

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF SOUTHERN WATER AND)
SEWER DISTRICT FOR AN ADJUSTMENT IN) CASE NO.
RATES PURSUANT TO THE ALTERNATIVE) 2012-00309
RATE FILING PROCEDURE FOR SMALL)
UTILITIES)

NOTICE OF FILING OF COMMISSION STAFF REPORT

Notice is hereby given that, in accordance with the Commission's Order of October 5, 2012, the attached report containing the findings and recommendations of Commission Staff regarding the Applicant's proposed rate adjustment has been filed in the record of the above-styled proceeding.



Jeff Derquen
Executive Director
Public Service Commission
P.O. Box 615
Frankfort, KY 40602

DATED NOV 01 2012

cc: Parties of Record

STAFF REPORT
ON
SOUTHERN WATER AND SEWER DISTRICT
CASE NO. 2012-00309

Southern Water and Sewer District provides service to approximately 7,000 water customers and approximately 200 wastewater customers residing in Floyd County and Knott County, Kentucky. On August 8, 2012, Southern Water and Sewer District ("Southern District") filed an application with the Commission requesting to adjust its rates for retail water service and retail sewer service.¹

Southern District requested retail water rates that are expected to produce \$644,070 in additional annual revenues, an increase of 21 percent over pro forma present rate revenues from retail water sales of \$3,043,054. These rates are shown in Appendix A of this report. It requested sewer rates that produce an additional \$19,043 in annual revenues, a 20 percent increase over pro forma present rate revenues from sewer sales of \$95,215. These rates are shown in Appendix B. As discussed in more detail on page 6 of this report, Southern District considered increasing the wholesale water rate charged to the city of Hindman from \$2.74 per thousand gallons to \$3.20; however, it did not increase this rate for fear of losing these sales.

Southern District's application was prepared with the assistance of Commission Staff ("Staff") pursuant to a written request from Southern District dated July 7, 2011. To prepare the application, a limited financial review was conducted of Southern District's test-year operations, the year ending December 31, 2010. Staff performed the

¹ The Application can be found at: <http://psc.ky.gov/Home/Library?type=Cases&folder=2012cases/2012-00309>.

review with assistance from Southern District's employees. The scope of the review was limited to determining whether operations reported for the test-year were representative of normal operations. Known and measurable changes to test-year operations were identified and adjustments were made when their effects were deemed to be material. Insignificant or immaterial discrepancies were not pursued and were not addressed.

After completing the financial review, Staff assisted Southern District in preparing the application and the financial exhibits attached thereto. The financial exhibits are listed below:

1. Pro forma Operating Statement, Attachment C;
2. Required Revenue Increase, Attachment D; and
3. Billing Analysis and Proposed Rates, Attachment E

In this report, Staff summarizes these financial exhibits and makes its recommendation regarding the rates requested by Southern District.

Staff agrees with the calculations shown in the Application and summarized in this report supporting the rates requested for the Sewer Division and recommends the Commission approve these rates.

Staff agrees with the calculations shown in the Application supporting the rates requested for the Water Division and recommends they be approved, except for the inclusion of the \$100,000 annual payment made to the Floyd County Fiscal Court. Details of this payment, along with Southern District's arguments supporting its recovery, are shown in the Application at Attachment H.

As explained in more detail starting on Page 9 of this report, while Staff finds the arguments for rate recovery of this payment are persuasive, Staff is unable to conclude that the payments are lawful under KRS Chapter 74 or KRS Chapter 278. In the

absence of clear evidence regarding the lawfulness, Staff will not make a recommendation regarding the reasonableness of this payment or the appropriate water rates.

In this report, Staff calculated the effect of removing the Fiscal Court payment from the requested rates for the Commission's consideration. Removing this payment reduces the required revenue increase to \$551,732, a 17.85 percent increase. The water rates without recovery of the Fiscal Court payment are shown in Appendix C. The rates including recovery of the payment to the Fiscal Court as proposed by Southern District are shown in Appendix A.

