

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF BLUEGRASS GAS)
SALES, INC. FOR AN ADJUSTMENT OF RATES) CASE NO. 98-305
PURSUANT TO THE ALTERNATIVE RATE FILING)
PROCEDURE FOR SMALL UTILITIES)

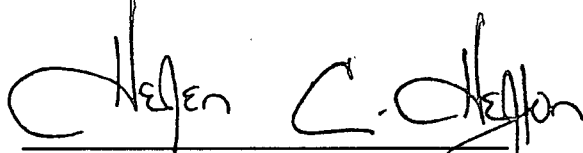
O R D E R

On June 8, 1998, Bluegrass Gas Sales, Inc. ("Bluegrass") filed its application for Commission approval of proposed gas rates. Commission Staff, having performed a limited financial review of Bluegrass'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 20 days from the date of this Order.

IT IS THEREFORE ORDERED that all parties shall have no more than 20 days from the date of this Order to provide written comments regarding the attached Staff Report or request a hearing or informal conference. If no request for a hearing or informal conference is received, this case shall be submitted to the Commission for decision.

Done at Frankfort, Kentucky, this 27th day of October, 1998.

ATTEST:


Executive Director

PUBLIC SERVICE COMMISSION


For the Commission

STAFF REPORT
ON
BLUEGRASS GAS SALES, INC.

Case No. 98-305

A. Preface

On June 8, 1998, Bluegrass Gas Sales, Inc. ("Bluegrass") filed an application for a rate adjustment pursuant to 807 KAR 5:076, the Alternative Rate Filing Procedure for Small Utilities ("ARF"). The rates originally proposed by Bluegrass were supposed to generate an additional \$23,073 in revenues, which Bluegrass claimed constituted a 25 percent increase over its existing revenues. However, as discussed in the Normalized Revenues Section of this Staff Report, Bluegrass incorrectly calculated its normalized test year revenues by using proposed, rather than current, rates. If Bluegrass had calculated its pro forma residential and commercial sales revenues using its current rates, it would have set out a revenue figure of \$202,237 instead of \$252,927. This is a difference of \$50,690 in the pro forma revenue figure upon which Bluegrass' proposed increase is predicated, and would have resulted in a requested additional \$73,763 in revenues instead of \$23,073. In order to meet the minimum filing requirements for an ARF, a utility must have less than 500 customers and less than \$300,000 in gross annual revenues. Bluegrass met the minimum requirements for an ARF filing.

The Commission Staff performed a limited financial review of Bluegrass' operations for the test year ending March 31, 1998. 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. Isaac

Scott and Leah Faulkner of the Commission's Division of Financial Analysis performed the staff review on July 30, 1998 at the business office of Mark O'Brien in Prospect, Kentucky. In addition, Staff reviewed information related to the case at the offices of John N. Hughes, Bluegrass' attorney, on August 27, 1998. In each instance, Staff submitted questions via facsimile in advance to Bluegrass in order to speed the acquisition of information. With the exception of the sections dealing with Normalized Revenues, Purchased Gas Expense, and Retail Rates, which were prepared by Ms. Faulkner, this report was prepared by Mr. Scott.

Scope

The scope of the review was limited to obtaining information to determine that the operating expenses as reported in Bluegrass' application for the period ending March 31, 1998 were representative of normal operations, and to gather information to evaluate the pro forma adjustments proposed in Bluegrass' 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 Balance Sheet Restatement

Conformity with USoA

Bluegrass maintains its accounting records primarily on a functional basis. It retains the accounting firm of Arthur Andersen LLP to prepare the financial statements submitted in the Annual Reports filed with the Commission and required tax returns and reports. Staff reviewed the Balance Sheet as of March 31, 1998 that was included with Bluegrass' application and determined that it was not in conformity with the Uniform

System of Accounts Prescribed for Natural Gas Companies, Title 18 of the Code of Federal Regulations, Part 201 ("USoA"). Attachment 1 of this Staff Report contains a conversion chart that relates the account titles shown on Bluegrass' Balance Sheet with the corresponding USoA account titles. The Staff recommends that as long as Bluegrass contracts with an independent accounting firm to assist it with the preparation of financial statements, Bluegrass should require as a condition of its contract that the accounting firm's work be in conformity with the requirements of the USoA.

Organization Costs

In Case No. 94-433¹ the Commission instructed Bluegrass to record \$17,848 of start-up legal and accounting costs as a Miscellaneous Deferred Debit, and amortize this cost over a 10-year period. A supporting schedule provided by Bluegrass indicates that Bluegrass has recorded \$20,400 in organization costs, and amortized \$13,710 of this total, leaving an unamortized balance as to test-year-end of \$6,690. The schedule also indicates that the amortization has been neither systematic nor on a 10-year basis. The Staff recommends that the test-year-end balance for Miscellaneous Deferred Debit be reduced to \$4,138, which is the amount approved by the Commission in Case No. 94-433 less the amortization Bluegrass has indicated it has already recorded. The additional costs that made up Bluegrass' reported costs of \$20,400 have not been submitted for Commission review. The accounting entry to record this adjustment is:

Unappropriated Retained Earnings – Debit	\$2,552
Miscellaneous Deferred Debit – Credit	\$2,552

¹ Case No. 94-433, The Petition of Bluegrass Gas Sales, Inc. for Approval of a Certificate of Convenience and Necessity to Construct Facilities, Approval of Financing, Approval of Initial Rates and Operation of a Natural Gas Distribution System, Order dated February 20, 1996.

