

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF AUXIER ROAD GAS CO.,)
INC. FOR AN ADJUSTMENT IN RATES AND) CASE NO.
CERTAIN NONRECURRING CHARGES) 2008-00156

ORDER

On April 29, 2008, Auxier Road Gas Company, Inc. ("Auxier Road") applied to the Commission for authority to adjust its base gas rates pursuant to 807 KAR 5:076, the alternative rate filing procedure for small utilities. Auxier moved to amend its application on May 2, 2008 to request authority to change several nonrecurring charges and to revise its tariffed purchased gas clause. Because of filing deficiencies, the Commission did not accept the application for filing until June 4, 2008.

Commission Staff, having performed a limited financial review of Auxier Road's operations, has prepared the attached report containing its findings and recommendations regarding the proposed rates. All parties should review the report carefully and submit any written comments about Staff's findings and recommendations or requests for a hearing or an informal conference no later than 14 days from the date of this Order.

IT IS THEREFORE ORDERED that:

1. All parties shall have 14 days from the date of this Order to submit to the Commission written comments, if any, regarding the attached Staff Report and to request a hearing or an informal conference in this matter.

2. Any party requesting a hearing in this matter shall state in its request its objections to the findings set forth in the Staff Report and provide a brief summary of testimony that it would present at hearing.

3. A party's failure to object to a finding or recommendation contained in the Staff Report within 14 days of this Order shall be deemed as agreement with that finding or recommendation.

4. If no request for a hearing or an informal conference is received within the 14 days, this case shall stand submitted to the Commission for decision.

Done at Frankfort, Kentucky, this 18th day of January, 2009.

By the Commission

ATTEST:



Executive Director

STAFF REPORT
ON
AUXIER ROAD GAS COMPANY, INC.
CASE NO. 2008-00156

Auxier Road Gas Company, Inc. ("Auxier Road") applied to the Commission for authority to adjust its base gas rates pursuant to 807 KAR 5:076, the alternative rate filing procedure for small utilities. Auxier moved to amend its application on May 2, 2008 to request authority to change several nonrecurring charges and to revise its tariffed purchased gas clause. Because of filing deficiencies, the Commission did not accept the application for filing until June 4, 2008.

In order to evaluate the requested increase, Commission Staff performed a limited financial review of Auxier Road's test-period operations for the calendar year ending December 31, 2007. 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.

Mark Frost and Dawn McGee of the Commission's Division of Financial Analysis performed the limited review. This report summarizes Staff's review and recommendations. Ms. McGee is responsible for the pro forma revenue adjustment, the development of the base rates, the nonrecurring charges and purchased gas adjustment clause. Mr. Frost is responsible for all pro forma expense adjustments and the revenue requirement determination.

The comparison of Auxier Road's actual and pro forma operations is attached hereto as Appendix A.¹ Based upon the recommendations and findings of Staff's limited review of the operating revenues and expenses reported in the 2007 Annual Report, Auxier Road's pro forma operating statement would appear as set forth in Appendix B.

The Commission has historically used an operating ratio approach² to determine revenue requirements for small, privately owned utilities.³ This approach is used because no basis for rate-of-return determination exists or the cost of the utility has fully or largely been recovered through the receipt of contributions. For these reasons, Staff finds that this method should be used to determine Auxier Road's revenue requirement. Staff further finds that an operating ratio of 88 percent will allow Auxier Road sufficient revenues to cover its reasonable operating expenses and to provide for reasonable equity growth.

As shown in Table 1 below, Auxier Road's pro forma operations, an allowance for income taxes and an 88 percent operating ratio results in a revenue requirement from base rates of \$454,850, which is an increase of 7.86 percent or \$33,126 over normalized revenues from existing base gas rates of \$421,724.

¹ Auxier Road's response to the filing deficiencies, Item 1.

² Operating Ratio is defined as the ratio of expenses, including depreciation and taxes, to gross revenues.

