COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF VALLEY GAS, INC. FOR AN ADJUSTMENT OF RATES PURSUANT TO THE ALTERNATIVE RATE FILING PROCEDURE FOR SMALL UTILITIES	))))	CASE NO. 95-231

O R D E R

On May 12, 1995, Valley Gas, Inc. ("Valley") filed its application for Commission approval of proposed gas rates. Commission Staff, having performed a limited financial review of Valley'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 6th day of October, 1995.

ATTEST:

Executive Director

PUBLIC SERVICE COMMISSION

For the Commission

COMMONWEALTH OF KENTUCKY

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STAFF REPORT

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STAFF REPORT

ON

VALLEY GAS, INC.

Case No. 95-231

A. Preface

On May 12, 1995, Valley Gas, Inc. ("Valley") filed an application for a rate adjustment pursuant to 807 KAR 5:076, the Alternative Rate Filing Procedure for Small Utilities ("ARF"). The rates proposed by Valley would generate $63,374 in additional annual revenues or approximately 17 percent based on normalized test-year sales. In order to meet the minimum filing requirements for an ARF, a utility must have less than 400 customers and less than $200,000 in gross annual revenues. Valley did not meet the minimum requirements for an ARF filing due to its number of customers, 500, and its level of revenues, $277,000. Valley, therefore, requested a waiver of the requirements. The Commission granted Valley a deviation from the ARF procedure by Order dated May 25, 1995.

The Commission Staff performed a limited financial review of Valley's operations for the test year ending December 31, 1994. The Commission's objective was to reduce or eliminate the need for written data requests, decrease the time necessary to examine the application and, therefore, decrease the expense to the utility. Tammy Page and Rebecca McDowell of the Commission's Division of Financial Analysis performed the staff review on June 12, 1995 at the offices of Valley, in Irvington, Kentucky. With the exception of the sections dealing with Normalized Revenues, Purchased Gas Expense, and Retail Rates, which were prepared by Leah Faulkner of the Division of Rates and Research, this report was prepared by Ms. Page.

Scope

The scope of the review was limited to obtaining information to determine that the operating expenses as reported in Valley's application for the period ending December 31, 1994 were representative of normal operations, and to gather information to evaluate the pro forma adjustments proposed in Valley's filing. Expenditures charged to test-year operations were reviewed, including any supporting invoices. Insignificant or immaterial discrepancies were not pursued and are not addressed herein.

B. Recommended Rate-Making Adjustments

Normalized Revenues from Sales

Normalized revenues from sales were computed based on Valley's average annual customer growth from 1992 to 1994 of .81 percent. Assuming 504 customers with 8.87 Mcf per month usage at retail rates currently in effect, normalized sales revenues are:

6,048 bills x $4.00 =	$ 24,192
53,646 Mcf x $4.9953 =	267,978
	$292,170

The adjustment to 1994 annual report revenue is $19,058.

Purchased Gas Expense

Valley's 1994 purchased gas expense was normalized to reflect the aforementioned customer growth and associated usage at the $3.3502 per Mcf gas cost currently reflected in Valley's rates. Normalized purchased gas expense is:

53,646 Mcf x $3.3502 = $179,725

(0% line loss is assumed because reported line loss in Valley's 1993 and 1994 annual reports is negative.)

The adjustment to 1994 annual report purchased gas expense is $15,198.

Operating Expenses

Based on the average annual increase in expenses for the last five years, Valley estimated that overall operating expenses will continue to increase at approximately the same rate. Valley proposed a 30 percent adjustment to total operating expenses to cover anticipated increases and to provide for the rate to be compensatory for at least two years. Even though Valley provided a quantified explanation for this proposed adjustment, it did not provide proper support for the proposed changes in price or activity levels, and any other factors which may affect the adjustment. Furthermore, Valley failed to demonstrate that its proposed pro forma cost increases were known and measurable. Therefore, Staff must recommend that this adjustment be denied. Staff reviewed Valley's records to determine whether adjustments should be made to reflect increases and decreases in revenue and expenses. Staff has made the following adjustments to reflect pro forma operating revenue and expenses for ratemaking purposes.

