

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF THE NORTH MCLEAN)
COUNTY WATER DISTRICT, OF MCLEAN COUNTY,)
KENTUCKY, FOR (1) A CERTIFICATE OF)
PUBLIC CONVENIENCE AND NECESSITY,)
AUTHORIZING AND PERMITTING SAID WATER)
DISTRICT TO CONSTRUCT A WATERWORKS)
CONSTRUCTION PROJECT, CONSISTING OF) CASE NO.
ADDITIONS AND IMPROVEMENTS TO THE) 9322
EXISTING WATERWORKS SYSTEM OF THE)
DISTRICT; (2) APPROVAL OF THE PROPOSED)
PLAN OF FINANCING OF SAID PROJECT; AND)
(3) APPROVAL OF THE INCREASED WATER)
RATES PROPOSED TO BE CHARGED BY THE)
DISTRICT TO CUSTOMERS OF THE DISTRICT)

O R D E R

The North McLean County Water District ("North McLean") filed its application on April 9, 1985, for approval of adjustments to its water service rates, authorization to construct a \$313,000 waterworks improvement project and approval of its plan of financing for this project. The planned financing includes a Farmers Home Administration ("FmHA") loan of \$245,000, and a local contribution of \$68,000 from North McLean. The FmHA loan will be secured by waterworks revenue bonds maturing over a 40-year period at an interest rate of 9 1/2 percent per annum.

The proposed construction will improve hydraulic flow and service reliability to customers northeast of Calhoun, Kentucky. Drawings and specifications for the proposed improvements as

prepared by Turner Engineering Co., Inc., of Nashville, Tennessee, ("Engineer") have been approved by the Division of Water of the Natural Resources and Environmental Protection Cabinet. Construction bids were received on August 8, 1985.

A hearing on North McLean's proposed construction, financing and rates was held in the offices of the Public Service Commission, Frankfort, Kentucky, on August 28, 1985. There were no intervenors present and no protests were entered.

North McLean requested rates which will produce an annual increase of \$28,959. In this Order, the Commission has approved rates which will produce an annual increase of \$7,740.

COMMENTARY

North McLean is a non-profit water utility engaged in the distribution and sale of water to approximately 740 customers in northern McLean County, Kentucky. There are two other non-profit water utilities providing water service in McLean County adjacent to North McLean's service area. The Beech Grove Water System, Inc., serves approximately 249 water use customers in the vicinity of the community of Beech Grove in northwestern McLean County. The Rumsey Water District provides water service to approximately 122 customers in the Rumsey community located in central McLean County.

KRS 74.361 states in part:

The general assembly of the Commonwealth of Kentucky determines as a legislative finding of fact that reduction of the number of operating water districts in the Commonwealth will be in the public interest, in

that mergers of such districts will tend to eliminate wasteful duplication of costs and efforts, result in a sounder and more businesslike degree of management and ultimately result in greater economies, less cost, and a higher degree of service to the general public; and that the public policy favors the merger of water districts wherever feasible.

Mr. James Bailey, Commissioner of North McLean, testified that the water district has not investigated the possibility of merging with either of the water systems adjacent to it in McLean County. In view of the legislative mandate, the Commission is of the opinion that McLean County should seriously consider merging with the other non-profit water systems in McLean County.

ADEQUACY OF PROPOSED FIRE HYDRANTS

North McLean proposes to install three conventional fire hydrants in northern McLean County as part of this project. While the Commission shares North McLean's concern about the safety of its customers, the Commission is not of the opinion that North McLean should mislead the public as to the capability of its water system. It is the Commission's opinion that the majority of the general public observing a typical fire hydrant assumes that the hydrant possesses the hydraulic capability of supplying adequate water for fire protection purposes. The record in this case does not indicate that the fire hydrants proposed by North McLean are capable of meeting standard service requirements for fire hydrants rated by the Insurance Services Office of Kentucky. North McLean's engineer stated in testimony before the Commission that only one of the proposed hydrants was expected to provide enough

hydraulic capability for fire flow requirements. In view of the evidence in this matter the Commission recommends that North McLean seriously reconsider the prudence of installing conventional fire hydrants as proposed. The Commission suggests that North McLean investigate alternative installations, such as flush-mounted hydrants, which would perform the same function as the proposed hydrants without confusing the general public as to the availability of fire protection.

