

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF HILLVIEW SEWER PLANT)	
#3, INC. FOR AN ADJUSTMENT OF RATES)	CASE NO.
PURSUANT TO THE ALTERNATIVE RATE)	99-067
FILING PROCEDURE FOR SMALL UTILITIES)	

O R D E R

On February 25, 1999, Hillview Sewer Plant (Hillview #3) filed its application for Commission approval of proposed sewer rates. Commission Staff, having performed a limited financial review of Hillview #3s 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 10 days from the date of this Order.

IT IS THEREFORE ORDERED that all parties shall have no more than 10 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 8th day of November, 1999.

ATTEST:

By the Commission

Executive Director

COMMONWEALTH OF KENTUCKY
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STAFF REPORT

Prepared by: Karen S. Harrod, CPA
Public Utility Financial Analyst
Water and Sewer Revenue
Requirements Branch
Division of Financial Analysis

Prepared by: Sam Reid
Public Utility Rate Analyst
Communications, Water and Sewer
Rate Design Branch
Division of Financial Analysis

STAFF REPORT
ON
HILLVIEW SEWER PLANT #3
CASE NO. 99-067

On February 25, 1999, Hillview Sewer Plant #3 (Hillview #3) filed its application seeking to increase its rates pursuant to 807 KAR 5:076. In order to evaluate the requested increase, Commission Staff (Staff) performed a limited financial review of Hillview #3 s test period operations, the year ending December 31, 1997.

The scope of Staff s review was limited to obtaining information as to whether the test period operating revenues and expenses were representative of normal operations. Insignificant or immaterial discrepancies were not pursued and are not addressed herein.

Karen Harrod of the Commission s Financial Audit Branch began the limited review on April 29, 1999. Ms. Harrod is responsible for the preparation of this Staff Report except for the determination of normalized operating revenue and Attachment D, which were prepared by Sam Reid of the Commission s Communication, Water, and Sewer Rate Design Branch.

A comparison of Hillview #3 s actual and proposed pro-forma operations is shown in Attachment A. Based on Staff s recommendations, Hillview #3 s operating statement would appear as set forth in Attachment B.

Attachment C shows the calculation of Staff s recommended revenue requirement. Hillview #3 determined its pro forma revenue requirement to be \$157,281, an increase over test year revenues of 180 percent. Staff recommends a revenue

requirement of \$84,393 which represents an increase of 51 percent over reported test year revenues.

Hillview #3 did not propose any change to its current rate design. Staff concurs that the current rate design is appropriate. The rates contained in Attachment D will achieve Staff's recommended level of revenue.

Signatures

Prepared by: Karen S. Harrod, CPA
Public Utility Financial Analyst
Water and Sewer Revenue
Requirements Branch
Division of Financial Analysis

Prepared by: Sam Reid
Public Utility Rate Analyst
Communications, Water and Sewer
Rate Design Branch
Division of Financial Analysis

ATTACHMENT A
 STAFF REPORT CASE NO. 99-067
 HILLVIEW SEWER PLANT #3. - REQUESTED OPERATIONS

	Test Year per Annual Report	Proposed Adjustments	Proposed Test Year
Operating Revenues	56,026	101,255	157,281
Operating Expenses:			
Owner/Manager Fee	2,400	4,600	7,000
Sludge Hauling	9,866	2,734	12,600
Water Cost	2,865	86	2,951
Electricity	9,053	272	9,325
Chemicals	3,316	166	3,482
Supplies	301	9	310
Lab Fees	1,740	6,580	8,320
Maintenance Fees	15,492	-	15,492
Maintenance of Treatment Plant	8,591	258	8,849
Maintenance of Other Plant Facilities	670	20	690
Collection Fees	2,727	267	2,994
Secretarial Fees	1,200	1,300	2,500
Outside Services Employed	2,395	(750)	1,645
Insurance Expense	724	(199)	525
Telephone	295	9	304
Miscellaneous	291	9	300
Bank Fees	56	-	56
Depreciation	5,326	(575)	4,751
Amortization	1,732	1,000	2,732
Property Taxes	158	649	807
PSC Assessment	-	102	102
Interest on LT Debt	8,902	-	8,902
Other Interest Expense	7,294	-	7,294
Cost of capital expenditures	-	26,982	26,982
Prior year operating losses	-	9,494	9,494
Total expenses	85,394	53,013	138,407
Operating Profit	(29,368)	48,242	18,874