Customer Accounts Expense

Supplies and Expenses, Account No. 903. Valley recorded $1,126.29 in Supplies and Expenses in the 1994 Annual Report. Based upon a review of Valley's records, Staff determined that this amount included short term interest expense of $344.79 which should have been recorded in Account No. 431, Other Interest Expense. Staff also discovered that $781.50 related to costs incurred in the prior year and has adjusted the balance to reflect this. These adjustments have resulted in a $0 balance in Supplies and Expenses.

Administrative and General Expenses

Office Supplies and Expenses, Account Number 921. During the review, Staff discovered that the test year expense level included the following: Donations $230.20, Telephone $1,607.38, Utilities $1,659.69, Travel $567.80, and Miscellaneous $709.11. Staff has excluded donations of $230.20 for rate-making purposes. This results in an adjusted balance of $4,543.98 in Account Number 921.

Advertising, Account Number 930.1. 807 KAR 5:016 provides that, "Advertising expenditures for .... institutional advertising by electric or gas utilities shall not be considered as producing a material benefit to the rate payers and, as such, those expenditures are expressly disallowed for rate-making purposes." The regulation further states that "institutional advertising" means advertising which has as its sole objective the enhancement or preservation of the corporate image of the utility and to present it in a favorable light to the general public." Valley incurred $95 in expense for advertising in Kentucky Sports History. The advertisement did not produce a material benefit as defined in KAR 5:016 (3), but primarily promoted the company. Based on the nature of this advertisement, Staff believes that it should be considered institutional, and therefore, not allowable for rate-making purposes.

Interest Expense, Account Number 431. Valley recorded a $0 balance in Account Number 431 for the test year. As previously discussed in the Customer Accounts Expense section of this report, $344.79 in interest costs had been erroneously recorded in Supplies and Expenses. Correcting that recording error results in a test-year-end balance of $344.79 in Account Number 431, Interest Expense.

Staff has normalized interest expense to reflect interest on the $45,000 in short-term debt on Valley's books as of the end of the test year. The debt was issued for a 3 month period and bore interest at 9.5 percent per annum. This resulted in an increase of $1,068.75 to the test year interest expense level as corrected by Staff.

A review of Valley's annual reports indicates that, for at least the past 3 years, Valley has annually borrowed funds on a short-term basis. This trend would seem to indicate that Valley is using short-term debt as a permanent source of capital. Staff recommends that the next time Valley needs to secure capital, it consider long-term financing. The effects would be two-fold: the utility would most likely experience lower interest costs over time; and, the capital structure of the utility would be better balanced.

Based on the recommendations proposed in this Staff Report, Valley's adjusted operations are as follows:

Accounts	Valley's Test-Year	Staff Proposed Adjustments	Staff Adjusted Balances
Operating Revenues:			
Gas Service Revenues	$ 273,113	$ 19,058	$ 292,171
Other Revenue Surcharge	3,962	-0-	3,962
Total Operating Revenues	$ 277,075	$ 19,058	$ 296,133
Operating Expenses:			
Natural Gas Purchases	$ 164,527	$ 15,198	$ 179,725
Mains & Service Labor	1,078	-0-	1,078
Rents	21	-0-	21
Maintenance of Meters	504	-0-	504
Meter Reading Labor	7,961	-0-	7,961
Accounting & Collecting	3,332	-0-	3,332
Supplies & Expenses	1,126	(1,126)	0
Uncollectible Accounts	22	-0-	22
Adm. & Gen. Salaries	31,200	-0-	31,200
Pensions	4,680	-0-	4,680
Office Supplies	4,760	(216)	4,544
Outside Services	24,890	-0-	24,890
Rents	6,000	-0-	6,000
Insurance	7,750	-0-	7,750
Transportation	1,341	-0-	1,341
Misc. General Exp.	1,142	-0-	1,142
Advertising	95	(95)	-0-
Depreciation	14,581	-0-	14,581
Taxes Other Than Income Taxes	14,004	-0-	14,004
Total Operating Exp.	$ 289,014	$ 13,761	$ 302,775
Net Operating Income	$ (11,939)	$ 5,297	$ (6,642)
Other Income:			
Interest & Dividends	$ 336	$ -0-	$ 336
Other Deductions:			
Other Interest Exp.	$ 345	$ 1,069	$ 1,414
NET INCOME	$ (11,948)	$ 4,228	$ (7,720)

C. Revenue Requirements

Valley proposed an increase of $63,374 in gas revenues based on a 12.5 percent return on the company's proposed net investment rate base of $115,400.

