

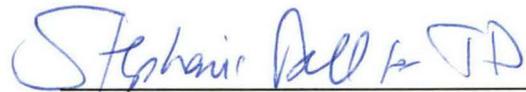
COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF MAGOFFIN COUNTY)	CASE NO.
WATER DISTRICT FOR RATE ADJUSTMENT)	2015-00022
PURSUANT TO 807 KAR 5:076)	

NOTICE OF FILING OF COMMISSION STAFF REPORT

Notice is hereby given that, in accordance with the Commission's Order of May 18, 2015, the attached report containing the findings of Commission Staff ("Staff") regarding the Applicant's proposed rate adjustment has been filed in the record of the above-styled proceeding. Pursuant to paragraphs 2 and 3 of the Commission's May 18, 2015 Order, Magoffin County Water District is required to file written comments regarding the findings of Staff no later than August 14, 2015.



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

DATED JUL 31 2015

cc: Parties of Record

STAFF REPORT
ON
MAGOFFIN COUNTY WATER DISTRICT
CASE NO. 2015-00022

Magoffin County Water District ("Magoffin County") provides water service to approximately 3,473 customers residing in Floyd and Magoffin counties, Kentucky.¹ On April 8, 2015, Magoffin County tendered an application to the Commission pursuant to 807 KAR 5:076 requesting to adjust its water service rates through a phase-in plan. After Magoffin County cured filing deficiencies, its application was accepted for filing on May 4, 2015.

Pursuant to the phase-in plan, Magoffin County proposes to increase its rates in two phases. Phase 1 rates would become effective immediately upon the Commission's approval and would remain in effect for one year. Phase 1 rates would increase test-year revenues by \$69,835, or 5.5 percent. Phase 2 rates would become effective upon the completion of Phase 1 rates and would remain in effect until changes are accepted or approved by the Commission. Phase 2 rates would increase Phase 1 revenues by \$73,676, or 5.5 percent. As shown in the table below, Magoffin County's requested cumulative increase to test-year revenues from the phase-in plan is \$143,510, or 11.3 percent.

¹ *Annual Report of Magoffin County Water District to the Public Service Commission for the Calendar Year Ended December 31, 2013 ("2013 Annual Report")* at 12 and 53.

	Annual Water Sales Prior to Increase	Annual Water Sales Subsequent to Increase	Revenue Increase
Phase 1	\$ 1,269,720	\$ 1,339,555	\$ 69,835
Phase 2	1,339,555	1,413,230	<u>73,676</u>
Total Revenue Increase			143,510
Divide by: Test-Year Revenue			<u>1,269,720</u>
Total Percentage Increase			<u><u>11.30%</u></u>

In its application, Magoffin County provided financial exhibits based on the test year ended December 31, 2013, which support an increase of \$279,392 or 22 percent; however, Magoffin County requested rates that will increase annual revenues by only \$143,510, or 11.3 percent. These exhibits are shown below in condensed form:

Overall Revenue Requirement and Required Revenue Increase

	<u>Magoffin County</u>
Pro Forma Operating Expenses	\$1,483,179 ²
Plus: Average Annual Principal and Interest Payments on Current Debts	116,398
Additional Working Capital	<u>23,280</u>
Overall Revenue Requirement	1,622,857
Less: Other Operating Revenue	(70,531)
Interest Income	(3,214)
Nonutility Income	<u> </u>
Revenue Required From Rates	1,549,112
Less: Pro Forma Present Rate Service Revenues	<u>(1,269,720)</u>
Required Revenue Increase	<u>\$ 279,392</u>
Percent Increase	<u>22.00%</u>

Staff performed a limited financial review of Magoffin County's operations for the test year ended December 31, 2013, to determine the reasonableness of the requested water service rates. The scope of Staff's 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.

Staff's findings are summarized in this report. David Foster and Ariel Turnbull reviewed the calculation of Magoffin County's Overall Revenue Requirement. Eddie Beavers reviewed revenues and rate design.

² This number reflects pro forma adjustments made by Magoffin County to its test-year amount.

Summary of Findings

1. Overall Revenue Requirement and Required Revenue Increase. By applying the Debt Service Coverage (“DSC”) Method, as generally accepted by the Commission, Staff found Magoffin County’s Overall Revenue Requirement to be \$1,584,506 and that a revenue increase of \$294,895, or 23.83 percent, above pro forma present rate revenues is necessary to generate the Overall Revenue Requirement.

