Mallard Point proposed a pro forma internal supervision expense of $9,780. Mallard Point's part-time employee spends approximately 1.5 to 2 hours performing the daily maintenance. When the plant is expanded, Mallard Point estimates that the part-time employee will spend to 3.5 hours to perform the same tasks, which is the basis for this adjustment.

Because the part-time employee is working for Mallard Point, an adjustment to reflect the increased hours would meet the known and measurable criteria. After consulting with Larry Updike of the Commission's Engineering Division, Staff determined that Mallard Point's estimated hours are reasonable. Therefore, Staff recommends inclusion of the pro forma adjustment of $9,880.[4]

<u>Maintenance of Treatment and Disposal Plant</u>: Mallard Point reported test period maintenance of treatment and disposal plant expense of $14,560. Mallard Point used the cash rather than accrual basis when it recorded payments to its T.M. Regan account payable of $3,271 to maintenance of treatment and disposal plant expense.

The Commission requires that accrual accounting be used by the utilities operating under its jurisdiction. This dictates that revenues and expenses be recorded in the period they occur unlike cash accounting which requires the revenues and expenses to be recorded in the period they are paid or received. Therefore, maintenance of treatment and disposal plant expense has been decreased by $3,271.

Staff reviewed the accountant's workpapers, and determined that a pump station repair of $9,260 is a nonrecurring expenditure that should be amortized rather than expensed. After consulting with Mr. Pour-Ghasemi, Staff determined that the pump station repair should be amortized over a 7 year period. Therefore,

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[4] $10.75 x 3.5 Hours = $38 x 260 Days = $9,880.

maintenance of treatment and disposal plant expense has been decreased by $9,260 and depreciation expense increased by $1,323.[5]

<u>Administrative & General Salaries</u>: Mallard Point did not report an administrative & general salary expense in the test period. Mallard Point has hired a bookkeeper/secretary at a monthly fee of $300 or $3,600 annually. Because the billing and collection is performed by Mallard Point's bookkeeper/secretary, Staff is of the opinion that a $300 monthly fee is reasonable. Accordingly, test period operations have been increased by $3,600.

<u>Office Supplies</u>: Mallard Point reported test period office supply expense of $3,199. The accountant's workpaper showed that this account included a $628 payment to KU which was misclassified.

Ordinarily, the incorrect classification of operating expenses would not affect the overall determination of Mallard Point's revenue requirement. However, Staff included the proper amount of pro forma electric expense in its analysis of the fuel and power account. Therefore, office supplies expense has been decreased by $628.

Mallard Point's test period postage expense was $375. The current postage rate of $0.29 combined with the number of customers

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[5] $9,260 ÷ 7 Years = $1,323.

used to calculate normalized operating revenue results in a collection expense of $734.[6]

An adjustment based on the actual postage rate at the current customer level would meet the rate-making criteria of known and measurable. Therefore, office supplies expense has been increased by $359.

During the test period Mallard Point reported a cellular phone payment of $125. Given Mallard Point's number of employees and size, a cellular phone is not warranted. Therefore, office supplies expense has been decreased by $125.

Accounting: Mallard Point proposed a pro forma level of accounting expense of $1,250. This adjustment reflects Mallard Point's estimate of the fee its accountant will charge to prepare the tax returns and Annual Report.

In 1993 Mallard Point paid its accountant $800 to prepare the 1993 returns and Annual Report. An adjustment based on the actual 1993 fee would meet the criteria of known and measurable, and it should be reflected in test period operations. Therefore, a pro forma adjustment of $800 has been included.

Insurance: Mallard Point proposed a pro forma level of insurance expense of $739, an increase of $51 above the test period

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[6] 211 Customers x 12 Months = 2,532 Bills x $0.29 = $734.

level. The insurance premium will increase due to the proposed treatment plant expansion, which is the basis for the adjustment.

Mallard Point's proposed adjustment meets the rate-making criteria of known and measurable, and Staff is of the opinion that the new premium appears reasonable. Therefore, insurance expense has been increased by $51.

Office Rent: Mallard Point did not report an office rent expense in the test period. At the end of 1993, Mallard Point moved into its office and began to pay a monthly rental fee of $325 or $3,900 annually.