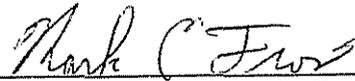
$$\text{Operating Ratio} = \frac{\text{Operating Expenses} + \text{Depreciation} + \text{Taxes}}{\text{Other Than Income Taxes}} \\ \text{Gross Revenues}$$

³ See, e.g., McKnight Utilities Co., Case No. 7553 (Ky. PSC Nov. 13, 1979).

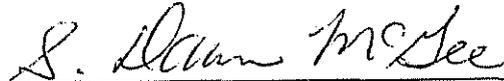
Operating Expenses (Net of Purchased Gas Costs & Income Taxes)	\$ 390,013
Divide by: Operating Ratio	÷ 88%
Revenue to Cover Operating Ratio	\$ 443,197
Add: Interest on Long-Term Debt	6,695
Other Income and Deductions	0
Income Taxes on Net Operating Income	+ 12,679
Total Revenue Requirement - Base Rates and Customer Charges	\$ 462,571
Less: Other Operating Revenues	- 7,721
Total Revenue Requirement Base Rates	\$ 454,850
Less: Operating Revenues (Less: Gas & Transportation Costs)	- 421,724
Revenue Increase	\$ 33,126

Staff recommends that the Commission approve the rates set forth in Appendix C, as they will produce the recommended revenue requirement from base rates of \$454,850. Auxier Road has proposed changing its nonrecurring charges and modifying the terms of its purchased gas adjustment ("PGA") clause in its tariff. The proposed changes to the PGA clause would allow Auxier Road to file its PGA monthly with 20 days' notice. Upon its review of Auxier Road's cost justification for its nonrecurring charges, Staff finds the proposed charges, as set out in Appendix C, to be reasonable. Staff further finds Auxier Road's proposed tariff revision to be appropriate. Therefore, Staff recommends that the Commission grant its approval of the nonrecurring charges listed in Appendix C and approve the proposed revision to the purchased gas adjustment clause.

Signatures



Prepared by: Mark C. Frost
Financial Analyst, Water and Sewer
Revenue Requirements Branch
Division of Financial Analysis



Prepared by: Dawn McGee
Rate Analyst, Electricity and Gas Rate
Design Branch
Division of Financial Analysis

APPENDIX A
STAFF REPORT CASE NO. 2008-00156
AUXIER ROAD'S REQUESTED
PRO FORMA INCOME STATEMENT

<u>Account Titles</u>	<u>2007</u>	<u>Pro Forma Adjustments</u>	<u>Adj. Ref.</u>	<u>Pro Forma Operations</u>
Operating Revenues:				
Total Gas Service Revenues	\$ 1,212,433	\$ -		\$ 1,212,433
Other Operating Revenues:				
Forfeited Discounts	\$ 5,319	\$ -		\$ 5,319
Miscellaneous Service Revenues	1,063	0		1,063
Other Gas Revenues	1,339	0		1,339
Gain on Sale of Asset	13,572	0		13,572
Total Operating Revenues	\$ 21,293	\$ -		\$ 21,293
Total Gas Operating Revenues	\$ 1,233,726	\$ -		\$ 1,233,726
Operating Expenses:				
Other Gas Supply Exp:				
Natural Gas City Gate Purchases	\$ 827,563	\$ 82,756	(b)	\$ 910,319
Operation Exp:				
Operation Supervision & Eng.	\$ 28,800	\$ -		\$ 28,800
Distribution Exp:				
Mains & Service Exp.	\$ 31,470	\$ 1,519	(a&b)	\$ 32,989
Meter & House Regulator Exp.	6,910	0		6,910
Rents	1,656	0		1,656
Maint. - Meters & House Reg	192	0		192
Total Distribution Expenses	\$ 40,228	\$ 1,519		\$ 41,747
Customer Accounts Exp:				
Meter Reading Labor	\$ 24,804	\$ 520	(a)	\$ 25,324
Customer Records & Collection Exp.	65,644	294	(a)	65,938
Uncollectible Accounts	1,698	0		1,698
Total Customer Accounts Exp	\$ 92,146	\$ 814		\$ 92,960
Administrative & General Exp:				
Administrative & General Salaries	\$ 91,500	\$ -		\$ 91,500
Office Supply & Exp	39,061	5,859	(a)	44,920
Outside Services Employed	2,500	0		2,500
Property Insurance	24,159	3,624	(a)	27,783
Employee Pension & Benefits	27,257	273	(a)	27,530
Misc. General Exp.	8,556	0		8,556
Rents	16,200	1,800	(b)	18,000
Maintenance of General Plant	19,456	2,918	(a)	22,374
Total Admin & Gen. Exp.	\$ 228,689	\$ 14,474		\$ 243,163
Total Gas Operation & Maint Exp.	\$ 1,217,426	\$ 99,563		\$ 1,316,989
Depreciation	67,992	0		67,992
Taxes Other Than Income Tax	52,612	5,920	(a)	58,532
Income Tax Expense	6,589	0		6,589
Total Gas Operating Expenses	\$ 1,344,619	\$ 105,483		\$ 1,450,102
Net Operating Income	\$ (110,893)	\$ (105,483)		\$ (216,376)
Other Deductions:				
Interest Long-Term Debt	\$ 20,840	\$ -		\$ 20,840
Net Income	\$ (131,733)	\$ (105,483)		\$ (237,216)

