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April 24, 2014

Sharla Dillon  
Tennessee Regulatory Authority  
502 Deaderick Street  
4<sup>th</sup> Floor  
Nashville, TN 37243

Re: Docket 14-00004

Dear Sharla:

Attached for filing in the above-captioned docket is the rebuttal testimony and exhibits of Robert T. Buckner and Michael Knotts.

Copies of this filing have been served on the parties of record.

Discs containing Mr. Buckner's exhibits will be provided separately to the Consumer Advocate and the TRA staff.

Sincerely,

BRADLEY ARANT BOULT CUMMINGS LLP

By:

A handwritten signature in dark ink, appearing to read 'H. Walker', written over the printed name 'Henry Walker'.

Henry Walker

HW/mkc  
Enclosure

**BEFORE THE TENNESSEE REGULATORY AUTHORITY**

**Nashville, Tennessee**

**PETITION OF BERRY'S CHAPEL )  
UTILITY, INC. TO INCREASE )  
RATES AND CHARGES; TARIFF )  
TO RECOVER THE COST OF )  
FINANCIAL SECURITY; ) DOCKET NO. 14-00004  
IMPLEMENTATION OF )  
PASS THROUGHs FOR )  
SLUDGE REMOVAL, )  
ELECTRICITY, CHEMICALS )  
AND PURCHASED WATER )**

**REBUTTAL TESTIMONY  
OF  
ROBERT T. BUCKNER**

**ON BEHALF OF BERRY'S CHAPEL UTILITY, INC.  
d/b/a HARPETH WASTEWATER COOPERATIVE**

**June 24, 2014**

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1 **Q. Please state your name, business name and address for the record.**

2 A. My name is Robert T. ("Terry") Buckner. I am operating as a sole  
3 proprietorship, Robert T. Buckner CPA, 2783 Saundersville Ferry Road,  
4 Mount Juliet, Tennessee 37122.

5  
6 **Q. On whose behalf are you testifying in this docket?**

7 A. I am submitting rebuttal testimony on behalf of Berry's Chapel Utility,  
8 Inc. ("the Company") d/b/a Harpeth Wastewater Cooperative.

9  
10 **Q. Have you filed Direct Testimony on behalf of the Company in this docket?**

11 A. Yes.

12  
13 **ATTRITION PERIOD OPERATING MARGIN AT CURRENT RATES**

14  
15 **Q. Please address the Consumer Advocate's position on the Company's  
16 proposed use of an operating margin for setting its rates in this docket.**

17 A. The Consumer Advocate claims that since the term "operating  
18 margin" is not included within the Company's calculations, then rates  
19 cannot be set using an operating margin even though the term is prevalent  
20 and defined in my direct testimony.<sup>1</sup> This straw man argument gives rise to  
21 the Consumer Advocate's use of a "cash needs" approach for developing  
22 revenue requirement because the use of the cash needs approach excludes  
23 depreciation expense. The Consumer Advocate goes on to misrepresent the

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<sup>1</sup> Direct Testimony of Robert T. Buckner, Page 5, Lines 19-22.



1 Company's response to the Consumer Advocate's Discovery Request #2  
2 ("Consumer Advocate DR #2"). The Consumer Advocate's interrogatory  
3 states,

4 "Typically, the use of an operating ratio approach  
5 to setting rates would only include Operation &  
6 Maintenance Expenses of the Company and  
7 therefore would exclude depreciation expense."  
8

9 There is no mention of a "cash needs" approach in that interrogatory.  
10 Moreover, I have done further research on the use of an operating ratio to  
11 set rates and concluded that this method does not, in fact, typically exclude  
12 depreciation. It is true that the operating margins of two other regulated  
13 wastewater companies in Tennessee do not include depreciation expense  
14 but that is because these two entities do not have any plant to depreciate.  
15 Virtually all of the fixed assets of those two utilities (Tennessee Wastewater  
16 Systems, Inc. and Cartwright Creek, LLC) are the result of capital  
17 contributions.

18 Furthermore, my research of other states which use an operating  
19 ratio approach shows that where the utility has fixed assets that are not the  
20 result of Contributions in Aid of Construction, depreciation is included as an  
21 expense. The Kentucky Public Service Commission includes depreciation  
22 expense in development of its Operating Ratio<sup>2</sup> (See Appendix A);  
23 additionally, the Florida Public Service Commission includes depreciation  
24 expense using the operating ratio methodology<sup>3</sup> (See Appendix B); and the

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<sup>2</sup> Commonwealth of Kentucky PSC, Staff Report CASE NO. 2013-00258, Page 19.

<sup>3</sup> Florida PSC, Docket No. 100471-SU, Pages 11 and 12.

Public Utilities Commission of the State of California include depreciation expense in its Rate of Margin<sup>4</sup> (See Appendix C). Therefore, the Company would submit to the TRA that the inclusion of depreciation expense within its case is correct to calculate a revenue requirement using an operating margin.

**Q. Has the TRA previously used an Operating Margin or Ratio in setting rates?**

A. Yes. The TRA approved a settlement by Tennessee Wastewater Systems, Inc and the Consumer Advocate in Docket #08-00202. The operating margin approved by the TRA in that case was 6.5%. Also, the TRA approved a settlement by Cartwright Creek, LLC and the Consumer Advocate in Docket #09-00056. The operating margin approved by the TRA in that case was 6.5%. As I said, depreciation expense is not an issue for either company because both were built with contributed capital.

**Q. Please describe the reason for the Company not making any debt cost payments over the last two years.**

A. Over the last two years there has been a change in the ownership of the debt, as was disclosed in my direct testimony, and the Company has had insufficient cash flow to make payments. At some point in the future payments will need to be made.

---

<sup>4</sup> Public Utilities Commission of the State of California, Resolution No. 4524, dated March 17, 2005, Attachment A, Page 2 of 5.

1 **Q. Please address the Consumer Advocate's reliance upon the Company's last**  
2 **rate case in TRA Docket #11-00198 as a threshold.**

3 A. The Consumer Advocate charges that based on the TRA's Order, the  
4 Company should have experienced a revenue stream of \$777,098 in annual  
5 operating revenues for the attrition period ending December, 2011.

6 In fact, those revenues never materialized. Operating Revenues were  
7 \$576,502 in 2011 and \$688,801 in 2012 and (normalized) revenue for 2013  
8 was \$744,825. Revenue was overestimated and expenses were  
9 underestimated. Operating Expenses were projected in the Order to be  
10 \$681,668. At that time, all of the employees performing tasks for the  
11 Company were employees of Tennessee Contractors, Inc. Consequently,  
12 labor was recorded on the Company's books through the use of journal  
13 entries. For various reasons, the Consumer Advocate did not recognize  
14 those journal entries as legitimate expenses. As a result, \$26,413 of Repair  
15 and Maintenance Labor, \$12,793 of Operations Labor, \$26,630 of  
16 Accounting Labor were excluded from the Company's expenses by the  
17 Consumer Advocate<sup>5</sup> and adopted in the TRA Order.

18 Today, the employees who operate the Company now are  
19 compensated directly by the Company; they no longer work for Tennessee  
20 Contractors. Because the Consumer Advocate did not recognize the costs of  
21 those employees in the last rate case, the level of expenses set in that case  
22 was artificially low. The low level of expenses, combined with a projected  
23 level of revenue that never materialized, means that the Company never

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<sup>5</sup> Rebuttal Testimony of Mr. James Ford, Pages 8 and 9.

1 had the opportunity to earn a just and reasonable return. That is why the  
2 Company has been forced to live off its depreciation to pay operating  
3 expenses. That is why the Company is so badly in need of a rate increase.  
4 To use the level of expenses set in the last rate case as a starting point for  
5 setting rates in this case, as the Consumer Advocate argues, is a strategy  
6 designed to perpetuate the Company's financial problems, not resolve  
7 them.

8  
9 **Q. Do you agree with the Consumer Advocate's statement, "BCU has**  
10 **consistently proven over and over again that they cannot be trusted with**  
11 **ratepayer funds"**<sup>6</sup>?

12 **A.** No. Regardless of what the Consumer Advocate thinks about the  
13 prior owners and managers of the Company, this comment is an insult to  
14 the ratepayers who took over control of the Company in March and now  
15 make all decisions regarding the Company's finances and operations. The  
16 Consumer Advocate has met with the new Board of Directors and is well  
17 aware that the new Board can be trusted to act responsibly for all of the  
18 ratepayers to fulfill its service obligation. They have exhibited a tireless  
19 work ethic without compensation and are informed advocates for the  
20 ratepayers. The ratepayers, who the Consumer Advocate claims to  
21 represent, are the Company. They own it; they control it; and they are  
22 responsible for their actions to the other ratepayers who elected them.  
23 They have no interest in increasing rates more than necessary to provide

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<sup>6</sup> Direct Testimony, Mr. Hal Novak, Page 7, Lines 16-17.

reliable service in as cost-effective manner as possible.

**Q. Do you agree with the Consumer Advocate's belief that the Company's depreciation rates are excessive?**

A. No. The Consumer Advocate does not appear to know that the Consumer Advocate and the Company agreed on the depreciation rates in 2007.<sup>7</sup> Those rates remain in effect. The Consumer Advocate has not performed a new depreciation study on the Company's assets and accumulated depreciation. There is no basis for the Consumer Advocate's claim that the rates are excessive.

**Q. Do you agree with the Consumer Advocate's proposal that the Company's depreciation expense be suspended wiping out the Company's proposed rate increase?**

A. No, it would be irresponsible. No reasonable person could testify that this Company does not need an immediate rate increase. Right now, there is no money to pay for necessary repairs, much less unforeseen emergencies. The Company cannot obtain a loan. Whatever money is needed for operations and capital expenses has to come from ratepayers. The Consumer Advocate appears willing to let the Company go bankrupt rather than give the Company just and reasonable rates, as the law requires.

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<sup>7</sup> TRA Docket #07-00007.

**RECOGNITION OF PRIOR PERIOD BILLING ERRORS**

**Q. In Question #21 of the Consumer Advocate’s direct testimony, the following question is posed, “Has the Company Recognized these billing errors on its books and records?” The Consumer Advocate’s response is “No.” Is their answer true?**

**A.** No, not entirely. The Consumer Advocate has misrepresented that none of the billing errors have been recorded on the Company’s books and records. In fact, \$73,680 of the billing errors has been or will be refunded to the customers by the Company by the end of September 2014. Also, \$534.66 in unauthorized late fees has been recorded on the Company’s books.<sup>8</sup>

**Q. Is it appropriate to discuss the prior period billing errors in this docket?**

**A.** No. These errors were recorded and heard in TRA Docket #11-00065. As of this date, the TRA Order in on Docket #11-00065 has yet to be issued. This rate case docket should not be muddled by the issues previously addressed in TRA Docket #11-00065.

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<sup>8</sup> Company response to CAPD DR #20.

**APPLICATION TO IMPLEMENT PASS THROUGH CHARGES FOR FUTURE  
CHANGES IN CERTAIN OPERATING EXPENSES**

**Q. Is the Company still seeking to implement pass through charges for future changes in certain operating expenses?**

**A. No.** The Company withdraws the tariff portion for the implementation of pass through charges and may seek this in a separate filing in the future.

