

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ELECTRONIC APPLICATION OF BREATHITT)
COUNTY WATER DISTRICT FOR AN) CASE NO.
ALTERNATIVE RATE ADJUSTMENT) 2017-00140

NOTICE OF FILING OF COMMISSION STAFF REPORT

Notice is hereby given that, in accordance with the Commission's Order of April 18, 2017, the attached report containing the findings of Commission Staff regarding the Applicant's proposed rate adjustment has been filed in the record of the above-styled proceeding. Pursuant to the Commission's April 18, 2017 Order, Breathitt County Water District is required to file written comments regarding the findings of Commission Staff no later than 14 days from the date of this report.



John S. Lyons
Acting Executive Director
Public Service Commission
P.O. Box 615
Frankfort, KY 40602

DATE JUL 21 2017
cc: Parties of Record

STAFF REPORT
ON
BREATHITT COUNTY WATER DISTRICT
CASE NO. 2017-00140

Breathitt County Water District ("Breathitt County") is a water utility district organized pursuant to KRS Chapter 74 that owns and operates a water distribution system through which it provides retail water service to approximately 1,694 customers that reside in Breathitt County, Kentucky.¹ On March 31, 2017, Breathitt County tendered an application ("Application") to the Commission requesting to increase its water service rates pursuant to 807 KAR 5:076. Breathitt County's Application was deemed filed on March 31, 2017. To ensure the orderly review of the Application, the Commission established a procedural schedule by Order dated April 18, 2017. On July 6, 2017, the Commission entered an Order amending the procedural schedule in order to permit Commission Staff ("Staff") additional time to complete the Staff Report on Breathitt County's Application.

As required by 807 KAR 5:076, Breathitt County based its requested rates on a historical test period that coincides with the reporting period shown in its most recent Annual Report on file with the Commission. Breathitt County presented financial exhibits in its Application demonstrating a rate increase that increases annual water sales revenues by \$629,600, a 76.23 percent increase to test-year water sales revenues in the amount of \$825,948.

¹ *Annual Report of Breathitt County District to the Public Service Commission for the Calendar Year Ended December 31, 2015* ("Annual Report") at 12 and 53.

Although a 76.23 percent rate increase was justified, Breathitt County did not request rates that would generate such additional annual revenues. Instead, it requested rates that would increase annual revenues by \$147,990, a 17.92 percent increase. The monthly bill of a typical residential customer would increase by \$6.52, from \$36.24 to \$42.76, or 17.96 percent.² Breathitt County did not provide an explanation for why it requested the lower amount. Breathitt County presented financial exhibits in its Application that show how Breathitt County calculated the amount that it could have requested. The exhibits are summarized below in condensed form.

Pro Forma Operating Expenses	\$ 1,373,883
Plus: Average Annual Debt Payments	115,891
Additional Working Capital	<u>13,049</u>
Overall Revenue Requirement	1,502,823
Less: Other Operating Revenue	<u>(47,275)</u>
Revenue Required From Rates	1,455,548
Less: Pro Forma Present Rate Revenues	<u>(825,948)</u>
Required Revenue Increase	<u>\$ 629,600</u>
Percent Increase	<u>76.23%</u>

To determine the reasonableness of the rates requested by Breathitt County, Staff performed a limited financial review of Breathitt County's test-year operations. 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

² A typical residential customer purchases 3,000 gallons of water per month through a 5/8-inch x 3/4-inch meter.

to be material. Insignificant and immaterial discrepancies were not necessarily pursued or addressed.

Staff's findings are summarized in this report. David Foster reviewed the calculation of Breathitt County's Overall Revenue Requirements. Sam Reid reviewed Breathitt County's reported revenues and rate design.

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 that Breathitt County's Overall Revenue Requirement is \$1,563,745 and that a \$717,164 revenue increase, or 85.25 percent, to pro forma present rate revenues, is necessary to generate the Overall Revenue Requirement.