(a) Proposed Adjustments. Auxier Road proposed numerous adjustments based on assumed increases ranging from 1 percent to 15 percent. According to Auxier Road, its proposed adjustments reflect the estimated impact of rising energy and transportation costs.¹ In a recent decision regarding a historical test-period with known and measurable adjustments, the Commission found that:

Where an applicant bases its application upon a historical test-period, it must provide "a complete description and quantified explanation for all proposed adjustments with proper support for any proposed changes in price or activity levels, and any other factors which may affect the adjustment." That support should, at a minimum, include some documentary evidence to demonstrate the certainty of some expected change of event.²

Since an application filed pursuant to 807 KAR 5:076, Alternative Rate Filing, relies upon a historical test-period, all proposed *pro forma* adjustments must meet the same rate-making criteria of being both known and measurable. Accordingly, Staff recommends these adjustments be denied.

(b) Remaining Adjustments. These operating expenses are discussed in Appendix B, Staff's discussions and explanations of its *pro forma* adjustments.

¹ Auxier Road's Response to the Commission Staff's First Information Request, Item 1.

² Case No. 2001-00211, The Application of Hardin County Water District No. 1 for (1) Issuance of Certificate of Public Convenience and Necessity; (2) Authorization to Borrow Funds and to Issue Its Evidence of Indebtedness Therefore; (3) Authority to Adjust Rates; and (4) Approval to Revise and Adjust Tariff, (Ky. PSC Mar. 1, 2002) at 7.