**PROPOSED TARIFF TO RECOVER THE COST OF FINANCIAL  
SECURITY**

**Q. Does the Consumer Advocate agree with the Company's proposal for a pass-through mechanism to fund the TRA's minimum funding requirement for financial security?**

**A.** No. The TRA rules, specifically 1220-4-13-.07, require that a wastewater utility furnish financial security of at least \$20,000. Moreover, the financial security must be a commercial bond or a letter of credit from a financial institution. However, the Company is unable to secure the financial security from a willing lender. Consequently, the Company is requesting that the TRA grant that the financial security be funded by customer contributions through a pass through mechanism. Paragraph (7) of 1220-4-13-.07 states the following:

The cost of the financial security may be funded from customer contributions by means of a pass-through

1 mechanism that shall adjust a customer's monthly rate  
2 by a specified amount. The amount of the rate  
3 adjustment shall be established by the Authority for a  
4 public wastewater utility on a case by case basis.  
5

6 The Company has set aside \$9,000 for use as financial security and  
7 can continue to contribute a monthly amount of no less than \$250 per  
8 month until the \$20,000 amount is achieved. Conversely, if the TRA will  
9 grant the remaining \$11,000 be funded through tariff, then the ratepayers  
10 would be charged \$1.08 per month for 12 months.

11 This monthly amount would be a single line item on the customer's  
12 bill over the twelve months of the attrition year and expire at the end of the  
13 attrition period. (Bills prepared by some of our customers' water provider,  
14 the City of Franklin, may not have this ability due to the City's technical  
15 limitations.)  
16

17 **Response to Consumer Advocate's Supplemental Testimony**  
18

19 **Q. Have you read the supplemental testimony filed on June 9 by**  
20 **Mr. Novak?**

21 **A.** Yes. Mr. Novak's supplemental testimony consists primarily of a new  
22 exhibit, WHN-5, comparing the level of expenses approved in the last rate  
23 case with the expenses requested in this case. As I explained earlier, the  
24 level of expenses approved in the last case did not include about \$66,000 of  
25 labor costs incurred by the company and needed for its operations. Mr.  
26 Novak apparently looked only at the level of expenses used in the last rate



1 case and was not asked to investigate the reason for the increase in the  
2 current rate case.<sup>9</sup> The exhibit also highlights the significant increase in the  
3 amount of legal expenses requested by the company in this case over the  
4 amount awarded in the last case. As the Authority and the Consumer  
5 Advocate are aware, the Company has had and continues to have a number  
6 of legal problems relating to billing and collection problems, environmental  
7 issues, and the continuing fall-out from the ten-month period in which the  
8 company believed in good faith that it was not subject to the TRA's  
9 jurisdiction. It is not surprising that the company's legal expenses have  
10 increased.

11  
12 **Q. Have you read the rebuttal testimony of Mr. Mike Knotts?**

13 A. Yes. His proposal to reduce the company's rate request to less than  
14 half of what the company originally sought essentially renders moot most of  
15 the Consumer Advocate's testimony. Since the company has decided to  
16 eliminate any request for an increase in operating expenses (other than the  
17 small amount of additional revenue resulting for the requested tariff  
18 changes), Mr. Novak's testimony about the requested increase in operating  
19 expenses is no longer relevant. As explained by Mr. Knotts, the company is  
20 now seeking only enough additional revenue to create an escrow account to  
21 cover capital costs and to comply with the Authority's financial security y

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<sup>9</sup> For example, the Company incurred an increase to Miscellaneous Expense of \$13,682. Approximately \$9,000 of that increase is the result of the Company's decision to bill its customers directly. The purchase and use of Logics software will result in the Company saving money beginning this fall and will reduce billing errors by third parties. The increases to Repairs and Maintenance, Operations Management, and Billing and Collection are largely attributed to the exclusion of labor costs in the last rate case as described in my testimony. The Company's Bad Debt Expense was deemed to fairly represent the on-going level of Bad Debts as calculated by the Company's external auditors.

1  
2  
3 **Q. If the Authority agrees with Mr. Knotts' proposal, will this provide the**  
4 **company with sufficient revenue to cover its costs?**

5 A. No. (See Appendix D) Under this reduced request, the company will  
6 still be unable to pay its depreciation expenses or its costs of debt. Those  
7 issues will have to be addressed later after the Board has implemented its  
8 cost-cutting measures and, the company hopes, restructured its outstanding  
9 debt. Mr. Knotts has proposed a short-term solution to meet the company's  
10 immediate and most pressing needs.  
11

12 **Q. Do you have any overall comments on the recommendation of the**  
13 **Consumer Advocate?**

14 A. Yes. In my opinion, Mr. Knotts and the Board of Directors have done a  
15 better job of protecting the company's ratepayers than the Consumer  
16 Advocate. The Board's proposal will allow the company to meet its  
17 immediate needs while planning for its future. The Consumer Advocate's  
18 position seems intended to force the company into insolvency. That is not in  
19 the best interest of the customers the Consumer Advocate purports to  
20 represent.  
21

22 **Q. Does this conclude your testimony?**

23 A. Yes.  
24

**Appendices of  
Robert T. Buckner  
Rebuttal Testimony  
Docket No. 14-00004**

# **Appendix A**

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION


In the Matter of:

APPLICATION OF CLASSIC CONSTRUCTION, )	CASE NO.
INC. FOR RATE ADJUSTMENT FOR SMALL )	2013-00258
UTILITIES 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 September 18, 2013, 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.

Please note that pursuant to the ordering paragraphs 2, 3, and 4 of Commission's Order of September 18, 2013, Classic Construction, Inc. is required to, no later than November 4, 2013, file with the Commission its written comments on and any objections to the findings and recommendations contained in the Report; any additional evidence for the Commission's considerations; and written notice as to whether this matter may be submitted for decision based upon the existing record without hearing.

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

DATED OCT 31 2013

cc: Parties of Record

STAFF REPORT  
ON  
CLASSIC CONSTRUCTION, INC.  
CASE NO. 2013-00258

Classic Construction, Inc. ("Classic Construction") provides wastewater service to approximately 107 customers residing in the Ridgewood Subdivision and the Circle Subdivision located in Franklin County, Kentucky.<sup>1</sup> On July 2, 2013, Classic Construction tendered an application to the Commission pursuant to 807 KAR 5:076 seeking to increase its flat monthly wastewater service rate from \$29.57 to \$45.00, an increase of \$15.43, or 52.18 percent.

Classic Construction based its application on the test year ending December 31, 2012.<sup>2</sup> The financial exhibits prepared by Classic Construction and included with its Application are shown below in condensed form.<sup>3</sup> These exhibits support a flat monthly rate of \$40.21. Classic Construction did not state the reason it sought a higher rate than supported by its financial exhibits.

---

<sup>1</sup> *Annual Report of Classic Construction, Inc. to the Public Service Commission for the Calendar Year Ended December 31, 2012 ("Annual Report")* at 1 and 8.

<sup>2</sup> 807 KAR 5:076, Section 8, requires that the Commission make its decision based upon the utility's annual report for the immediate past year. At the time Classic Construction submitted its application, the most recently filed report was for the year ended December 31, 2012.

<sup>3</sup> Application, ARF FORM 1, ATTACHMENT RR-OR.

Pro Forma Operating Expenses Before Taxes	\$ 44,479
Divide by: Operating Ratio	<u>88%</u>
Operating Revenues Before Taxes and Interest	50,544
Less: Pro Forma Operating Expenses Before Taxes	<u>(44,479)</u>
Net Income Allowable	6,065
Add: Provision for State and Federal Income Taxes	175
Interest Expense	908
Pro Forma Operating Expenses Before Taxes	<u>44,479</u>
Total Revenue Requirement	51,627
Divide by: Number of Customers	107
12 Months	<u>12</u>
New Flat Monthly Rate	40.21
Less: Current Rate	<u>(29.57)</u>
Increase	<u>\$ 10.64</u>
Percentage Increase	<u>35.98%</u>

To determine the reasonableness of the proposed rates, Staff performed a limited financial review of Classic Construction's test-year operations. 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 and immaterial discrepancies were not pursued or addressed.

Staff's findings are summarized in this report. Jack Scott Lawless and Daryl Parks reviewed Classic Construction's Overall Revenue Requirement. Sam Reid reviewed Classic Construction's reported revenues and rate design.

### Summary of Findings

1) Overall Revenue Requirement, Required Revenue Increase, and Rates.

Staff applied the Operating Ratio Method, as historically used by the Commission, to determine that Classic Construction has supported a \$38,903 overall revenue requirement and that a \$935 revenue increase is appropriate at this time; however, when responding to this report, Classic Construction may file additional documents with the Commission that support the expenditures listed in Attachment B of this report and additional loan documents that support a higher revenue increase. A flat monthly rate of \$30.30 will generate a \$935 revenue increase.

2) Internal Controls. Classic Construction did not receive and retain vendor invoices for all test-year expenditures. Classic Construction should keep all source documents supporting all transactions. At a minimum, these documents should include invoices that are prepared by the vendor providing the product or service. Each invoice should include a clear statement of the services or products provided, the location to which the product or service was delivered, the date delivered, and the amount of the vendor's charges. Classic Construction should write on each vendor invoice the check number used to pay the invoice and the date the invoice was paid. Classic Construction should pay all invoices by check to strengthen internal controls.

3) Correction of Prior Period Accounting Errors. After reviewing Classic Construction's financial records, Staff determined that the adjusting journal entry shown below is required to correct prior-period accounting errors made to Utility Plant in Service, Accumulated Depreciation, Other Current and Accrued Assets, Other Deferred Debits, Contributions in Aid of Construction ("CIAC"), and Miscellaneous Operating



Reserves.<sup>4</sup> Correction of the prior-period adjustments to Other Current and Accrued Assets and Other Deferred Debits required an adjustment to Retained Earnings.

---

<sup>4</sup> Utility Plant in Service. Construction of the wastewater treatment and collection facilities located in the Ridgewood Subdivision that currently serve Ridge Wood Subdivision and the Circle Subdivision was completed in 1979 by James Mitchell at an original cost of \$88,880. (See 1979 Annual Report for Ridgewood Subdivision Sewer System). The plant's original cost must be reported on Classic Construction's balance sheet, since it is still in service and owned and operated by Classic Construction. After adding this amount to the original cost of the two plant improvements listed on Classic Construction's Asset Summary Schedule that have a total original cost of \$10,951 (See Application at 20. A third asset, a "Jetter," is also listed on this schedule that has been removed from service and should not be reported on Classic Construction's financial statements), Staff determined that Classic Construction's correct Utility Plant in Service account balance is \$99,831.

Accumulated Depreciation. The 1979 wastewater treatment and collection facilities have been fully depreciated. This depreciation should be reported by Classic Construction along with the plant's original cost. By adding the depreciation accumulated on the 1979 assets, \$88,880, to the depreciation accumulated on the two plant improvements shown on Classic Construction's Asset Summary Schedule, \$3,383, Staff determined that the correct Accumulated Depreciation balance is \$92,263.

Other Current and Accrued Assets. Classic Construction reported \$1,780 as Other Current and Accrued Assets at December 31, 2012. This amount was first reported as a part of the accounting entry used by Classic Construction to record its purchase of the wastewater assets serving the Coolbrook Subdivision in 2004. The amount should have been removed from Classic Construction's financial statements upon its sale of those assets in 2008.

Other Deferred Debits. In 2012 Classic Construction expensed \$9,700 paid to the Kentucky Department for Environmental Protection Division of Water to renew its Kentucky Pollutant Discharge Elimination System Permit. The new permit is effective from March 1, 2013, to February 28, 2018. Proper accounting requires the cost of the permit to be accrued as a regulator asset to Other Deferred Debits that is amortized over the five-year term of the permit.

