

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

PETITION OF STEPP BRANCH	)	
GAS COMPANY, INC. TO CEASE	)	CASE NO.
OPERATIONS OF ITS NATURAL	)	2002-00182
GAS DISTRIBUTION SYSTEM	)	

ORDER

On May 30, 2002, Stepp Branch Gas Company, Inc. ( Stepp Branch ) filed with the Commission a request to cease operations of its gas distribution system. Commission Staff has prepared the attached Staff Report based on a limited financial review of Stepp Branch s operations. All parties should review the report carefully and provide any written comments no later than 7 days from the date of this Order.

IT IS THEREFORE ORDERED that all parties shall have no more than 7 days from the date of this Order to provide written comments regarding the attached Staff Report.

Done at Frankfort, Kentucky, this 3<sup>rd</sup> day of July, 2002.

By the Commission

ATTEST:

  
Executive Director

STAFF REPORT  
ON  
STEPP BRANCH GAS COMPANY  
CASE NO. 2002-00182

On May 30, 2002, Stepp Branch Gas Company ( Stepp Branch ) filed with the Commission a request to cease operations of its gas distribution system. In that filing, Stepp Branch stated that it had been working with Commission Staff ( Staff ) on a rate application. In order to assist Stepp Branch in filing a rate application, Staff originally began a review of Stepp Branch's records in October 2001 for the year ended December 31, 2000. Because of inadequate recordkeeping and little supporting documentation, Staff determined that historical operations were unreliable. Therefore, the pro forma financial information included in this staff report is based on projected operations as well as some information in the 2000 annual report.

Due to events that have taken place in the past several months, it became necessary to include certain items pertaining to the correction of administrative and safety violations as well as to repair damage to the system resulting from a landslide in the area served by Stepp Branch. The initial cash outlay for these items is estimated to be \$158,800. However, the Commission's policy is to amortize or depreciate items that benefit more than one year and therefore has treated those items accordingly as discussed later in this staff report.

Staff has determined that Stepp Branch's revenue requirement is \$65,771, resulting in a simple cash flow of \$21,972 annually. A simple cash flow includes net income plus depreciation and amortization. Staff believes that the simple cash flow

resulting from the required rate increase cannot provide sufficient funds to pay for the actions needed to bring Stepp Branch into full operational compliance. Staff also does not believe the simple cash flow would supply adequate debt service if Stepp Branch chose to borrow the money for the required capital investment of \$158,800.

Stepp Branch's pro forma operating income statement is included in this report as Attachment A. Staff used an 88 percent operating ratio and determined a revenue requirement of \$65,771. The rates to produce this revenue are listed in Attachment B.

### Natural Gas Purchases

Stepp Branch's current Gas Cost Adjustment ( GCA ) of \$.9572/Mcf recovers gas purchases from Columbia Natural Resources ( CNR ) during winter months when the supply from local wells cannot meet customer demand. As a result of a break in Stepp Branch's distribution line, CNR is now supplying gas for most of Stepp Branch's customers. The contract between Stepp Branch and CNR established the price for all gas delivered equal to the Index price of spot gas delivered to Columbia Gas Transmission Corporation, Appalachia, as reported in the first publication each month of Inside F.E.R.C.'s Gas Market report, plus \$1.00/Dth. Using the June 1, 2002 Inside F.E.R.C. Index price and excluding prior quarter adjustments and volume conversions, Stepp Branch's estimated GCA would be \$4.54 per Mcf, resulting in a purchased gas expense of \$14,955 as shown in Attachment B. These assumptions are based on Stepp Branch making no repairs to the distribution line and continuing to take gas from CNR. These assumptions are subject to change if Stepp Branch repairs the distribution line.

### Supervision

In keeping with previous Commission decisions, it was determined that an owner/manager fee of \$2,400 is reasonable for a utility the size of Stepp Branch.

### Maintenance of Mains

Maintenance labor was estimated to be one 8-hour day a month at \$10 per hour for an annual total of \$960. It is anticipated that this work will be contract labor. In addition, it is estimated that consistent compliance with regulatory requirements would cost approximately \$1,500 annually. Typical regulatory requirements include leak surveys, corrosion surveys, odorant tests, patrols, and proper signage and postings. The total included in this account is \$2,460.