2. Water Service Rates. Breathitt County proposes to increase its current water service rates by approximately 18.00 percent evenly across the board. Breathitt County has not performed a cost-of-service study ("COSS"). The Commission has previously found that an across-the-board increase is an appropriate and equitable method of cost allocation in the absence of a COSS. Staff finds that an across-the-board increase is the appropriate means to allocate the increased revenue requirement. The rates set forth in the Attachment to this report are based upon the revenue requirement as calculated by Staff and will produce sufficient revenues from water sales to recover the \$1,548,206 Revenue Requirement determined by Staff, an approximate 86.30 percent increase. These rates will increase a typical residential customer's monthly water bill from \$36.24 to \$67.56, an increase of \$31.32, or approximately 86.43 percent.

Pro Forma Operating Statement

Breathitt County's Pro Forma Operating Statement for the test year ended
December 31, 2015, as determined by Staff, appears below.

	<u>Test Year</u>	<u>Adjustment</u>	<u>(Ref.)</u>	<u>Pro Forma</u>
Operating Revenues				
Sales of Water	\$ 825,948	\$ (2,159)	(A)	
		(7,273)	(B)	
		(25,048)	(C)	
		39,574	(D)	\$ 831,042
Other Water Revenue	47,275	(31,736)	(E)	15,539
Total Operating Revenues	873,223	(26,642)		846,581
Operating Expenses				
Operation and Maintenance Expenses				
Salaries and Wages - Employees	143,784	17,374	(F)	161,158
Salaries and Wages - Officers	18,000			18,000
Employee Pensions and Benefits	71,214	10,732	(G)	
		(8,992)	(H)	72,954
Purchased Water	277,602	15,451	(I)	293,053
Purchased Power	62,181	3,461	(J)	65,642
Materials and Supplies	50,987			50,987
Contractual Services	18,090			18,090
Water Testing	3,774			3,774
Rents	4,333			4,333
Transportation	45,611			45,611
Insurance	18,075			18,075
Bad Debt	3,099			3,099
Miscellaneous	12,968			12,968
Total Operation and Maintenance Expenses	729,718	38,026		767,744
Depreciation Expense	970,085	(325,920)	(K)	644,165
Taxes Other Than Income		1,329	(L)	
		11,437	(L)	12,766
Total Operating Expenses	1,699,803	(275,128)		1,424,675
Net Operating Income	(826,580)	248,485		(578,095)
Interest Income	353			353
Income Available to Service Debt	\$ (826,227)	\$ 248,485		\$ (577,742)

(A) Billing Analysis Adjustment. Breathitt County's Application stated test-year revenues from water sales to be \$825,948. Also included in this level of revenues are collections of customer payments and additional miscellaneous revenues. Breathitt County included in its Application a billing analysis, which was based on actual customer

water usage and derived from Breathitt County's electronic billing software. Staff has reviewed Breathitt County's billing analysis and finds that the water-sales revenues determined by the billing analysis provided in the Application is a more accurate representation of normalized test-year revenue from water sales than the amount used by Breathitt County in the Application; therefore, staff reduced test-year water sales revenue by \$2,159.

(B) Leak Adjustment. Breathitt County tracks customer account billing adjustments for billing errors, leak-adjustment fees, misread meters, and equipment failures and manually inputs the financial adjustment into Breathitt County's billing program; however, the billing program does not allow for corresponding usage adjustments. The test-year billing analysis provided in the Application does not reflect the adjustments made to customers' bills that were made after the bills were issued. Staff reduced test-year water-sales revenues stated in the test-year billing analysis by \$7,273 to reflect credits to customer accounts for leak adjustments.

(C) Billing Adjustment. Staff reduced test-year water-sales revenues stated in the test-year billing analysis by \$25,048 to reflect credits to customer accounts for misread meters and billing errors.