Staff has determined the net investment rate base for Valley to be $100,848, calculated as follows:

Utility Plant		$267,451
ADD:	Working Capital	$ 11,808[1]
Subtotal		$279,259
LESS:	Accumulated Depreciation	178,411
NET INVESTMENT RATE BASE		$100,848

The difference between Valley's proposed rate base and Staff's rate base is attributable to two things. First, Staff's adjusted operating expenses are lower which results in a difference in the provision for working capital. Second, in response to Staff inquiries, Valley could not support its proposed accumulated depreciation balance. Therefore, in accordance with accepted ratemaking practices, Staff used the actual test year end level of accumulated depreciation.

According to the 1994 Annual Report, Valley's capitalization consists of $116,875 in common stock, negative retained earnings

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[1]

Operating Expenses		$302,775	$94,466
Less:	Depreciation	14,581	x 1/8
	Taxes	14,004	$11,808
	Gas Purchases	$179,724	
		$ 94,466	

totalling $86,301 and $45,000 in short term debt. This results in a total capitalization of $75,574, calculated as follows:

	Test Year End Balance	Percentage of Total
Debt	$45,000	60.00%
Common Equity	$30,574	40.00%
	$75,574	100.00%

Applying the company-proposed 12.5 percent return to the Staff calculated net investment rate base results in a 17 percent return on capital. This is clearly excessive for a utility such as Valley and beyond the range of reasonable returns normally allowed.

Normally, under the return on capital approach, revenue requirements are determined by applying the rate of return on capital to the total capitalization. In determining a reasonable rate of return on common equity, Staff has given consideration to the nature of Valley's operations and its economic circumstances. Staff believes that an 11.5 percent rate of return on common equity is reasonable for Valley under the current economic conditions. This results in an overall rate of return on capitalization of 10.3 percent, shown as follows:

	Percentage		Cost	Overall Rate of Return
Debt	60.00%		9.5%	5.7%
Common Equity	40.00%	x	11.5%	4.6%
				10.3%

A return of 10.3 percent will provide sufficient income to meet Valley's needs and provide a reasonable cash flow. The application of a 10.3 percent rate of return on Valley's capitalization would yield a net operating income of $ 7,784. This approach, including an allowance for state and federal income taxes and the Public Service Commission assessment, would require an increase in Valley's revenues of $17,706.

Valley indicated its required revenue increase was based on a rate of return on net investment rate base of 12.5 percent. The recommended 10.3 percent return on capitalization results in a 7.72 percent rate of return on the Staff proposed net investment rate base. Staff notes that its proposed rate base of $100,848 is $25,274 larger than Valley's total capitalization. The 7.72 percent rate of return on rate base is reasonable for Valley because of the significant difference between the rate base and the total capitalization.

The staff recommends the following determination of revenue requirements and revenue increase for Valley:

Total Operating Expenses		$302,775
Total Capitalization	$ 75,574	
Rate of Return	10.3%	
Required Operating Income		$ 7,784
Revenue Requirement		$310,559
Normalized Revenues		296,133
Increase required		14,426
Gross-Up Factor		1.2254902[2]
		17,679
PSC Assessment		27
Increase in Revenues		$ 17,706

Staff's recommended revenue increase of $17,706 should allow Valley to meet its operating expenses, and provide for reasonable equity growth.

Rate Design

Valley requested no change in rate design, and proposed to increase its customer charge from $4.00 to $5.00 per month. Applying an approximate six percent increase to the customer charge, which is the overall allowed increase in total revenues, produces a more reasonable customer charge. The resulting rates for Valley are:

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[2]

Operating Revenue	1000.000000
Less: PSC Assessment of .001509	1.509000
Net Income Before Fed & State Income Tax	998.491000
Less: State Income Taxes @ 4%	39.939640
Net Income Before Fed Income Tax	958.551360
Less: Federal Income Tax @ 15%	143.782704
Net Income	814.768656
Gross Up Factor(998/814)	1.2254902
Composite Tax Rate	18.4%

Monthly Customer Charge	$4.25
All Mcf	$5.2975 per Mcf

D. Signatures

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Electric and Gas Revenue
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