

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF FANCY FARM SEWER)
DISTRICT FOR A RATE ADJUSTMENT)
PURSUANT TO THE ALTERNATIVE RATE) CASE NO. 96-263
FILING PROCEDURE FOR SMALL UTILITIES)

O R D E R

On June 6, 1996, Fancy Farm Sewer District ("Fancy Farm") filed its application for Commission approval of proposed sewer rates. Commission Staff, having performed a limited financial review of Fancy Farm'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, or 90 days after the date the application was filed, whichever is later, 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 23rd day of September, 1996.

ATTEST:


Executive Director

PUBLIC SERVICE COMMISSION


For the Commission

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF FANCY FARM)
SEWER DISTRICT FOR A RATE)
ADJUSTMENT PURSUANT TO THE) CASE NO.96-263
ALTERNATIVE RATE FILING PROCEDURE)
FOR SMALL UTILITIES)

STAFF REPORT

Prepared By: Carl Salyer Combs
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Financial Analysis Division

Prepared By: Christopher H. Smith
Public Utility Rate Analyst
Communications, Water and Sewer
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Rates and Research Division

STAFF REPORT

ON

CASE NO. 96-263

A. Preface

On June 6, 1996, Fancy Farm Sewer District ("Fancy Farm") filed an application with the Commission seeking to increase its sewer rates pursuant to the Alternative Rate Filing Procedure for Small Utilities. The proposed rates would generate approximately \$38,693 annually in additional revenues, an increase of 58.8 percent over normalized test-year revenues of \$65,772.

In order to evaluate the requested increase, the Commission Staff ("Staff") chose to perform a limited financial review of Fancy Farm's operations for the test period, calendar year 1994. Since Fancy Farm requested and received Staff assistance in preparing this application, the field review was done prior to the filing of the application. Carl Salyer Combs conducted the review on March 28-29, 1996, at Fancy Farm's office in Fancy Farm, Kentucky. Mr. Combs is responsible for this Staff Report except for the sections on operating revenues and rate design which were prepared by Christopher H. Smith of the Commission's Division of Rates and Research.

During the course of the review, Fancy Farm was informed 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 Fancy Farm be authorized to increase its annual operating revenues by \$37,687.

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

Fancy Farm reported 244 customers and one industrial customer at year-end. Fancy Farm's net operating income statement for the test year showed test year revenues from sewer service in the amount of \$63,118. Based on current rates and year-end customers, Fancy Farm had normalized operating revenue from sewer service in the amount of \$65,772. The increase in revenues is a result of additional customers. Total test-year operating revenue from sewer service is considered to be \$65,772.

Operating Expenses

Fancy Farm incurred, and the Staff-assisted application included, test-period operating expenses of \$81,839. Fancy Farm proposed to increase that amount by \$5,169. Fancy Farm's proposed adjustments and Staff's recommendations are discussed in the following sections:

Maintenance of Structures and Improvements

Fancy Farm proposed to increase reported test-year maintenance of structures and improvements expense of \$3,474 by \$2,531 based upon additional expense related to more stringent testing requirements of the Division Of Water ("DOW") of the Kentucky

Natural Resources and Environmental Protection Cabinet. With DOW requiring weekly testing, Fancy Farm's annual testing expense totals \$3,575 (\$68.75 x 52 weeks). Larry Updike of the Commission's Engineering Division confirmed that weekly testing is required of sewer utilities by DOW. Since test-year testing expense totaled \$1,044, Staff recommends that the proposed adjustment of \$2,531 be accepted which results in inclusion of annual expense of \$3,575 related to testing and total annual maintenance of structures and improvements expense of \$6,005.

Office Supplies and Other Expense

Fancy Farm proposed to increase reported test-year office supplies and other expense of \$15,942 by \$2,172 to reflect salary increases for two employees during 1995. One maintenance employee received an increase of \$100 per month or \$1,200 annually, while the utility's secretary received an increase of \$81 per month or \$972 annually. Staff is of the opinion that the salary increases are reasonable, and therefore, recommends that Fancy Farm's proposed annual adjustment of \$2,172 for salary increases be included for rate-making purposes.

Because Fancy Farm's reported test-year office supplies and other expense of \$15,942 represents a significant portion of total reported test-year expense, Staff requested a breakdown of charges to this account. The breakdown provided by Fancy Farm revealed that 45.9 percent, or \$7,317 was for outside services, including \$1,400 for accounting services and \$5,917 for services provided by Fancy Farm's water division for which reimbursement was paid. According to John Jones, a certified public accountant employed by Fancy Farm, the \$5,917 was composed of, but not limited to, the following expense

items: telephone, postage, automobile, insurance, office supplies, and general maintenance. Mr. Jones stated that all of these expenses are recurring monthly expenses and are not unusual or extraordinary in nature. Another 15.8 percent (\$2,521) was for employee benefits, and 32 percent (\$5,120) was for insurance expenses. With regard to future annual reports, Staff recommends that Fancy Farm show such charges in those specific accounts rather than lumping them together in the office supplies and other expense account.