CIAC. Classic Construction reported \$20,029 for CIAC. This amount represents the unamortized balance of the developer contribution of the original wastewater treatment plant and collection system made in 1979 to the sewer corporation. Amortization of this contribution is proper and necessary to match the contribution to the accounting periods benefited by the contributed assets; however, the amortization should not be charged to Contributions-in-Aid-of-Construction. It should be charged to Miscellaneous Operating Reserves. The test-year amount reported for CIAC must be increased by \$68,851 to restate the account balance to the original amount of the developer contribution, \$88,880.

Miscellaneous Operating Reserves. The entire cost of the original plant was funded by a developer contribution when constructed in 1979. The cost of the original plant has been fully depreciated. To match full depreciation of the plant, the developer contribution must be fully amortized. This amortization must be reported using the Miscellaneous Operating Reserves account.

	<u>Debit</u>	<u>(Credit)</u>
Utility Plant in Service	\$ 53,456	
Other Deferred Debits	3,700	
Miscellaneous Operating Reserves	88,880	
Accumulated Depreciation		\$ (73,485)
Other Current Assets		(1,780)
Retained Earnings		(1,920)
Contributions-in-Aid-of-Construction		(68,851)

Classic Construction's adjusted balance sheet appears below.

	Balance Annual Report 12/31/2012	Adjusting Journal Entry	Restated Balance 12/31/2012
Utility Plant	\$ 46,375	\$ 53,456	\$ 99,831
Accumulated Depreciation	(18,778)	(73,485)	(92,263)
Cash	986		986
Other Current Assets	1,780	(1,780)	
Other Deferred Debits		3,700	3,700
<b>Total Assets</b>	<b>\$ 30,363</b>	<b>\$ (18,109)</b>	<b>\$ 12,254</b>
Common Stock	\$ (1,000)		\$ (1,000)
Other Paid in Capital	(8,848)		(8,848)
Retained Earnings	17,672	(1,920)	15,752
Note Payable	(4,185)		(4,185)
Note Payable to Asso.	(13,973)		(13,973)
CIAC	(20,029)	(68,851)	(88,880)
Misc. Oper. Res.		88,880	88,880
<b>Total Liabilities and Equity</b>	<b>\$ (30,363)</b>	<b>\$ 18,109</b>	<b>\$ (12,254)</b>

#### Pro Forma Operating Statement

Classic Construction's Pro Forma Operating Statement for the test year ended December 31, 2012, as determined by Staff, appears below.

	Test Year	Adjustments Ref.	Pro forma
Operating Revenue			
Sewer Service Revenue	\$ 35,984	\$ 1,984 (A)	\$ 37,968
Total Operating Revenue	35,984	1,984	37,968
Operating Expenses			
Operation and Maintenance			
Owner/Manager Fee		3,600 (B)	3,600
Collection System	9,049	2,951 (C)	12,000
Treatment System - Sludge Hauling	2,605		2,605
Treatment System - Water Cost	304		304
Fuel and Power	4,631	(3,152) (D)	1,479
Chemicals	284		284
Routine Maintenance Fees	1,450	1,874 (E)	3,324
Maintenance of Pumping System	1,961	(1,756) (D)	205
Maintenance of Treatment and Disposal Plant	2,942	(2,203) (D)	
		(96) (F)	
		(200) (G)	443
Agency Collection Fee	5,398	(H)	5,398
Office Supplies and Other Expenses	1,148	(417) (D)	
		(197) (I)	534
Outside Services Employed	1,350	(1,050) (G)	300
Transportation Expenses	379	(379) (J)	
Total Operation and Maintenance Expense	31,501	(1,025)	30,476
Amortization		740 (K)	740
Depreciation	796	1,499 (L)	2,295
Taxes Other Than Income	6,173	(1,908) (D)	
		(3,700) (K)	
		(205) (M)	360
Total Operating Expenses Before Income Taxes	38,470	(4,599)	33,871
Net Operating Income Before Income Taxes	\$ (2,486)	\$ 6,583	\$ 4,097

(A) Sewer Service Revenue. Classic Construction used a cash basis of accounting to report test-year revenues at \$35,984. The Uniform System of Accounts requires Classic Construction to prepare its financial statements using an accrual basis of accounting.<sup>5</sup> Staff determined that test-year revenues should be increased by \$1,984

<sup>5</sup> USoA for Class C and D Sewer Utilities at 15.

to \$37,968 to restate test-year revenues to an accrual basis.<sup>6</sup> The test-year normalized revenues represent sales at the present rate and customer levels.

(B) Owner/Manager Fee. The Commission has historically allowed a small, investor-owned sewer utility recovery of a \$3,600 owner/manager fee to be paid to the utility's owner for serving as its chief executive officer. In the cases of the very small utilities, the fee is also considered compensation for providing additional services.<sup>7</sup> In this case, Classic Construction has requested recovery of a \$3,600 owner/manager fee in return for Mr. Givens' service to Classic Construction as its executive officer. It is Staff's opinion that Classic Construction's request is consistent with prior Commission rulings and has increased Classic Construction's test-year expenses by \$3,600.

6

Flat Monthly Charge Per Customer	\$	29.57
Times: Number of Customers		107
12 Months		<u>12</u>
Pro Forma Present Rate Revenues		37,968
Less: Test Year		<u>(35,984)</u>
Increase	\$	<u>1,984</u>

<sup>7</sup> In Case No. 2007-00397, *Application of Woodland Estates Sewage System for an Adjustment of Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC Dec. 27, 2007), the Commission found that the \$3,600 owner/manager fee awarded to Woodland Estates Sewage System, who served 24 customers at the time its rate application was filed, was appropriate compensation for the owner serving as the utility's executive officer and for the owner's contribution to the utility of office space, office supplies, telephone service, billing and collection services, and bookkeeping services. In Case No. 2005-00036, *Application of Lewis Sanitation Company, Inc., D/B/A Garden Heights Sewer Division for Adjustment of Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC Apr. 14, 2005), the Commission found that the \$3,600 owner/manager fee was appropriate compensation for only the owner's executive oversight of the utilities operations. In addition to the owner/manager fee, the Commission allowed rate recovery for expenses that were incurred by the utility for bookkeeping services, office rent, office supplies, office utilities, and reimbursement to the owner for transportation expenses. Lewis Sanitation Company, Inc. served 108 customers at the time its rate application was filed.

(C) Certified Operator Fee. Pursuant to 401 KAR 5:010, Section 1, Classic Construction is required to retain an operator that is certified by the Kentucky Division of Water ("DOW"). Since 2002, Classic Construction has contracted with Chris Keffer for \$800 per month, or \$9,600 annually, to satisfy the requirements of the regulation.<sup>8</sup> This fee was recently renegotiated to \$1,000 per month, or \$12,000 annually. The new fee is scheduled to begin on January 1, 2014, to coincide with the anticipated date the Commission approves new wastewater service rates for Classic Construction.

The proposed fee is consistent with the level of the contract operator fees most recently approved by the Commission for other small sewer systems and is, therefore, reasonable. Finding that the new fee is reasonable, Staff increased test-year expenses by \$2,951. If the Commission accepts Staff's adjustment, Classic Construction should be required to submit a copy of the cancelled check used to make the first \$1,000 payment to Mr. Keffer for services rendered during January, 2014, to verify that the new amount is being paid. The Commission should take action should Classic Construction

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<sup>8</sup> The test-year expense was reported on a cash basis. The amount paid to Mr. Keffer during the test year was \$9,049.

fail to submit this copy. Such action would result in a \$2.12 decrease to the monthly rate approved by the Commission in this proceeding.<sup>9</sup>

(D) Unsupported Expenditures. Classic Construction did not retain vendor invoices for all expenditures reported for the test year. These expenditures are individually listed in this report at Attachment A and Attachment B. For the items listed in Attachment A, Staff was able to review other supporting documentation, such as a cancelled check, to determine that their rate recovery is appropriate. It is Staff's opinion that the Commission should allow rate recovery for these items, but should also remind Classic Construction of the importance of receiving and retaining source documents in an orderly manner for all transactions.

Staff cannot determine whether rate recovery is appropriate for the expenditures listed in Attachment B absent an invoice detailing the products or services received by Classic Construction.<sup>10</sup> Staff removed the total of these expenditures to calculate Classic Construction's overall revenue requirement. The Commission should allow rate recovery for any of these expenditures for which Classic Construction provides

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Increase to Annual Fee	\$ 2,400
Divide by: Operating Ratio	<u>88%</u>
Reduction to Revenue Requirement	2,727
Divide by: 12 Months	12
107 Customers	<u>107</u>
Reduction to Monthly Rate	<u>\$ 2.12</u>

<sup>10</sup> As shown on Attachment B, Staff's adjustment for unsupported expenses exceeded the total amount of the checks listed in the Attachment by \$12.78. The amount of unsupported expenses eliminated was limited to the amount actually reported in test-year expenses.

documentation demonstrating that the amount of the expenditure was reasonable and that it was incurred by Classic Construction for the operation of the wastewater facilities serving the Ridgewood Subdivision and the Circle Subdivision. Classic Construction should file this documentation when responding to this report.

(E) Routine Maintenance Fees - Testing. During the test year, Classic Construction was required to renew its Kentucky Pollutant Discharge Elimination System ("KPDES") Permit. The new permit required Classic Construction to switch from quarterly testing to monthly testing. Classic Construction's current routine testing is performed by McCoy and McCoy Laboratories at a cost of \$277 per month. Staff increased test-year expenses by \$1,874 to annualize the current monthly payment to McCoy and McCoy Laboratories.<sup>11</sup>

(F) Maintenance of Treatment and Disposal – Double Entry. During the test year, Classic Construction paid two invoices from Lowes that totaled \$96. It mistakenly recorded these invoices twice in its general ledger. Staff reduced test-year expenses by \$96 to remove the effects of this accounting error.

(G) Maintenance of Treatment and Disposal and Outside Services Employed – Inappropriate Expenses. During the test year, Classic Construction paid \$1,250 to Whitehead-Hancock Plumbing & Heating, Inc. ("Whitehead") on an account payable that

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Monthly Testing Fee	\$	277
Times: 12 Months		<u>12</u>
Pro forma		3,324
Less: Test Year		<u>(1,450)</u>
Increase	\$	<u>1,874</u>

accrued in 2008 with an original balance of \$7,374. The total amount was split in amounts of \$200 to Maintenance of Treatment and Disposal expenses and \$1,050 to Outside Services Employed expenses. The original fee was for work performed at a lift station located in the Coolbrook Subdivision, where Classic Construction then owned and operated the wastewater treatment and collection facilities.<sup>12</sup> The services performed by Whitehead did not benefit Classic Construction's operations in the Ridgewood Subdivision or Circle Subdivision. Classic Construction's current customers should not bear the financial responsibility for the payment of these services. Staff removed this expenditure from Classic Construction's test-year operations.

(H) Billing and Collection Fee. On August 25, 2008, Classic Construction entered into a contract with Peaks Mill Water District ("Peaks Mill") pursuant to which Peaks Mill provides billing and collection services to Classic Construction in return for 15 percent of Classic Construction's revenues that are generated from its monthly service rate. The billing and collection fee reported for the test year was \$5,398. Because the fee is based on Classic Construction's revenues, the rate increase authorized by the Commission in this case will increase the billing and collection fee by

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<sup>12</sup> The Commission authorized Classic Construction, Inc. to transfer control of its wastewater collection and treatment facilities located in Coolbrook Subdivision to Coolbrook Utilities, LLC in Case No. 2008-00257, *Joint Application of Classic Construction, Inc. and Coolbrook Utilities, LLC for Approval of the Transfer of Wastewater Treatment Plant to Coolbrook Utilities, LLC* (Ky. PSC Oct. 21, 2008).



a proportionate amount. If the Commission approves the \$45 monthly rate requested by Classic Construction, the annual billing and collection fee will increase to \$8,667.<sup>13</sup>

As part of the contractual agreement, Peaks Mill amended its tariff on file with the Commission to include a provision for the disconnection of its water service when a customer does not pay Classic Construction for sewer service. The threat of water disconnection has drastically reduced Classic Construction uncollectable accounts. It reported no bad debt expense for the test year.