TEST PERIOD

North McLean proposed and the Commission has accepted the 12-month period ending December 31, 1984, as the test period in this matter.

REVENUES AND EXPENSES

North McLean incurred actual test period operating income of \$25,241. North McLean proposed no pro forma adjustments to its test period operating revenues and expenses. The Commission has made the following adjustments for rate-making purposes to more fairly reflect the actual operating conditions of North McLean:

Purchased Water

North McLean incurred purchased water expense in the amount of \$55,802 for the test period. In response to the initial information request dated May 16, 1985, North McLean informed the Commission that one of North McLean's three water suppliers, the City of Calhoun, had increased the cost of its water from \$0.67 per 1,000 gallons to \$0.90 per 1,000 gallons. The Commission

determined that this would result in an increase of \$1,604¹ to test period purchased water expense. North McLean agreed to this determination in response to item number 1 of the second information request dated July 22, 1985. Therefore, purchased water expense has been increased by \$1,604.

Depreciation Expense

North McLean incurred a depreciation expense in the amount of \$8,733 for the test period. It has been the practice of the Commission in previous decisions to compute depreciation expense for rate-making purposes on the basis of original cost of the plant in service less contributions in aid of construction, as a utility should not be allowed recovery of that portion of the plant which has been provided at zero cost.

North McLean's test-period depreciation expense of \$8,733 reflects depreciation on the total existing plant using a composite rate of approximately 1.697 percent.² The balance sheet filed by North McLean shows contributions in aid of construction at the end of the test period to be \$357,000. This amount is approximately 69.4 percent of the total cost of the existing utility plant in service. In determining the pro forma depreciation expense, the Commission has utilized the depreciation rate applied by North McLean and has excluded depreciation

¹ 19,101 gpd x 365 days = 6,971.865 M-gals. x \$0.90 = \$6,275
19,101 gpd x 365 days = 6,971.865 M-gals. x \$0.67 = 4,671
Amount of Adjustment to Purchased Water = \$1,604

² \$8,733 ÷ \$514,763 = 1.697%

associated with contributed property. The adjusted depreciation expense for the existing plant is \$2,675,³ a reduction of \$6,058 from test-period actual depreciation expense.

In the information filed September 10, 1985, in response to requests made at the hearing Mr. William Breakfield, Consulting Engineer to North McLean, stated that the yearly depreciation expense for the proposed construction in his estimate should be \$4,490.⁴ The Commission concurs with Mr. Breakfield and has increased test year depreciation expense by \$4,490 which when combined with the previous decrease of \$6,058 results in a final adjusted level of \$7,165.

Maintenance of Mains

North McLean incurred maintenance of mains expense in the amount of \$10,187 for the test period. In the response to item number 2 of the initial request North McLean stated that test period maintenance of mains expense included \$1,063 for the cost of nine new meters and \$1,080 for the cost of installing the nine meters for a combined cost of \$2,143. North McLean went on to add that the normal year end procedure would be to capitalize the cost of the new meters and the cost of the installation of the meters.

3	Total Existing Plant	\$ 514,763
	Less: Contributions in Aid of Construction	<u>357,108</u>
	Non-Contributed Existing Plant	\$ 157,655
	Times: Composite Rate for Existing Plant	<u>1.697%</u>
	Depreciation on Existing Plant Allowed for Rate-Making Purposes	\$ 2,675
4	Water Transmission Facilities = \$104,220 x 2.5% =	\$ 2,605
	Water Storage Facilities = \$94,230 x 2% =	<u>1,885</u>
	Depreciation on Proposed Construction for Rate-Making Purposes	\$ 4,490

The Commission concurs with North McLean and is of the opinion that it would be appropriate to depreciate these items over 10 years. Therefore, maintenance of meters expense has been reduced by \$2,143 and depreciation increased by \$214 for a net reduction in test period operating expenses of \$1,929.