ATTACHMENT B
STAFF REPORT CASE NO. 99-067
STAFF S RECOMMENDED OPERATIONS

	Test Year per Annual Report	Recommended Adjustments	Ref.	Recommended Test Year
Operating Revenues	56,026	674	(a)	56,700
Operating Expenses:				
Owner/Manager Fee	2,400	1,200	(b)	3,600
Sludge Hauling	9,866	-	(c)	9,866
Water Cost	2,865	-	(d)	2,865
Electricity	9,053	-	(e)	9,053
Chemicals	3,316	166	(f)	3,482
Supplies	301	-	(g)	301
Lab Fees	1,740	6,580	(h)	8,320
Maintenance Fees	15,492	-	(l)	15,492
Maintenance of Treatment Plant	8,591	-	(l)	8,591
Maintenance of Other Plant Facilities	670	-	(j)	670
Collection Fees	2,727	196	(k)	2,923
Secretarial Fees	1,200	-	(l)	1,200
Outside Services Employed	2,395	(750)	(m)	1,645
Insurance Expense	724	(463)	(n)	261
Telephone	295	-	(o)	295
Miscellaneous	291	-	(p)	291
Bank Fees	56	-		56
Depreciation	5,326	(194)	(q)	5,132
Amortization	1,732	(1,732)	(r)	-
Property Taxes	158	(37)	(s)	121
PSC Assessment	-	102	(t)	102
Interest on LT Debt	8,902	(8,902)	(u)	-
Other Interest Expense	7,294	(7,294)	(v)	-
Cost of capital expenditures	-	-	(w)	-
Prior year operating losses	-	-	(x)	-
Total expenses	<u>85,394</u>	<u>(11,128)</u>		<u>74,266</u>
Operating Profit	<u>(29,368)</u>	<u>11,802</u>		<u>(17,566)</u>

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(a) Operating Revenues. Hillview #3 reported in its annual report operating revenue in the amount of \$56,026. Based on Hillview #3 s current tariffed rate of \$11.25 per month and a customer level of 420, Staff has calculated normalized test year operating revenues to be \$56,700. This results in an increase over test year reported revenues of \$674.

(b) Owner/Manager Fee. For the test year Hillview #3 reported \$2,400 in owner/manager fees. An adjustment was proposed to increase this fee to a level of \$7,000. The primary purpose of the management fee is to compensate the management for duties performed for the utility. Staff finds that minimal attention is required by the owner/manager of Hillview #3 as it is a relatively small utility that has contractors performing its primary operations. Accordingly, Staff finds that \$3,600 is a reasonable fee for the owner/manager of this utility and has increased test year expense by \$1,200 to a level of \$3,600.

(c) Sludge Hauling. During the test year Hillview #3 incurred sludge hauling expenses of \$9,866. An adjustment was proposed to increase this expense by \$2,734 based on a notice from the vendor indicating an increase in the cost of hauling sludge to \$525 per 5,000-gallon load. Based on the notice submitted by Hillview #3, as of January 1999, F & W Operations has been hauling sludge for \$411.10 per 5,000-gallon load. Based on an Hillview #3 s projection of 24 loads per year, this would result in an annual expense of \$9,866, equal to the test year level.

No competitive bids were provided for this service. Hillview #3 s current owner, Mr. Frank Wethington, is also the president of F & W Operations, the company that has managed and operated Hillview #3 since its inception in February

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of 1987. Because Hillview #3 and F & W Operations have common ownership, the sludge hauling fee is a less-than-arms-length transaction. Transactions that are less-than-arms-length are more closely scrutinized to insure that they do not result in unreasonable costs being passed on to the ratepayers.

As a result Staff reviewed sludge hauling expense for similarly situated utilities and determined the average cost per load to be \$400. Accordingly, Staff is of the opinion that \$411.10 is a reasonable cost per load and has made no adjustment to test year expense.

(d) Purchased Water. Hillview #3 reported purchased water expense of \$2,865 for the test period which it proposed to increase by \$86. The proposed increase was based on an estimated three percent increase in water charges anticipated by the Louisville Water Company. No documentation was provided to support the projected increase. Therefore, Staff has excluded this adjustment for rate-making purposes.

(e) Purchased Power. During the test year Hillview #3 incurred purchased power expense of \$9,053. In its application an adjustment was proposed to increase this expense by \$272 based on a projected increase of three percent per year. No documentation was presented to support the increase. Since it does not meet the rate-making criteria of being known and measurable, Staff has disallowed the proposed increase.

(f) Chemicals. For the test year Hillview #3 reported chemicals expense of \$3,316. An adjustment was proposed to increase this expense to a level of \$3,482, based on a notice received from the supplier. Staff has reviewed the notice and has adjusted test year chemicals expense by an increase of \$166.