### Meter Reading Expenses

Meter reading labor was estimated to be one 8-hour day a month at \$10 per hour for a total annual cost of \$960. This work will primarily be done by a part-time employee of Stepp Branch.

### Rents

All billing and bookkeeping for Stepp Branch is done at the home of Lisa Davis and all records are kept there. In addition, all materials and supplies related to the distribution system are stored on Mike Davis's property. While no formal agreement exists between Stepp Branch and Mike or Lisa Davis, it is reasonable to compensate them for the use of this space. An amount of \$50 per month for each was used for an annual total rent of \$1,200. This amount includes all utilities except telephone.

### Administrative and General Salaries

It was estimated that it requires two 8-hour days per month to prepare and send customer bills, post customer payments, make disbursements for Stepp Branch expenses, and correspond with customers and other utility contacts for a total annual cost of \$1,920. This work will be performed by a part-time employee. In addition, Stepp Branch is required to have a Certified Operator but currently does not employ one. The Certified Operator must reside in the immediate area of the Stepp Branch system to respond to emergencies in a timely manner. Staff estimated that hiring a Certified Operator would cost approximately \$25,000 per year. The total included in this account is \$26,920.

### Office Supplies and Expenses

Office supplies consists of ordinary annual expenses. Stepp Branch uses a cell phone as its primary form of communication. This phone is shared by a related company, Davis Drilling. Therefore, 50% of the actual 2000 expense was allocated to Stepp Branch. Office supplies are detailed as follows:

Cell phone	\$360	(50% of actual 2000 expense)
Postage	150	(12 mos. x 46 cust. x \$.21 = \$116 + incidental postage)
Bank charges	96	(\$8 per month x 12 months = \$96)
Billing cards	36	estimated to order once a year at actual cost
Check order	14	estimated to order once a year at actual cost
	<u>\$656</u>	

### Outside Services Employed

This account includes 2000 actual expenses of \$210 to the utility's CPA for annual report and tax return preparation and \$52 to the utility's attorney for a total of \$262.

### Miscellaneous General Expenses

This account includes 2000 actual expense of \$35 for a natural gas seminar and travel for the seminar in the amount of \$50 for a total of \$85.

### Transportation Expenses

Mike Davis estimates that he travels to the Stepp Branch system once a week. In addition, a trip is made to read meters once a month. The 2001 federal standard mileage rate was used to calculate transportation expense as follows:

Mike Davis	(52 trips annually x 96 miles round trip x \$.345 per mile)	\$1,722
Meter Reader	(12 trips annually x 96 miles round trip x \$.345 per mile)	397
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		\$2,119

### Insurance Expense

General liability insurance is estimated to cost \$4,200 annually based on a comparison of other small gas companies in the area.

### Amortization Legal

Stepp Branch incurred legal expenses in 2000 of \$572 related to an earlier decision to cease operations. This is a non-recurring expense and is being amortized over 5 years for an annual cost of \$114.

### Amortization Administrative Plans

Administrative Plans are required by federal pipeline safety regulations specifically dealing with the administration and operation of a gas distribution system. Required Administrative Plans are listed in the Comprehensive Inspection Report dated November 8, 2000. The estimated cost of these plans is \$3,500. This is a non-recurring expense and is being amortized over 3 years for an annual cost of \$1,167.

#### Amortization Distribution System Repair

Due to a landslide on May 4, 2002, a major portion of Stepp Branch's distribution system was disconnected from the only operating gas well. The cost to reconnect the system to the operating gas well and properly relocate the pipeline is approximately \$3,000. This is a non-recurring expense and is being amortized over 3 years for an annual cost of \$1,000.

In addition, Stepp Branch has been cited by the Commission for a section of steel distribution pipe that is not protected from corrosion. Installation of corrosion protection equipment for this section of pipe is estimated to cost \$2,500. This is a non-recurring expense and is being amortized over 3 years for an annual cost of \$833. The total included in this account is \$1,833.