(D) New Customers. Breathitt County's Application states the current number of customers is 1,785. The PSC annual report for the 2015 test year states an end-of-year customer number of 1,694. Staff increased test-year revenues by \$39,574 to account for this customer growth.³ The additional customer growth occurred over several

³ 91 customers using an average of 3,000 gallons per month at the current rate of \$12.08 per 1,000 gallons $((91*3,000)*12)*\$12.08$ per 1,000= \$39,574.

months after the 2015 test year. Staff annualized the usage for these additional customers based on Breathitt County's test-year monthly average customer usage.

(E) Other Water Revenue. During the test year, Breathitt County collected water tap-on fees in the total amount of \$31,736. Breathitt County reported this amount to account 474, Other Water Revenues, which was closed at the end of the accounting cycle to account 215.1, Retained Earnings from Income Before Contributions. As a result, the tap-on fees were included in the determination of Breathitt County's Net Operating Income ("NOI").

Breathitt County's accounting for test-year tap-on fees violates the accounting methods prescribed by the Uniform System of Accounts ("USoA"). Tap-on fees are contributions in aid of construction ("CIAC") that the USoA requires to be reported using account 432, Proceeds from Capital Contributions, which is closed to account 215.2, Donated Capital, without being included in the determination of NOI.⁴ To comply with the requirements of the USoA, Staff removed the test-year tap-on fees from Other Water Revenues.

(F) Salaries and Wages – Employees. During the test year, Breathitt County had three full-time employees and four part-time employees. It reported \$143,784 for test-year Salaries and Wages – Employee expense. Staff determined, based on conversations with utility personnel, that an increase of \$17,374 to Salaries and Wages – Employees was warranted to reflect the two items as described below.

During its review, Staff noted that two part-time employees who were employed during the test year are no longer employed by Breathitt County. One was terminated

⁴ USoA for Water Districts and Associations at 57.

during the test year and another resigned subsequent to the test year. Breathitt County filled both of these positions by promoting two test-year part-time employees to full-time positions.

In addition to the changes to Breathitt County's staffing levels, Staff noted that there were changes to employee wages subsequent to the test year. Upon review of the December 21, 2016 minutes of Breathitt County's Board of Commissioner's meetings, Staff found that wage increases granted to Breathitt County's employees ranged from 3 to 12 percent. There was no discussion in the minutes of Breathitt County's Board of Commissioner's meetings describing the variance in the percentages awarded to the employees. Staff finds that the amount of the pay increases is known and measurable and may be included in the calculation of Breathitt County's pro forma operations. Following the practice of recent Commission Orders, Staff notes that the Commission has begun placing more emphasis on having utilities provide support for salary increases, especially those that may be considered excessive as they relate to competitiveness in a broad marketplace.⁵ Future rate applications filed by Breathitt County should include a basis to justify raises that are granted to Breathitt County's employees.

Staff determined total pro forma wage expense to be \$161,158 by applying the current pay rate of each employee by 2,080 regular work hours and overtime hours worked during the test year. Staff's calculation accounts for current wage rates and changes to staffing levels during and subsequent to the test year. Staff's calculations are shown below:

⁵ See Case No. 2015-00312, *Application of Kenergy Corp. for a General Adjustment in Rates* (Ky. PSC Sept. 15, 2016), at 15, and Case No. 2016-00169, *Application of Licking Valley Electric, Inc. for a General Adjustment of Rates* (Ky. PSC Feb. 16, 2017) at 8.