Pro forma Operating Statement

Water Division: Southern District's Water Division reported test-year Income Available to Service Debt in the amount of \$(818,680). It proposed 22 adjustments totaling \$750,011 to increase this amount to \$(68,669). These adjustments are shown below:

	<u>Adjustment Amount</u>
Water Sales	\$(112,411)
Other Operating Revenue	(20,972)
Gain on Sale of Service Vehicles	(8,969)
Nonutility Income	<u>(1,161)</u>
 Total Adjustments to Revenue Accounts	 <u>(143,513)</u>
 Salaries and Wages – Employees	 (75,744)
Salaries and Wages – Commissioners	11,900
Employee Benefits	71,014
Purchased Water	(201,346)
Purchased Power Pumping	(103,543)
Purchased Power Office	(1,189)
Fuel for Vehicles	(3,664)
Chemicals	(57,452)
Materials and Supplies	(14,051)
Contractual Services – Accounting	(980)

Contractual Services – Other	(10,365)
Transportation Equipment	(1,225)
Insurance – General Liability	(4,573)
Insurance – Workers’ Compensation	(1,157)
Bad Debt Expense	23,178
Miscellaneous	(1,171)
Depreciation	(495,770)
Taxes Other Than Income	<u>(27,386)</u>
 Total Adjustments to Expense Accounts	 <u>(893,524)</u>
 Net Adjustment to Income Available to Service Debt	 <u>\$750,011</u>

Sewer Division: At the time it filed its application in this matter, Southern District operated two small wastewater collection and treatment facilities that served 195 total customers. Southern District’s Sewer Division reported test-year Income Available to Service Debt in the amount of \$(83,766). It proposed 19 adjustments totaling \$(6,965) to decrease this amount to \$(90,731).

The construction and financing of a third wastewater treatment facility was approved by the Commission in Case No. 2012-00165.² This facility is expected to become operational on, or about, June 13, 2013. Eight additional adjustments were made to show the changes in revenues and expenses that are expected to occur after this facility is placed into service. These adjustments decreased Income Available to Service Debt by an additional \$(15,091). The effects of these adjustments are not included in the calculation of the requested rates. These adjustments were made only to demonstrate that the requested rates will produce net revenues that meet the requirements of Southern District’s bond resolutions after the facilities are operational. This is discussed in more detail on page 13.

All 27 adjustments to sewer operations are shown below:

² Case No. 2012-00165, Application of Southern Water and Sewer District for a Certificate of Public Convenience and Necessity to Construct and Finance Pursuant to KRS 278.023 (Ky. PSC May 18, 2012).

	<u>Current Plants</u>	<u>New Plant</u>
Sewage Revenue	\$2,898	\$115,158
Other Operating Revenue	3,662	
Nonutility Income	<u>1,161</u>	
Total Adjustments to Revenue Accounts	<u>7,721</u>	<u>115,158</u>
Collection System	10,018	
Salaries and Wages – Commissioners	900	
Employee Benefits	1,656	
Purchased Power Pumping	16,417	11,760
Chemicals	1,767	1,260
Pumping System	2,760	4,620
Utilities Office	1,189	
Maintenance		1,260
Maintenance of General Plant		3,080
Contractual Services – Accounting	980	
Fuel for Vehicles	3,664	
Transportation Expense	1,225	
Insurance – General Liability	4,573	8,500
Insurance – Workers’ Compensation	1,157	
Bad Debt Expense	714	
Miscellaneous	974	
Depreciation	(36,149)	99,769
Taxes Other Than Income	<u>2,841</u>	
Total Adjustments to Expense Accounts	<u>14,686</u>	<u>130,249</u>
Net Adjustment to Income Available to Service Debt	<u><u>\$(6,965)</u></u>	<u><u>\$(15,091)</u></u>

Staff agrees with all adjustments made to test-year operations of the Water Division and Sewer Division and recommends they be accepted by the Commission. Additional comments regarding some of the adjustments that have a material impact on Southern District's operations appear below.

Wholesale Sales. As discussed on Page 4 of Attachment C to the Application, during the test year Southern District provided wholesale water service to Knott County Water District ("Knott District") and the city of Hindman ("Hindman") at a wholesale rate of \$2.77 per thousand gallons. Sales to Knott District ended in 2011 after Knott District completed construction of its own water treatment facility. At the same time, Knott District began providing wholesale water service to Hindman. Knott District's wholesale rate to Hindman is \$2.00 per thousand gallons.