An adjustment to reflect Mallard Point's office rent would meet the rate-making criteria of known and measurable, and the monthly rental fee appears reasonable. Accordingly, test period operations have been increased by $3,900.

Depreciation: Mallard Point proposed to increase its test period depreciation expense of $11,500 to $21,650, an adjustment of $10,150. This adjustment reflects depreciating Mallard Point's proposed plant expansion.

The depreciation schedule shows that Mallard Point uses an accelerated depreciation method and a composite depreciation life of 10 years. For Commission reporting purposes utilities are required to use straight line depreciation. After consulting with Mr. Pour-Ghasemi, Staff determined that a 20 year composite life is a more accurate representation of Mallard Point's plant investment.

Using straight line depreciation and a 20 year composite life, Staff has determined that Mallard Point's test period depreciation expense should be decreased by $5,111, to an adjusted level of $6,389.[7]

An adjustment for the proposed plant expansion would meet the rate-making criteria of known and measurable, and it should be reflected in pro forma operations. The bids provided by Mallard Point show that when completed the plant expansion will cost $191,028. This combined with a composite depreciation life of 20 years results in an increase to depreciation expense of $9,551.

Amortization: Mallard Point proposed to increase its test period operations by $4,333, to reflect amortizing its legal fees of $5,000 and engineering fees of $8,000 over a 3 year period.

Mallard Point's engineering fees represent the cost to design the proposed plant expansion. Design costs are considered construction overhead that should be depreciated over the associated plant life rather than amortized. Therefore, this fee is included in the calculation of depreciation expense and has been eliminated from the proposed amortization expense.

Mallard Point's legal fees represent the cost to file this rate case and the construction case. Based on its review of the attorney's estimate, Staff is of the opinion that the fee is

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[7] $127,775 Plant Investment ÷ 20 Years = $6,389.

reasonable. Accordingly, test period operations have been increased by $1,667.[8]

The invoices provided by T.M. Regan showed that in the test period Mallard Point paid a consulting fee of $1,985. The consulting fees are associated with the pump station repair and should therefore be amortized over the same 7 year period. Amortization expense has been increased by $284[9] to reflect the amortization of the consulting fees.

Other Deductions

Interest Expense: Mallard Point proposed a pro forma level of interest expense of $15,934, an increase of $1,500 above its test period level of $14,434. Mallard Point has requested Commission approval of its proposed plan to finance its plant expansion, which is the basis for this adjustment.

Attached to the application is a copy of a December 31, 1993 First National Bank & Trust ("First National") note in the amount of $200,000. The First National note has a 1 year term and an annual interest rate of 8 percent.

According to KRS 278.300(1), "[n]o utility shall issue any securities or evidences of indebtedness, or assume any obligation or liability in respect to the securities or evidences

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[8] $5,000 Legal Fee ÷ 3 Years = $1,667.

[9] $1,985 ÷ 7 Years = $284.

of indebtedness of any other person until it has been authorized so to do by order of the commission." Mallard Point has delayed its plant expansion pending Commission approval of this construction in Case No. 94-267. However, the proposed package treatment plant was purchased in a lease/purchase agreement with American Equipment Leasing in 1989.

Because the lease/purchase agreement was executed without Commission approval, it appears to be in violation of KRS 278.300(1). Furthermore, the application is unclear as to what costs Mallard Point is requesting to finance by means of the $200,000 First National note. For these reasons, Staff is of the opinion that the only interest expense Mallard Point should be allowed to recover through rates is associated with the construction costs that have yet to be incurred, the installation costs of $80,000.[10]

In Case No. 9517,[11] the Commission found that, "when utilities acquire assets through borrowing or some other type of financing

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[10]

Installation Cost	$ 72,000
Engineering Fee	+ 8,000
Total Installation Cost	$ 80,000

[11] Case No. 9517, The Application of Mallard Point Disposal Systems, Inc., for an Order Pursuant to Chapter 278 of the Kentucky Revised Statutes for a Certificate of Public Convenience and Necessity and for an Order Approving Uniform Rates for a Waste Water Treatment System to Serve the Residents of Mallard Point Subdivision, Scott County, Kentucky, Order issued September 22, 1986.

arrangement the repayment period is often 20 to 40 years with some attempt to match the repayment period with the useful, revenue-generating lives of the assets." To recognize the matching concept and to allow Mallard Point a degree of protection if the depreciation lives were underestimated, the Commission amortized the interest in Case No. 9517 over a 10 year period.