2. Water Service Rates. Magoffin County proposes an across-the-board increase in general water service rates of approximately 11.3 percent and that this increase be phased in using two steps, with the first increase to occur at the time the Commission rules on the requested increase. The Commission has previously found that an across-the-board percentage increase is an appropriate and equitable method to increase rates in the absence of a cost-of-service study. The Commission has found that a phased-in approach to a large rate increase is an appropriate way to manage gradualism in an effort to lessen rate shock.

The rates set forth in the Attachment to this report are based upon the revenue requirement as calculated by Staff and will produce revenues of at least \$1,532,305 from water service rates, an approximate 23.8 percent increase. Commission Staff has followed Magoffin County’s proposed two-phase increase to rates approach with the rates shown in the Attachment to this report.

The known and measurable adjustments found appropriate by Staff are detailed in the Pro Forma Operating Statement shown below:

	Test Year	Adjustment (Ref.)	Pro Forma
Operating Revenues			
Metered Water Sales	\$ 1,269,720	\$ (45,952) (A)	
		(3,035) (B)	
		(2,792) (C)	
		(3,053) (D)	
		22,522 (E)	\$ 1,237,410
Other Water Revenues	70,531	45,952 (A)	
		(37,731) (F)	
		(32,800) (D)	45,952
Total Operating Revenues	1,340,251	(56,889)	1,283,362
Operating Expenses			
Operation and Maintenance Expenses			
Salaries and Wages - Employees	300,613	22,439 (G)	
		(6,900) (H)	
		12,638 (I)	328,790
Salaries and Wages - Officers	7,800		7,800
Employee Pensions and Benefits	109,418		109,418
Purchased Water	532,222		532,222
Purchased Power	8,824		8,824
Materials and Supplies	28,088	(6,900) (H)	21,188
Contractual Services	4,000		4,000
Rents	9,300		9,300
Transportation Expenses	36,377		36,377
Insurance	30,483		30,483
Advertising Expenses	601		601
Bad Debt Expense	1,431		1,431
Miscellaneous Expenses	100,881	3,300 (J)	104,181
Total Operation and Maintenance Expenses	1,170,038	24,577	1,194,615
Depreciation Expense	223,639	276 (H)	223,915
Taxes Other Than Income	79,948	(35,560) (D)	
		(22,439) (G)	
		4,349 (K)	26,298
Total Operating Expenses	1,473,625	(28,797)	1,444,828
Net Operating Income	(133,374)	(28,092)	(161,466)
Interest and Dividend Income	3,214		3,214
Nonutility Income		3,035 (B)	3,035
Income Available to Service Debt	\$ (130,160)	\$ (25,057)	\$ (155,217)

(A) Other Water Revenues. During the test year, Magoffin County recognized \$45,952 for non-recurring charge revenues, excluding tap-on fees. The entire amount was reported as Metered Water Sales. Staff reclassified this revenue to Other Water Revenues.

(B) Sewer Collection Revenue. Magoffin County reported as Metered Water Sales, Sewer Collection Revenue that is collected from the city of Salyersville for providing the billing data to the city each month. The collection fees for 2013 totaled \$3,035. Staff reclassified this revenue as Nonutility Income, which is reported below Net Operating Income.

(C) Insurance Proceeds. During the test year, Magoffin County received an insurance payout for a total amount of \$2,792 for a service vehicle that was damaged by hail. Magoffin County erroneously reported this amount as Metered Water Sales. Because this payout was to offset the effects of damage done to a depreciable asset, the Uniform System of Accounts (“USoA”) requires that this amount be accounted for using the accumulated depreciation account.³ Through this accounting treatment, the depreciable basis of a replacement asset is adjusted to include the amount of the gain. The gain would then be recognized as a component of depreciation expense recorded on the replacement asset in future periods. Accordingly, Staff removed \$2,792 from Metered Water Sales.

(D) School Tax. Magoffin County collects and remits school taxes from its Magoffin County customers on behalf of the Magoffin County Board of Education.

³ USoA at 42, Account 180.1 B.

Magoffin County improperly reported test-year tax collections in the amount of \$35,853⁴ as revenues, and the tax remittances of \$35,560 as an expense. The collection of these taxes is not revenue, nor is the remittance thereof an expense. Accordingly, Staff removed these amounts from test-year operations.

(E) Billing Analysis Adjustment. Magoffin County provided a billing analysis with its application using the 12-month test year ended December 31, 2013. During the course of this case, Staff learned that Magoffin County made leak adjustments to customers' bills. Magoffin County's computer software does not allow for this type of adjustment to the gallons sold after a customer's bill has been generated, therefore the adjustments were not reflected in the billing analysis. Residential customer Water Sales were adjusted by 883,916 gallons using the leak adjustment formula set out in Magoffin County's tariff. The leak adjustment results in a reduction of \$6,251 to Water Sales. Additionally, Water Sales must be increased by \$28,773 to adjust Magoffin County's Water Sales from a collected basis to a billed basis. This results in a net adjustment to Metered Water Sales of \$22,522.