Classic Construction argues that the Peaks Mill billing and collection services are vital to the collection of its monthly sewer service fee and that the 15 percent charge is therefore reasonable. In support of its position, Classic Construction stated that 62 of its 107 customers are renters that reside in multiple-family dwellings and that 51 of these rental accounts had past-due balances that totaled \$8,525 as of June, 2007. This amount did not include unpaid account balances for renters that had moved and could not be located. It stated that it experienced this level of uncollectibles because the Commission would not allow the property's owner to be held responsible for the payment of sewer service that was used by a renter.<sup>14</sup>

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13

Requested Monthly Rate	\$	45
Times: Number of Customers		107
12 Months		<u>12</u>
Pro forma Annual Revenue at Requested Rates		57,780
Times: 15 Percent		<u>15%</u>
Pro Forma Billing and Collection Fee at Requested Rates	\$	<u>8,667</u>

<sup>14</sup> Addendum to Cover Letter of Application.

The Commission has long found that billing and collection fees that are set equal to 15 percent of revenues are unreasonable. Specifically, the Commission has found that such fees result in a high level of expense and that the level of the expense will grow with revenues. The Commission found it unreasonable that, with each additional increase in the monthly sewer rate, a concurrent 15 percent of billing and collection expense would be incurred with no new service being provided.<sup>15</sup>

In the earliest cases, the Commission found that a billing and collection fee assessed by a water district to a privately owned sewer utility should be based on the actual costs incurred by the district to perform the billing and collection service, rather than on a percentage of the sewer utility's revenues. Unable to calculate the water district's actual costs, the Commission limited the wastewater utility's rate recovery for billing and collection costs to \$1 per customer. This per customer charge was calculated using the average billing and collection costs, adjusted for inflation, that were reported by 40 small wastewater systems using account 903, Customer Records and Collection Expense, in their 1980 Annual Reports.<sup>16</sup>

In more recent cases, the Commission allowed rate recovery of either the billing and collection expense calculated as a percentage of normalized test-year revenues;<sup>17</sup>

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<sup>15</sup> Case No. 2007-00436, *Application of Farmdale Development Corporation for an Adjustment in Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC July 30, 2008).

<sup>16</sup> Case No. 8102, *Application and Petition of the Farmdale Development Corporation, Inc., for an Order Authorizing Said Corporation to Revise Rates* (Ky. PSC Aug. 5, 1981); Case No. 8493, *Notice of Adjustment of Rates of 4-Way Enterprises, Inc., D/B/A Coolbrook Sewage Treatment Plant to Become Effective April 20, 1982* (Ky. PSC Nov. 4, 1982).

<sup>17</sup> Case No. 91-394, *Application of Four-Way Enterprises, Inc. for Rate Adjustment Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC Feb. 18, 1992).

the amount awarded to the company in its previous rate case;<sup>18</sup> or the actual billing and collection expense reported for the test year.<sup>19</sup> In every case, the Commission disallowed rate recovery of the increase to the billing and collection expense that would result from the rate increase that was authorized by the Commission in the proceeding. The Commission also instructed each wastewater utility to take efforts to determine whether more economical billing and collection alternatives were available than those provided by the water district.

This is the first rate case filed by Classic Construction since the Peaks Mill contract was executed. To follow one of the methods most recently accepted by the Commission, Staff allowed rate recovery of Classic Construction's test-year expense. If, when responding to this report, Classic Construction argues that a higher fee should be allowed, it should support its position with bids from at least three independent billing and collection agents.

There are benefits realized by Classic Construction from the Peaks Mill contract that would be lost if another agent were to replace Peaks Mill. Peaks Mill has agreed to disconnect water service to any Classic Construction customer that does not timely pay its wastewater bill. Also, all Classic Construction customers are Peaks Mill water customers, allowing Peaks Mill to provide Classic Construction with instantaneous

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<sup>18</sup> Case No. 2007-00436, *Application of Farmdale Development Corporation for an Adjustment in Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC July 30, 2008).

<sup>19</sup> Case No. 98-284, *Application of 4-Way Enterprises, Inc., Coolbrook Sanitation Division for a Rate Adjustment Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC Mar. 25, 1999); Case No. 2010-00314, *Alternative Rate Filing of Coolbrook Utilities, LLC* (Ky. PSC June 6, 2011); and Case No. 2011-00433, *Alternative Rate Filing of Coolbrook Utilities, LLC* (Ky. PSC Aug. 30, 2012). In Case No. 2011-00433, Coolbrook reported test-year fees of \$17,534. In its report, Commission Staff recommended this amount be increased by \$71 to allow recovery of the amount agreed to in Coolbrook's previous rate case, but Staff did not include the adjustment in Coolbrook's pro forma financial statements. The Commission accepted the financial statements prepared by Staff without the \$71 adjustment.

changes to its customer base for billing and other purposes. A loss of these benefits would likely result in a return to the high level of uncollectible accounts that Classic Construction experienced prior to the execution of the Peaks Mill contract. The independent bids would provide the Commission with cost information with which it could evaluate the reasonableness of the fees paid to Peaks Mill. If the Peaks Mill contract fee exceeds these bids, the Commission could determine whether the value of the extra benefits provided by the Peaks Mill contract warrant the higher fee. Based on the information provided by Classic Construction, Staff estimates these benefits to be worth at least \$1,860 on an annual basis, or 5.17 percent of test-year sales revenue.<sup>20</sup>

Staff's estimate is conservative. In its Application, Classic Construction noted that as of June, 2007, it had \$8,525 in past-due accounts from renters that were customers at that time. Assuming Classic Construction first began billing these customers for service in December, 2002,<sup>21</sup> the average annual allowance for uncollectible accounts to be accrued to account for these past-due balances would be

<sup>20</sup>

Past Due Accounts as of June, 2007	\$ 8,525
Divide by: Number of Months Owned by Classic Construction	<u>55</u>
Monthly Accrual for Allowance for Uncollectible Accounts	155
Times: 12 Months	<u>12</u>
Annual Accrual for Allowance for Uncollectible Accounts	1,860
Divide by: Annual Test-Year Sales	<u>35,984</u>
Percentage of Uncollectibles to Revenues	<u>5.17%</u>

<sup>21</sup> Classic Construction was authorized by the Commission to accept ownership of the wastewater treatment facilities that serve the Ridgewood and Circle Subdivisions on November 18, 2002 (See Case No. 2002-00320, *Transfer of Ridgewood Sewage Treatment Plant to Classic Construction, Inc.*).

\$1,860 as calculated above. This amount does not account for all past-due accounts. It does not include past-due accounts from renters that were no longer customers as of June, 2007, nor does it include past-due accounts from nonrenters.

(I) Office Supplies and Other Expenses. Classic Construction incurred a \$197 expense for the Limited Liability Entity ("LLE") tax paid to the Kentucky State Treasurer. It reported this amount as Office Supplies and Other Expenses. Staff reclassified this amount to the Income Taxes account to comply with the accounting requirements of the USoA.<sup>22</sup> Discussion of the LLE tax appears in the Income Taxes section of this report.

(J) Transportation Expense. Classic Construction reported \$379 for test-year transportation expense. This amount was paid to reimburse Classic Construction's sole stockholder for use of his personal vehicle. The amount was determined by applying the 2012 mileage reimbursement rate approved by the Internal Revenue Service to the stockholder's estimated mileage driven in the performance of Classic Construction's business activities.

Staff removed the test-year Transportation Expense to calculate pro forma operations. Classic Construction's stockholder did not maintain a mileage log documenting the business use of his personal vehicle. Absent this log, there is no documentation supporting the test-year expense.

(K) Amortization Expense – KPDES Discharge Permit. During the test year, Classic Construction paid a fee of \$3,700 to renew its KPDES permit. The renewed

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<sup>22</sup> USoA for Class C and D Sewer Utilities at 86.

permit expires five years from its origination date. Classic Construction recorded the renewal fee in account 408, Taxes Other Than Income.

The KPDES permit renewal fee is a regulatory asset that should be amortized over the five-year life of the permit. Accordingly, Staff removed \$3,700 from test-year Taxes Other Than Income and increased Amortization Expense by \$740.<sup>23</sup>

(L) Depreciation Expense. Classic Construction reported three assets on its depreciation schedule upon which it accrued \$796 for test-year depreciation expense.<sup>24</sup> Staff made several adjustments to the plant schedule that increased the test-year amount by \$1,499.

The property described on the depreciation schedule as "Jetter" was removed from service during the test year. Staff removed this asset from Classic Construction's pro forma plant schedule. Classic Construction's depreciation schedule includes a fence surrounding its treatment plant with an original cost of \$5,518 that was installed in 2011. Classic Construction calculated depreciation on this asset using the double-declining-balance method. Staff recalculated depreciation on this asset using the straight-line method as required by the USoA.<sup>25</sup>

Lastly, subsequent to the test year, Classic Construction performed a complete overhaul of the pumping equipment located at the Ridgewood lift-station at a cost of

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23

Renewal Fee	\$ 3,700
Divide by: Five Years	<u>5</u>
Annual Amortization Expense	<u>\$ 740</u>

<sup>24</sup> Application at 20.

<sup>25</sup> USoA for Class C and D Sewer Utilities at 83.

~~\$11,585.~~ Staff depreciated the cost of this improvement over seven years. Inclusion of depreciation accrued on this post-test-period plant addition is appropriate when calculating Classic Construction's pro forma depreciation expense. Its construction was complete and it was operational as of the date of Staff's field work. No other test-year revenues or expenses will be affected by this plant addition. As discussed in the section of this report dedicated to Interest Expense, this capital addition may also impact Classic Construction's cost of capital as determined appropriate by the Commission.

Plant Description	Year In Service	Original Cost	Service Life	Pro Forma Depreciation
Original Plant, Fully Depreciated	1979	\$ 88,880	-	
Sewage Treatment Plant	2003	5,434	20	\$ 272
Fencing	2011	5,518	15	368
Pump Overhaul at Lift Station	2013	<u>11,585</u>	7	<u>1,655</u>
Total		<u>\$ 111,417</u>		2,295
Less: Test Year				<u>(796)</u>
Increase				<u>\$ 1,499</u>

(M) Taxes Other Than Income. During the test year, Classic Construction paid \$360 in state property taxes and \$205 in late-payment penalties and interest on those taxes. Both amounts were reported in Taxes Other Than Income. Staff removed the late-payment penalty and interest. Classic Construction's customers should not bear the financial burden for the company's failure to pay property taxes in a timely manner.

Overall Revenue Requirement, Required Revenue Increase,  
and Rate for Service to Produce Increase

Using the operating ratio method<sup>26</sup> as historically accepted by the Commission, Classic Construction calculated its Overall Revenue Requirement to be \$51,627 and determined that a \$15,643 revenue increase is necessary to generate the overall requirement.<sup>27</sup> Classic Construction's calculation is shown below.