The adjustment to reflect the amortization of this deferred debit will be discussed later in this Staff Report.

Accumulated Depreciation

Bluegrass reported test-year-end accumulated depreciation of \$24,003. Staff review of the depreciation calculation indicates that Bluegrass has not been using the depreciation rates it proposed and the Commission adopted in Case No. 94-433. As discussed further in the Depreciation Expense section of this Staff Report, the Staff has recalculated the annual depreciation expense for Bluegrass for the years 1995, 1996, and 1997, as well as for the year ending March 31, 1998. This recalculation results in a balance of \$17,659 for Accumulated Depreciation. Therefore, the Staff recommends that the Accumulated Depreciation account balance be reduced \$6,344. The entry to record this adjustment is:

Accumulated Depreciation – Debit	\$6,344
Unappropriated Retained Earnings – Credit	\$6,344

Based on the recommendations proposed in this Staff Report, Bluegrass' Balance Sheet is as follows:

Account Title	Test Year End Balances	Staff Adjustments	Staff Adjusted TYE Balances
Assets and Other Debits:			
Utility Plant -			
Utility Plant	\$300,508	\$0	\$300,508
Less: Accumulated Depreciation	(24,003)	6,344	(17,659)
Net Utility Plant	<u>\$276,505</u>	<u>\$6,344</u>	<u>\$282,849</u>
Current and Accrued Assets -			
Cash	17,083	0	17,083
Customer Accounts Receivable	1,647	0	1,647
Prepayments	400	0	400
Total Current and Accrued Assets	<u>\$19,130</u>	<u>\$0</u>	<u>\$19,130</u>
Deferred Debits -			
Unamortized Debt Expense	1,933	0	1,933
Miscellaneous Deferred Debits	6,690	(2,552)	4,138
Total Deferred Debits	<u>\$8,623</u>	<u>(\$2,552)</u>	<u>\$6,071</u>
Total Assets and Other Debits	<u><u>\$304,258</u></u>	<u><u>\$3,792</u></u>	<u><u>\$308,050</u></u>
Liabilities and Other Credits:			
Proprietary Capital -			
Common Capital Stock	\$25,000	\$0	\$25,000
Unappropriated Retained Earnings	(3,157)	3,792	635
Total Proprietary Capital	<u>\$21,843</u>	<u>\$3,792</u>	<u>\$25,635</u>
Long-Term Debt -			
Other Long-Term Debt	<u>\$190,292</u>	<u>\$0</u>	<u>\$190,292</u>
Current and Accrued Liabilities -			
Notes Payable	14,655	0	14,655
Accounts Payable	72,905	0	72,905
Accounts Payable to Assoc. Companies	3,343	0	3,343
Interest Accrued	1,220	0	1,220
Total Current and Accrued Liabilities	<u>\$92,123</u>	<u>\$0</u>	<u>\$92,123</u>
Total Liabilities and Other Credits	<u><u>\$304,258</u></u>	<u><u>\$3,792</u></u>	<u><u>\$308,050</u></u>

C. Recommended Rate-Making Adjustments

Bluegrass presented its test-year operating statement based on its functional accounting classifications, rather than using USoA accounts. Attachment 2 to this Staff Report contains a conversion chart that relates the account titles shown on Bluegrass' Operating Statement with the corresponding USoA account titles.

Bluegrass proposed numerous adjustments to its test-year operations. Based upon Staff's review of the proposed adjustments, we recommend that the adjustments to non-operating income, bad debt expense, and nomination and balancing services be accepted for rate-making purposes. The Staff's evaluation of all remaining proposed adjustments follows.

Normalized Revenues

Bluegrass proposed pro forma gas sales revenues of \$252,927. This is based on a projected 363 residential customers using an annual average of 70 Mcf and a projected 30 commercial customers using 95 Mcf annually. Bluegrass performed its computation using its proposed rates, and included no revenues for customers paying the minimum bill for 0 usage. Normalized revenues should be calculated using the rates approved in Bluegrass' Gas Cost Recovery ("GCR") filing effective April 1, 1998, which were in effect at the time of Bluegrass' filing of this case. In order to reflect some level of customer growth over and above the test year average of 238 customers (205 residential and 33 commercial), Staff used the end of test year customer number of 349 (315 residential and 34 commercial). Applying Bluegrass' proposed average annual customer usage of 70 MCF for residential and 95 Mcf for commercial customers results in a sales volume of 25,280 Mcf. According to Bluegrass, its number of 0 usage bills for the test year was 252 bills. Staff included 0 usage bills in its calculation of normalized revenues based on the percentage of bills they represented for the test year, applied to the number of bills that 349 customers would generate. Staff also included revenue from three service reconnections that Bluegrass said it had performed during the test year.