Staff is of the opinion that the matching concept should be applied in this instance and that a 10 year term is appropriate. Financing $80,000 over a 10 year loan term at an annual interest rate of 8 percent, results in an interest expense of $6,235. Therefore, test period interest expense has been decreased by $8,199.

Upon review of the Order in Case No. 9517, Staff noted that Mallard Point was allowed to recover interest expense of $1,720 which reflected amortizing Mallard Point's interest over a 10 year period. Mallard Point failed to include this interest expense in its test period operations.

Given that approximately 2 years of interest expense remain, Staff is of the opinion that it should be reflected in test period operations. Accordingly, interest expense has been increased by $1,720.

Operations Summary

Based on the recommendations of Staff contained in this report, Mallard Point'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 small, privately-owned utilities is the operating ratio. This approach is used primarily when there is no basis for rate-of-return determination or the cost of the utility has fully or largely been recovered through the receipt of contributions. Staff recommends the use of this approach in determining Mallard Point's revenue requirement.

Mallard Point requested an operating ratio of 88 percent. Staff is of the opinion that this operating ratio would allow Mallard Point sufficient revenues to cover its operating expenses, and to provide for reasonable equity growth. Staff's adjusted operations provide Mallard Point with an operating ratio of 106.45 percent.[12]

An operating ratio of 88 percent results in a revenue requirement of $75,893.[13] Therefore, Staff recommends that Mallard

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12 $59,785 ÷ $56,160 = 106.45%.

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Adjusted Operating Expenses	$ 59,785
Operating Ratio	÷ 88%
Subtotal	$ 67,938
Add: Interest Expense	+ 7,955
Required Operating Revenue	$ 75,893

Point be allowed to increase its annual operating revenues by $19,733.[14]

In the event a certificate is not granted to expand Mallard Point's treatment plant, the recommendations contained herein related to financing and for this construction project would change accordingly. Assuming the construction is approved, Staff recommends that the proposed debt as amended herein be included in revenue requirements.

D. Rate Design

All of Mallard Point's customers are residential; therefore, they can be assumed to impose an approximately equal burden on the system. The application of a flat monthly rate for all customers is, therefore, appropriate. The rate recommended by Staff and set out in Appendix A will generate $75,893 annually, an adequate amount to cover Mallard Point's annual expenses.

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[14]

Required Operating Revenue	$ 75,893
Normalized Operating Revenue	- 56,160
Required Revenue Increase	$ 19,733

E. Signatures

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APPENDIX A

The following rate is recommended for customers of Mallard Point Disposal System:

Flat Monthly Rate	$30.00

APPENDIX B

TO THE STAFF REPORT IN CASE NO. 94-266

	1993 Annual Report	Pro Forma Adjustments	Pro Forma Operations
Operating Revenue:			
Flat Rate - Residential	$ 54,269	$ 1,891	$ 56,160
Operating Expenses:			
Operation & Maintenance:			
Owner/Manager Fee	$ -0-	$ 2,400	$ 2,400
Testing Fee	-0-	1,857	1,857
Fuel & Power	-0-	10,311	10,311
Chemicals	-0-	430	430
Routine Maint. Fee	-0-	1,200	1,200
Internal Supervision	-0-	9,880	9,880
Maintenance	14,560	<12,531>	2,029
Admin. & Gen. Salaries	-0-	3,600	3,600
Office Supplies	3,199	< 394>	2,805
Accounting	-0-	800	800
Insurance	688	51	739
Miscellaneous	160	-0-	160
Rent	-0-	3,900	3,900
Total Operation & Maint	$ 18,607	$ 21,504	$ 40,111
Depreciation	11,500	4,440	15,940
Amortization	-0-	3,274	3,274
Taxes Other Than Income Tax	460	-0-	460
Total Operating Expenses	$ 30,567	$ 29,218	$ 59,785
Net Operating Income	$ 23,702	$ <27,327>	$ < 3,625>
Interest Expense	14,434	< 6,479>	7,955
Net Income	$ 9,268	$ <20,848>	$ <11,580>