(F) Insurance Proceeds. During the test year, Magoffin County erroneously reported as Other Water Revenue income of \$37,731 that was received as a result of an insurance payout on its general liability insurance policy. This income was to replace inventory that was stolen from its premises. In order to properly account for this income, the entire amount should be charged against the inventory account on the balance sheet. Accordingly, Staff reduced Other Water Revenue by \$37,731 to correct this error.

⁴ This amount is split into two accounts in Magoffin County's 2013 Annual Report. \$3,053 was reported as Metered Water Sales, and \$32,800 was reported as Other Water Revenue.

(G) Reclassification of Payroll Taxes. Magoffin County pays quarterly Social Security and Medicare taxes to the United States Treasurer. These taxes are equal to 15.3 percent of employee wages. Magoffin County withholds one-half of these taxes from employee wages. Magoffin County should report the withheld amount as an employee wage expense. It should report the portion of the amount that is not withheld as Taxes Other Than Income. Magoffin County improperly reported the total test-year tax payments as Taxes Other Than Income. Staff reclassified the test-year tax withholdings to the employee wage expense account. The amount of taxes paid during the test year that was not withheld from employee wages remains reported as Taxes Other Than Income.

(H) Capitalization of Test-Year Meter Installations. During the test year, Magoffin County installed 23 new water taps and expensed all the costs incurred to make the new connections. These costs include employee wages, wage overhead charges, materials and supplies, transportation costs, insurance, and depreciation on equipment. Proper accounting principles require that these costs be capitalized as Utility Plant in Service and depreciated over their estimated useful lives.⁵

⁵ USoA Accounting Instruction 19 and 33.

Because the actual cost was not available, Staff removed the estimated cost of these connections from test-year expenses and included a provision for their recovery in pro forma depreciation expense. To make the adjustment, Staff assumed that the total connection costs were equal to the tap fees collected by Magoffin County to recover the cost of the installations. Based on Magoffin County's tariffed tap fee of \$600, the cost of the water connections is estimated to be \$13,800 (\$600 tap fee x 23 taps). Accordingly, Staff increased test-year depreciation expense by \$276 ($\$13,800 \times 2$ percent capitalization rate).

Ideally, each expense account that contains installation costs would be reduced by a portion of the capitalized costs but, for simplicity, Staff only decreased wages expense and materials and supplies expense each by one-half of the connection costs. Both Magoffin County's wage expense and its materials and supplies expense were decreased by \$6,900.

(l) Post Test-Period Wage Rate Adjustments. In its application, Magoffin County requested to increase test-year wage expenses by \$8,400 to account for a wage rate increase that became effective on January 1, 2015. As shown in the table below, Staff determined that total pro forma wages should be \$335,966. Staff determined Magoffin County's pro forma wage expense to be \$328,790 by multiplying

total pro forma wages of \$335,966 by the test-year wage expense ratio of 97.86 percent.⁶ This results in an adjustment to increase wage expense by \$12,638.

	Base Salary	Current Pay Rate	Regular Hours	Overtime Hours (x1.5)	Clothing Allowance	Health Insurance Reimbursement	Pro Forma
Office Employees							
Employee 1	\$ 25,640	\$ 11.66	40	3	\$ 541		\$ 26,933
Employee 2	20,740	9.30	40	1	541	\$ 1,600	23,453
Employee 3	25,024	24.06	221		541	3,612	37,153
Employee 4	8,637	13.58			541		9,178
Field Employees							
Employee 5	40,827	19.15	40	171	541	600	48,029
Employee 6	36,674	17.30		98	541		39,758
Employee 7	34,894	16.30		76	541		37,293
Employee 8	26,640	12.90	11	62	541		28,584
Employee 9	26,500	12.29		109	541		29,041
Superintendent	50,950	24.01	40		541	3,612	56,544
Total Pro Forma							335,966
Times: Test-Year Expense Ratio							<u>97.86%</u>
Pro Forma Expense							328,790
Less: Test-Year Wages Adjusted for FICA Taxes and Test-Year Meter Installations							<u>(316,152)</u>
Increase							<u><u>\$ 12,638</u></u>

(J) Water Testing. Magoffin County reported total test-year water-testing expenses in the amount of \$2,984 as a Miscellaneous Expense. In its application, Magoffin County stated that new Division of Water testing requirements will increase this amount by \$2,356. During its review, Staff found that Magoffin County's

⁶

	Wages	Ratio
Expense	\$ 316,152	97.86%
Capitalize	6,900	2.14%
Total	<u><u>\$ 323,052</u></u>	<u>100%</u>

additional test requirements will increase test year expenses by \$3,300.⁷ Staff increased Magoffin County's test-year expenses by this amount.