APPENDIX B
STAFF REPORT CASE NO. 2008-00156
STAFF'S RECOMMENDED
PRO FORMA INCOME STATEMENT

Account Titles	2007 Operations	Pro Forma Adjustments	Adj. Ref.	Pro Forma Operations
Operating Revenues:				
Total Gas Service Revenues	\$ 1,212,433	\$ (790,709)	(a)	\$ 421,724
Other Operating Revenues:				
Forfeited Discounts	\$ 5,319	\$ -		\$ 5,319
Miscellaneous Service Revenues	1,063	0		1,063
Other Gas Revenues	1,339	0		1,339
Gain on Sale of Asset	13,572	(13,572)	(b)	0
Total Operating Revenues	\$ 21,293	\$ (13,572)		\$ 7,721
Total Gas Operating Revenues	\$ 1,233,726	\$ (804,281)		\$ 429,445
Operating Expenses:				
Other Gas Supply Exp:				
Natural Gas City Gate Purchases	\$ 827,563	\$ (827,563)	(c)	\$ -
Operation Exp:				
Operation Supervision & Eng.	\$ 28,800	\$ (28,800)	(d)	\$ -
Distribution Exp:				
Mains & Service Exp.	\$ 31,470	\$ 2,652	(d)	\$ 34,122
Meter & House Regulator Exp.	6,910	(5,720)	(e)	1,190
Rents	1,656	0		1,656
Maint. - Meters & House Reg.	192	0		192
Total Distribution Expenses	\$ 40,228	\$ (3,068)		\$ 37,160
Customer Accounts Exp:				
Meter Reading Labor	\$ 24,804	\$ 2,652	(d)	\$ 27,456
Customer Records & Collection Exp.	65,644	(1,600)	(d)	64,044
Uncollectible Accounts	1,698	0		1,698
Total Customer Accounts Exp.	\$ 92,146	\$ 1,052		\$ 93,198
Administrative & General Exp:				
Administrative & General Salaries	\$ 91,500	\$ (30,400)	(d)	\$ 61,100
Office Supply & Exp.	39,061	(8,285)	(f)	30,776
Outside Services Employed	2,500	(2,500)	(g)	0
Property Insurance	24,159	0		24,159
Employee Pension & Benefits	27,257	(27,257)	(h)	0
Misc. General Exp.	8,556	(750)	(i)	7,806
Rents	16,200	(16,200)	(j)	0
Maintenance of General Plant	19,456	0		19,456
Total Admin & Gen. Exp.	\$ 228,689	\$ (85,392)		\$ 143,297
Total Gas Operation & Maint Exp.	\$ 1,217,426	\$ (943,771)		\$ 273,655
Depreciation	67,992	0		67,992
Taxes Other Than Income Tax	52,612	(4,246)	(k)	48,366
Income Tax Expense	6,589	0		6,589
Total Gas Operating Expenses	\$ 1,344,619	\$ (948,304)		\$ 396,602
Net Operating Income	\$ (110,893)	\$ 144,023		\$ 32,843
Other Deductions:				
Interest Long-Term Debt	20,840	(14,145)	(l)	6,695
Net Income	\$ (131,733)	\$ 158,168		\$ 26,148

a. Operating Revenue – Base Rate. Auxier Road reported total test-period operating revenues from gas sales of \$1,212,433. However, included in this amount are purchased gas costs, which are recovered by Auxier Road through its purchased gas adjustment and are excluded from the base rate revenues. Accordingly, Staff proposes to reduce operating revenues from gas sales by \$790,709 to eliminate the purchased gas costs.

b. Gain on Sale of Asset. During calendar year 2007, Auxier Road reported a gain on the sale of a company vehicle of \$13,572. Because the gain on the asset sale is nonrecurring, Staff is reducing operating revenues by \$13,572 to remove the gain that was recognized during the test period.

c. Natural Gas Purchases and Transmission Fees. Auxier Road proposed to increase transmission fees by \$82,756 due to an increase in the cost of the natural gas. However, natural gas purchases are recovered through Auxier Road's purchased gas adjustment and should be eliminated from Auxier Road's operating expenses. Staff proposes to reduce operating expenses by \$827,563 to remove the purchased gas cost.

d. Salaries and Wages. Auxier Road reports a test-period level of salaries and wages expense of \$232,608. Using Auxier Road's employee level and the wage rates that are currently in effect,¹ Staff calculates a pro forma salaries and wages expense of \$177,112. Staff believes that this level of salaries and wages is reasonable and should be reflected in Auxier Road's pro forma operations. Accordingly, Staff proposes to decrease salaries and wages expense by \$55,496.

