COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF HOLLY CREEK PRODUCTION COMPANY FOR AN ADJUSTMENT OF RATES PURSUANT TO THE ALTERNATIVE RATE FILING PROCEDURE FOR SMALL UTILITIES	)))))	CASE NO. 2002-00253

O R D E R

On June 28, 2002, Holly Creek Production Company (Holly Creek) applied for an adjustment of rates pursuant to Administrative Regulation 807 KAR 5:076, the alternative rate filing procedure for small utilities. Having performed a limited financial review of Holly Creek s operations, Commission Staff (Staff) has submitted to the Commission a report of its findings and recommendations regarding the proposed rate adjustment. All parties should review the report carefully and submit any written comments on Staff s findings and recommendations 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, no later than 10 days from the date of this Order, submit written comments, if any, regarding the attached Staff Report or request for a hearing or informal conference. If no request for a hearing or informal conference is received by this date, this case shall stand submitted to the Commission for a decision.

Done at Frankfort, Kentucky, this 25th day of November, 2002.

By the Commission

ATTEST:

Thomas M. Dorman

Executive Director

STAFF REPORT

ON

HOLLY CREEK PRODUCTION COMPANY

Case No. 2002-00253

Preface

On June 28, 2002, Holly Creek Production Company (Holly Creek) filed an application for a rate adjustment pursuant to Administrative Regulation 807 KAR 5:076, the Alternative Rate Filing Procedure for Small Utilities (ARF). Commission Staff (Staff) has determined that Holly Creek is requesting an increase produced by the proposed rates of $4,986, which represents a 16.8 percent increase over revenues from existing rates. In order to meet the minimum filing requirements for an ARF, a utility must have less than 500 customers or less than $300,000 in gross annual revenues. During 2001, Holly Creek met the minimum requirements for an ARF filing.

Holly Creek is a wholly-owned subsidiary of Beh Brothers, Inc. headquartered in Des Moines, Iowa. Holly Creek owns and operates a natural gas production system and serves approximately 40 farm tap customers.

Staff performed a limited financial review of Holly Creek s operations for the test year ending December 31, 2001. On July 15, 2002, the Staff issued a letter specifying what information would be needed to assist Staff in performing the financial review. On September 6, 2002, the Staff issued a Data Request to gather information to evaluate the revenues and expenses of Holly Creek. Holly Creek responded to the Data Request on September 26, 2002 and revised the operating statement from that provided in the original application. The modified total company operating statement is attached as Schedule I. Andrea Edwards is responsible for the calculation of the revenue requirements for this Staff Report. Michael Nantz is responsible for all revenue adjustments and calculation of the recommended rates.

Scope

The scope of the review was limited to obtaining information to determine that the test-year operating revenues and expenses as reported in Holly Creek s application for the period ending December 31, 2001 were representative of normal operations. Holly Creek did not propose any pro forma adjustments to the test year. Insignificant or immaterial discrepancies were not pursued and are not addressed herein.

Accounting and Record-Keeping Procedures

Holly Creek submitted test-year operating statements that included both production expenses as well as farm tap expenses. Holly Creek determined an allocation of expenses based on revenue of the production and farm tap systems. The total test-year revenue was $106,646. The production system revenue was $77,007 or 72 percent while the farm tap system revenue was $29,639 or 28 percent. The Staff agrees that the allocation of expenses based on an allocation of revenue is generally reasonable in this situation and accepts Holly Creek s allocation method. The adjustments presented in this Staff Report represent the portion allocated to the farm tap system, 28 percent of the original adjustment, unless otherwise noted.

Currently, Holly Creek does not maintain separate records for its production operations and its farm tap system. The lack of such records raises the risk that farm tap customers may subsidize the production operations, or vice versa. Therefore, Staff recommends that Holly Creek maintain separate accounting records for its production operations and the farm tap system. Proper classification of farm tap expenses and the allocation of joint costs are necessary in order to accurately identify the costs that should be recovered from the farm tap customers. This is necessary to ensure that the rates Holly Creek charges its farm tap customers reflect only the costs of the farm tap system.

