COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF DELTA NATURAL GAS COMPANY, INC. FOR AN ORDER AUTHORIZING THE PURCHASE OF THE ASSETS OF THE MT. OLIVET NATURAL GAS COMPANY	))))	CASE NO. 98-613

O R D E R

On January 11, 1999, Delta Natural Gas Company, Inc. (Delta) applied to the Commission for authority to transfer all of the assets of Mt. Olivet Natural Gas Company, Inc. (Mt. Olivet) to Delta. The application also contains a request for Commission approval of the imposition of Delta s tariff in the Mt. Olivet service area and a request for recovery of a Gas Plant Acquisition Adjustment ("GPAA"). In conformity with Commission regulations, Delta filed an Adoption Notice stating that the rates and services of Mt. Olivet would be adopted until the transfer was closed. It is Delta s intention to impose its tariffs in the Mt. Olivet service area upon the completion of the transfer.

On April 22, 1999, Delta filed proof of publication of the notice as required by 807 KAR 5:011, Section 9.[1] The notice published by Delta set out the rate structure proposed by Delta to be implemented in the Mt. Olivet service area. After publication of this notice, the Commission received over 35 protest letters, several signed by more

[1] Affidavit Of Publication, The Ledger Independent, March 22, 29, and April 5, 1999.

than one person, including a protest from the mayor of Mt. Olivet. All of these letters protested the rate increase as contained in the notice publication filed by Delta. These letters were placed in the case file and considered by the Commission. However, there were no intervening parties in this case.

On May 5, 1999, the Commission established a procedural schedule for this case and required Delta to file information. A public hearing was held in this matter on July 1, 1999 at which members of Delta s management testified and submitted exhibits.

Due to the fact that Delta requested an increase in the rates of the Mt. Olivet customers and approval of recovery of the GPAA in addition to the request for approval of the transfer, this case could not be processed within the time frame established in the Kentucky Revised Statutes. On March 3, May 11, and August 6, 1999, Orders were entered extending the 60-day statutory time frame for processing a request for approval of a transfer.

REQUEST FOR APPROVAL OF TRANSFER OF THE ASSETS OF MT. OLIVET

KRS 278.020(5) requires the Commission to grant, modify, refuse, or prescribe terms and conditions within 60 days after the filing of an application to transfer assets. The requirements for determining if such a transfer should be approved are contained in KRS 278.020(4), wherein the Commission must grant the transfer if the person acquiring the utility has the financial, technical, and managerial abilities to provide reasonable service. KRS 278.020(5) provides that the Commission shall approve the transfer if it finds the transfer is to be made in accordance with the law, for a proper purpose, and is consistent with the public interest.

Mt. Olivet is a small local distribution company ("LDC") that serves approximately 335 customers in the Mt. Olivet-Sardis communities and in rural Robertson and Mason counties in Kentucky. Mt. Olivet has one full-time employee. In 1998 Mt. Olivet had total operating revenues of $193, 084.[2]

Delta is a major LDC with over 2,000 miles of gathering, transmission, and distribution lines in Kentucky and Tennessee. Delta serves approximately 38,000 customers in 20 counties of central and southeastern Kentucky. The Delta system includes 10 branch offices; warehouses, and subsidiary companies which buy and sell natural gas, operate production and storage fields and an intrastate pipeline.[3] The Commission finds that Delta has the technical ability to provide reasonable service.

Delta plans to operate the Mt. Olivet system as part of its Owingsville branch. One additional employee of that branch will be assigned to customer service for the Mt. Olivet system. Purchasing, accounting, and billing will be conducted by either Delta s Owingsville office or in its corporate office in Winchester, Kentucky.[4]

Delta is a Kentucky corporation with its principal office in Winchester, Kentucky. Delta s President and CEO, Glenn Jennings, is a certified public accountant. He has been employed by Delta since 1979 and has also served on several boards and committees concerned with the natural gas industry. Delta s upper level management is able to deal with the needs and requirements of operating the Mt. Olivet system.

[2] Annual Report of Mt. Olivet Natural Gas Co., Inc.

[3] Direct Testimony of Glenn R. Jennings, filed March 18, 1999, at 3.

[4] Id. at 3.

Likewise, the Commission finds that Delta has the managerial ability to provide reasonable service.

As of August 31, 1998, Delta had total assets of over $101 million and operating revenues of over $37 million. The financial statements filed by Delta demonstrate that Delta has the financial ability to provide reasonable service.[5]

The Commission finds that Delta should be authorized to acquire the assets of the Mt. Olivet system as set out in the Agreement of Purchase and Sale of Assets.[6]

RECOVERY OF GPAA

As a part of the application in this case, Delta requested that its rates be applied to the customers of Mt. Olivet. That being the case, the Commission chose to treat the application as a request for an increase in rates, pursuant to KRS 278.190, and required that Delta give notice of the proposed increase to the customers of Mt. Olivet. Inasmuch as the Commission has treated this as an application for a rate increase, the issue of recovery of the GPAA was fully explored in this proceeding.