#### Amortization Operator Certification

Stepp Branch has not established an Operator Qualification Program as required by federal pipeline safety regulations. The cost to establish an Operator Qualification Program is estimated to be \$1,000. This is a non-recurring expense and is being amortized over 2 years for an annual cost of \$500. Additionally, the utility is required to have a certified operator. The Kentucky Gas Association offers training courses for this certification. Using KGA information, it was determined that certification courses over the next 2 years will cost \$1,975. The annual certification cost is \$988. The total included in this account is \$1,488.

#### Amortization Relocation of Above Ground Line

The Commission has ordered Stepp Branch to bury an above ground, temporary, plastic line which connects the distribution system to the CNR tap. The cost to bury this

line is estimated to be \$3,800. This amount is being amortized over three years for an annual cost of \$1,267.

Depreciation

When the ownership of Stepp Branch was transferred in 1998, gross utility plant was stated at \$68,292. In addition to purchasing the stock of Stepp Branch, as a part of the transaction, Mike Davis also purchased leaseholds in the two wells which supply gas to the utility. In recording the transfer, \$20,000 was incorrectly added to utility plant and is not included here. A pro forma addition is being made to plant to reflect the replacement of 12 meters at a cost of \$75 each. Depreciation is calculated as follows:

	Date in Service	Cost	Useful Life	Annual Deprec.
Lines and services	1/1/89	\$68,292	40	\$1,707
Office equipment	6/20/98	2,877	3	959
Equipment	6/20/98	600	3	200
New meters		900	20	45
				<u>\$2,911</u>

However, in order to establish an adequate, efficient and reasonably priced source of gas, it should be taken into account that Stepp Branch would need to install a permanent connection to the Columbia Transmission system. The estimated cost of the connection is \$145,000. This pro forma addition should be depreciated over 40 years, the estimated useful life of the plant. Annual depreciation expense related to the connection would be \$3,625. The total included in depreciation expense is \$6,536.

Taxes Other Than Income

Taxes other than income are based on actual 2000 expenses for property taxes and the PSC assessment. Payroll taxes are based on the allowed salary as noted in



Meter Reading Labor and Administrative and General Salaries multiplied by a rate of .0765, the current combined FICA and Medicare rate.

Payroll Taxes	\$2,133
Local property taxes	400
State property taxes	104
PSC assessment	50
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	\$2,687

Dawn McGee is responsible for all revenue adjustments and calculation of the recommended rates. Chris Whelan and Andrea Edwards are responsible for the determination of the revenue requirement.

#### Signatures

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Prepared by: Dawn McGee  
Rate Analyst III  
Electric and Gas Rate Design Branch  
Division of Financial Analysis

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Prepared by: Chris Whelan, CPA  
Audit Reviewer  
Financial Audits Branch  
Division of Financial Analysis

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Prepared by: Andrea Edwards  
Financial Analyst  
Revenue Requirements Branch  
Division of Financial Analysis

ATTACHMENT A  
Stepp Branch Gas Company  
Pro Forma Operating Income Statement

Item Per Annual Report	Pro forma Present Rates	Adjustments	Pro forma Proposed Rates
Operating Revenue			
Minimum Bill Revenue	3,312	(3,312)	0
Customer Charge Revenue	0	3,312	3,312
Base Rate Revenue	16,222	46,237	62,459
Purchase Gas Revenue	0	14,955	14,955
Miscellaneous Charge Revenue	150	0	150
Total Operating Revenue	19,684	61,192	80,876
Operating Expenses			
Operation and Maintenance Expenses:			
Natural Gas Purchases	3,263	11,692	14,955
Supervision	2,400		2,400
Maintenance of Mains	2,460		2,460
Meter Reading Expenses	960		960
Rents	1,200		1,200
Administrative and General Salaries	26,920		26,920
Office Supplies and Expenses	656		656
Outside Services Employed	262		262
Miscellaneous General Expenses	85		85
Transportation Expenses	2,119		2,119
Insurance Expense	4,200		4,200
Amortization - Legal	114		114
Amortization - Administrative Plans	1,167		1,167
Amortization - Distribution System Repair	1,833		1,833
Amortization - Operator Certification	1,488		1,488
Amortization - Relocation of above ground line	1,267		1,267
Total Operation and Maintenance Exp.	50,394	11,692	62,086
Depreciation	6,536		6,536
Taxes Other Than Income	2,687		2,687
Total Operating Expenses Before Income Taxes	59,617	11,692	71,309
Net Operating Income (Loss) Before Income Taxes	(39,933)	49,500	9,567
<u>Revenue Requirement Calculation/Based on an 88% Operating Ratio</u>			
Pro Forma Operating Expenses Before Income Tax	71,309		
Less: Natural Gas Purchases	14,955		
Subtotal	56,354		
Divided by: 88%	88%		
Amount to be Recovered in Rates	64,039		
Plus: Income Taxes on Net Operating Income	1,733		
Total Revenue Required	65,771		