Normalized test year revenue should be calculated as follows:

369 0 usage bills x \$7.1563	=	\$2,640.67
25,280 Mcf x \$7.1563	=	180,911.26
3 reconnects x \$25.00	=	75.00
		<hr/>
		\$183,626.94

Purchased Gas Expense

Bluegrass calculated its purchased gas expense using its rate from Sirius, its gas supplier, applied to a projected level of Mcf volumes as described in the Normalized Revenues section above. Bluegrass' calculation of purchased gas expense, called Cost of Sales, included transportation cost set out separately from commodity cost as well as odorant expense. Odorant is addressed separately in this report. Bluegrass' Total Cost of Sales as proposed is \$106,095, including odorant expense of \$1,250. Its normalized purchased gas expense has been recalculated using the 25,280 Mcf sales volumes that Staff derived from the end of test year customer numbers, adjusted for test year line loss of 1.75 percent. The gas cost rate used should be the GCR rate approved for April 1, 1998, which was in effect when Bluegrass made its filing with the Commission. This rate includes both commodity and transportation expense.

Normalized purchased gas expense should be calculated as follows:

$$25,722 \text{ Mcf} \times \$4.0360 = \$103,814$$

Projected Customer Growth Related Adjustments

Bluegrass proposed a 15 percent increase in the expense levels for several accounts to reflect its expected increase in customers during the next year. Bluegrass contends that these expenses are variable costs that fluctuate proportionately with the increase in customers served by Bluegrass. The Staff recommends that this group of proposed adjustments be rejected for two reasons. First, adjustments based on the

projected growth in customers do not meet the criteria of "known and measurable" and are inappropriate for a historic test period based proceeding, such as this ARF filing. Second, Bluegrass has offered no evidence supporting its contention that there is a proportional relationship between the expense level and the number of customers.

Other Gas Supply Expense

Bluegrass proposed to increase its expenses by \$1,250 to reflect the estimated cost of odorant. According to Bluegrass' operating statement, it did not incur any expense in the test year for this item, although Bluegrass is required to add odorant to the gas it sells. The Staff is aware that Bluegrass has been cited by the Commission's Engineering Division for having insufficient levels of odorant in its gas. However, Bluegrass has not provided any documentation to support this estimated expense. While recognizing the legitimacy of this expense, the Staff recommends that the proposed amount be denied for lack of evidence to support its reasonableness.

Maintenance of Lines

Bluegrass proposed that its repair and maintenance expenses be adjusted to reflect its projected customer growth during the next year. As discussed previously, the Staff has recommended the denial of this adjustment. However, during the review, Staff analyzed the disbursements journal entries for this and other Bluegrass functional accounts. Staff has determined that \$129 of repair and maintenance expenses should have been recorded as miscellaneous expenses, while \$1,631 of miscellaneous expenses should have been recorded as repair and maintenance expenses. The Staff recommends a net reclassification adjustment to the Maintenance of Lines account of \$1,502.

Customer Service and Information

Bluegrass proposed that its public relations expense be adjusted to reflect its projected customer growth during the next year. As discussed previously, the Staff has recommended the denial of this adjustment.

Administrative and General Expenses

Bluegrass proposed adjustments totaling \$8,020 relating to officer and employee compensation: a \$6,000 increase in officer salary; a \$500 increase in officer expenses; and a \$1,520 increase in salary for its administrative and field services employees. Bluegrass contends that these increases are necessary to adequately compensate its officers and employees due to increased workloads and responsibilities. During the July 30, 1998 meeting, Bluegrass disclosed that it had failed to include the cost of two independent contractors who were hired to handle field emergencies and provide rapid response to safety problems in the field. The annual expense for both is \$2,400.

The Staff recommends that the proposed adjustments totaling \$8,020 be denied. Bluegrass has offered no documentation that justifies these proposed increases. Staff notes that the Bluegrass officer affected by the proposal is also an officer of a gas transportation company and is involved with a medical care company. No documentation concerning the amount of time spent on Bluegrass activities has been provided for the officer. Likewise, time sheets or other time keeping records are not maintained for the administrative and field services employees. No documentation has been provided which supports the contention that these employees are working additional hours relative to additional workloads.

However, Staff recommends that the \$2,400 in annual expense for the two independent contractors be included for rate-making purposes. The hiring of these individuals is a reasonable approach to addressing safety concerns for Bluegrass' system.

Office Supplies and Expenses

Bluegrass proposed adjustments totaling \$2,282 for its office supplies and expenses composed of a \$365 adjustment to reflect its projected customer growth during the next year, and a \$1,917 adjustment to reflect the first year's amortization of the estimated cost of new computer billing software. Bluegrass contends that the new computer billing software will be needed due to the increased number of customers and the corresponding need for accurate and timely customer billings. However, Bluegrass has neither purchased nor installed this new software. As discussed previously, the Staff has recommended the denial of the projected customer growth adjustment. Concerning the new computer software, Bluegrass has not documented the cost of the new software or actually purchased the software. The Staff recommends that the proposed amortization adjustment be denied.