<u>Employee</u>	<u>2017 Wages</u>		<u>2015 Hours</u>		<u>Total Pro Forma Wages</u>
	<u>Regular</u>	<u>Overtime</u>	<u>Regular</u>	<u>Overtime</u>	
1	\$ 16.00	24.00	2080	8	\$ 33,472
2	22.00	33.00	2080	246	53,878
3	8.50	12.75	2080		17,680
4	8.50	12.75	2080	15.50	17,878
5	15.25	22.88	2080	285.50	<u>38,251</u>
Pro Forma Wages					161,158
Less: Test Year Wages					<u>(143,784)</u>
Increase					<u>\$ 17,374</u>

(G) Retirement Expense Pursuant to GASB 68. Breathitt County provides pension benefits and post-retirement health care benefits to its employees by participating in the County Employee Retirement System (“CERS”). As a participating member, Breathitt County is required to contribute a percentage of its employee wages to CERS. The table below summarizes the CERS contribution rates for each of the previous six fiscal years beginning July 1.

<u>Fiscal Year Beginning July 1,</u>	<u>Employer Contribution Rate</u>
2011	16.93%
2012	18.96%
2013	19.55%
2014	18.89%
2015	17.67%
2016	17.06%

During the test year, Breathitt County contributed \$30,463 to CERS on behalf of its employees. Prior to the test year, Breathitt County was required to report annual pension costs and post-retirement health care costs pursuant to Governmental

Accounting Standards Board (“GASB”) Statement No. 27 (“GASB 27”). GASB 27 required that Breathitt County report its CERS contributions as employee retirement expense. In addition, GASB 27 did not require that Breathitt County report a liability on its financial statements for a portion of either CERS’s Net Pension Liability (“NPL”) or CERS’s underfunded post-retirement health care costs.

Due to the passage and implementation of GASB 68, the accounting and reporting requirements for the CERS pension benefits changed during the test year. GASB 68 did not change the accounting for post-retirement health care costs but did require the reporting of the following for pensions beginning in the test year.

- 1) A charge against Retained Earnings to account for the cumulative effect of switching from GASB 27 to GASB 68;
- 2) Breathitt County’s proportionate share of the CERS NPL;
- 3) Deferred Inflow of Resources and Deferred Outflow of Resources related to pensions; and
- 4) Annual pension expense that includes:
 - a. pension contributions to CERS during the reporting period that were made prior to the NPL’s measurement date;
 - b. the amortization of Breathitt County’s proportionate share of Deferred Outflow of Resources and Deferred Inflow of Resources related to pensions;
 - c. Breathitt County’s proportionate share of the plan’s actuarially determined annual pension expense; and
 - d. the increase or decrease that occurs during the reporting period to the amount of Breathitt County’s proportionate share of the CERS NPL.

To implement GASB 68 during the test year, Breathitt County relied on the results of the CERS actuarial valuation for the fiscal year ended June 30, 2014. Using the 2014 valuation, Breathitt County reported the following account balances to account for GASB 68 and its impact on Breathitt County’s test-year beginning balance of Retained Earnings.⁶

NPL	\$ 200,000
Impact on Retained Earnings	(206,000)
Deferred Outflows	26,732
Deferred Inflows	22,000
Retirement Expense	13,377

In Case No. 2016-00163,⁷ after considering the effects of GASB 68 on Marion County Water District’s (“Marion District”) test-year operations, the Commission found that, except for the NPL, the difference between the amounts reported for retirement costs pursuant to GASB 68 and those that would have been reported pursuant to GASB 27 should be accounted for as a regulatory asset as allowed by GASB 62. The Commission found that its method would mitigate the impact of GASB 68 on Marion District’s Balance Sheet and that it would smooth the level of annual retirement expense reported by Marion District in future reporting periods because the annual expense would always be equal to the amount of Marion District’s contributions to CERS, which historically have been fairly constant.

⁶ Note that Breathitt County’s implementation of GASB 68 resulted in its reporting test-year retirement expense in the amount of \$13,377, or \$10,731 less than the amount of its actual test-year contributions to CERS that were allocated to the CERS pension fund.

⁷ Case No. 2016-00163, *Alternative Rate Adjustment Filing of Marion County Water District* (PSC Ky. Nov. 10, 2016).