ATTACHMENT A  
 Stepp Branch Gas Company  
 Pro Forma Operating Income Statement

Calculation of Income Tax Allowance

Revenue for operating coverage ratio	64,039	
Less: Operating expenses before taxes	<u>56,354</u>	less natural gas revenues less natural gas purchases
Net Operating Income Allowed	7,685	
Times: Gross-up factor	<u>1.225490196</u>	
Net Operating Income Before Taxes	9,417	
Less: Net Operating Income Allowed	<u>7,685</u>	
Income Tax Expense	<u><u>1,733</u></u>	

Calculation of Gross-up Factor

Revenues	1	
Less: State tax	<u>0.04</u>	
Sub-total	0.96	
Less: Federal tax (15% of sub-total)	<u>0.144</u>	
Percent change in Net Operating Income	<u>0.816</u>	
Gross-up Factor (Revenue of 1 divided by percent change in NOI)	<u><u>1.225490196</u></u>	

ATTACHMENT B  
Stepp Branch Gas Company  
Pro Forma Operating Income Statement

**BILLING ANALYSIS**

Stepp Branch Gas Co., Inc.  
Proposed Rates

**Customer Charge**

2000	Current # Customers	Customer Charge	Revenue
January	46	\$6.00	\$276.00
February	46	\$6.00	\$276.00
March	46	\$6.00	\$276.00
April	46	\$6.00	\$276.00
May	46	\$6.00	\$276.00
June	46	\$6.00	\$276.00
July	46	\$6.00	\$276.00
August	46	\$6.00	\$276.00
September	46	\$6.00	\$276.00
October	46	\$6.00	\$276.00
November	46	\$6.00	\$276.00
December	46	\$6.00	\$276.00
<b>TOTAL</b>			<b>\$3,312.00</b>

**Base Rate Revenue  
(100% of sales volume)**

Month	Base Rate	Volume	Revenue
January	\$18.9608	580.78	\$11,012.06
February	\$18.9608	610.26	\$11,571.03
March	\$18.9608	373.62	\$7,084.14
April	\$18.9608	226.20	\$4,288.94
May	\$18.9608	96.22	\$1,824.41
June	\$18.9608	47.28	\$896.47
July	\$18.9608	41.00	\$777.39
August	\$18.9608	62.05	\$1,176.52
September	\$18.9608	50.40	\$955.62
October	\$18.9608	185.65	\$3,520.07
November	\$18.9608	396.45	\$7,517.01
December	\$18.9608	624.20	\$11,835.34
<b>TOTAL</b>		<b>3294.11</b>	<b>\$62,459.00</b>

**GCA Revenue  
Appalachian Index June 2002 \$3.54  
Contract Price \$3.54 + \$1.00**

Month	Volume	Current Rate	Revenue
January	580.78	\$4.5400	\$2,636.81
February	610.26	\$4.5400	\$2,770.58
March	373.62	\$4.5400	\$1,696.21
April	226.20	\$4.5400	\$1,027.04
May	96.22	\$4.5400	\$435.04
June	47.28	\$4.5400	\$214.85
July	41.00	\$4.5400	\$186.34
August	62.05	\$4.5400	\$281.71
September	50.40	\$4.5400	\$228.82
October	185.65	\$4.5400	\$844.85
November	396.45	\$4.5400	\$1,799.88
December	624.20	\$4.5400	\$2,833.87
<b>TOTAL</b>	<b>3294.11</b>		<b>\$14,955.26</b>

Revenue from Customer Charge	\$3,312.00
Revenue from Base Rates	\$62,459.00
Revenue from GCA	\$14,955.26
Revenue from Misc. Chgs	\$150.00
<b>Total Revenue</b>	<b>\$80,876.26</b>