Outside Services Employed

Bluegrass proposed to increase its expense for legal services by \$338, to reflect an estimated annual expense of \$3,600. Bluegrass contends that this estimate is representative of its average annual legal services needs. Bluegrass has not provided any documentation which supports this estimated level of expense, and the Staff recommends that the proposed increase of \$338 be denied. In addition, Staff has reviewed the disbursements journal entries for this account and determined that there

were two instances of duplicate expenses during the test year. First, Bluegrass included a duplicate entry of \$1,000 for its payment for operation services to Mammoth Petroleum for the months of May and June 1997. Second, Bluegrass recorded \$3,000 in officer compensation payments for the last quarter of the test year in this account as well as recognizing it in Administrative and General Salaries. The Staff has removed the \$4,000 in duplicate entries from the outside services employed account for rate-making purposes.

Property Insurance

The Staff has included the annual premium of \$2,696 for insurance coverage in the operating statement, based on the premium notice provided by Bluegrass.

Injuries and Damages

Bluegrass proposed to increase its expenses by \$1,800 to include the cost of workers compensation for its officers and full-time employees. The estimated expense was computed by applying a rate of 4 percent to the total gross payroll for the officers and full-time employees. During the review, Staff examined the documentation for the proposed adjustment, which was a quote for workers compensation coverage, rather than an actual premium. The quote clearly states that the quote did not provide coverage for any corporation officers. No percentage rate was included on the quote, only a total cost for coverage. Bluegrass did not receive the quote until May 20, 1998. Bluegrass did not record any expense in the test year for workers compensation coverage, and given the language contained in the quote, probably had not secured the coverage by the time the ARF filing was made. As Bluegrass has apparently not

actually incurred this expense, the Staff recommends that the proposed adjustment be denied.

Regulatory Commission Expense

Bluegrass proposed to amortize an estimated \$5,000 of rate case expenses over a three year period. Bluegrass has not provided any documentation which supports this estimated level of expense, and the Staff recommends that the proposed adjustment of \$1,667 be denied. However, the Staff would be willing to consider recommending the inclusion of Bluegrass' actual rate case expenses when the final Order in this proceeding is prepared. Such a recommendation would be subject to the rate-making treatment normally followed by the Commission, and upon the submission by Bluegrass of adequate documentation.

In addition, Staff is recommending that the unamortized balance of organization cost in the Miscellaneous Deferred Debit account, as discussed in the Organization Costs section of this Staff Report, be amortized over the time remaining from the original 10-year period established by the Commission in Case No. 94-433. As of test-year-end, Staff has determined that 81 months remain of the original amortization period. Staff recommends an annual amortization expense of \$613² be included for rate-making purposes.

Miscellaneous General Expenses

Bluegrass had proposed that miscellaneous expenses be adjusted to reflect projected customer growth during the next year. As discussed previously, Staff has

² The account balance of \$4,138 divided by 81 months yields a monthly amortization of \$51; multiplying the monthly amount by 12 results in an annual expense of \$613.

recommended the denial of this adjustment. Staff also reviewed the disbursements journal for this account and has determined that some expenses need to be reclassified while others need to be removed for rate-making purposes. In addition to the reclassifications discussed in the Maintenance of Lines section of this Staff Report, \$788 of various taxes and assessments should be reclassified as Taxes Other Than Income Taxes. The net reduction due to reclassifications is \$2,290. Cash balance reconciliation adjustments to the disbursements journal, a charitable donation, and a reduction to Bluegrass' recorded professional organization membership fees should be removed for rate-making purposes. The total of the removed items is \$1,173. Therefore, the Staff recommends a net reduction to the Miscellaneous General Expenses account of \$3,463.

Transportation Expenses

Bluegrass proposed to increase its Transportation Expenses by \$5,809 to reflect costs associated with its acquisition of a new truck. The total annual cost was comprised of: vehicle lease payments of \$5,400; insurance of \$1,430; gasoline expense of \$2,000; and vehicle maintenance of \$4,200. The gasoline expense was calculated using 20,000 annual miles, 10 miles per gallon, and a gasoline price of \$1.00 per gallon. The maintenance expense was calculated using 20,000 annual miles and the Internal Revenue Service's ("IRS") standard mileage rate, with the results multiplied by 65 percent. Bluegrass contends that this additional expense is necessary due to the need to serve its additional customers and in recognition of how spread apart geographically Bluegrass is becoming.

Staff reviewed the lease agreement and the vehicle insurance premium, and determined that Bluegrass had overstated both amounts. The annualized lease cost is \$4,533 and the annualized vehicle insurance premium is \$1,162.³ Nothing has been provided to determine the reasonableness of the estimates for annual mileage, gasoline, or maintenance expense. The use of the IRS standard mileage rate was not an appropriate surrogate to use when estimating Bluegrass' vehicle maintenance expenses. The standard mileage rate, which includes vehicle insurance, gasoline expenses, maintenance expenses, and vehicle depreciation, is used for income tax purposes if the taxpayer owns the vehicle.