Staff finds that the method of accounting for retirement costs applied by the Commission to Marion District will provide the same benefits to Breathitt County and should, therefore, be applied in this proceeding. Application of the Commission's method to Breathitt County's audited retirement costs requires the following journal entry.

	Dr.	Cr.
Regulatory Asset	\$ 200,000	
Deferred Inflows	22,000	
Retirement Expense	10,732	
Retained Earnings		\$ 206,000
Deferred Outflows		26,732

The above journal entry results in the Staff adjusted account balances shown below.

Regulatory Asset	\$ 200,000
NPL	200,000
Impact on Retained Earnings	
Deferred Outflows	
Deferred Inflows	
Retirement Expense	24,109

Accordingly, Staff increased Breathitt County's test-year retirement expense by \$10,732 to restate the expense to \$24,109, the amount of Breathitt County's test-year contribution to the CERS pension fund.

(H) Employee Contribution for Health Insurance. Breathitt County reported \$71,214 for test-year Employee Pensions and Benefits expense. This amount included \$39,361 for the cost of providing health insurance benefits to all qualifying full-time employees.

Breathitt County currently pays 100 percent of the monthly premiums for health insurance for its employees and dependents. Breathitt County also pays 100 percent of life insurance premiums for all of its employees. Staff notes that in its recent Orders the Commission has made ratemaking adjustments to reduce the cost of employee benefit packages paid by some utilities on behalf of their employees to levels that are more commensurate with those of other businesses. For example, in Case No. 2016-00325, the Commission found that North Mercer Water District (“North Mercer”) paid, on behalf of its employees, 100 percent of the cost of family health insurance plans, family dental insurance plans, single dental insurance plans and 100 percent of each employee’s life insurance premium.⁸ In that proceeding, the Commission excluded from rates 32 percent of the cost of the family health insurance plans, and it excluded from rates 60 percent of the cost of dental insurance plans. It did not reduce the amount of life insurance premiums.

Likewise, in Case No. 2016-00367, the Commission removed, for ratemaking purposes, the cost of the Nolin Rural Electric Cooperative Corporation’s (“Nolin”) contributions to a 401(k) plan made on behalf of all employees who qualified and participated in the National Rural Electric Cooperative Association Retirement and Security Program (“NRECARSP”), which is a defined dollar pension benefit plan.⁹ The Commission did not remove the 401(k) contributions made by Nolin on behalf of its employees who had been employed longer than 30 years and, therefore, no longer

⁸ *Electronic Application of North Mercer Water District for Rate Adjustment Made Pursuant to 807 KAR 5:076* (Ky. PSC May 19, 2017) at 2.

⁹ *Application of Nolin Rural Electric Cooperative Corporation for a General Rate Increase* (Ky. PSC June 21, 2017).

qualified for participation in the NRECARSP. Also in that case, the Commission, finding that it was unreasonable for Nolin to provide 100 percent of the cost of health insurance coverage to employees, ordered that rate recovery by Nolin for the cost of family health insurance coverage be reduced by 32 percent and the rate recovery by Nolin for single health insurance coverage be reduced by 21 percent. Following this practice of recent Commission Orders, Staff determined that Breathitt County's test-year health insurance expense should be decreased by a total of \$8,992,¹⁰ as explained below.

Breathitt County has two employees who have health insurance policies which include coverage for dependents and two employees that have single coverage. As shown below, Staff annualized the most recent monthly premiums paid on behalf of all full-time employees who were receiving health benefits at the time of Staff's review.

Current Premium for Full-time Employees	\$ 3,488
Times: 12 Months	<u>12</u>
Annualized	41,860
Less: Test Year	<u>(39,361)</u>
Increase	<u>\$ 2,500</u>

Additionally, consistent with recent orders where the Commission has reduced benefit expenses for utilities that pay 100 percent of an employee's health insurance

¹⁰

Annualized Premium Increase	\$ 2,500
Benefit Reduction	<u>(11,491)</u>
Total Decrease	<u>\$ (8,992)</u>

coverage, Staff reduced Breathitt County's family health insurance premiums ("Parent Plus") by 32 percent and the single premiums by 21 percent, as shown below.