Staff Recommended Accounting and Rate-Making Adjustments

Holly Creek presented its test-year operating statement for the calendar year 2001. Holly Creek has proposed no adjustments to its test-year operations. Staff has made adjustments where sufficient information is available to make the appropriate adjustment. The Staff s evaluation of the adjustments is discussed below. Schedule II contains a pro forma income statement with the allowable adjustments.

Payroll

For the test year, Holly Creek s operating statement indicated that total payroll was $3,477. However, according to tax records submitted by Holly Creek, the total payroll paid during the test year totaled $4,368. After reviewing both the operating statement and the tax records, Staff has concluded that the amount presented in the tax records is the more accurate indicator of the payroll for 2001. Accordingly, Staff recommends a increase to payroll of $891 to balance with payroll tax records.

Royalties

Holly Creek has included $8,333 in royalties paid to investors during the test year. According to the response to the data request, royalties are paid in accordance with the Farmout Agreement to investors based on the production of natural gas. As such, the royalties are part of the production system. Therefore, the farm tap allocation would not apply to production system expenses. However, since the farm tap system obtains its gas from the production system, it is appropriate to allocate royalties costs based on gas volumes. The farm tap sales of 5,540 Mcf equal 13.67 percent of the total Mcf produced of 40,254 Mcf. This production allocator should be applied to allocate production system expenses to the farm tap system. Using the production allocator, Staff has decreased the royalties expense by $4,265, to $4,068.

Office, Insurance, and Rent

Telephone. Holly Creek s allocated test year $1,318 telephone expense for the farm tap system included $857 for cellular service. Holly Creek states that the cellular service had been billed for the wrong service plan during the test year and the monthly bill frequently contained errors. Holly Creek has changed cellular service plans and submitted copies of its current billing for cellular service which indicates a monthly expense of $16 or $195 annually. The Staff believes it is reasonable to use this corrected level of expense for rate-making purposes. Therefore, Staff has decreased the farm tap system cellular service expense by $662.

Rent. During the test year, Holly Creek rented office/warehouse space in Kentucky and rented office space and parking in Iowa. Holly Creek allocated $3,323 to the farm tap system. A review of actual rent invoices submitted to Staff shows, on an allocated basis, that the expense for office space and parking in Iowa was $3,048 and the expense for office/warehouse space in Kentucky was $420. Since the billing function and other administrative activities for the farm tap system are handled in the Iowa office, it is reasonable to include the allocated share of the Iowa office space and parking expense in the operating expenses of the farm tap system. Accordingly, Staff has increased the rent expense by $145.

Miscellaneous. Holly Creek included in the operating expenses for both its production operations and farm tap system an expense of $305 that included prior years filing fees and penalties for delinquent payments relating to its corporation reinstatement, which had been allowed to lapse. This $305 expense had been recorded by Holly Creek as Other Taxes; however, Staff has reclassified the expense to the Office, Insurance and Rent account because the expense relates to Holly Creek s incorporation status in Kentucky. The total expense of $305 includes $290 of prior year filing fees and penalties. The Staff believes it is not reasonable to include these prior expenses for rate-making purposes. These fees and penalties should not represent recurring expenses to Holly Creek. The Staff does believe it is reasonable to include the current annual filing fee of $15. Since this filing fee applies to both the production operations and the farm tap system, it must be allocated using the 28 percent allocation. Therefore, the Staff has included an expense of $4.

The net effect of all of the above adjustments, plus the correction of a mathematical error, to Office, Insurance and Rent expense is a decrease of $516.

Well Service

In its application, Holly Creek proposed well service expenses of $556. Servicing of the wells is a necessary function of the production system and not the farm tap system. Accordingly, the farm tap allocation does not apply to these production system expenses. The production allocator of 13.67 percent should be applied to these expenditures. Using the production allocator, Staff has decreased the well service expense by $285, to $271.

Capital Additions

Holly Creek reported as operating expenses amounts expended for capital additions for the total company. Holly Creek proposed to remove the capital additions as non-operating expenses. Expenditures for capital additions should be capitalized and reflected on Holly Creek s balance sheet. Staff agrees with the proposal and has excluded the capital additions from the pro forma operating expenses.