In support of its contention that the issue of recovery of the GPAA could be approved for rate-making purposes in this case, Delta submitted copies of published cases in other regulatory jurisdictions where plant acquisition adjustments were approved in transfer cases.[7] In all of the cases provided, the rates of the utility being acquired were higher than the rates of the acquiring utility. Under those circumstances

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[5] Exhibit A and B of Delta s Application filed November 23, 1998.

[6] Exhibit C of Delta s Application filed November 23, 1998.

[7] Letter dated February 19, 1999 from Robert M. Watt, Counsel for Delta.

the regulatory body authorized the recovery of the GPAA while approving the rate reduction for the customers being acquired.

The circumstances in this case are unique. Normally when a large utility acquires a small utility, the rates of the larger utility are lower than those of the smaller utility, due primarily to the economies of scale. In this case, Mt. Olivet s rates for a customer using 10 Mcf of gas per month are approximately 54 percent lower than Delta s rates.[8] Delta testified that in its experience, some small companies it has investigated for purchase have had lower rates and some have been higher.[9] Delta testified further that since the rates include the cost of gas, which will be higher for Mt. Olivet in the winter than in the summer, Delta s rates might be lower at the time the transfer occurs if it is in the winter months.[10]

In this instance the operating costs of Mt. Olivet appear to be abnormally low. Based on information contained in the annual reports of Mt. Olivet on file with the Commission, most of the plant in service is fully depreciated. Virtually no major additions have been made to plant in service in the recent past. It is likely that the cost to operate the system will be greater in the future. It is also likely under the circumstances that the system would require major repairs in the foreseeable future.

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[8]Affidavit Of Publication, The Ledger Independent, March 22, 29, and April 5, 1999.

[9] Transcript of Evidence, July 1, 1999, at 25-27.

[10] Transcript of Evidence at 48.

One primary source of information regarding the Commission s past position on GPAAs is Case No. 9059.[11] In the final Order in that case, the Commission was not unanimous in denying recovery of a GPAA that was later allowed on rehearing. The position of the Commissioner dissenting in that case was that the issue of recovery of a GPAA should be considered on a case-by-case basis, and if the record demonstrates that the consumers are benefited by the acquisition, the recovery should be allowed.[12] The Order on rehearing in that case sets out five criteria that should be taken into consideration when granting recovery of a GPAA.[13] A discussion of each of those criteria as it pertains to this case follows:

1. The purchase price was established upon arm's-length negotiations.

Delta stated that the purchase was negotiated between two parties.[14] Although the witness for Delta could not recall who initiated the transaction, Delta contends that negotiations resulted in a price that was favorable to Delta. Delta further indicated that the price it has agreed to is below Mt. Olivet s initial asking price.[15]

Although the Commission agrees that the negotiations were at arm's length, the Commission is concerned about the minimal level of evidence provided by Delta to support the reasonableness of the purchase price. Although the price paid by Delta

[11] Case No. 9059, An Adjustment of Rates of Delta Natural Gas Company, Inc.

[12] Case No. 9059, Final Order dated December 21, 1984, Dissenting Opinion of Chairman Richard D. Heman, Jr., at 3.

[13] Case No. 9059, Order dated September 11, 1985, at 3.

[14] Direct Testimony of Glenn R. Jennings, filed March 18, 1999, at 4.

[15] Transcript of Evidence at 19.

was stated to be below the initial asking price, Delta did not provide any information regarding the appraised value of the system or the reasonableness of the price in relation to comparable asset sales. For Delta, the purchase price is considered to be reasonable since the investment per customer is below the required investment to extend service to new customers. This should not be the only consideration given when establishing the reasonableness of the price to be paid when purchasing the assets of another utility. Utilities seeking to acquire assets should conduct careful analysis to establish the value of the assets being purchased and the reasonableness of the purchase price.

2. <u>The initial investment plus the cost of restoring the facilities to required standards will not adversely impact the overall costs and rates of the existing and new customers.</u>

Although in the initial operations of the Mt. Olivet system by Delta, there will be an adverse impact on costs and the rates to the Mt. Olivet customers, the long-run effects of adding these customers will be positive. The imbedded cost per customer is lower than Delta s current cost per customer and the cost per customer of the Mt. Olivet system is considerably lower than Delta s current incremental cost of adding customers in the normal course of business. Incorporating the customers of Mt. Olivet into the Delta system will improve the economies of scale and result in lower costs for all customers in the long run.