Transportation Expense

North McLean incurred transportation expense in the amount of \$4,281 for the test period. In the responses to item number 1 of the initial information request North McLean stated that the water commissioners and bookkeeper were paid \$0.50 per mile for transportation and that all other employees were paid \$.35 per mile. Mr. James Bailey, commissioner of North McLean, stated in his testimony that the transportation charge for all employees would be reduced to \$0.205 per mile.⁵ In the information supplied after the hearing North McLean provided a calculation showing adjusted transportation expense in the amount of \$2,166, which reflects the reduced per mileage rate.⁶ Therefore, the Commission has reduced test period transportation expense by \$2,115 which results in an adjusted level of \$2,166.

Insurance

North McLean incurred insurance expense in the amount of \$1,823 for the test period. In the response to item number 4 of the second request North McLean supplied an invoice from McLean

⁵ Transcript of Evidence ("T.E."), 9/28/85, page 64.

⁶ $2,337 \div \$0.35 = 6,677 \text{ miles} \times \$0.205 = \$ 1,369$
 $1,944 \div \$0.50 = 3,889 \times \$0.205 = \quad \quad \quad 797$
Adjusted Transportation Expense $\quad \quad \quad \$ 2,165$

County Insurance Agency in the amount of \$523. The invoice represented an additional premium on a 3-year audit of a liability policy for the period of January 28, 1981, to January 28, 1984. At the hearing Mr. Chester Hoover, C.P.A. and accountant for North McLean, agreed with the Commission that the payment was for services rendered prior to the test period and that the payment should be removed from test period operating expenses.⁷ Therefore, test period insurance expense has been reduced by \$523 for an adjusted level of \$1,300.

Administrative and General Salaries

North McLean incurred administrative and general salaries expense in the amount of \$7,375 for the test period which included commissioners salaries of \$3,975. On August 6, 1985, the North McLean commissioners were granted retroactive salary raises by Order of the Honorable Richard Hopkins, Judge-Executive of McLean County, Kentucky. When the new salaries are annualized they result in adjusted commissioners salaries of \$8,400⁸ which is an increase of \$4,425 over test period actual. Therefore, this Commission has increased administrative and general salaries expense by \$4,425 for an adjusted level of \$11,800.

⁷ T.E., pages 41 and 42.

⁸

D. W. Wiggington	\$175 monthly salary x 12 =	\$ 2,100
Gary Floyd	\$150 monthly salary x 12 =	1,800
James Bailey	\$125 monthly salary x 12 =	1,500
Nathel Jennings	\$125 monthly salary x 12 =	1,500
Carrol B. Troutman	\$125 monthly salary x 12 =	1,500
Annualized Salary Increases		<u>8,400</u>

Interest Income

North McLean incurred interest income expense in the amount of \$10,875 for the test period. To help finance the proposed construction cost North McLean will have to contribute \$68,000, which will come from North McLean's invested funds. At the hearing Mr. Hoover estimated that interest income would be approximately \$3,000 due to the anticipated reduction of investments.⁹ The Commission concurred with Mr. Hoover and has therefore, reduced test period interest income by \$7,875.

Outside Services

North McLean incurred outside services expense in the amount of \$10,577 for the test period. In response to item number 1 of the initial request North McLean provided an analysis of this expense account which showed payments of \$3,545 for the services of the Honorable Charles Wible, attorney for North McLean, and \$3,053 for the services of Black and Veatch, engineers for North McLean. In response to item number 3a of the second request North McLean informed the Commission that the payments were incurred in defense of a law suit brought against North McLean by the City of Livermore, Kentucky.¹⁰

North McLean stated in response to item number 3b of the second request that it did not feel that it would be appropriate to amortize or capitalize the cost of the law suit. At the

⁹ T.E., page 58.

¹⁰ Amber Henton and the City of Livermore, Kentucky, vs. North McLean County Water District, Civil Action No. 78-Ci-073.

hearing Mr. Hoover defended North McLean's position by stating that North McLean had incurred substantial legal fees in the past and he expects these fees to continue into the future.¹¹ The Commission is of the opinion that it would be appropriate to amortize the cost of the law suit over the life of the water purchase contract since the cost is highly unusual and a non-recurring expense item. However, Mr. Hoover stated at the hearing and the Commission concurs that the duration and final cost of the law suit are both unknown at this time.¹² Therefore, because of the future uncertainties the Commission is of the opinion that it would be appropriate to amortize the cost of the law suit expense over a 5-year period. This results in a decrease of \$6,598 to test period outside services and an increase of \$1,320 to amortization expense.