As shown on Page 1 of Attachment E to the Application, test-year sales to Knott District totaled \$29,266. These sales will not recur and were removed to calculate pro forma present rate revenues. The test-year sales to Hindman were reported at \$47,306. Although these sales may cease as a result of Hindman's connection to Knott District, it is not yet a certainty. As of August 8, 2012, Hindman continues to purchase water from Southern District.

When preparing its Application, Southern District considered increasing the current rate charged to Hindman from \$2.77 per thousand gallons to \$3.20. This would generate additional revenue of \$7,942.³ Attempting to preserve its sales to Hindman, Southern District decided not to increase its wholesale rate at this time. While this decision will result in lost revenue of \$7,942, loss of all sales would be more costly.

³ \$55,248, revenue at \$3.20 – \$47,306, test year. Application, Exhibit E, Page 2 and Page 3.

Although Southern District chose not to increase the wholesale rate, it included the revenue that would have resulted from the increase when calculating the revenue required from retail customers. This is demonstrated in the Application on Page 3 of Exhibit E.

Water Loss. As shown in the Application on Page 13 of Attachment C, Southern District's water loss for the test year was determined to be 44.35 percent. As shown on Page 12 of Attachment C, \$275,463 of the Water Division's test-year Purchased Water, Power for Pumping, and Chemicals was eliminated to remove the expenses incurred to purchase, pump, and treat water lost in excess of the 15 percent allowed for ratemaking purposes by 807 KAR 5:066, Section 6(3).

Allocation and Assignment. As noted throughout Attachment C and Attachment D of the Application, many adjustments were made to test-year operations to properly assign or allocate revenues, expenses, and debt payments to the Water Division and the Sewer Division. During the test year Southern District did not make proper assignment and allocation when accounting for these transactions. Staff recommends the Commission require Southern District to make the necessary revisions to its accounting procedures and internal controls so that proper assignment and allocation of revenues and expenses are properly recorded in its books of original entry in all future reporting periods.

Depreciable Lives. In its Application, Southern District proposed changes to the depreciable lives assigned to many of its water assets and sewer assets. Staff recommends that the adjustments to test-year depreciation expense resulting from the new lives be accepted by the Commission. Staff further recommends that the lives

assigned to assets in Southern District's application be used for accounting purposes in all future reporting periods.

Required Revenue Increase

Water Division: As shown in Table D1 of Attachment D to the Application, Southern District determined that a revenue increase of \$651,732, or 21 percent, is required. A condensed calculation of this amount is shown below:

Pro forma Operating Expenses	\$3,324,165
Annual Payment to Floyd Fiscal Court	100,000
Debt Service Requirement	<u>483,063</u>
Total Revenue Requirement	3,907,228
Less: Pro forma Present Rate Revenue and Other Revenues	<u>(3,255,496)</u>
Required Revenue Increase	<u>\$651,732</u>

The detailed calculation of pro forma expenses in the amount of \$3,324,165 and the pro forma present rate revenue and other revenues in the amount of \$3,255,496⁴ is shown in Table C1 of Attachment C to the Application. These revenues and expenses result from the adjustments to test-year operations previously recommended by Staff. Staff recommends the Commission account for the effects of these adjustments to test-year operations when calculating the required revenue increase.

Annual Payment to Floyd County Fiscal Court. The \$100,000 annual payment to the Fiscal Court is discussed in Attachment H of the Application. This payment is to assist the Floyd County Fiscal Court with retiring bonds the court issued to finance a contribution in aid of construction paid to Southern District. As shown on Attachment H-

4	Water Sales	\$3,090,360
	Other Operating Revenue	118,404
	Gain on the Sale of Water Service Trucks	2,242
	Interest Income	6,936
	Nonutility Income	<u>37,554</u>
	Total Pro form Present Rate Revenue and Income	<u>\$3,255,496</u>