Clarification by Fancy Farm's accountant regarding insurance expense revealed that test-year payments were made for both 1994 and 1995 insurance coverage. Therefore, Staff is of the opinion that only the 1995 portion of \$4,110 should be included for rate-making purposes which results in a reduction of \$1,010 to the test-year amount of \$5,120 included in this account. Coupled with the aforementioned increase of \$2,172, the reduction of \$1,010 to the reported test-year amount of \$15,942 results in annual office supplies and other expense of \$17,104, and Staff recommends that that amount be included for rate-making purposes.

Depreciation Expense

Fancy Farm reported test-year depreciation expense of \$38,125 and proposed an increase of \$466 based upon the need to purchase a new pump which it proposed to depreciate over a 5-year period. Larry Updike of the Commission's Engineering Division concurs with Fancy Farm's assertion that the pump is needed. Fancy Farm provided a copy of the related cost estimate for the pump which lists a price of \$2,332. According to Ben Muncy of the Commission's Engineering Division, 5 years is an appropriate period over

which to depreciate the new pump. Therefore, Staff recommends inclusion of annual depreciation expense of \$38,591 for rate-making purposes.

Operations Summary

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

	<u>Test Period Application</u>	<u>Recommended Adjustments</u>	<u>Test Year Adjusted</u>
OPERATING REVENUE	\$ 63,118	\$ 2,654	\$ 65,772
OPERATING EXPENSE:			
Treatment System	\$ 10,019	\$ -0-	\$ 10,019
Fuel and Power	13,736	-0-	13,736
Misc. Supplies	543	-0-	543
Maintenance of Structures & Imp.	3,474	2,531	6,005
Office Supplies & Other Expense	15,942	1,162	17,104
Depreciation	<u>\$ 81,839</u>	<u>\$ 4,159</u>	<u>\$ 38,998</u>
Total Operating Exp.	<u>\$ 81,839</u>	<u>\$ 4,159</u>	<u>\$ 85,998</u>
OPERATING INCOME:	\$ (18,721)	\$ (1,505)	\$ (20,226)
<u>OTHER INCOME:</u>			
Interest/Div.	\$ 479	\$ -0-	\$ 479
INCOME AVAILABLE FOR DEBT SERVICE	<u>\$(18,242)</u>	<u>\$(1,505)</u>	<u>\$(19,747)</u>

C. Revenue Requirements Determination

Staff has calculated Fancy Farm's average annual debt service to be \$14,950.¹ Fancy Farm's adjusted operations reflect \$(19,747) in income available for debt service which results in a debt service coverage ("DSC") of (1.32X). Staff is of the opinion that Fancy Farm's current rates are inadequate and will not cover payment of operating expenses and debt service requirements. In cases involving water and sewer districts, the Commission's normal practice is to allow a 1.2X DSC which provides a 20 percent margin above annual principal and interest requirements. In this instance, Staff is of the opinion that Fancy Farm should be granted an increase in revenues sufficient to produce a DSC ratio of 1.2X. Therefore, Staff recommends an increase in annual revenues of \$37,687 calculated as follows:

1.2X DSC	\$ 17,940
Adjusted Operating Expense	<u>85,998</u>
Total Revenue Requirement	\$103,938
LESS:	
Adjusted Test-Year Revenues	65,772
Other Income	<u>479</u>
Increase Required	\$ <u>37,687</u>

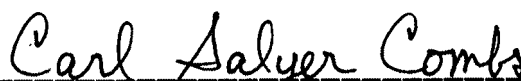
D. Rate Design

In its application, Fancy Farm filed a scheduled of present and proposed rates. Staff is of opinion that the present flat rate for residential customers is reasonable. Fancy Farm proposed to bill the school on a residential equivalent basis. Sewer rates are

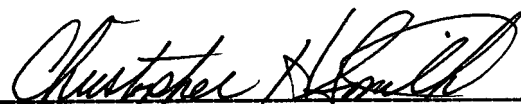
¹ 3-year average of principal payments due	\$ 4,667
3-year average of interest payments due	<u>10,283</u>
Total of 3-year avg. of P&I payments due	\$ <u>14,950</u>

generally based on the amount of plant capacity allocated to each customer classification. Residential customers are allocated 400 gallons per day or 12,000 gallons per month. The rates of commercial customers and other large users are based on a residential equivalent. For example, a commercial customer who used 26,000 gallons would be billed at a rate of 2.17 times the residential rate. Staff is of the opinion that billing large users on a residential equivalency basis is reasonable.

E. Signatures



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APPENDIX A
TO STAFF REPORT CASE NO. 96-263
FANCY FARM SEWER DISTRICT

The Staff recommends the following rate be prescribed for customers of Fancy Farm Sewer District.

Monthly Residential Rates

\$35.34

Monthly Residential Rates with Grinder Pump

\$34.34

Monthly Rate for Fancy Farm School

\$35.34 per residential equivalent¹

¹ A residential equivalent is defined as 12,000 gallons or fraction thereof. A fraction shall not be rounded to the next whole number.