During the test year, Holly Creek purchased and installed house meters and included the expense of $150 with the operating expenses. This expenditure represents a capital addition, which should be shown on the balance sheet as part of the utility plant and be depreciated. Therefore, Staff has excluded the $150 for house meters from the pro forma operating expenses. Depreciation expense for the house meters will be discussed later in this Report.

Loan Payments

For the test year, Holly Creek reported loan payments as part of the operating expenses for the total company. Holly Creek indicated that the proceeds of these loans had been used to cover operating expenses for its overall operations. However, Holly Creek proposed to remove the loan payments from the operating expenses, noting the expense should be consider a non-operating expense. Based on a review of the information submitted by Holly Creek concerning the loans, the Staff agrees with the proposal and has excluded the loan payments from the pro forma operating expenses.

Bank Charges

During the test year, Holly Creek incurred bank charges, of which $350 was allocated to the farm tap operations. In the response to the data request, Holly Creek states that the bank charges were excessive and the account has been closed.[1] Since the account has been closed, the charges represent non-recurring expenses that should not be included for rate-making purposes. Therefore, Staff has removed the bank charges from the pro forma operating expenses.

Legal Expenses

During the test year, Holly Creek incurred legal expenses and allocated $71 to the farm tap system. In the response to the data request, Holly Creek states that the legal expenses were incurred to reincorporate Beh Brothers, Inc., the parent corporation of Holly Creek.[2] It is not reasonable to include such legal expenses for the corporate parent for rate-making purposes for Holly Creek s farm tap system. The Staff has excluded the expense from the pro forma operating expenses.

Depreciation

Holly Creek reported that all its assets were fully depreciated, and it reflected no depreciation expense for the test year. As discussed previously in this Report, Staff capitalized an expense of $150 for house meters. The Staff believes it is reasonable to include the first year depreciation on these meters when determining Holly Creek s

[1] Response to the Commission Staff s Data Request dated September 6, 2002, Item 4(l).

[2] Response to the Commission Staff s Data Request dated September 6, 2002, Item 3(m).

revenue requirements. The Staff also believes it is reasonable to apply a 25-year depreciable life to these assets, which will result in a depreciation expense of $6.

Taxes Other Than Income Taxes

A review of the expenses included by Holly Creek as Taxes Other than Income Taxes revealed items that should not be included in the operating expenses. The major item was the inclusion of Kentucky Sales taxes, which Holly Creek collects on behalf of the Commonwealth and forwards to the Kentucky Revenue Cabinet. The account Taxes Other than Income Taxes should include employer payroll taxes, licenses (representing other taxes) and property taxes. Based on the information available, Staff has recomputed employer payroll taxes based on normalized payroll as follows:

Total Adjusted Test Year Salaries and Wages	$4,368	
FICA and OASDI tax rate	7.65%	
FICA and OASDI taxes employer portion computed		$ 334
State Unemployment (SUI) wages subject to tax	$ 2,240	
SUI tax rate	2.257%	
SUI tax computed on applicable employee wage limit		$ 50
Federal Unemployment (FUTA) wages subject to tax	$ 1,960	
FUTA tax rate	0.80%	
FUTA tax computed on applicable employee wage limit		$ 16
SUBTOTAL		$ 400
Property taxes		$ 31
License		9
Staff Adjusted Test Year Balance		$ 440

Revenue Requirements

Holly Creek did not explain how it determined the amount of increase it proposed in its application. Normally, a utility will propose a rate of return on rate base approach or the operating ratio method to determine its total revenue requirements. The operating ratio method is used primarily when there is no sound basis for a rate of return determination using the required return on rate base method. The Commission generally uses an 88 percent operating ratio to determine a reasonable level of earnings for small utilities.

Given the fact that Holly Creek is a small farm-tap system, the Staff believes it is reasonable to use the operating ratio approach to determine Holly Creek s revenue requirements. Applying the operating ratio to the Staff adjusted operating expenses results in a total revenue requirement of $32,690. Staff accepted the test-year revenues based on the actual test-year sales of $29,639. Therefore, Staff recommends an increase in operating revenue of $3,051.