An additional benefit to the customers of Mt. Olivet is that upon the purchase of Mt. Olivet by Delta, Mt. Olivet's customers will no longer be responsible for the ongoing maintenance of their service lines. Delta testified that the customer service lines were made of bare steel pipe that is not going to last very long.[16] Under the present ownership, the repair and replacement of the service line is the responsibility of the customer. Under Delta s tariffs, the company is responsible for replacement of the lines. Delta will periodically check the service lines on customer premises and repair or replace those as necessary. This added service, to be provided by Delta, will result in significant savings to customers who must repair or replace their service line. This service will also provide an additional safety measure for the customers of Mt. Olivet.

3. Operational economies can be achieved through the acquisition.

Mt. Olivet s current cost of providing gas service is below Delta s current cost; however, there is reason to believe that this situation cannot continue into the future. Based on the financial reports of Mt. Olivet, there have been very few plant additions in recent years. It also appears that very little money is spent on ongoing maintenance of the system. These factors reflect that there could be significant increases in Mt. Olivet s capital additions and maintenance cost in the near future. In consideration of the fact that maintenance is not currently at optimal levels, it is clear that, due to its size, Delta can operate and maintain the Mt. Olivet system at a lower cost than Mt. Olivet operating independently can. Considering that Delta is in a better position to raise new capital at lower rates, the cost to refurbish the system will be lower in the long run.

Another operational efficiency offered by Delta is the ability to purchase gas at lower prices. Delta stated at the hearing that it can provide the gas supply at a lower cost due to the storage capability and the ability to avoid buying gas supply at higher cost in the winter months. If gas prices suddenly increase in the winter, Mt. Olivet is

[16] Transcript of Evidence at 39.

subject to paying the higher prices, whatever they are. This could cause the cost to increase substantially to the customers.[17]

4. <u>The purchase price of the utility and non-utility property can be clearly identified.</u>

Mt. Olivet has maintained its financial records in accordance with the Uniform System of Accounts (USoA) prescribed by the Commission. The most recent annual reports on file with the Commission indicate that Mt. Olivet has no non-utility property recorded on its books.[18] Therefore, the accounting records adequately identify the original cost of the assets being purchased. Using the purchase price and the original cost of the assets, we can assure that the purchase is recorded properly on the books of Delta.

5. <u>The purchase will result in overall benefits in the financial and service aspects of the utility s operations.</u>

As stated above, since the new customers can be added to the Delta system at a cost per customer that is lower than the embedded cost as well as the incremental cost of adding new customers through other means, there should be a financial benefit to Delta s customers in the long run. Delta has inspected the Mt. Olivet system and believes that its investment per customer, even after needed improvements, will be below the cost to build new facilities to serve additional customers. The positive aspects of customer growth and economies of scale should benefit both the customers of Delta and Mt. Olivet in the long run. Delta has also committed to enhancing

[17] Transcript of Evidence, July 1, 1999, at 27.

[18] Direct Testimony of Glenn R. Jennings, dated March 18, 1999, at 4.

economic development efforts in the Mt. Olivet service area.[19] These efforts could produce additional customers, as well as improvements in the financial and economic conditions of the customers in this area.

The Commission is of the opinion that the circumstances in this case justify the purchase price in excess of the depreciated original cost. The Commission will approve the recording of the plant acquisition adjustment in accordance with the USoA and will allow recovery of the annual amortization of the GPAA in rates. For the reasons set out below, the GPAA should be amortized over a period of no more than 10 years.

REQUEST FOR INCREASE IN RATES TO THE CUSTOMERS OF THE MT. OLIVET SYSTEM

As a part of its application in this matter, Delta requested that the rates of Mt. Olivet's customers be increased at the time of the transfer to the level currently authorized for Delta. The Commission has considered the argument of Delta and the cases submitted by Delta s counsel and finds that the matter of rates can be considered within this particular transfer case. Re Mobile Gas Service Corporation, 141 P.U.R. 4th 312 (Ala. P.S.C. 1993), Re Indiana Gas Company, Inc., 89 P.U.R. 4th, (Indiana Utility Regulatory Comm., 1988). The Commission has required Delta to meet the notice requirements, pursuant to 807 KAR 5:011, Section 9. Delta has filed sufficient information to allow the Commission to fully consider the revenue requirements for the customers of Mt. Olivet, and to establish fair, just, and reasonable rates for those customers.