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(g) Supplies. Hillview #3 reported supplies expense of \$301 for the test year which it proposed to increase by \$9. The proposed increase was based on a projected three percent increase for inflation. Since the increase does not meet the rate-making criteria of being known and measurable, it has been disallowed in the determination of Hillview #3 s revenue requirement.

(h) Lab Fees. In its application Hillview #3 reported test year lab fees expense of \$1,740. An increase of \$6,580 was proposed based on a letter received from Beckmar Labs stating that the cost of lab analysis would increase from \$145 monthly to \$160 weekly. Staff has reviewed the letter and actual invoices reflecting this increased cost. Accordingly, an adjustment has been made to increase lab fees expense to a level of \$8,320.

(i) Maintenance Treatment Plant & Other Plant Facilities. For the test year Hillview #3 reported maintenance of treatment plant expense and maintenance of other plant facilities expense of \$8,591 and \$670, respectively. Adjustments were proposed to these accounts based on a projected three percent increase for inflation. Since these adjustments do not meet the rate-making criteria of being known and measurable, they have been disallowed in the determination of Hillview #3 s revenue requirement.

(j) Collection Fees. Hillview #3 reported collection fees expense for the test period of \$2,727. An adjustment was proposed to increase this expense to a level of \$2,994, based on the estimated collection expense for 1998. The actual collection expense for 1998 was \$2,923, or a \$196 increase over the test year level.

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Accordingly, Staff recommends an increase of \$196 be allowed for rate-making purposes.

(k) Secretarial Fees. For the test year Hillview #3 reported secretarial fees expense of \$1,200 which it proposed to increase by \$1,300. This increase was based on a rate of \$10.00 per hour for 250 working hours. Staff reviewed an itemized list of the duties performed by Hillview #3 s secretary and the approximate number of hours worked on each. The list includes responsibilities related to billing and collecting which are services currently being performed by the Louisville Water Company. Other itemized responsibilities included the recording of accounts payable and the balancing of the checkbook with the disbursements ledger. However, based on the cash disbursements ledger, an average of only 11.5 checks are written per month. Based on these findings, Staff is of the opinion that the services performed by the secretary could be performed in substantially fewer than 250 hours per year. Although Staff concurs that \$10.00 per hour is a reasonable rate for contracted services, Staff recommends that no adjustment be made to test year expense for secretarial services.

(l) Legal and Professional Fees. Hillview #3 reported legal and professional fees of \$2,395 in its test period operations. An adjustment was proposed to decrease this expense by \$750 to a level of \$1,645, due to services performed during the test year that were not expected to be performed in subsequent years. Based on Staff s review, these fees were for accounting services. The actual invoice received in 1998 for accounting services totaled \$1,645. As a result Staff concurs with Hillview #3 s adjustment to decrease test year expense by \$750.

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(m) Insurance Expense. Hillview #3 s test year operations reflect insurance expense of \$525. Documentation was provided to support liability insurance in the amount of \$261. However, the invoice provided in support of property insurance was dated October 23, 1995 and did not specify the portion of the invoice attributed to Hillview #3. Therefore, for rate-making purposes, Staff has decreased test year insurance expense to the known and measurable level of \$261.

(n) Telephone Expense. For the test year Hillview #3 reported telephone expense of \$295 which it proposed to increase by \$9. The proposed increase was based on a projected three percent increase for inflation. Since the increase does not meet the rate-making criteria of being known and measurable, it has been disallowed in the determination of Hillview #3 s revenue requirement.

(o) Miscellaneous Expense. For the test year Hillview #3 reported telephone expense of \$291, which it proposed to increase by \$9. The proposed increase was based on a projected three percent increase for inflation. Since the increase does not meet the rate-making criteria of being known and measurable, it has been disallowed in the determination of Hillview #3 s revenue requirement.

(p) Depreciation Expense. Hillview #3 reported depreciation expense of \$5,326 for the test period which it proposed to decrease by \$575, to the projected 1998 level of \$4,751. Based on Staff s review of the 1998 depreciation schedule, actual 1998 depreciation expense was \$5,132. Therefore, Staff recommends a decrease of \$194 be included for rate-making purposes.

(q) Amortization Expense. Hillview #3 reported test year amortization expense of \$1,732. Based on the amortization schedule and Hillview #3 s October 26, 1999

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response to Item 5 of the Commission's Order dated September 9, 1999, this expense was for the 5-year amortization of organizational costs and loan closing costs incurred when the plant was transferred in 1994. It is Staff's opinion that these costs provided no benefit to the ratepayers and should be excluded for rate-making purposes.