¹ Auxier Road's Response to the Commission Staff's First Information Request, Item 10(a).

e. Contract Labor. Included in test-period operating expenses is a contract labor expense of \$5,720. This contract labor expense represents payments made to Kim Crisp, Auxier Road's Vice-President/Director/Accountant,² for the weekly cleaning of Auxier Road's office. Auxier Road currently pays Ms. Crisp an annual salary of \$41,600³ which Staff believes to be an adequate level of compensation. Auxier Road has failed to show that the payment of \$5,720 to Ms. Crisp is reasonable and that the performance of the office cleaning duties should entitle her to additional compensation. Therefore, Staff proposes to reduce operating expenses by \$5,720.

f. Office Supplies. Auxier Road reports a test-period level of office supply expense of \$39,061. The items listed below in Table 2 represent personal costs of Auxier Road's owner that were reported as Auxier Road's operating expenses.

Date	Description	Amount
04/25/07	University of Kentucky - Season Football Tickets: Personal Expense - Owner	\$ 2,304
05/25/07	Keeneland \$124; Churchill Downs \$50: Personal Expense - Owner	174
06/25/07	Churchill Downs \$99; Ruth's Chris Steak House \$110	209
01/26/07	Stoney River, Nashville TN; Desha's, Lexington, KY: Personal Lunches - Owner	84
02/28/07	Airline Tickets: Personal Trip - Owner	2,026
03/28/07	Chop House, Charleston, WV: Personal Lunch - Owner	63
03/22/07	TLF Gene's 5th Ave Floor: Personal Lunch - Owner	105
04/24/07	Airport Parking, Cincinnati, OH: Personal Expense - Owner	42
04/24/07	Hotels, Food & Beverages: Personal Expense - Owner	2,411
05/25/07	Food & Beverages: Personal Expense - Owner	867
Total		\$ 8,285

Staff believes that the items listed in Table 2 are the personal responsibility of the owners, and therefore, should not be borne by Auxier Road's ratepayers. For this reason, Staff recommends that operating expenses be reduced by \$8,285.

² Auxier Road's Response to the Commission Staff's Second Information Request, Item 5(a).

³ \$20 (Hourly Wage Rate) x 2,080 (Annual Hours) = \$41,600.

g. Outside Services Employed. Auxier Road reports a test-period level of outside services employed expense of \$2,500, which represents the payment to Ms. Crisp for the “[P]reparation of 2006 Federal and State Corporate Income Tax Returns, the Public Service Commission Annual Report and Tangible Property tax Return.”⁴ As the Vice-President/Director/Accountant, Ms. Crisp is responsible for the preparation of Auxier Road’s financial statements.⁵ As previously, stated Staff believes that Ms. Crisp is adequately compensated for her services and that the \$2,500 is redundant. Therefore, Staff recommends the Commission reduce operating expenses by \$2,500 to eliminate the payment for the preparation of the 2006 financial statements.

h. Employee Pensions and Benefits. Auxier Road reports a test-period level of employee pensions and benefits expense of \$27,257. Auxier Road records the costs related to the employee health insurance premiums, pension contributions, health insurance copayments/deductibles, and life insurance premiums in this expenses account.

Currently, Auxier Road’s policy is to provide health insurance coverage and pension benefits only to its management employees.⁶ Staff believes that this represents a less-than-arm’s-length transaction, because the utility owners, Auxier Road’s managers, made the decision to offer fringe benefits to management level employees only. There is no evidence in the record to show that additional compensation is required because non-owner employees are not provided the fringe

⁴ Auxier Road’s Response to the Commission Staff’s Second Information Request, Item 6(e).

⁵ Id. Item 5(a).