(K) Taxes Other Than Income – Payroll Taxes. Below, Staff calculated Magoffin County's pro forma payroll taxes by multiplying the total taxable wages by the payroll tax rate. Accordingly, Staff increased payroll tax expense by \$4,349.

	Pro Forma
Pro Forma Employee Wages	\$ 335,966
Commissioners' Salaries	<u>7,800</u>
Total Wages Subject to Payroll Taxes	343,766
Times: Tax Rate	<u>7.65%</u>
Payroll Tax Expense	26,298
Less: Test Year	<u>(21,949)</u>
Adjustment	<u><u>\$ 4,349</u></u>

7

New Quarterly Water Testing per Invoice	\$ 825
Times: 4 Quarters	<u>4</u>
Total Adjustment	<u><u>\$ 3,300</u></u>

Overall Revenue Requirement and Required Revenue Increase

Staff applied the DSC method as generally accepted by the Commission to calculate Magoffin County's Overall Revenue Requirement. This method allows for recovery of: 1) cash-related pro forma operating expenses; 2) recovery of depreciation expense, a non-cash item, to provide working capital;⁸ 3) the average annual principal and interest payments on all long-term debts, and 4) working capital that is in addition to depreciation expense.

A comparison of Magoffin County's and Staff's calculation of the Overall Revenue Requirement and Required Revenue Increase is shown below:

⁸ The Kentucky Supreme Court has held that the Commission must permit a water district to recover its depreciation expense through its rates for service to provide internal funds to be used for renewing and replacing assets. See *Public Serv. Comm'n of Kentucky v. Dewitt Water Dist.*, 720 S.W.2d 725, 728 (Ky.1986). Although a water district's lenders require that a small portion of the depreciation funds be deposited annually into a debt reserve/depreciation fund until the account's balance accumulates to a required threshold, neither the Commission nor the Court requires that revenues collected for depreciation be accounted for separately from the water district's general funds or that depreciation funds be used only for asset renewal and replacement. The Commission has recognized that the working capital provided through recovery of depreciation expense may be used for purposes other than renewal and replacement of assets. See Case No. 2012-00309, *Application of Southern Water and Sewer District for an Adjustment in Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC Dec. 21, 2012).

	Magoffin County	Staff
Pro Forma Operating Expenses	\$ 1,483,179	\$ 1,444,828
Plus: Average Annual Principal and Interest Payments on Current Debts	116,398	116,398
Additional Working Capital	23,280	23,280
	<hr/>	<hr/>
Overall Revenue Requirement	1,622,857	1,584,506
Less: Other Operating Revenue	(70,531)	(45,952)
Interest Income	(3,214)	(3,214)
Nonutility Income		(3,035)
	<hr/>	<hr/>
Revenue Required From Rates	1,549,112	1,532,305
Less: Pro Forma Present Rate Service Revenues	(1,269,720)	(1,237,410)
	<hr/>	<hr/>
Required Revenue Increase	\$ 279,392	\$ 294,895
Percent Increase	22.00%	23.83%
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(1) Average Principal and Interest Payments. Magoffin County currently has outstanding indebtedness in the form of one bond payable to the Kentucky Rural Water Finance Corporation ("KRWFC"). In its Application, Magoffin County requested recovery of the three-year average principal and interest payments due in 2016, 2017, and 2018 on this bond. Staff agrees that the \$116,398 requested by Magoffin County represents, in all material respects, the average annual debt payments that will be made on the utility's long-term debt in each year that the water rates approved by the Commission in this proceeding will be in effect.

(2) Additional Working Capital. The DSC method, as historically applied by the Commission, includes an allowance for additional working capital that is equal to the minimum net revenues required by Magoffin County's lenders that are above its average annual debt payments. Historically, the Commission allows a water district recovery of additional working capital that is equal to the minimum net revenues required by the utility's lenders that are above the utility's average annual debt payments. In this case, KRWFC requires that Magoffin County charge rates that produce net revenues that are at least 120 percent of its average annual bond payments. Following the Commission's historic practice, Staff calculated Magoffin County's allowance for additional working capital to be \$23,280 as shown below.⁹ Staff included this amount in the calculation of Magoffin County's Overall Revenue Requirement.