Staff does not contend that Bluegrass will not incur expenses for gasoline and maintenance for the new truck. But Bluegrass has failed to document or establish a reasonable means to determine what these expenses should be. As the documented expenses for the new truck are below the \$7,221 of test-year-end actual transportation expenses, Staff recommends no adjustment to this account.

Depreciation Expense

As discussed previously, the Staff has recalculated the annual depreciation expense for Bluegrass, using the plant in service account balances reported in the 1995, 1996, and 1997 Annual Reports and the March 31, 1998 account balances provided by Bluegrass. The depreciation rates proposed by Bluegrass and adopted by the Commission in Case No. 94-433 have been applied to the account balances to determine the annual depreciation expense. As a result of these calculations, Staff has

³ The monthly lease payment of \$377.72 multiplied by 12 equals \$4,532.64. The semiannual insurance premium of \$581.20 multiplied by 2 equals \$1,162.40.

determined that the test year expense should be reduced from \$13,775 to \$8,131. Therefore, the Staff recommends a reduction of \$5,644 to the Depreciation Expense account. The Staff's calculation of the annual Depreciation Expense and the restated Accumulated Depreciation is as follows:

Plant Classification	Life (In Years)	Reported Plant Balances as of			
		12/31/95	12/31/96	12/31/97	03/31/98
<u>Utility Plant in Service -</u>					
Land and Land Rights	NA	\$0	\$1,000	\$1,000	\$1,000
Mains	40	93,191	201,209	226,784	232,468
Meas. & Regul. Station Equip.	25	2,830	12,629	12,629	12,629
Meters	30	2,500	11,583	20,218	22,227
House Regulators	30	8,567	15,915	22,908	23,583
Other Equipment	30	3,478	4,456	8,601	8,601
Totals		\$110,566	\$246,792	\$292,140	\$300,508
<u>Annual Depreciation Expense -</u>					
Land and Land Rights	NA	\$0	\$0	\$0	\$0
Mains	40	2,330	5,030	5,670	5,812
Meas. & Regul. Station Equip.	25	113	505	505	505
Meters	30	83	386	674	741
House Regulators	30	286	531	764	786
Other Equipment	30	116	149	287	287
Totals		\$2,928	\$6,601	\$7,899	\$8,131
<u>Accumulated Depreciation -</u>					
Beginning Balance		\$0	\$2,928	\$9,528	\$17,427
Addition for Year		2,928	6,601	7,899	232
Ending Balance		\$2,928	\$9,528	\$17,427	\$17,659

Note: Because of the 9-month overlap between 1997 and the Test-Year-End, only the increment amount is included.

Taxes Other Than Income Taxes

Bluegrass proposed adjustments totaling \$2,122 relating to various taxes it routinely pays: a \$1,314 increase in Federal payroll taxes; a \$340 increase in State payroll taxes; a \$313 increase in property taxes; a \$75 increase in Bluegrass' Public Service Commission ("PSC") Assessment; and a \$80 increase in its Kentucky state

sales tax. Bluegrass indicated that the payroll taxes were adjusted to represent 10 percent and 5 percent of projected gross payroll for Federal and State purposes, respectively. Bluegrass contends that the PSC Assessment is set at \$75 annually. Bluegrass' proposed increases to property taxes and sales taxes were to reflect its projected customer growth during the next year.

The Staff recommends that all five adjustments as proposed be rejected. Staff has recalculated the Federal and State payroll taxes based on the salaries recommended for rate-making purposes and the appropriate tax rates. This calculation results in a net decrease to the test year level of payroll taxes of \$837. Concerning the property tax proposal, the Staff recommends that this adjustment be denied, as the level of property tax expense is not directly proportional to the number of customers Bluegrass has nor is it appropriate to base such an adjustment on a projected level of customers.

Concerning the Kentucky state sales taxes, this is not an expense of Bluegrass. Bluegrass collects these taxes in association with gas sales to commercial customers and forwards the collections to state government. These taxes should not be recorded as an expense or revenue of Bluegrass. Staff has removed the test year level of \$535 from both Bluegrass' expenses and revenues. The following accounting entries should be followed when Bluegrass bills, collects, and forwards its state sales taxes:

Customer Accounts Receivable – Debit	\$	
Gas Service Revenues – Credit		\$
Miscellaneous Current and Accrued Liabilities – Credit		\$

To record the billing of gas sales that are subject to state sales taxes.

Cash – Debit	\$	
Customer Accounts Receivable – Credit		\$

To record the payment of the gas bill.

Misc. Current and Accrued Liabilities – Debit	\$	
Cash – Credit		\$

To record the forwarding of state sales taxes to the appropriate authorities.

Concerning the PSC Assessment, each jurisdictional utility reports its gross operating revenues annually. During the following year, the Kentucky Revenue Cabinet determines the appropriate assessment rate, based on the total gross operating revenues reported and the budget established for the PSC. Using the Staff adjusted test-year operating revenues and the PSC Assessment rate for 1998, the Staff has determined that Bluegrass' normalized assessment is \$336.⁴ Staff recommends an increase to Bluegrass' PSC Assessment of \$280 to reflect the normalized level of the assessment. Staff has also become aware that Bluegrass included \$204,973 of non-operating income, which was related to a write-off of liabilities to shareholders, in its 1997 Gross Operating Revenues Report. Consequently, the PSC Assessment received by Bluegrass in 1998 is overstated, and Staff recommends that Bluegrass contact the appropriate divisions at the Commission and possibly the Kentucky Revenue Cabinet to correct this error.