2, the total amount of the Fiscal Court's bonds was \$2,600,000. The total principal and interest payment for the immediate annual period is \$162,555. The Fiscal Court used the proceeds from the bonds to pay a contribution in the amount of \$2,474,000 to Southern District to be used to finance a portion of a \$6,172,900 waterworks improvement project.⁵

As discussed in the Application, the Fiscal Court's contribution was part of a financing package for an improvement project that consisted of grant funds in the amount of \$1,183,900 and a loan in the amount of \$2,515,000. Prior to the Fiscal Court commitment, Southern District had secured a "significant" amount of grant funding for the project but long-term debt would be required to finance the remaining cost of the project.⁶ To minimize Southern District's "debt load" and to "minimize the impact on water customers,"⁷ the Fiscal Court elected to borrow funds to make the contribution to the district. At the time it committed its contribution to the project in 2001, the court had no intention of seeking repayment from the district; however, due to unexpected financial hardships, in early 2004 the court requested that the district pay \$100,000 annually to assist in retiring the bonds.⁸

Absent the Fiscal Court's contribution, Southern District would have been required to significantly scale back the project, abandon the project entirely, or borrow additional funds in the amount of the fiscal court's contribution. If Southern District had

⁵ Case No. 2002-00166, Application of Southern Water and Sewer District of Floyd and Knott Counties, Kentucky, for a Certificate of Public Convenience and Necessity to Construct, Finance and Increase Rates Pursuant to KRS 278.023 (Ky. PSC June 7, 2002).

⁶ Application, Attachment H-3. At Attachment H-1, Page 1, the grant funds are identified that total \$1,183,900.

⁷ Application, Attachment H-3.

⁸ Application, Attachment H.

cut or abandoned the project, as many as 2,400 residents of Floyd County might have remained without potable water service today.⁹ If Southern District had borrowed funds in the amount of the Fiscal Court's contribution under terms and conditions equal to those of the Fiscal Court bonds, Southern District's annual payments would be \$162,555. The actual assistance payment of \$100,000 represents savings of \$62,555, or 38.48 percent, a significant savings to Southern District's ratepayers when compared to the cost of the project without the fiscal court's contribution.

Although the Fiscal Court's contribution lowered the cost of financing the construction of the water system improvements necessary to extend service and the payment to the Fiscal Court represents a savings when compared to alternative financing arrangements available at the time, the Commission may consider removing the Fiscal Court payment from Southern District's revenue requirements. There is no formal agreement between the parties requiring the payment, and Commission approval of such an agreement may be required pursuant to KRS 278.300. Southern District has not demonstrated how the payment is appropriate and consistent with KRS Chapter 74 in the absence of any legal obligation to make such payment. For these reasons, Staff makes no recommendation regarding the recovery of this payment, but has shown the effects of its removal for the Commission's consideration.

Removing the Fiscal Court payment from revenue requirements would result in a required revenue increase of \$551,732, a 17.85 percent increase over Pro Forma Present Rate Revenues of \$3,090,360. The rates necessary to meet this increase are shown in Appendix C.

⁹ Application, Attachment H-3.

Debt Service Requirement. The calculation of the annual debt service requirement of \$483,063 is detailed in the Application at Table D3 of Attachment D. The amount includes the five-year average principal and interest payments on all debt instruments outstanding at the time the Application was filed that are either directly assignable to the Water Division or allocable to the Water Division. These debts include three notes payable to First Guaranty Bank (“FGB”); two loans payable to Kentucky Infrastructure Authority (“KIA”); and three bond issuances payable to the United States Department of Agriculture Rural Development (“RD”).

In addition to the principal and interest payments, a coverage requirement was added to the KIA loans equal to 10 percent of their annual principal and interest payments. A 20 percent coverage was included for the RD bonds. Inclusion of these coverages follows the historic method used by the Commission to calculate a water district’s revenue requirements. An administrator fee assessed by KIA was also included in the calculations.

Except for the FGB 2009 loan, Commission approval was sought and obtained, when required, for all debts listed on Table D3. As Southern District explains on Page 5 of Attachment D, it was not aware that a note with a four-year term secured to purchase service vehicles required the Commission’s approval. Southern District states that it now has a clear understanding of the requirements of KRS 278.300 and will ensure that future violations do not occur.