North McLean stated in response to item number 3a of the second request that \$450 of the outside service expense was for the six monthly cash flow statements prepared by Mr. Hoover and that the annualized cost of the statements would be \$900. Therefore, the Commission has increased test period outside service expense by \$450 for a final combined reduction to test period operating expenses of \$4,828.

Therefore, North McLean's test period operations have been adjusted as follows:

¹¹ T.E., page 52.

¹² T.E., pages 50-52.

	North McLean's Test Period <u>Actual</u>	Commission Adjustment	Commission Adjusted
Operating Revenue	\$145,690	-0-	\$145,690
Operating Expenses	<u>120,449</u>	<u>\$ <4,934 ></u>	<u>115,515</u>
Operating Income	<u>\$ 25,241</u>	<u>\$ 4,934</u>	<u>\$ 30,175</u>

REVENUE REQUIREMENT

North McLean's annual debt service based on debt outstanding during the test period and debt proposed in this proceeding is \$34,096.¹³ North McLean's adjusted net operating income of \$30,175 plus adjusted interest income of \$3,000 provides a debt service coverage ("DSC") of 0.97X. The Commission is of the opinion that this coverage is unfair, unjust and unreasonable. To achieve a DSC of 1.2X, which the Commission is of the opinion is the fair, just and reasonable coverage necessary for North McLean to pay its operating expenses and to meet the requirements of its lenders, North McLean would require a net operating income of \$37,915. Accordingly, the Commission has determined that additional revenue of \$7,740 is necessary to provide the 1.2X DSC which will ensure the financial stability of North McLean.

¹³ Existing Debt - (5-year average of Principal)	\$ 2,000
(5-year average of interest)	7,878
Proposed Debt - (5-year average of Principal)	1,000
(5-year average of interest)	<u>23,218</u>
Total Debt Service	<u>34,096</u>

Debt service does not include other interest expense of \$184 which according to North Mclean was a non-recurring item.

RATE DESIGN

In its petition North McLean submitted increased rates for general water service, tap-on fees, reconnection charges, and for customer deposits.

North McLean proposed rates that would produce revenues in excess of the revenue requirement given by the Commission in this Order, therefore the proposed rates should be denied. The Commission has provided rates in Appendix A which produce sufficient revenue and which are considered to be fair, just and reasonable.

North McLean proposed to increase the tap-on fees for 5/8-inch x 3/4-inch size meters, larger than 5/8-inch x 3/4-inch size meters up to 2 inches, and connections larger than 2 inches. The Commission is of the opinion that the cost information for tap-on fees and reconnection charges provided by North McLean was adequate and that the charges proposed are fair, just and reasonable.

807 KAR 5:006, Section 7, allows a utility to require a cash deposit or other guaranty to secure payment of bills not to exceed 2/12 of the customer's estimated annual bill when bills are rendered monthly, or the utility may establish an equal deposit amount for all customers of the same class of service. When the former method is chosen, the utility may develop standard criteria for determining whether or not a deposit should be required of a particular customer, and rental or ownership of property may be included in such criteria as one factor to be considered; however, the utility may not discriminate against a particular group of

customers within a class, such as renters, or trailer inhabitants, by making one of these the only consideration in the deposit determination. In instances when the equal deposit option is chosen, the deposit amount may not be in excess of 2/12 of any customer's bill and must be required of all applicants for the same class of service.

North McLean's proposed tariff reflects that it will utilize the equal deposit option where all customers in the same class of service are charged the same amount. However, the amount proposed by North McLean exceeds 2/12 of an average customer's annual bill. Therefore, the Commission has reduced the deposit amount proposed by North McLean and provided an alternative amount set out in Appendix A.

FINDINGS AND ORDERS

The Commission, after consideration of the application and evidence of record and being advised, is of the opinion and finds that:

1. Public convenience and necessity require that the construction proposed in the application and record be performed and that a certificate of public convenience and necessity be granted.

2. The approved construction includes about 3.8 miles of water mains, a 200,000-gallon water storage tank, and miscellaneous appurtenances thereto. The low bids received for the proposed work totaled \$198,450, which will require about \$313,000 after allowances are made for fees, contingencies, indirect costs

and additional construction being considered as a result of receiving bids that totaled less than the Engineer's estimate.