<u>Policy Type</u>	<u>Annual Expense</u>	<u>Percentage Reduction</u>	<u>Adjustment</u>
Parent Plus	\$ 24,553	32%	\$ 7,857
Single	17,307	21%	<u>3,635</u>
Total Decrease			<u>\$ 11,491</u>

(I) Purchased Water. As previously discussed in Item (D), Breathitt County purchases water from the cities of Jackson and Campton. Effective July, 14, 2016, the city of Jackson increased its wholesale rate from \$3.42 per 1,000 gallons to \$3.52 per 1,000 gallons. Breathitt County accounted for the purchased water adjustment in its billing analysis that was included in its Application. Staff made an adjustment to account for customer growth.¹¹ Because test-year Water Sales Revenue were increased to account for customer growth, Purchased Water expense must also be increased to avoid

¹¹ Staff added 91 new residential meters in 2016, estimating 3,000 gallons per month usage per meter. Staff increased test-year gallons sold by 3,276,000 gallons, an increase of 4.84 percent, to account for these customers.

Additional Customers	91
Times: Monthly Average Usage per Customer 12 Months	<u>3,000</u> 12
Total Additional Gallons	3,276,000
Divide by: Test Year Gallons Sold	58,858,973
Percentage Increase	<u>5.57%</u>

a mismatch of revenues and expenses. As shown below, using the sales growth rate, Staff estimates the increase to purchased water expense to be \$15,451.

Test-Year Expense	\$ 277,602
Times: Percentage Increase Necessary to Meet Customer Growth	<u>5.57%</u>
 Increase for Customer Growth	 <u>\$ 15,451</u>

(J) Purchased Power. Like Purchased Water, test-year Purchased Power for Pumping must also be increased by the customer growth rate to properly match revenues and expenses. The calculation is shown below.

Test-Year Expense	\$ 62,181
Times: Growth Rate	<u>5.57%</u>
 Increase	 <u>\$ 3,461</u>

(K) Depreciation. In its Application, Breathitt County stated that the useful lives assigned to certain assets were outside of the life ranges found reasonable in the National Association of Regulatory Utility Commissioners' ('NARUC') publication titled "Depreciation Practices for Small Utilities" ("NARUC Study").¹² For ratemaking purposes, Breathitt County proposed to adjust the lives assigned to these assets to conform to the NARUC Study. Breathitt County determined that application of its proposed lives would decrease test-year depreciation expense by \$325,920.

Generally, the Commission requires that a "large" utility perform a depreciation study to determine the appropriate depreciable lives to be assigned to each of its utility plant account groups. Detailed property records specific to historic plant additions, plant

¹² Application, ARF Form 1, Attachment SAO-W, References.

retirements, and salvage practices are required to complete a depreciation study. Generally, “small” water utilities, such as Breathitt County, do not maintain property records with enough detail to properly complete a formal study. Even when adequate records are maintained, “small” utilities do not have the financial resources to fund a formal study. Therefore, to evaluate the reasonableness of the depreciation practices of small water utilities, the Commission has historically relied upon the NARUC Study published in 1979.¹³

The NARUC Study provides a range of average service lives that are assigned to water plant account groups by water utilities across the country that design, install, and maintain their systems in accordance with good engineering practices. It concludes that the ranges are intended to be used as a guide by state regulatory commissions and other water utilities when developing the depreciable lives to be assigned to water plant account groups. For example, the NARUC Study found that transmission and distribution mains are depreciated between 50 and 75 years. Lives outside the NARUC ranges are acceptable when conditions warrant alternative lives.