Pro Forma Operating Expenses Before Taxes	\$ 44,479
Operation Ratio	<u>88%</u>
Sub-Total	50,544
Less: Operating Expenses Before Taxes	<u>(44,479)</u>
Net Margin Allowed for Working Capital	6,065
Add: State Limited Liability Entity Tax	175
Interest Expense	908
Pro Forma Operating Expenses	<u>44,479</u>
Overall Revenue Requirement	51,627
Less: Pro Forma Present Rate Revenue	<u>(35,984)</u>
Required Revenue Increase	\$ 15,643
Percentage Increase	<u>43.47%</u>

<sup>26</sup> Operating Ratio is defined as the ratio of expenses, including depreciation and taxes other than income taxes, to gross revenues. It is illustrated by the following equation:

$$\text{Operating Ratio} = \frac{\text{Operation \& Maintenance Exp. + Depreciation + Taxes}}{\text{Gross Revenues}}$$

<sup>27</sup> Application, ARF FORM 1 – Attachment RR-OR. Also, in its Application at ARF-FORM 1 – ATTACHMENT RR-DC, Classic Construction supported the Overall Revenue Requirement and Revenue Increase using the Debt Service Coverage Method.



As shown below, the Overall Revenue Requirement calculated by Classic Construction results in an 86.49 percent operating ratio:

Operating Expenses	\$ 44,654
Divided by: Operating Revenues	<u>51,627</u>
Operating Ratio	<u>86.49%</u>

As shown below, Staff also followed the Commission's historic application of the operating ratio method to calculate Classic Construction's Overall Revenue Requirement to be \$38,903.

		Ref.
Pro Forma Operating Expenses Before Income Taxes	\$ 33,871	
Divide by: Operating Ratio	<u>88%</u>	
Allowable Revenues Before Taxes and Interest Expense	38,490	
Less: Pro Forma Operating Expenses Before Income Taxes	<u>33,871</u>	
Net Margin Allowed for Working Capital	4,619	
Add: LLE Tax	175	(A)
Interest Expense	238	(B)
Pro Forma Operating Expenses Before Income Taxes	<u>33,871</u>	
Overall Revenue Requirement	<u>\$ 38,903</u>	

This Overall Revenue Requirement requires a revenue increase of \$935, which produces an 87.52 percent operating ratio. These calculations are shown below:

Overall Revenue Requirement	\$ 38,903
Less: Pro Forma Present Rate Revenues	<u>(37,968)</u>
Required Increase	\$ 935
Percentage Increase	<u>2.46%</u>
Operating Expenses	\$ 34,046
Divide by: Operating Revenues	<u>38,903</u>
Operating Ratio	<u>87.52%</u>

A monthly rate of \$30.30 assessed to Classic Construction's 107 customers will produce the required operating revenues. This represents a 2.46 percent increase to Classic Construction's current \$29.57 rate.<sup>26</sup>

(A) State Limited Liability Entity Tax. When first organized, Classic Construction elected to be taxed under Subchapter S of Chapter 1 of the Internal Revenue Code. A Subchapter S Corporation ("S-Corp") is a pass-through entity that has no federal income tax liability. Its annual earnings are automatically passed through to its stockholders and recognized as taxable income on the stockholder's individual federal income tax returns. This tax treatment is drastically different than taxes levied pursuant to Subchapter C of Chapter 1 of the Internal Revenue Code.

<sup>26</sup>

Overall Revenue Requirement	\$ 38,903
Divide by: 107 Customers	107
12 Months	<u>12</u>
New Rate	30.30
Less: Current Rate	<u>(29.57)</u>
Increase	\$ 0.73
Percentage Increase	<u>2.46%</u>

A Subchapter C Corporation ("C-Corp") accrues and pays federal income taxes that are calculated on its reported earnings. Earnings that remain after deducting income tax expense do not automatically pass through to stockholders. Instead, these earnings may be distributed to stockholders through dividend payments at the discretion of the C-Corp's Board of Directors. Dividends are recognized as taxable income by the stockholder in the year they are received. This results in double taxation of the C-Corp's earnings. First, taxes accrue to the C-Corp when income is recognized. Taxes again accrue on these earnings when they are distributed as stockholder dividends. Double taxation is a distinct disadvantage when compared to the single taxation of S-Corps.

Kentucky State Income Tax Statutes for pass-through entities, including S-Corps, are currently different from Federal Statutes, but were not always. For tax years that began prior to January 1, 2005, the Kentucky Department of Revenue's taxation of S-Corps conformed with the federal tax treatment. All earnings were passed through to stockholders for state income tax purposes. No income taxes were accrued or paid by the corporate body. This changed when the 2005 General Assembly passed House Bill 272. House Bill 272 made pass-through entities, including S-Corps, subject to state corporate income taxes. This meant double taxation at the state level on pass-through entities for tax years beginning on or after January 1, 2005.

The effects of House Bill 272 were short-lived. On June 28, 2006, during a Special Legislative Session, the General Assembly enacted House Bill 1 that included "Income Tax Relief for Small Businesses." House Bill 1 reversed House Bill 272. After this reversal, state taxation on pass-through entities again conformed with federal tax

law. But, House Bill 1 created a new Limited Liability Entity ("LLE") tax to be imposed on C-Corps and pass-through entities.

The LLE tax became effective for all taxable years beginning on or after January 1, 2007. The minimum annual LLE tax by all LLE's is \$175. An additional LLE tax is required for entities reporting annual gross receipts or gross profits that are greater than \$3 million.<sup>29</sup> The additional LLE tax may be used by the LLE's owner as a personal income tax credit, reducing the owner's income tax liability by the amount of the additional LLE tax. The \$175 minimum LLE tax may not be used as a credit.

The Commission has long recognized the different tax treatments of pass-through entities and C-Corps when determining their overall revenue requirements. Generally, the Commission has found that federal and state income tax expense reported by a C-Corp is an annual, recurring operating expense of the C-Corp for which rate recovery is necessary to allow the utility a reasonable opportunity to earn its authorized rate of return. Conversely, the Commission has not allowed recovery of federal or state income taxes for S-Corps, finding that there is no double taxation on the earnings of S-Corps and that the only income tax that is accrued on an S-Corp's earnings is a tax liability of the S-Corp's stockholder.<sup>30</sup>

When determining the revenue requirement of an S-Corp, the Commission has not distinguished the LLE tax from state income tax. Accepting Staff's findings, the Commission has identified the LLE tax as a state income tax for which rate recovery is

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<sup>29</sup> The additional tax is equal to the lesser of \$0.095 per \$100 of Kentucky gross receipts or \$0.75 per \$100 of Kentucky gross profits. The amount of the additional tax is decreased using a formula for entities reporting annual gross receipts or gross profits that are less than \$6,000,000.

<sup>30</sup> See Case No. 2012-00375, *Alternative Rate Adjustment Filing of Middletown Waste Disposal, Inc.* (Ky. PSC Apr. 2, 2013).

not appropriate.<sup>31</sup> In this instance, Classic Construction is requesting recovery of the \$175 minimum LLE tax and a \$22 late payment penalty on the tax.

After reexamining the LLE tax, Staff finds that its recovery is appropriate. The minimum LLE tax is a state tax liability of a pass-through entity. It is not a tax liability accruing to the LLE's owner. Also, the minimum tax represents double taxation. The minimum LLE tax liability is calculated on the same gross receipts and gross profits that are passed through to the personal state income tax return of the LLE's owner.

Recovery of the \$22 late payment penalty is not appropriate. Classic Construction customers should not be required to pay the cost of Classic Construction's untimely payment of the tax.

(B) Interest Expense / Cost of Capital. Historically, the Commission has found that the operating ratio is a reasonable and necessary alternative to the rate of return method<sup>32</sup> for calculating the revenue requirements for small sewer investor-owned utilities ("IOU"). Specifically, it has found that the rate of return method cannot be used

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<sup>31</sup> *Id.*

<sup>32</sup> The rate of return method is used for large IOUs whose stocks are either publicly traded or held by parent companies whose stocks are publicly traded. Through this method, the Commission authorizes a rate of return to calculate the IOUs allowable net operating income ("NOI"). The rate of return is set equal to the weighted cost of capital, which includes the cost of common equity and the cost of debt.

When applying the rate of return method, either the rate base approach or the capital cost recovery approach is used. These approaches are very similar and often result in NOIs that have no material difference. When using the rate base approach, the NOI is determined by multiplying the rate of return by the utility's net investment rate base. Net investment rate base is the net book balance of all assets dedicated to providing utility service that was funded with either debt or equity.

Through the capital cost recovery approach, a utility's allowable NOI is set equal to the cost of debt plus the cost of equity. Generally, the Commission applies the rate base approach when the net rate base investment is less than the total debt and equity capital investment. When rate base exceeds the debt and equity capital investment, the capital cost recovery method is applied.

because there is "no basis" upon which to determine a rate of return for these utilities<sup>33</sup> and that they often do not maintain adequate records for rate base accounts or capital investment accounts. Further, it has found that the operating ratio method is appropriate when plant investment is low and operating expenses are high.<sup>34</sup> The Commission made its position most clear when it stated:

While the Commission has traditionally considered the original cost of utility plant, the net investment, the capital structure and the cost of reproduction as a going concern in the determination of fair, just, and reasonable rates, its experience in the establishment or adjustment of rates for sewer utilities has indicated that these valuation methods are not always appropriate. Sewage utilities are unique to the extent that the cost of facilities has usually been included in the cost of the individual lot. The owner and/or operator of the utility is, in many instances, the developer of the real estate and title may have changed hands prior to the effective date of the Commission jurisdiction (January 1, 1975). Further, the Commission has found that the books, records, and accounts of these utilities are, for the most part, incomplete, so as to make impossible the fixing of rates on the above mentioned methods of valuation. Therefore, the Commission is of the opinion that for the purpose of making rate determinations for sewage utilities, the operating ratio method should be utilized, although it is recognized that there may be instances where this method or procedure would not be valid.<sup>35</sup>

The Commission's findings are well supported. For large IOUs, the Commission sets the cost of common equity at a level that is commensurate with the financial risk assumed by its stockholders. This is accomplished through analysis of financial

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<sup>33</sup> Case No. 95-236, *Application of Thelma Waste Control, Inc. for a Rate Adjustment Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC. Apr. 15, 1996) at 6.

<sup>34</sup> Case No. 7982, *Notice of Application of Fern Lake Company* (Ky. PSC. Aug. 27, 1981) at 3.

<sup>35</sup> Case No. 7553, *McKnight Utilities, Inc. and Maple Oak Development Company Application and Petition for an Order of Certificate of Convenience and Necessity Immediately Following the Hearing, and for an Order Approving Uniform Rates for a Sewage Treatment Plant with Tertiary Treatment Facilities Located in Maple Oaks Trails Subdivision, Campbell, Kentucky* (Ky. PSC. Nov. 13, 1979) at 2.

information for proxies that can consist of both regulated and non-regulated companies that expose investors to risks similar to those of the regulated IOU. The financial information for these public entities is published by reliable sources and is readily available. Similar financial information for small IOUs is not available, making the creation of a reliable proxy difficult. Absent this information, the Commission has found that there is no reasonable basis upon which to determine a fair rate of return on common equity.

Further, the stocks of these small IOUs are not publically traded and they are, therefore, not required by the Security and Exchange Commission to have an audit performed in accordance with Generally Accepted Auditing Standards. Records of the small sewer utilities were generally comingled with those of the development company that constructed the sewer assets. Often, records were not maintained in a manner that allowed proper separation of rate base accounts and capital investment accounts of the comingled companies. Absent an audit report or proper records, it was difficult to verify that the amounts reported for these accounts were properly stated.