Although Southern District determined an overall revenue increase in water sales of \$651,732 is warranted, it requested retail rates that will generate additional annual revenues of only \$644,070. While this level of revenue does not meet the full

requirement, it provides net revenues that exceed, by a large margin, the debt service coverage ratios required by Southern District's lenders.¹⁰ This is demonstrated below:

Annual Total Revenue at Requested Rates	\$3,899,566 ¹¹
Less: Pro forma Operating Expenses	(3,324,165) ¹²
Less: Excess Water Loss Expenses	(275,463)
Add Back: Depreciation Expense	785,490 ¹³
Less: Payment to Fiscal Court	(100,000)
Less: KIA Administrative Fee on 1995 Loan and 1998 Loan	(426) ¹⁴
Less: FGB Loan Payments, No Coverage Required	<u>(38,712)¹⁵</u>
 Net Revenues	 946,290
Divide by: KIA and RD Annual Debt Service Payments	<u>\$401,771¹⁶</u>
 Debt Service Ratio	 <u>236%</u>

Also, as demonstrated below, the Debt Service Ratio will also be met if the Commission approves rates that do not include recovery of the Fiscal Court payment.

This is shown below:

¹⁰ As discussed on Page 4 of Attachment D to the Application, the coverage ratio required by RD is 120 percent and the coverage required by KIA is 110 percent.

¹¹ Pro forma Present Rate Revenue	\$3,090,360
Increase in Revenue from Requested Rates	644,070
Other Operating Revenue	118,404
Gain, Interest Income, and Nonutility Income	<u>46,732</u>
 Total Revenue	 <u>\$3,899,566</u>

¹² Application, Attachment C, Page 1, Table C1.

¹³ *Id.*

¹⁴ Application, Attachment D, Page 4, Table D3.

¹⁵ *Id.*

¹⁶ *Id.*

Net Revenues at Requested Rates	\$946,290
Less: Revenues to Recover Payment to Fiscal Court	<u>(100,000)</u>
Net Revenue Without Recovery of Payment to Fiscal Court	(846,290)
Divide by: KIA and RD Annual Debt Service Payments	<u>\$401,771</u>
Debt Service Ratio	<u>211%</u>

Sewer Division: As shown in Table D1 of Attachment D to the Application, by applying methods generally accepted by the Commission, Southern District determined that a revenue increase of \$95,485, or 100.28 percent, is allowable prior to the construction, financing and operation of the third wastewater treatment facility; however, its requested rates only produce additional annual revenues of \$19,043. A condensed calculation of the allowable revenue increase is shown below:

Pro forma Operating Expenses	\$190,769
Debt Service Requirement	<u>4,754</u>
Total Revenue Requirement	195,523
Less: Pro forma Present Rate Revenue and Other Revenues	<u>(100,038)</u>
Required Revenue Increase	<u>\$95,485</u>

While the requested rates will not produce the full amount of the allowable revenue increase, they will produce net revenues equal to 776 percent of the Sewer Division's annual debt service payments to KIA. This debt service coverage ratio well exceeds the minimum 110 percent required by KIA. The calculation of the 776 percent debt service ratio is shown below:

Annual Total Revenue at Requested Rates	\$119,081 ¹⁷
Less: Operating Expenses	(190,769) ¹⁸
Add Back: Depreciation Expense	101,249 ¹⁹
Less: KIA Administrative Fee on 2005 Loan	(70) ²⁰
Less: FGB Loan Payment, No Coverage Required	<u>(586)²¹</u>
Net Revenues	28,905
Divide by: KIA Annual Debt Service Payments	<u>\$3,725²²</u>
Debt Service Ratio	<u>776%</u>

¹⁷ Pro forma Present Rate Revenue	\$95,215
Increase in Revenue from Requested Rates	19,043
Other Operating Revenue	3,662
Nonutility Income	<u>1,161</u>
Total Revenue	<u>\$119,081</u>

¹⁸ Application, Attachment C, Page 2, Table C2.