When evaluating a water district’s depreciable lives, the Commission considers an asset group’s construction materials, condition, and other factors to determine an appropriate depreciable life that falls either inside or outside of the NARUC ranges. The Commission has assigned lives at the short end and long end of the NARUC ranges when evidence is presented to support such lives. For example, in Case No. 2012-00309,¹⁴

¹³ Case No. 2012-00278, *Application of Graves County Water District for an Adjustment in Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC Sept. 5, 2012).

¹⁴ 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 July 12, 2013).

the Commission found that Southern Water and Sewer District's mains should be depreciated using a 50-year life, the shortest life within the NARUC range because the majority of its mains had decayed at a more rapid rate than originally anticipated. It stated that this deterioration is evident by its excessive water loss,¹⁵ which was 44.35 percent.¹⁶ In Case No. 2012-00413, the Commission accepted Staff's finding that the depreciable life assigned to Pendleton County Water District's mains should be 75 years because they were thought to be free of noticeable decay and in excellent condition.¹⁷

When no evidence exists to support a specific life that is inside or outside the NARUC ranges, the Commission has used the mid-point of the NARUC ranges to depreciate utility plant. In Case No. 2013-00154, the Commission found that Henderson County Water District ("Henderson District") was depreciating the cost of some main using a 40-year life and others using a 50-year life. Even though the 50-year life is within the NARUC range, the Commission found that the depreciable life assigned to all of Henderson District's mains should be 62.5 years, the mid-point of the NARUC range, since no evidence was presented to support the 40-year or 50-year lives.¹⁸

Breathitt County proposed to adjust the lives of assets that were outside of the NARUC ranges to the mid-point of the depreciable life ranges. In this proceeding, Staff found no evidence to support depreciable lives that vary significantly from the mid-point

¹⁵ *Id.*, Application, Attachment C, at 19–20.

¹⁶ *Id.* at 13.

¹⁷ Case No. 2012-00413, Commission Staff Report on Pendleton County Water District (filed Oct. 29, 2012) at 10.

¹⁸ Case No. 2013-00154, *Application of Henderson County Water District for an Alternative Rate Filing* (Ky. PSC Nov. 14, 2013) at Appendix B.

of the NARUC ranges. After reviewing Breathitt County's plant ledger, Staff agrees with Breathitt County's decrease to depreciation expense of \$325,920.

(L) Taxes Other Than Income. As discussed in Item (F), Staff determined that Breathitt County's test-year employee wages will increase by \$17,374 due to changes made to Breathitt County's test-year employee staffing and wage rates. Breathitt County's test-year FICA taxes will increase as a result of these changes. As calculated below, Staff determined that the increase to test-year FICA taxes will be \$1,329. Accordingly, Staff increased test-year Taxes Other Than Income by \$ 1,329.

Increase to Employee Wages Expense	\$ 17,374
Times: 7.65% FICA Tax Rate	<u>7.65%</u>
FICA Tax Rate Increase	<u>\$ 1,329</u>

In its Application, Breathitt County inadvertently omitted expenses for Taxes Other Than Income. Breathitt County reported \$35,892 for Taxes Other Than Income.¹⁹ Included in this amount was \$24,530 for school, sales, and unemployment taxes. The collection of these taxes is not revenue, nor is the remittance thereof an expense. Accordingly, Staff removed these amounts from test-year operations. Staff included the remaining amount of \$11,437 for regulatory agency and payroll taxes.

Overall Revenue Requirement and Required Revenue Increase

The Commission has historically applied a DSC method to calculate the Overall Revenue Requirement of water districts and water associations. This method allows for

¹⁹ *Annual Report* at 49.

recovery of: 1) cash related pro forma operating expenses; 2) recovery of depreciation expense, a non-cash item, to provide working capital;²⁰ 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 Breathitt County's and Staff's calculations of Breathitt County's Overall Revenue Requirement and Required Revenue Increase using the DSC method is shown below.