Most importantly, the Commission has recognized that many of these small IOUs have no, or low, capital investment upon which to calculate a return. Generally, their original capital was contributed by developers. Since the Commission will not allow a return on contributed property, there would be no rate base or capital investment upon which a rate of return could be applied. NOI would be set to zero and there would be no working capital available for the utility to continue operations if revenues decrease or expenses increase. Recognizing that a regulated utility must be allowed an NOI to provide working capital, the Commission adopted the operating ratio method. When

this working capital is realized, it is available for stockholder dividend payment, even though stockholders have no equity investment.

The contributed property of these small systems has aged since the early days of the Commission's regulation of the small sewer IOUs. Many systems have either already performed major construction projects to improve or replace their original systems or are in the planning process of improving these assets. These capital improvement projects will require significant capital investment. Because these systems are built out, developer contributions are generally not available to fund these capital improvements. Their funding must come from either equity invested by the stockholder, customer contributions, long-term debts, or a combination of the three.

In previous cases where capital investment has been made, the Commission continues application of the operating ratio method. This is appropriate. The operating ratio is recognized as a method for allowing recovery of the cost of capital that includes the cost of debt and the cost of equity.<sup>36</sup> The Commission adjusts the level of the allowable operating ratio to account for interest costs when debt is used to fund investment, but does not make an adjustment to the ratio when capital is funded with equity investment.

In this case, Classic Construction requests an adjustment to the operating ratio for \$908 in interest accrued on two loans that have a combined outstanding principal

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It has been observed that revenues must be adequate to offset the operating costs of the system plus the cost of capital required to support the system. Since operating costs can be identified for the period of operation under review, it is possible to use a target operating ratio result in fixing total revenue requirements by dividing the operating costs by the target operating ratio.

*Accounting for Public Utilities* § 3.06 (1991).



balance of \$17,931. The first loan with an original balance of \$5,000 is a one-year note payable from Classic Construction to Farmers Bank and Capital Trust ("Farmers") that accrues interest annually at 6 percent. The note originated on May 24, 2012, and matured on May 24, 2013. At the time of Staff's field visit, the note had a past-due principal balance of \$3,958 upon which \$238 in annual interest will accrue. Classic Construction does not have the financial ability to repay the past-due balance and is expected to refund this amount with a new one-year note that accrues interest at 6 percent annually.

The second loan was from Classic Construction's sole stockholder, Russell Givens. There is no formal document memorializing this related party loan. The loan balance was stated in the application at \$13,973.<sup>37</sup> Mr. Givens could not identify the terms or conditions under which repayment of the loan would be made by Classic Construction. He simply stated that Classic Construction would make repayment as funds become available. Classic Construction requested recovery of annual interest accrued on this loan at 4.8 percent, or \$670.

At the time of its field work, Staff determined that Classic Construction had \$23,839 in capital investment upon which the cost of capital may be included for rate recovery.<sup>38</sup> Following the Commission's historic application of the operating ratio method, Staff adjusted Classic Construction's operating ratio to include interest costs on

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<sup>37</sup> Application at 21.

<sup>38</sup>

Restated Equity and Liabilities as of December 31, 2012	\$	12,254
Plus: Post-Test-Period Capital Improvement, Pumping Station		<u>11,585</u>
Total Capital Investment	\$	<u>23,839</u>

loans up to this amount; however, Classic Construction has shown only formal documentation for the Farmers loan.

An adjustment to the operating ratio to allow rate recovery of \$238 in interest accrued on the Farmers loan is appropriate. A new loan that has a one-year term and accrues annual interest at 6 percent will refund the past-due balance of the current Farmers loan. The original balance of the past-due loan was used to refund a like note that originated in 2011 that was used to install a new security fence surrounding the wastewater treatment facility. Photographical images of the old fence taken during the Commission's 2010 inspection of Classic Construction facilities demonstrate that the fence replacement was appropriate. Neither the original loan, the past-due loan, nor the new loan has a term longer than two years, and the original loan was assumed less than six years ago, exempting each from the requirements of KRS 278.300.<sup>39</sup> Classic Construction must be mindful that Commission approval is required for any loan used to refund the Farmers' loan that has a term exceeding two years or when the aggregate term of the original 2011 loan and all refunding loans exceeds six years.

Classic Construction did not provide formal loan documents for the loan from Russell Givens. Absent formal loan documents, Staff cannot evaluate the terms of the loan to determine whether it requires Commission approval or whether rate recovery of interest on the loan is appropriate. Staff did not adjust the operating ratio to allow

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<sup>39</sup> KRS 278.300 (1) states that "[n]o utility shall issue any securities or evidences of indebtedness, or assume any obligation or liability in respect to the securities or evidences of indebtedness of any other person until it has been authorized to do so by order of the Commission." KRS 278.300 (8) states that subsection (1) "does not apply to notes issued by a utility, for proper purposes and not in violation of law, that are payable at periods of not more than two (2) years from the date thereof, or to like notes, payable at a period of not more than two (2) years from date thereof, that are issued to pay or refund in whole or in part any such notes, or to renewals of such notes from time to time not exceeding in the aggregate six (6) years from the date of the issue of the original notes so renewed or refunded."

recovery of interest on this loan. Staff assumed that Classic Construction's \$19,881 capital investment that is above the amount funded by the Farmers' loan represents stockholder Paid-In-Capital upon which the 88 percent operating ratio, after adjusting for interest costs on the Farmers loan, provides a rate of return. Classic Construction's capital structure and cost of capital, as determined by Staff, appears below:

	Account Balance	Cost Rate	Cost of Capital
Debt	\$ 3,958	6%	\$ 237
Common Equity	<u>19,881</u>	23%	<u>4,619</u>
	<u>\$ 23,839</u>		<u>\$ 4,856</u>


If when responding to this report, Classic Construction presents formal documents to the Commission supporting up to \$19,881 in additional loan funds, following the Commission's historic application of the operating ratio method, Staff would make an adjustment to the operating ratio to include the interest accruing on the additional loan funds. If interest accrued on the additional loan at 6 percent annually, Staff would adjust the operating ratio to 84.91 percent as calculated below to include recovery of \$1,193 in additional interest costs.


Net Margin Allowed for Working Capital	\$ 4,619
Add: LLE Tax	175
Interest Expense, Farmers Loan	238
Interest Expense, Additional Loan Funds	1,193
Pro Forma Operating Expenses Before Income Taxes	<u>33,871</u>
Overall Revenue Requirement	<u>\$ 40,096</u>
Operating Expenses	\$ 34,046
Divide by: Operating Revenues	<u>40,096</u>
Operating Ratio	<u>84.91%</u>


Classic Construction's capital structure and cost of capital would appear as shown below:

	Account Balance	Cost Rate	Cost of Capital
Debt	\$ 23,839	6%	\$ 1,430
Common Equity	<u>-</u>	Undefined	<u>4,619</u>
	<u>\$ 23,839</u>		<u>\$ 6,049</u>

Signatures:

  
Prepared by: Daryl Parks  
Financial Analyst, Water and Sewer  
Revenue Requirements Branch  
Division of Financial Analysis

  
Prepared by: Sam Reid  
Rates and Tariffs Branch Manager  
Division of Financial Analysis

  
Jack Scott Lawless, CPA  
Rates and Tariffs Branch Manager  
Division of Financial Analysis

~~ATTACHMENT A~~  
STAFF REPORT, CASE NO. 2013-00258  
EXPENDITURES NOT REMOVED FROM TEST-YEAR OPERATIONS

Check No.	Date	Payee	Amount	Account
1725	1/14	Chris Keffer	\$ 800.00	Collection System
1728	1/16	McCoy & McCoy Labs	280.00	Routine Maintenance Fees
1729	1/16	Peaks Mill Water	45.48	Treatment System - Water Cost
1736	1/31	Perry's Septic Service	205.00	Treatment System - Sludge Hauling
1739	2/6	Perry's Septic Service	205.00	Treatment System - Sludge Hauling
1743	2/15	USPS	58.00	Maintenance of Treatment and Disposal Plant
1744	2/17	Chris Keffer	525.00	Collection System
1747	2/20	Peaks Mill Water	23.00	Treatment System - Water Cost
1748	2/28	Perry's Septic Service	205.00	Treatment System - Sludge Hauling
1749	2/29	Perry's Septic Service	205.00	Treatment System - Sludge Hauling
1753	3/13	Perry's Septic Service	350.00	Treatment System - Sludge Hauling
1754	3/14	Perry's Septic Service	205.00	Treatment System - Sludge Hauling
1756	3/19	Perry's Septic Service	205.00	Treatment System - Sludge Hauling
1757	3/19	Perry's Septic Service	205.00	Treatment System - Sludge Hauling
1758	3/19	Chris Keffer	646.00	Collection System
1761	4/4	Perry's Septic Service	205.00	Treatment System - Sludge Hauling
1763	4/14	Chris Keffer	800.00	Collection System
1765	4/17	Peaks Mill Water	45.20	Treatment System - Water Cost
1769	4/20	Leslie Pools	92.34	Chemicals
1773	5/15	Peaks Mill Water	25.39	Treatment System - Water Cost
1776	5/16	Chris Keffer	650.00	Collection System
1785	5/30	Perry's Septic Service	205.00	Treatment System - Sludge Hauling
1791	6/15	Chris Keffer	800.00	Collection System
1792	6/18	Peaks Mill Water	23.08	Treatment System - Water Cost
1795	6/18	AT&T	151.83	Office Supplies and Expenses
1796	6/18	Ky State Treasurer	15.00	Taxes Other Than Income
1806	7/17	Chris Keffer	740.00	Collection System
1808	7/19	AT&T	199.52	Office Supplies and Expenses
1809	7/20	McCoy & McCoy Labs	20.00	Routine Maintenance Fees
1814	7/30	USPS	43.00	Maintenance of Treatment and Disposal Plant
1817	8/14	AT&T	152.01	Office Supplies and Expenses
1818	8/17	Chris Keffer	850.00	Collection System
1823	8/31	McCoy & McCoy Labs	277.00	Routine Maintenance Fees
1824	8/31	Peaks Mill Water	57.86	Treatment System - Water Cost
1826	9/5	Juett Pools	95.35	Chemicals
1831	9/17	Chris Keffer	650.00	Collection System
1832	9/18	McCoy & McCoy Labs	42.16	Routine Maintenance Fees
1834	10/6	Leslie Pools	96.08	Chemicals
1838	10/17	Peaks Mill Water	28.67	Treatment System - Water Cost
1841	10/18	Chris Keffer	800.00	Collection System
1847	11/3	McCoy & McCoy Labs	277.00	Routine Maintenance Fees
1849	11/18	Chris Keffer	668.00	Collection System
1851	11/24	Peaks Mill Water	55.30	Treatment System - Water Cost
1855	12/7	Chris Keffer	320.00	Collection System
1858	12/18	Chris Keffer	800.00	Collection System
1862	12/31	McCoy & McCoy Labs	277.00	Routine Maintenance Fees
Total			<u>\$13,624.27</u>	

**ATTACHMENT-B**  
**STAFF REPORT, CASE NO. 2013-00258**  
**UNSUPPORTED EXPENDITURES THAT WERE**  
**REMOVED FROM TEST-YEAR OPERATIONS**