¹⁹ *Id.*

²⁰ Application, Attachment D, Page 4, Table D3.

²¹ *Id.*

²² *Id.*

The requested rates are also expected to produce net revenues that meet KIA's debt service coverage requirement after the third wastewater treatment facility becomes operational, adding 140 customers to the system. This is demonstrated below:

Annual Total Revenue at Requested Rates after Construction	\$234,239 ²³
Less: Operating Expenses	(321,018) ²⁴
Add Back: Depreciation Expense	201,018 ²⁵
Less: KIA Administrative Fee	(1,602) ²⁶
Less: FGB Loan Payment, No Coverage Required	(586) ²⁷
Net Revenues	112,051
Divide by: KIA Annual Debt Service Payments	<u>\$46,168</u> ²⁸
Debt Service Coverage	<u>243%</u>

As evidenced herein, the proposed sewer rates produce revenues sufficient to meet the requirements of Southern District's lending agency, Staff recommends that they be approved by the Commission.

Rates and Billing Analysis

The water and sewer rates requested in the application were determined by increasing the current rates evenly across the board. These rates and the billing analyses summaries showing that they generate the appropriate level of revenues for the Water Division and the Sewer Division, are shown on Page 3 and Page 5,

²³ Pro forma Present Rate Revenue	\$95,215
Increase in Revenue from Requested Rates, Current Customers	19,043
Increase in Revenue from Requested Rates, 140 New Customers	115,158
Other Operating Revenue	3,662
Nonutility Income	<u>1,161</u>
Total Revenue	<u>\$234,239</u>

²⁴ Application, Attachment C, Page 2, Table C2.

²⁵ *Id.*

²⁶ Application, Attachment D, Page 4, Table D3. \$70 for 2005 KIA Loan + 1,532 for New KIA Loan.

²⁷ *Id.*

²⁸ *Id.* \$3,725 for 2005 KIA Loan + \$42,443 for New KIA Loan.

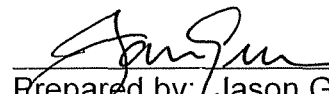
respectively, of Attachment E to the Application. The water rates and billing analysis summary without recovery of the Fiscal Court payment are shown in Appendix C.

Staff members Jack Scott Lawless and Jason Green prepared this report. Mr. Lawless is responsible for the calculation of revenue requirements. Mr. Green is responsible for the determination of the rates.

Signatures



Prepared by: Jack Scott Lawless, CPA
Manager, Water and Sewer Revenue
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Prepared by: Jason Green
Rate Analyst, Communications, Water
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Division of Financial Analysis

APPENDIX A
STAFF REPORT, CASE NO. 2012-00309
REQUESTED WATER RATES

Monthly Water Rates

First 2,000 gallons
Over 2,000 gallons

\$24.11 Minimum bill
8.34 per 1,000 gallons

APPENDIX B
STAFF REPORT, CASE NO. 2012-00309
STAFF'S RECOMMENDED SEWER RATES

Monthly Sewer Rates

First 2,000 gallons	\$28.38 Minimum bill
Over 2,000 gallons	9.52 per 1,000 gallons

APPENDIX C
 STAFF REPORT, CASE NO. 2012-00309
 WATER RATES WITHOUT FISCAL COURT PAYMENT
 AND BILLING ANALYSIS SUMMARY

Monthly Water Rates

First 2,000 gallons	\$23.48 Minimum bill
Over 2,000 gallons	8.13 per 1,000 gallons

Billing Analysis Summary

Meter Size	Gallons Sold	Revenue
5/8 inch	239,504,000	\$2,517,670
	118,140,000	1,266,928
Retail Total	<u>357,644,000</u>	<u>3,784,597</u>
City of Hindman	17,265,000	55,248
Wholesale Total	<u>17,265,000</u>	<u>55,248</u>
Totals	374,909,000	3,839,845
Less: Billing Adjustments		<u>(197,217)</u>
Total Revenue		<u>\$3,642,628</u>
Proposed Rates	First 2,000 Gallons	\$23.48
	Over 2,000 Gallons	\$8.13

Hubert Halbert
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