The net effect of all these adjustments to the Taxes Other Than Income Taxes account, including the reclassifications discussed in the Miscellaneous General Expenses section of this Staff Report, is a decrease of \$304.

⁴ The Staff adjusted test-year operating revenues of \$183,627 multiplied by the 1998 assessment rate of .001828 results in a total assessment of \$336.

Other Deductions

Refinanced Loan. On April 30, 1998, Bluegrass refinanced its outstanding Transfinancial Bank ("Transfinancial") debt with a new loan from Stock Yards Bank and Trust Company ("Stock Yards"). The Stock Yards loan was in the amount of \$203,000; with a term of five years; bearing a fixed interest rate of 9 percent; with payments due each November through April, beginning on November 30, 1998. Bluegrass paid origination fees of \$2,030. As of test-year-end, the Transfinancial outstanding debt balance was \$190,292; with remaining loan terms of approximately seven to twelve years; payments due monthly; and at a variable interest rate, which was 9.5 percent at test-year-end.

Bluegrass' actions have complicated its ARF filing. While it proposed no adjustments related to the new loan, Bluegrass' included the documentation for the new loan in its ARF application. The new loan was issued a month after the test-year-end for this ARF filing. The Commission normally does not recognize this type of post-test-year-end transaction when using a historic test period. But far more serious is the fact that Bluegrass did not seek or secure Commission approval prior to executing this loan. At the July 30, 1998 meeting, Bluegrass indicated that it did not believe it needed Commission approval, since none of the circumstances relating to the loan had changed. However, there are four significant changes between the old and new loans: the amount of money borrowed; the term of the loan; the interest rate; and the repayment schedule. KRS 278.300(1) clearly states that no utility shall issue any evidences of indebtedness until it has been authorized to do so by Order of the Commission.

The Stock Yards loan constitutes a post-test-year event, and an unauthorized action by Bluegrass; consequently, this loan should not be recognized for rate-making purposes. Staff recommends that the Commission consider initiating a proceeding to determine whether Bluegrass should be penalized for its violation of KRS 278.300(1). Staff also recommends that Bluegrass should in the future obtain Commission approval prior to issuing any evidences of indebtedness whose payment period exceeds two years, in accordance with KRS 278.300(1).

Amortization of Debt Expense. Bluegrass reported loan costs of \$1,933 related to the Transfinancial debt. Based on a review of the information provided by Bluegrass, the Transfinancial loan costs were not amortized until the last quarter of the test year. General Instruction No. 17 of the USoA requires that this cost be amortized over the life of the loan. In accordance with General Instruction No. 17 of the USoA, Staff has calculated an annual amortization expense of \$212.⁵ Bluegrass should record this annual amortization expense in the Amortization of Debt Discount and Expense account.

Other Interest Expense. Staff has normalized the interest expense for the Transfinancial debt, multiplying the test-year-end outstanding balance of \$190,292 by the 9.5 percent interest rate in effect as of March 31, 1998. The normalized interest

⁵ The Transfinancial debt reflects two loans, one for a term of 169 months and the other for 110. Staff has determined that 27 months have past since these loans were originally issued. The unamortized loan cost has been allocated to the two loans based on their respective outstanding balances. The unamortized loan cost balance was divided by the remaining term for each loan, with the results multiplied by 12. This results in annual amortization expenses of \$96 and \$116 for the loans, or a total of \$212.

expense will be \$18,078. To recognize this adjustment, Staff recommends that the test-year Other Interest Expense be reduced by \$1,586.

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

Account Title	Test Year End Balances	Staff Adjustments	Staff Adjusted TYE Balances
Operating Revenues	\$143,614	\$40,013	\$183,627
Operating Expenses:			
Natural Gas Purchases	\$80,029	\$23,785	\$103,814
Other Gas Supply Expenses	1,289	(1,289)	0
Maintenance of Lines	3,938	1,502	5,440
Uncollectible Accounts Expense	0	400	400
Customer Service and Information	422	0	422
Administrative & General Expenses	37,480	2,400	39,880
Office Supplies and Expenses	2,433	0	2,433
Outside Services Employed	17,139	(4,000)	13,139
Property Insurance	1,573	1,123	2,696
Injuries and Damages	0	0	0
Regulatory Commission Expenses	0	613	613
Miscellaneous General Expenses	6,130	(3,463)	2,667
Rents	3,000	0	3,000
Transportation Expenses	7,221	0	7,221
Total Operating & Maintenance	<u>\$160,654</u>	<u>\$21,071</u>	<u>\$181,725</u>
Depreciation Expense	13,775	(5,644)	8,131
Taxes Other Than Income Taxes	7,716	(304)	7,412
Total Operating Expenses	<u>\$182,145</u>	<u>\$15,122</u>	<u>\$197,267</u>
Net Operating Income	<u>(\$38,531)</u>	<u>\$24,891</u>	<u>(\$13,640)</u>
Misc. Nonoperating Income	204,973	(204,973)	0
Other Deductions:			
Amortization of Debt Disc. & Expense	0	212	212
Other Interest Expense	19,664	(1,586)	18,078
Total Other Deductions	<u>\$19,664</u>	<u>(\$1,374)</u>	<u>\$18,290</u>
NET INCOME	<u><u>\$146,778</u></u>	<u><u>(\$178,708)</u></u>	<u><u>(\$31,930)</u></u>