Account	Check No.	Date	Vendor	Amount	Total
Fuel and Power	1728	1/18	KU	\$ 362.67	
	1745	2/20	KU	215.13	
	1759	3/19	KU	309.90	
	1777	5/16	KU	351.23	
	1800	7/9	KU	614.88	
	1820	8/18	KU	440.44	
	1827	9/6	KU	370.11	
	1835	10/10	KU	413.88	
	Expense for KU for which a check or invoice was not provided			74.00	\$ 3,152
Maintenance and Supplies	1724	1/12	Cash	190.00	
	1730	1/18	Ky State Treasurer	122.00	
	1731	1/20	Cash	40.00	
	1732	1/21	Cash	50.00	
	1733	1/26	Cash	50.00	
	1734	1/28	Cash	50.00	
	1735	1/30	Cash	25.00	
	1737	2/1	Cash	80.00	
	1738	2/2	Cash	50.00	
	1740	2/6	Car Wash	16.00	
	1741	2/9	Perry's Septic Services	410.00	
	1750	3/6	Lowes	101.76	
	1751	3/6	Cash	40.00	
	1752	3/12	Cash	275.00	
	1760	4/3	Cash	45.00	
	1771	5/5	Cash	40.00	
	1772	5/11	Cash	40.00	
	1774	5/15	Lowes	48.54	
	1778	5/20	Lyons	25.95	
	1781	5/25	Cash	40.00	
	1783	5/30	Wilson Electric	225.00	
	1784	5/30	Lowes	16.73	
	1790	6/4	Cash	30.00	
	1794	6/18	Wilson Electric	257.30	
	1797	6/23	Cash	50.00	
	1798	6/26	Cash	30.00	
	1799	7/1	Lowes	104.94	
	1801	7/8	Lowes	26.29	
	1802	7/8	Lowes	69.85	
	1803	7/10	Cash	100.00	
	1804	7/14	Lowes	31.79	
	1810	7/25	Cash	75.00	
	1811	7/27	Car Wash	15.95	
	1812	7/27	Lowes	117.82	
	1813	7/30	Cash	75.00	
	1816	8/11	Cash	100.00	
	1819	8/18	Cash	40.00	
	1825	8/31	Cash	60.00	
	1829	9/14	Lowes	21.17	
	1830	9/15	Cash	70.00	
	1833	9/22	Cash	40.00	
	1842	10/20	Cash	40.00	
	1843	10/20	Burch Satellite	70.00	
	1844	10/25	Cash	75.00	
	1848	11/15	Manihote cover & lid	349.80	
	1853	12/1	Edmossori Supply	341.55	
	1857	12/13	Ky Car Wash	18.00	
	1861	12/26	Ky Welding	263.50	4,363
Taxes Other Than Income	1780	5/25	Franklin Co Sheriff	1,024.22	
	1786	6/18	Kentucky License Fee	15.00	
	1852	11/30	Franklin Co Sheriff	868.84	1,908
Total Amount of Checks Written				9,423.22	9,423
Less: Adjustments Shown on Pro Forma Operating Statement for:					
Fuel and Power				(3,152)	
Maintenance of Pumping System				(1,756)	
Maintenance of Treatment and Disposal Plant				(2,203)	
Office Supplies and Other Expenses				(417)	
Taxes Other Than Income Taxes				(1,908)	(9,436)
Reconciled Difference Between Unsupported Checks and Staff's Adjustment				\$ (12.78)	\$ (13)

ATTACHMENT C  
STAFF REPORT, CASE NO. 2013-00258  
RATE CALCULATED BY STAFF

Monthly Sewer Rate

\$30.30

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## **Appendix B**

**WARNING:**

*Changes in appearance and in display of formulas, tables, and text may have occurred during translation of this document into an electronic medium. This HTML document may not be an accurate version of the official document and should not be relied on. For an official paper copy, contact the Florida Public Service Commission at [contact@psc.state.fl.us](mailto:contact@psc.state.fl.us) or call (850) 413-6770. There may be a charge for the copy.*

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**DATE:** September 8, 2011

**TO:** Office of Commission Clerk (Cole)

**FROM:** Division of Economic Regulation (Roberts, Bruce, Fletcher, Hudson, Maurey, Simpson)  
Office of the General Counsel (Robinson)

**RE:** Docket No. 100471-SU – Application for staff-assisted rate case in Marion County by S&L Utilities, Inc.

**AGENDA:** 09/20/11 – Regular Agenda – Proposed Agency Action except for Issues 10, 14 and 15 – Interested Persons May Participate  
Graham, Edgar, Brisé

**COMMISSIONERS ASSIGNED:** Brisé

**PREHEARING OFFICER:** 05/23/12 (15-Month Effective Date (SARC))

**CRITICAL DATES:** None

**SPECIAL INSTRUCTIONS:** S:\PSC\ECR\WP\100471.LRCM.DOC

**FILE NAME AND LOCATION:**

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Case Background

*S&L Utilities, Inc. (S&L or Utility) is a Class C utility which is currently providing wastewater service to approximately 76 customers in Marion County. The Utility is located in the Southwest Florida Water Management District (SWFWMD). According to the Utility's 2010 Annual Report, S&L reported operating revenues of \$58,469 and operating expenses of \$27,102. The test period for setting rates is the historical twelve-month period ended December 31, 2010.*

*S&L was granted Certificate No. 334-S in 1983. The Utility's last staff-assisted rate case (SARC) was in 1987. On December 22, 2010, S&L filed an application for a SARC and paid the appropriate filing fee on February 21, 2011. The Commission has jurisdiction in this case pursuant to Sections 367.011, 367.0814, and 367.081, Florida Statutes (F.S.).*

Discussion of IssuesIssue 1:

*Is the quality of service provided by S&L satisfactory?*

Recommendation:

*The quality of service provided by S&L is marginal. (Simpson)*

Staff Analysis:

Pursuant to Rule 25-30.433(1), F.A.C., the Commission determines the overall quality of service provided by a utility by evaluating three separate components of wastewater operations. These components are the quality of the utility's product, the operating condition of the utility's plant and facilities, and the utility's attempt to address customer satisfaction. Comments or complaints received by the Commission from customers are reviewed and the Utility's compliance with the Florida Department of Environmental Protection (DEP) is also considered.

Quality of the Utility's Product and Operational Condition of the Plant and Facilities

In its last rate case, the quality of service provided by S&L was found to be unsatisfactory. <sup>(1)</sup> It was noted that the plant capacity was critically overloaded and customers complained about odor and sewer backups. The Utility subsequently doubled the plant capacity from 15,000 gallons per day (gpd) to 30,000 gpd in 1987.

DEP issued a domestic wastewater facility operating permit to the Utility on October 13, 2004, with a requirement that the percolation pond be routinely maintained to control vegetation growth and to maintain percolation capability by removal of solids. The Utility has not complied with this requirement. On February 13, 2010, DEP renewed the Utility's wastewater facility operating permit with a condition that the percolation pond be cleaned within 90 days of the issuance of the permit. However, to date the pond has not been cleaned.

As a result of a July 2010 DEP inspection, a Warning Letter was issued citing unauthorized discharge of effluent to a stormwater pond, unauthorized discharge of raw influent from the plant onto the ground, and failure to provide notification of unauthorized discharge of effluent to a stormwater pond. In addition, following a December 2010 inspection, DEP issued a noncompliance letter on February 1, 2011, noting the Utility's failure to clean the pond as previously required, as well as the Utility's failure to submit Discharge Monitoring Reports (DMRs) and provide an annual calibration report for the effluent meter. In addition, the letter noted that the Utility's February 2010 DMR indicated an excessive nitrate level, the percolation pond contained excessive solids and vegetation, and the clarifier weir was not level. The Utility made substantial repairs and improvements and, on March 18, 2011, DEP issued a short form consent order (SFCO) indicating that the corrective actions required to bring the facility into compliance with the Warning Letter had been performed. The SFCO required the Utility to pay a fine. The Utility requested a payment plan after the original SFCO was executed. DEP agreed and an amended SFCO was executed on June 15, 2011 extending payments out to 12 months from execution.

Staff conducted a field investigation of the service area on March 30, 2011. The wastewater treatment plant appeared to be operating normally, but components of the system need further improvements. According to DEP, the Utility is currently in compliance with DEP's standards with respect to nitrate levels and the Utility is now submitting the required DMRs. However, while the Utility has resolved some of DEP's concerns addressed in the February 1, 2011 noncompliance letter, DEP's concerns with respect to the pond have not been resolved. According to DEP, the Utility will be required to clean the pond as soon as possible. The Utility indicated that it has not had sufficient funds to clean the pond.

The Utility has requested that pro forma plant related to cleaning the pond, replacing pumps at the lift stations, replacing air blowers at the wastewater plant, and performing a videography of the collection system be considered. These proposed improvements are addressed in Issues 3 and 13.

The Utility's Attempt to Address Customer Satisfaction

A customer meeting was held on June 23, 2011, in Ocala, Florida. Representatives of the Utility were present. Seven customers attended and six spoke describing sewage backups, the condition of the percolation pond, wastewater treatment plant odor, and the customers' inability to contact the Utility. In addition, about 25 customer's petitioned the Commission to deny the rate increase, stating that they cannot afford a rate increase because they live on a fixed income.

Several customers complained, at the customer meeting and in writing, about chronic sewage backups. One customer indicated that a 2007 sewage backup resulted in damage to her house. She also noted that she had to personally pay for the remodeling because the Utility was unwilling to pay for the damage caused by the spill. Another customer described a March 2011 sewage backup in his home. Customers living in the vicinity of lift station #2 have had to install a sewer backflow valve, at the customer's expense, to prevent sewage from entering their homes. According to DEP, a 100-gallon spill occurred at lift station #1 in February 2011, due to a broken PVC fitting.

Two customers complained about not being able to contact the Utility. The Utility indicated that S&L Utilities is listed in the local telephone directory and the Utility's telephone number is on the monthly billing statements. Further, there are signs posted at the treatment plant and lift stations that provide the telephone number of the company retained to operate the system. The Utility also states that the operator is on call 24 hours.

Customers also commented about an offensive odor at the wastewater treatment plant and the Utility's failure to clean the percolation pond. Staff contacted DEP about odor complaints, but DEP was not aware of that problem. Additionally, none of the complaints received by the Commission addressed the issue of odor at the wastewater plant.

Staff also reviewed the Commission's Consumer Activity Tracking System (CATS) for the past three years. While no complaints have been filed in the past three years, one complaint that was made in 2007 was recently closed after repairs were made to a lift station gravity line near a customer's home.

Summary

*Although the Utility's WWTP is currently operating satisfactorily, the Utility has failed to comply with DEP requirements to clean and perform routine maintenance at the percolation pond on a timely basis and the lift stations have not been properly maintained resulting in chronic spills. While the Utility has made some efforts to comply with DEP and has requested that pro forma plant be considered in this case to address outstanding DEP concerns, staff recommends that the quality of S&L's product and the operational condition of the plant be considered marginal. However, the Utility appears to address customer concerns satisfactorily. Based on these criteria, staff recommends that the Utility's overall quality of service should be considered marginal.*

Issue 2:

*What are the used and useful percentages of the wastewater treatment plant and the collection system?*

Recommendation:

*The wastewater treatment plant and the collection system should be considered 100 percent used and useful. (Simpson)*

Staff Analysis:

*The Utility's wastewater treatment system includes two lift stations, a collection system of vitrified clay pipe, and an extended aeration, activated sludge treatment plant. The wastewater treatment plant (WWTP) is permitted by DEP at 30,000 gpd based on the three-month average daily flow. Liquid chlorine disinfection is applied prior to the wastewater effluent flowing into the percolation pond.*

*Pursuant to Rule 25-30.432, F.A.C., the used and useful (U&U) percentage for a WWTP is based on the plant flows, a growth allowance, less any excessive inflow and infiltration (I&I), divided by the permitted capacity of the plant. Other factors, such as whether the service area is built out and whether the plant flows have decreased due to conservation, may also be considered. In the last rate case, the S&L WWTP and collection system were found to be 100 percent U&U.*

*The S&L WWTP plant three-month average daily flow during the test year was 16,133 gpd. There does not appear to be excessive infiltration and inflow in the collection system. There are no vacant lots in the service area, therefore the system is built out. Staff recommends that the WWTP and collection system are 100 percent U&U because the system is built out.*

Issue 3:

What is the appropriate average test year rate base?