Following is a calculation of the revenue requirement:

Pro Forma Operating Expenses Before Income Tax	$28,009
Divided by : 88%	88%
Amount to be Recovered in Rates	$31,829
Plus: Income Taxes on Net Operating Income	861
Total Revenue Required	$32,690

The increase in revenue proposed by Holly Creek is based on an increase, from $5.35 to $6.25 per Mcf, in the rate it charges its farm tap customers. Based on Holly Creek s test year sales volumes of 5,540 Mcf, and the our recommended revenue requirement of $32,690, Holly Creek s rate for farm tap service will need to be increased to $5.90 per Mcf.

Signatures:

Prepared By: Andrea Edwards
Public Utility Financial Analyst
Electric and Gas Revenue
Requirements Branch
Division of Financial Analysis

Prepared By: Michael Nantz
Public Utility Financial Analyst
Electric and Gas Rate
Design Branch
Division of Financial Analysis

Schedule I
Holly Creek (Total Company)
Operating Statement

Item Per Application	Original Application Test Year	Holly Creek Revisions to Test Year	Revised Application Test Year
Operating Revenue			
Minimum Bill Revenue	4,911		4,911
Base Rate Revenue	24,728		24,728
Production System Revenue	77,007		77,007
Total Operating Revenue	106,646		106,646
Operation and Maintenance Expenses:			
Payroll	12,420		12,420
Royalties Farmout 1993	10,009	2,243	12,252
Royalties Landowners	18,479	(973)	17,506
Maintenance/Truck	24,447	88	24,534
Office, Insurance & Rent	25,676	(1,808)	23,867
Extra Labor	9,654		9,654
Leak Repairs	6,300		6,300
Well Service	1,985		1,985
Capital Additions	5,674	(231)	5,442
House Meters	0	150	150
Loan Payments	5,147	251	5,397
Bank Charges	0	1,251	1,251
Publications	0	254	254
Travel & Entertainment	0	3,409	3,409
Miscellaneous	1,756	(1,148)	608
Legal Expenses	253		253
Total Operation and Maintenance Exp.	121,798		125,282
Depreciation	0		0
Taxes Other Than Income	9,365	115	9,481
Total Operating Expenses Before Income Taxes	131,163	115	134,763
Net Operating Income (Loss) Before Income Taxes	(24,517)	(115)	(28,117)

Schedule II
Holly Creek Farm Tap System
Pro Forma Income Statement

Item Per Application	Revised Application Test Year	Farm tap Allocation (28%)	Staff Proposed Adjustments	Pro forma Proposed Test Year
Operating Revenue				
Minimum Bill Revenue	4,911	4,911		4,911
Base Rate Revenue	24,728	24,728	0	24,728
Total Operating Revenue	29,639	29,639	0	29,639
Operation and Maintenance Expenses:				
Payroll	12,420	3,477	891	4,368
Royalties Farmout 1993	12,252	3,431	(1,756)	1,675
Royalties Landowners	17,506	4,902	(2,509)	2,393
Maintenance/Truck	24,534	6,870		6,870
Office, Insurance & Rent	23,867	6,841	(516)	6,325
Extra Labor	9,654	2,703		2,703
Leak Repairs	6,300	1,764		1,764
Well Service	1,985	556	(285)	271
Capital Additions	5,442	1,524	(1,524)	(0)
House Meters	150	150	(150)	(0)
Loan Payments	5,397	1,511	(1,511)	0
Bank Charges	1,251	350	(350)	0
Publications	254	71		71
Travel & Entertainment	3,409	954		954
Miscellaneous	608	170		170
Legal Expenses	253	71	(71)	(0)
Total Operation and Maintenance Exp.	125,282	35,345	(7,782)	27,563
Depreciation	0	0	6	6
Taxes Other Than Income (1)	9,481	5,563	(5,123)	440
Total Operating Expenses Before Income Taxes	134,763	40,908	(12,899)	28,009
Net Operating Income (Loss) Before Income Taxes	(105,124)	(11,269)	12,899	1,630

(1) Holly Creek used 58.68% as Farm tap
Tax Allocation