D. Revenue Requirements

During the July 30, 1998 meeting, Bluegrass indicated that it had utilized the operating ratio method in determining its revenue requirements for this case, and had used an 85 percent ratio. However, Bluegrass provided no calculations or documentation that supported this contention. In fact, the ARF application did not include any explanation as to how the proposed revenue increase was determined.

Staff has determined the net investment rate base for Bluegrass to be \$292,588, calculated as follows:

Utility Plant in Service	\$300,508
ADD: Working Capital Allowance	<u>9,739</u>
Subtotal	<u>\$310,247</u>
LESS: Accumulated Depreciation	<u>17,659</u>
NET INVESTMENT RATE BASE	<u><u>\$292,588</u></u>
Working Capital Allowance:	
Total Oper. & Maint. Expenses	\$181,725
LESS: Gas Purchases	<u>103,814</u>
Subtotal	<u>\$77,911</u>
Multiply by 1/8	<u>0.125</u>
Working Capital Allowance	<u><u>\$9,739</u></u>

Staff has also determined that Bluegrass' total capitalization, as adjusted, is \$215,927.⁶ In this case, Staff believes it is reasonable to calculate revenue requirements based on a rate of return determination using the required return on capital and/or rate base

⁶ Total capitalization is composed of \$190,292 in Long-Term Debt and \$25,635 of Proprietary Capital.

method. As shown above, Bluegrass' net investment rate base exceeds its capitalization by \$76,661. Staff has concluded that Bluegrass' capitalization is a valid basis on which to determine the appropriate level of earnings. Therefore, Staff recommends that the revenue requirements in this case be determined using the rate of return on capital methodology.

The rate of return on capital methodology applies a weighted average cost of capital to the total capitalization to determine the net operating income found reasonable for the utility. The difference between this net operating income and the adjusted test-year net operating income reflects the change in revenue requirements necessary for the utility. The weighted average cost of capital requires the use of cost rates applied to the different components of total capitalization. In Bluegrass' case, the cost rate for its long-term debt is the interest rate on the Transfinancial loan, which is 9.5 percent. Staff has evaluated the financial condition of Bluegrass and the business environment it operates in. Based on a review of recent Commission decisions and current economic factors, Staff believes 11.6 percent is a reasonable return on common equity, and recommends it as the cost rate for Bluegrass' proprietary capital. Staff recommends a weighted average cost of capital for Bluegrass of 9.749 percent, calculated as follows:

	Staff Adjusted TY Balances	Capital Structure	Cost Rate	Weighted Average Cost of Capital
Long-Term Debt	\$190,292	88.13%	9.50%	8.372%
Proprietary Capital	25,635	11.87%	11.60%	1.377%
Total Capitalization	\$215,927	100.00%		9.749%

Applying the 9.749 percent weighted average cost of capital to Bluegrass' total capitalization results in a Staff recommended net operating income of \$21,051. The Staff adjusted test-year net operating income is a negative \$13,640. The difference between these two amounts of \$34,691 represents the increase in revenues required for Bluegrass using the rate of return on capital methodology, before adjusting for the PSC Assessment. Staff believes it is appropriate to recognize the impact this revenue increase would have on the PSC Assessment determined for Bluegrass. Applying the 1998 assessment rate of .001828 to the \$34,691 increase results in an additional \$64 for the PSC Assessment.

This additional adjustment results in a total recommended revenue increase of \$34,755. This increase should allow Bluegrass to meet its operating expenses, service its long-term debt, and provide for reasonable equity growth. Therefore, Staff recommends an increase in operating revenue of \$34,755. The calculation of the total increase is shown below:

Total Capitalization	\$215,927
Weighted Average Cost of Capital	<u>9.749%</u>
Staff Recommended Net Operating Income	\$21,051
Less: Adjusted Net Operating Income	<u>(13,640)</u>
Staff Recommended Increase in Revenue Requirements	\$34,691
Additional PSC Assessment	<u>64</u>
Total Staff Recommended Increase in Revenue Requirements	<u><u>\$34,755</u></u>

Rates


Based on the \$34,755 revenue increase recommended in this Staff Report and using the 369 0 usage bills and 25,280 Mcf sales as set out in the Normalized Revenue section, the base rate for Bluegrass is:

All Mcf (minimum bill) \$4.4754

Adding Bluegrass' April 1, 1998 gas cost, which was used in the calculation of purchased gas expense in this report, yields a rate of:

All Mcf (minimum bill) \$8.5114

E. Signatures



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ATTACHMENT 1 TO THE STAFF REPORT ON
BLUEGRASS GAS SALES, INC., CASE NO. 98-305

ACCOUNT TITLE CONVERSION FOR THE BALANCE SHEET ACCOUNTS

BLUEGRASS GAS SALES, INC. ACCOUNT TITLES	TEST YEAR BALANCES	UNIFORM SYSTEM OF ACCOUNTS ACCOUNT TITLES
Assets:		
Current Assets -		Current & Accrued Assets ("C&A") -
Cash	17,083	Cash
Accounts Receivable	1,647	Customer Accounts Receivable
Total Current Assets	<u>18,730</u>	
Property, Plant & Equipment -		
Property & Equipment	300,508	Utility Plant
Accumulated Depreciation	(24,003)	Utility Plant - Accumulated Depreciation
Total PP&E	<u>276,505</u>	
Investments -		
Prepays	400	C&A - Prepayments
	4,440	Deferred Debits - Other Deferred Debits
Loan Costs	1,933	Deferred Debits - Unamortized Debt Expens
Organization Costs	2,250	Deferred Debits - Misc. Deferred Debits
Total Investments	<u>9,023</u>	
Total Assets	<u><u>304,258</u></u>	
Liabilities:		
Current Liabilities -		Current & Accrued Liabilities -
Account Payable	72,243	Accounts Payable
Payroll Withholding	662	Accounts Payable
Notes Payable - Current	14,655	Notes Payable
Accrued Interest	1,220	Interest Accrued
Intercompany Account	3,343	Acct. Pay. To Assoc. Co.
Total Current Liabilities	<u>92,123</u>	
Long Term Debt	<u>190,292</u>	Long-Term Debt - Other Long-Term Debt
Total Liabilities	<u><u>282,415</u></u>	
Capital:		Proprietary Capital -
Capital	25,000	Common Capital Stock
Retained Earnings	(6,236)	Unappropriated Retained Earnings
Net Income	3,079	Unappropriated Retained Earnings
Total Capital	<u>21,843</u>	
Total Liabilities & Equity	<u><u>304,258</u></u>	

**ATTACHMENT 2 TO THE STAFF REPORT ON
BLUEGRASS GAS SALES, INC., CASE NO. 98-305**

ACCOUNT TITLE CONVERSION FOR THE OPERATING STATEMENT ACCOUNTS

BLUEGRASS GAS SALES, INC. ACCOUNT TITLES	BALANCES AT TEST YEAR END	UNIFORM SYSTEM OF ACCOUNTS ACCOUNT TITLES	BALANCES AT TEST YEAR END
Gas Sales	143,614	Operating Revenues	143,614
Gas Purchases - resid./comm. Transportation	65,564 14,465	Natural Gas Purchases	80,029
Nomination & Balancing Sys. Odorant	1,289 0	Other Gas Supply Expenses	1,289
Repairs & Maintenance	3,938	Maintenance of Lines	3,938
Bad Debt Expense	0	Uncollectible Accounts Exp.	0
Public Relations	422	Customer Serv. & Info. Exp.	422
Officers Expenses	12,000	Admin. & General Salaries	37,480
Salaries & Exp. - Admin.	12,740		
Field Services	12,740		
Supplies - Office	983	Office Supplies & Expenses	2,433
Computer Services	0		
Postage	1,326		
Bank Fees	124		
Prof. Fees - Legal	3,262	Outside Services Employed	17,139
Prof. Fees - Accounting	3,877		
Outside Services	10,000		
Insurance	1,573	Property Insurance	1,573
Worker Comp. Insurance	0	Injuries and Damages	0
Rate Case Expenses	0	Regulatory Commission Exp.	0
Misc. Expenses	3,662	Miscellaneous General Exp.	6,130
KY Gas Association	890		
Telephone	949		
Utilities	595		
Cable	0		
Travel Expenses	34		
Rent - Office	3,000	Rents	3,000
Vehicle Insurance	1,430	Transportation Expenses	7,221
Truck & Gas Expense	(3,809)		
Truck Lease	5,400		
Truck Maintenance	4,200		
Total Operating & Maintenance Exp.	<u>160,654</u>	Total Operating & Maintenance Exp.	<u>160,654</u>
Depreciation	13,775	Depreciation & Depletion	13,775
Payroll Taxes - Federal	3,186	Taxes Other than Income	7,716
Payroll Taxes - State	1,910		
Taxes - Property	2,085		
PSC Assessment	0		
KY State Sales Tax	535		
Total Operating Expenses	<u>182,145</u>	Total Operating Expenses	<u>182,145</u>
Net Operating Income	<u>(38,531)</u>	Net Operating Income	<u>(38,531)</u>
		Other Income:	
Other Income	204,973	Miscellaneous Nonoperating	204,973
		Other Deductions:	
Interest Expense	19,664	Other Interest Expense	19,664
NET INCOME	<u><u>146,778</u></u>	NET INCOME	<u><u>146,778</u></u>