	Breathitt District	Staff	(Ref.)
Pro Forma Operating Expenses	\$ 1,373,883	\$ 1,424,675	
Plus: Average Annual Debt Payments	115,891	115,891	(1)
Additional Working Capital	<u>13,049</u>	<u>23,178</u>	(2)
Overall Revenue Requirement	1,502,823	1,563,745	
Less: Other Operating Revenue	<u>(47,275)</u>	<u>(15,539)</u>	
Revenue Required From Rates	1,455,548	1,548,206	
Less: Pro Forma Present Rate Revenues	(825,948)	(831,042)	
Interest Income	<u>0</u>	<u>(353)</u>	
Required Revenue Increase	<u>\$ 629,600</u>	<u>\$ 716,811</u>	
Percent Increase	<u>76.23%</u>	<u>86.25%</u>	

²⁰ 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 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).

(1) Average Annual Principal and Interest Payments. At the time of filing, Breathitt County had one outstanding bond series payable to the United States Department of Agriculture Rural Development and two loans payable to the Kentucky Infrastructure Authority. In its Application, Breathitt County requested recovery of the three-year average annual principal and interest payments due in 2017, 2018, and 2019 in the amount of \$115,891. Staff agrees that the \$115,891 requested by Breathitt County represents, in all material respects, the average annual debt payments that will be made in each year that the water rates approved by the Commission in this proceeding will remain 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 a district's lenders that are above its average annual debt payments. In addition to depreciation expense, Breathitt County requested rate recovery of additional working capital in the amount of \$13,049. Following the Commission's historic practice, Staff calculated Breathitt County's allowance for

additional working capital, based on a DSC ratio of 1.20, to be \$23,178, as shown below.²¹

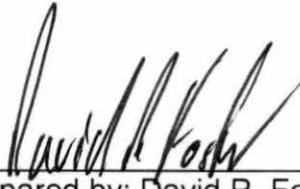
Staff included this amount in the calculation of Breathitt County's Overall Revenue Requirement.

Average Annual Principal and Interest	\$ 115,891
Times: DSC Coverage Ratio	<u>120%</u>
Total Net Revenues Required	139,069
Less: Average Annual Principal and Interest Payments	<u>(115,891)</u>
Additional Working Capital	<u><u>\$ 23,178</u></u>

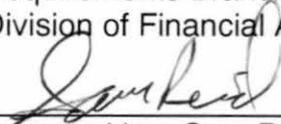
²¹ Inclusion of the additional working capital in Breathitt County's revenue requirement is not necessary for it to earn revenues that meet the minimum DSC ratio required by its lenders. As depreciation is a noncash item, it is excluded from the ratio calculation, which is actually a measure of cash flow. As shown below, Breathitt 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	\$ 1,563,745	\$ 1,540,566
Less: Operating and Maintenance Expense	(767,744)	(767,744)
Taxes Other Than Income	<u>(12,766)</u>	<u>(12,766)</u>
Net Revenues	783,234	760,056
Divided by: Average Annual Debt Payments	<u>115,891</u>	<u>115,891</u>
DSC Ratio	<u><u>676%</u></u>	<u><u>656%</u></u>

Signatures



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Water and Sewer Revenue
Requirements Branch
Division of Financial Analysis



Prepared by: Sam Reid
Water and Sewer Rate Design Branch
Division of Financial Analysis

ATTACHMENT

ATTACHMENT TO A STAFF REPORT OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 2017-00140 DATED **JUL 21 2017**

Monthly Water Rates

5/8-inch x 3/4-inch Meter

First	2,000 gallons	\$45.05 Minimum Bill
Over	2,000 gallons	22.51 per 1,000 gallons

Leak Adjustment rate 13.20 per 1,000 gallons

Wholesale Rate

Village of Buckhorn 8.63 per 1,000 gallons

Kentucky Mountain Bible College

First	10,000 gallons	\$225.05 Minimum Bill
Next	190,000 gallons	13.25 per 1,000 gallons
Over	200,000 gallons	11.05 per 1,000 gallons

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