3. North McLean should obtain approval from the Commission prior to performing any additional construction not expressly certificated by this Order.

4. Any deviations from the approved construction which could adversely affect service to any customer should be subject to prior approval of this Commission.

5. The financing proposed by North McLean for this project will be needed to pay for the work herein approved. North McLean's financing plan should, therefore, be approved.

6. North McLean should file with the Commission duly verified documentation which shows the total costs of construction including all capitalized costs (engineering, legal, administrative, etc.) within 60 days of the date that construction is substantially completed. Said construction costs should be classified into appropriate plant accounts in accordance with the Uniform System of Accounts for Water Utilities prescribed by this Commission.

7. North McLean's contract with its Engineer should require the provision of construction inspection under the general supervision of a professional engineer with a Kentucky registration in civil or mechanical engineering. The supervision and inspection should insure that the construction work is done in accordance with the contract drawings and specifications and in conformance with the best practices of the construction trades involved in the project.

8. North McLean should require the Engineer to furnish a copy of the record drawings and a signed statement that the construction has been satisfactorily completed in accordance with the contract drawings and specifications within 60 days of the date of substantial completion of this construction.

9. North McLean should file with the Commission a copy of all contractual agreements for the provision of services or the purchase of services which are subject to the approval of this Commission.

10. North McLean should investigate the feasibility of merging with the Beech Grove Water System, Inc., and the Rumsey Water District. North McLean should file a written report on the results of its investigation with the Commission within 90 days of the date of this Order.

11. The rates proposed by North McLean produce revenues in excess of the revenues found reasonable herein and should be denied upon application of KRS 278.030.

12. The rates and charges in Appendix A are the fair, just and reasonable rates and charges to be charged by North McLean in that they should produce gross revenues from North McLean's operations of \$153,430.

IT IS THEREFORE ORDERED that North McLean be and it hereby is granted a certificate of public convenience and necessity to proceed with the waterworks improvements projects set forth in the drawings and specifications of record hereby approved.

IT IS FURTHER ORDERED that North McLean shall comply with all matters set out in Findings 3 through 10 as if the same were individually so ordered.

IT IS FURTHER ORDERED that the rates proposed by North McLean be and they hereby are denied.

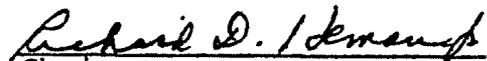
IT IS FURTHER ORDERED that the rates in Appendix A be and they hereby are approved for service rendered by North McLean on and after the date of this Order.

IT IS FURTHER ORDERED that within 30 days from the date of this Order North McLean shall file with this Commission its revised tariff sheets setting out the rates approved herein.

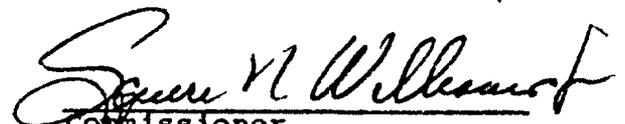
Nothing contained herein shall be deemed a warranty of the Commonwealth of Kentucky, or any agency thereof, of the financing herein authorized.

Done at Frankfort, Kentucky, this 21st day of October, 1985.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Secretary

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 9322 DATED 10/21/85

The following rates and charges are prescribed for the customers receiving water service from North McLean County Water District. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the effective date of this Order.

<u>Monthly Charges</u>	<u>Rate</u>
First 2,000 gallons	\$ 8.10 Minimum Bill
Next 2,000 gallons	2.50 per 1,000 gallons
Next 2,000 gallons	2.00 per 1,000 gallons
Next 4,000 gallons	1.70 per 1,000 gallons
Next 30,000 gallons	1.40 per 1,000 gallons
Next 60,000 gallons	1.20 per 1,000 gallons
All Over 100,000 gallons	1.00 per 1,000 gallons
<u>Tap On Service Connection Charges</u>	
5/8 inch x 3/4 inch	\$ 350 per connection
All connections larger than 5/8 inch x 3/4 inch up to 2 inches	\$ 500 per connection
All connections larger than 2 inches	Actual cost of installation
<u>Reconnection Charge</u>	
Charge per reconnection	\$ 30
<u>Deposits</u>	
All applicants for service	\$ 35