Under the circumstances in this case, the revenue requirements of Mt. Olivet should be based on estimates of the cost of Delta to operate the Mt. Olivet system. The

[19] Direct Testimony of Glenn R. Jennings at 5.

review in this case is similar to the type of review conducted when initial rates are established for a utility that has not been in existence prior to the establishment of the initial rates. In its response to the Commission s Order of May 11, 1999, Delta provided an estimate of the expected cost for Delta to operate Mt. Olivet s system, along with its expected revenue requirement for serving Mt. Olivet customers. In Delta s response to the Commission s Order of May 28, 1999, Delta provided a calculation of its expected revenue from Mt. Olivet customers. Delta applied its current tariffed rates to the customer level and billing analysis from Mt. Olivet's most recent rate case.[20]

Following the July 1, 1999 hearing, Delta submitted a revised revenue requirement, including the additional plant investment Delta will make to bring the Mt. Olivet system up to its operating standards. Delta also supplied a revenue requirement comparison assuming 6-, 10-, and 15-year amortization periods for the GPAA amortization expense. Using the information supplied by Delta, and after taking into consideration a 10-year amortization of the GPAA, the rates of Delta are adequate to cover the cost of operations of the Mt. Olivet system. Moreover, the rate increase to Mt. Olivet s customers is justified based on the cost of Delta to operate the system.

Although the transfer will result in an increase in the rates to the Mt. Olivet customers, the Commission believes that the transfer will benefit both the existing and new customers in the long run. Delta s request to increase the rates of the Mt. Olivet customers to the level authorized for Delta should be approved. Likewise, all other

[20] Case No. 97-389, The Application of Mt. Olivet Natural Gas Co., Inc. for a Rate Adjustment Pursuant to the Alternative Rate Filing Procedure for Small Utilities, dated April 24, 1998.

provisions of Delta's tariff should be applied to the customers of Mt. Olivet upon the effective date of the transfer.

ACCOUNTING FOR GPAA

Delta s acquisition of Mt. Olivet s operating system should be accounted for in accordance with the USoA. The amounts included in the gas plant accounts of Mt. Olivet should be recorded on Delta s books at cost, which by definition is the cost incurred by the person who first devoted the property to utility service.

According to the USoA, Delta s recording of plant purchased, including expenses incidental thereto, must first be charged to USoA 102, Gas Plant Purchased or Sold. Then, from Mt. Olivet s records, Delta should credit the original cost of the plant acquired to account 102 while charging the original cost to the appropriate Gas Plant in Service accounts. The allowance for depreciation on the plant acquired shall be charged to account 102, and a corresponding amount credited to the accumulated provision for depreciation on Delta s books. The remaining balance in Gas Plant Purchased or Sold then is closed to USoA 114, GPAA.

Pursuant to the USoA, amortization of the GPAA may be recorded in account 425, Miscellaneous Amortization. The amortization period cannot exceed the remaining useful life of the properties to which such amounts relate.[21] The Commission must approve any exceptions to the amortization period. Delta proposed to amortize the GPAA over 40 years, which is the average life of the plant in service categories to which Delta would record newly constructed assets.[22]

[21] 18 Code of Federal Regulations, Chapter 1, Part 201, at 213.

[22] Transcript of Evidence, Hearing July 1, 1999, at 94.

From the review of recent annual reports of Mt. Olivet, the Commission believes the remaining life could be as few as six years. Delta stated that it believes Mt. Olivet depreciated its gas plant distribution system over a shorter useful life than the 40 years used by Delta. The Commission agrees that Mt. Olivet s annual reports indicate a shorter useful life than Delta uses. Delta did not perform an analysis and no information was provided to establish the remaining life of the assets of Mt. Olivet. Delta has informed the Commission that it would agree to a 10-year amortization period. Therefore, in this case the Commission finds that it is reasonable to allow a 10-year amortization period for the GPAA.

After consideration of the evidence of record in this case, the Commission finds that the transfer of the assets of Mt. Olivet to Delta is in accordance with law, is for a proper purpose, is in the public interest, and should be approved. The Commission finds that the increase in rates to the customers of Mt. Olivet is reasonable under the circumstances prescribed herein and should be approved. Furthermore, the Commission has fully explored the proposed recovery of the GPAA associated with the purchase of Mt. Olivet and finds that recovery is justified in this instance and should be approved.

IT IS THEREFORE ORDERED that:

1. The transfer of the assets of Mt. Olivet to Delta is approved.

2. Delta shall notify the Commission of the transfer within 10 days of the completion thereof.

3. Delta's request to implement its rates, charges, and other tariffs in the service area of Mt. Olivet, as set out in Paragraph 9 of the petition, is granted.

4. Delta shall record a GPAA on its books in accordance with the requirements of the USoA.

5. Within 30 days of the completion of the transaction, Delta shall file the journal entries used to record the purchase and identify the detailed plant accounts to which the assets are recorded. Delta shall also file the proposed entries to be made for the annual amortization of the GPAA as a journal entry and may include the GPAA in its rate base.

Done at Frankfort, Kentucky, this 7th day of September, 1999.

By the Commission

ATTEST:

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Executive Director