⁹ Inclusion of the additional working capital in Magoffin County's revenue requirement is not necessary for it to earn revenues that meet the minimum DSC ratio required by its lenders. As depreciation is a noncash item, it is excluded from the ratio calculation, which is actually a measure of cash flow. As shown below, Magoffin County's minimum DSC ratio is met with or without the inclusion of additional working capital.

	With Additional Working Capital	Without Additional Working Capital
Overall Revenue Requirement	\$ 1,584,506	\$ 1,561,226
Less: Operating and Maintenance Expense	(1,194,615)	(1,194,615)
Taxes Other Than Income	(26,298)	(26,298)
	<hr/>	<hr/>
Net Revenues	363,593	340,313
Divided by: Average Annual Debt Payments	116,398	116,398
	<hr/>	<hr/>
DSC Ratio	312%	292%

Average Annual Principal and Interest	\$ 116,398
Times: DSC Coverage Ratio	<u>120%</u>
Total Net Revenues Required	139,678
Less: Average Annual Principal and Interest Payments	<u>(116,398)</u>
Additional Working Capital	<u>\$ 23,280</u>

Signatures



Prepared by: David P. Foster
 Financial Analyst, Water and Sewer
 Revenue Requirements Branch
 Division of Financial Analysis



Prepared by: Ariel Turnbull
 Financial Analyst, Water and Sewer
 Revenue Requirements Branch
 Division of Financial Analysis



Prepared by: Eddie Beavers
 Rate Analyst, Water and Sewer
 Rate Design Branch
 Division of Financial Analysis

ATTACHMENT
STAFF REPORT CASE NO. 2015-00022
RATES CALCULATED BY STAFF

Monthly Water Rates

Phase 1

Residential

5/8-Inch Meter

First	2,000 gallons	\$16.68 Minimum bill
Next	3,000 gallons	7.74 per 1,000 gallons
Next	5,000 gallons	6.89 per 1,000 gallons
Over	10,000 gallons	6.33 per 1,000 gallons

1-Inch Meter

First	5,000 gallons	\$39.00 Minimum bill
Next	5,000 gallons	6.89 per 1,000 gallons
Over	10,000 gallons	6.33 per 1,000 gallons

Commercial

3/4-Inch Meter

First	3,000 gallons	\$29.88 Minimum bill
Next	2,000 gallons	9.57 per 1,000 gallons
Next	5,000 gallons	8.84 per 1,000 gallons
Next	5,000 gallons	8.12 per 1,000 gallons
Over	15,000 gallons	7.78 per 1,000 gallons

1-Inch Meter

First	5,000 gallons	\$49.02 Minimum bill
Next	5,000 gallons	8.84 per 1,000 gallons
Next	5,000 gallons	8.12 per 1,000 gallons
Over	15,000 gallons	7.78 per 1,000 gallons

2-Inch Meter

First	15,000 gallons	\$133.82 Minimum bill
Over	15,000 gallons	7.78 per 1,000 gallons

Phase 2

Residential

5/8-Inch Meter

First	2,000 gallons	\$18.45 Minimum bill
Next	3,000 gallons	8.23 per 1,000 gallons
Next	5,000 gallons	7.62 per 1,000 gallons
Over	10,000 gallons	7.00 per 1,000 gallons

1-Inch Meter

First	5,000 gallons	\$43.14 Minimum bill
Next	5,000 gallons	7.62 per 1,000 gallons
Over	10,000 gallons	7.00 per 1,000 gallons

Commercial

3/4-Inch Meter

First	3,000 gallons	\$33.06 Minimum bill
Next	2,000 gallons	10.59 per 1,000 gallons
Next	5,000 gallons	9.78 per 1,000 gallons
Next	5,000 gallons	8.98 per 1,000 gallons
Over	15,000 gallons	8.61 per 1,000 gallons

1-Inch Meter

First	5,000 gallons	\$54.24 Minimum bill
Next	5,000 gallons	9.78 per 1,000 gallons
Next	5,000 gallons	8.98 per 1,000 gallons
Over	15,000 gallons	8.61 per 1,000 gallons

2-Inch Meter

First	15,000 gallons	\$148.04 Minimum bill
Over	15,000 gallons	8.61 per 1,000 gallons

*Joe Burns
Kentucky Rural Water Association
Post Office Box 1424
3251 Spring Hollow Avenue
Bowling Green, KENTUCKY 42102-1424

*Magoffin County Water District
749 Parkway Road
P. O. Box 490
Salyersville, KY 41465

*Allen McCarty
Superintendent
Magoffin County Water District
749 Parkway Rd
P. O. Box 490
Salyersville, KY 41465