An adjustment was proposed by Hillview #3 to include \$1,000 in pro-forma expenses for the amortization of rate case expense incurred in this proceeding. The estimated total rate case expense was \$3,000. Based on information submitted to Staff after the field review, the total estimated cost increased to \$4,000 which would result in annual amortization expense of \$1,333. As of the date of this report no invoices have been provided to support actual rate case expense. Accordingly, Staff has disallowed the amortization of rate case expense in the calculation of Hillview #3's revenue requirement.

(r) Property Taxes. Hillview #3 reported personal property tax expense of \$158 for the test year. An adjustment was proposed to include real estate tax expense in pro-forma operations at an estimated level of \$649. Based on information provided by Hillview #3, the utility has not received real estate and personal property bills for the past two years, 1997 and 1998. Calculations were provided to support estimated 1999 property tax bills to be \$117.37 for personal property and \$3.92 for real estate. Accordingly, Staff has included property tax expense of \$121 for rate-making purposes.

(s) Public Service Commission Assessment. The Public Service Commission (PSC) Assessment Expense was not reflected in Hillview #3's test year operations.

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An adjustment was proposed to include this expense at the 1998 level of \$102 was proposed in the application. Staff has verified the 1998 assessment and has included the increase to test year expense.

(t) Interest on Long-term debt. For the test year Hillview #3 reported interest on long-term debt in the amount of \$8,902. No adjustment was proposed in the application to increase this amount although Hillview #3 included the expense in determining its proposed rates. The interest on long-term debt is related to monies borrowed by Mr. Wethington when he purchased the plant in 1994. In Case No. 94-311¹ it was determined that the loan was not necessary for or consistent with the proper performance of utility service but merely facilitated a change in utility ownership. Therefore, Staff is of the opinion that interest associated with this loan should not be borne by Hillview #3 s ratepayers. As a result, this expense has been excluded from Hillview #3 s test period operations.

(u) Other Interest Expense. Hillview #3 reported other interest expense for the test year in the amount of \$7,294. There were no adjustments proposed to increase or eliminate this expense for rate-making purposes. The other interest expense is payable to F & W Operations and has been accrued on operation and maintenance accounts payable that Hillview #3 has been unable to pay. Staff is of the opinion that allowing the interest on debt incurred to pay Hillview #3 s past operating expenses would constitute retroactive rate-making by requiring current customers to pay for

¹The Application of Hillview Sewer Plant #3, Inc. for Approval to Issue Indebtedness to Purchase the Plant and the Installation of a Final Settling Collector Chain.

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providing service to past customers. Therefore, Staff recommends that test period operations be decreased by \$7,294.

(v) Cost of Capital Expenditures. In its application Hillview #3 proposed two capital expenditures. The first was for the replacement of a defective sewer main line at an estimated cost of \$2,610. The other capital expenditure proposed by Hillview #3 was for the slip lining of 3,690 feet of sewer lines and 50 connections at an estimated total cost of \$150,968. Hillview #3 proposed to finance these expenditures with a 10-year note at an interest rate of nine percent.

Staff has determined that, based on the December 31, 1998 annual report, the cost of the slip lining and related projects represents 39 percent of total utility plant of \$450,952. Accordingly, the project would be considered material in nature and should not be reviewed within the scope of an ARF Application. By letter dated September 7, 1999, Hillview #3 was advised that the construction and related financing would not be considered in the ARF proceeding and that the utility should file an application requesting approval for the proposed construction and financing.

(w) Prior Year Operating Losses. Hillview #3 proposed to recover prior year operating losses totaling \$94,936 over a period of 10 years. This would result in an increase to test year operations of \$9,494 per year. These losses accrued from payments due to F & W Operations for the operation and maintenance of the sewer plant. As stated in the discussion of Item (u), Other Interest Expense, recovery of these expenses would be considered retroactive rate-making and should be disallowed in the determination of Hillview #3's current revenue requirement and rates.

ATTACHMENT C
 STAFF REPORT CASE NO. 99-067
 CALCULATION OF REQUESTED AND RECOMMENDED
 REVENUE REQUIREMENTS

	Requested by Hillview #3	Recommended by Staff
Adjusted Operating Expenses	138,407	74,266
Operating Ratio	.88	0.88
Revenue Requirement	157,281	84,393
Less: Reported Test-Year Revenue	56,026	
Normalized Test-Year Revenue		56,700
Required Increase	101,255	27,693

ATTACHMENT D
STAFF REPORT CASE NO. 99-067
RECOMMENDED SEWER RATES

RECOMMENDED RATES

Single Family Residential

\$16.75