⁶ Id. Item 8.

benefits. In a previous decision,⁷ the Commission found that the employee deductibles and co-payments are the employee's personal responsibility and excluded those costs from test-period operating expenses. Further, Auxier Road has not shown how the life insurance policies for Estill and Sallye Branham provide a benefit to its ratepayers. For these reasons, Staff is proposing to reduce operating expenses by \$27,257 to eliminate pensions and benefits from Auxier Road's test-period operating expenses.

i. Miscellaneous General. During the test period Auxier Road paid Estill Branham an annual board of directors fee of \$750. This fee will not be incurred by Auxier Road on an on-going basis and, therefore, Staff proposes to reduce miscellaneous general expense by that amount.

j. Office Rents. Auxier Road proposed to increase test-period office rent expense of \$16,200 by \$1,800 to a pro forma level of \$18,000. During the test period, Auxier Road paid to Estill Branham Rental, a related subsidiary, \$1,500 per month for office rent.⁸ According to Auxier Road, the office and Auxier Road are currently owned by Sallye Branham.⁹ However, a commercial real estate appraisal report, which was issued on October 10, 2008, states that the office building "is currently in the name of

⁷ Case No. 2001-00252, The Application of River Bluffs, Inc. for A Rate Adjustment Pursuant to the Alternative Rate Filing Procedure for Small Utilities (KY. PSC July 29, 2002).

⁸ Auxier Road's Response to the Commission Staff's First Information Request, Item 6 at 56.

⁹ Auxier Road's Response to the Commission Staff's Second Information Request, Item 2.

Auxier Road Gas Company, Inc. Transferred to current owners via deed and has not been further conveyed within past three years.”¹⁰

Given that Auxier Road owns its office building, any related payments for the use of such building are unreasonable and should be excluded. Accordingly, Staff proposes to reduce test-period operating expenses by \$16,200 to eliminate the office rent expense.

k. Payroll Taxes. Auxier Road reports a test-period level of taxes other than income tax expense of \$52,612. Using the pro forma payroll determined reasonable herein and the current “FICA” rate of 7.65 percent, Staff calculates a pro forma payroll tax expense of \$13,549,¹¹ a decrease of \$4,246 below the test-period level of \$17,795.¹² Accordingly, Staff proposes to decrease taxes other than income tax expense by \$4,246.

l. Interest Expense. Auxier Road reports a test-period level of long-term interest expense of \$20,840. Auxier Road currently has two long-term debt issuances outstanding: a Gas System Restoration Board (“GRSB”) loan; and a loan from Ford Motor Company. Using the amortization schedules¹³ for the outstanding long-term debt, Staff calculates a 5-year average interest expense of \$6,695 for calendar years 2008

¹⁰ Auxier Road’s Supplemental Response to the Commission Staff’s Second Information Request, Item 2.

¹¹ \$177,112 (Pro Forma Salaries and Wages Expense) x 7.65% (FICA Rate) = \$13,549.

¹² \$232,608 (Test Period Salaries and Wages Expense) x 7.65% (FICA Rate) = \$17,795.

¹³ Auxier Road’s Response to the Commission Staff’s Second Information Request, Item 12.

through 2012, as shown in Table 1 below. Accordingly, Staff proposes to reduce long-term interest expense by \$14,145 to reflect the 5-year average.

Table 3: Long-Term Interest Expense			
Year	GRSB Loan	Ford Loan	Interest
2008	\$ 7,137	\$ 2,462	\$ 9,599
2009	6,462	1,623	8,085
2010	5,761	702	6,463
2011	5,032	21	5,053
2012	4,273	-	4,273
Total	<u>\$ 28,665</u>	<u>\$ 4,808</u>	\$ 33,473
Divided by: 5 Years			÷ 5
Average Interest			\$ 6,695

APPENDIX C
STAFF REPORT CASE NO. 2008-00156
STAFF'S
RECOMMENDED BASE RATES AND
NONRECURRING CHARGES

RATES AND CHARGES

<u>RATE CLASSIFICATION</u>			<u>BASE RATE</u>
First	1 MCF	\$	6.36 Minimum bill
Over	1 MCF	\$	5.3953 per McF

SPECIAL NONRECURRING CHARGES

Reconnect for Non-Payment	\$ 100.00
Reconnect by Request	\$ 100.00
Collection Fee	\$ 25.00
Returned Check	\$ 15.00

Sallye Branham
President
Auxier Road Gas Company, Inc.
P. O. Box 785
Prestonsburg, KY 41653