Recommendation:

The appropriate average test year rate base for S&L is \$27,394. (Roberts, Simpson)

Staff Analysis:

S&L's rate base was last established by Order No. 18394. <sup>[2]</sup> Staff selected a test year ended December 31, 2010, for this rate case. A summary of each component and the adjustments follows:

Utility Plant In Service (UPIS): The Utility recorded a test year UPIS balance of \$152,328. Staff's recommended adjustments relate to recording plant additions based on invoices and to capitalize plant recorded as expenses. Also, S&L completed certain pro forma plant additions in May and June 2011, which were outside of the test year. The Utility replaced the pumps on its two lift stations to address customer concerns related to sewage backups. The total cost for the pro forma plant additions is \$4,426. Staff believes the cost of the pro forma plant additions is reasonable and prudent. Therefore, staff recommends that UPIS be increased to reflect the pro forma plant additions. Staff has decreased UPIS by \$3,321 to reflect the retirement of replaced plant associated with the pro forma additions. Staff recommends the following adjustments to the UPIS amount.

Table 3-1

UTILITY PLANT IN SERVICE	WASTEWATER
1. To reflect 2008 plant additions to Acct. No. 370 for installing new pumps at lift station.	\$4,247
2. To reflect 2008 plant retirements to Acct. No. 370 for installing new pumps at lift station.	(3,185)
3. To reflect 2009 plant additions to Acct. No. 382 for building the return line and main blower line.	1,049
4. To reflect 2009 plant additions to Acct. No. 360 for installing new motors at lift station.	2,575
5. To reflect 2009 plant retirements to Acct. No. 360 for installing new motors at lift station.	(1,388)
6. To reclassify plant recorded as expense to Acct. No. 360 for costs of pool pumps, motor starter, and clock.	2,265
7. To reclassify plant recorded as expense to Acct. No. 365 for new sewer line.	1,094
8. To reflect an averaging adjustment.	(1,680)
9. To reflect pro forma plant additions to Acct. No. 370 for installing new pumps at lift station.	4,426
10. To reflect pro forma plant retirement to Acct. No. 370 for installing new pumps at lift station.	(3,321)
Total	\$6,083

The net result of staff's adjustments to UPIS represents an increase of \$6,083. Staff recommends a UPIS balance of \$158,411.

Land & Land Rights: S&L recorded a test year land value of \$12,955. Staff has reduced the land value by \$12,955. In S&L's last rate case, the land value was reduced to zero because the Utility did not hold title to the land. Also, S&L was to obtain title or a long-term lease for the land. <sup>[3]</sup> According to the Marion County Property Appraiser, S&L now has title to the land. However, the land was contributed to the Utility by a quit claim deed. Therefore, staff recommends a land value of \$0.

Non-used and Useful Plant: As discussed in Issue 2, S&L's service territory is built out and staff recommends the wastewater treatment plant be considered 100 percent U&U. Therefore, no adjustments are necessary.

Accumulated Depreciation: The Utility recorded a test year accumulated depreciation balance of \$134,728. Staff has calculated accumulated depreciation using the prescribed rates set forth in Rule 25-30.140, F.A.C. As a result, accumulated depreciation was increased by \$6,700 to reflect depreciation calculated per staff. In addition, staff increased this account by \$957 to reflect an averaging adjustment and by \$3,320 to reflect the removal of accumulated depreciation related to the plant retirement. Finally, staff has increased accumulated depreciation by \$89 for accumulated depreciation related to pro forma plant. These adjustments result in an average accumulated depreciation balance of \$137,239.

Working Capital Allowance: Working capital is defined as the investor-supplied funds that are necessary to meet operating expenses. Consistent with Rule 25-30.433(2), F.A.C., staff used the one-eighth of the operation and maintenance (O&M) expense formula approach for calculating the working capital allowance. Applying this formula, staff recommends a working capital allowance of \$6,222 (based on O&M expense of \$49,773). Working capital has been increased by \$6,222 to reflect one-eighth of staff's recommended O&M expenses.

Rate Base Summary: Based on the forgoing, staff recommends that the appropriate test year average rate base is \$27,394. Rate base is shown on Schedule No. 1-A. The related adjustments are shown on Schedule No. 1-B.



Issue 4:

*What is the appropriate return on equity and overall rate of return?*

Recommendation:

*The appropriate return on equity (ROE) is 9.93 percent with a range of 8.93 percent to 10.93 percent. The appropriate overall rate of return is 7.83 percent. (Roberts)*

Staff Analysis:

*The Utility's capital structure consists of 57.5 percent common equity and 42.5 percent long-term debt. The appropriate ROE is 9.93 percent using [A] the Commission-approved leverage formula currently in effect. The Utility's capital structure has been reconciled with staff's recommended rate base. Staff recommends an ROE of 9.93 percent, with a range of 8.93 percent to 10.93 percent, and an overall rate of return of 7.83 percent. The ROE and overall rate of return are shown on Schedule No. 2.*

Issue 5:

*What is the appropriate amount of test year revenues?*

Recommendation:

*The appropriate test year revenues for S&L are \$40,577. (Roberts, Bruce)*

Staff Analysis:

*S&L recorded total revenues of \$35,650. This amount included \$34,956 for service revenues, \$294 for miscellaneous revenues, and \$400 for uncategorized income. Based on staff's review of the test year billing units, staff has determined test year service revenues to be \$40,283. Staff has increased test year revenues by \$5,327 (\$40,283-\$34,956) to reflect the appropriate service revenues. In addition, staff has removed the recording of salvage value as income of \$400 pursuant to Audit Finding 5. Based on the above adjustments, staff recommends test year revenues of \$40,577 (\$40,283 + \$294). Test year revenues are shown on Schedule No. 3-A.*

Issue 6:

*What are the appropriate total operating expenses?*

Recommendation:

*The appropriate amount of total operating expenses for S&L is \$54,955. (Roberts)*

Staff Analysis:

The Utility recorded operating expenses of \$29,198 during the test year ended December 31, 2010. The test year O&M expenses have been reviewed, and invoices, canceled checks, and other supporting documentation have been examined. Staff made several adjustments to the Utility's operating expenses, as summarized below:

Salaries and Wages Officers (610/710) – S&L did not record a salary for its president. The Utility requested an annual salary for the Utility's president of \$520 per month or \$6,240 annually. The Utility president works 35 hours a month attending to customer service and other administrative duties. Staff believes \$520 a month is a reasonable amount. Therefore, staff recommends officer annual salary expense of \$6,240.

Contractual Services - Professional (631/731) – The Utility recorded contractual services - professional expense of \$4,748. Staff decreased this expense by \$708 to capitalize plant recorded as expense. In addition, staff decreased this expense by \$3,680 to reclassify the plant operator expense to contractual services - other. Staff's net adjustment represents a decrease of \$4,388. Therefore, staff recommends contractual services – professional expense of \$360.

Contractual Services - Other (636/736) – S&L recorded contractual services - other expense of \$4,248. Staff has made several adjustments to contractual services – other expense that relate to capitalized plant additions, reclassified expenses, office manager fees and plant operator fees. The Utility has requested an office manager fee of \$1,170 per month or \$14,040 annually for Mr. Clark Yandle. Mr. Yandle works approximately 39 hours per month handling all of the primary duties of the Utility. He is responsible for providing oversight of all contract labor, resolving customer complaints, performing all accounting functions, acting as the liaison between the Utility and all regulatory agencies, preparing and mailing customer bills, processing the customer payments, and making the deposits at the bank. Staff believes the office manager fee is reasonable for his duties.

During the test year, the Utility paid \$5,520 for plant operator services and testing. S&L's test year amount for operator and testing services is not reflective of the actual cost of the services. This amount was paid to a company which had been providing the services to S&L at a reduced cost. On a going-forward basis, the company had indicated to the Utility that it was not going to be able to continue its services at the reduced cost. However, S&L has changed its operator services to another company.

The Utility has entered into a contract with U.S. Water Corporation (U.S. Water). S&L believes U.S. Water is better suited at assisting the Utility with achieving and maintaining compliance with regulatory agencies. The contract amount with U.S. Water is \$720 per month, or \$8,640 per year. Staff believes this amount is reasonable for the duties performed by U.S. Water. Therefore, staff has increased this account by \$3,120 to reflect the appropriate plant operator fee. Staff recommends the following adjustments:

Table 6-1

CONTRACTUAL SERVICES - OTHER (736)	WASTEWATER
1. To capitalize plant recorded as expense to Acct. No. 360.	- (\$1,559)
2. To capitalize plant recorded as expense to Acct. No. 365.	- (1,093)
3. To reclassify plant operator expense from miscellaneous expense.	- 1,840
4. To reclassify repairs from miscellaneous expense.	- 2,961
5. To reclassify lawn services from miscellaneous expense.	- 650
6. To reclassify plant operator expense from contractual services – professional.	- 3,680
7. To reflect management fee.	- 14,040
8. To reflect pro forma adjustment for increase operator fee.	- 3,120
Total	\$23,639

*Based on staff's net adjustment of \$23,639, staff recommends contractual services – other expense of \$27,887.*

Rent Expense (640/740) – The Utility recorded rent expense of \$0 for the test year. The Utility's office is located in the personal residence of the Utility's president. The home is 2,100 square feet (sq. ft.). The office space is 256 sq. ft. Staff believes the Utility's allocation should be based on the percentage of sq. ft. occupied by S&L, which is approximately 12 percent (256 sq. ft. / 2,100 sq. ft.). The monthly cost related to the mortgage and electricity is \$872. The Utility's allocation of 12 percent of the monthly cost is approximately \$105, monthly or \$1,255 annually. Staff recommends rent expense of \$1,255.

Insurance Expense (655/755) – The Utility recorded insurance expense of \$819. Staff decreased this expense by \$819 to remove a non-Utility insurance expense related to the personal residence of the Utility president. During the test year, the Utility did not have general liability insurance. S&L has obtained general liability insurance and paid the annual premium of \$2,543. Therefore, staff recommends a pro forma increase in insurance expense for the general liability policy. Staff recommends insurance expense of \$2,543.

Regulatory Commission Expense (665/765) – During the test year, S&L recorded \$0 in this account. Pursuant to Section 367.0816, F.S., rate case expense is amortized over a 4-year period. The Utility is required by Rule 25-22.0407(b)(9), F.A.C., to mail notices of the customer meeting in this case to its customers. Staff has estimated noticing expense of \$67 for postage expense, \$53 for printing expense, and \$8 for envelopes. S&L's filing fee was \$200. Based on the above, total rate case expense for the filing and noticing is \$328 (\$67+\$53+\$8+\$200) with a resulting 4-year amortization of \$82. Staff has increased this account by \$82 (\$328/4). Staff recommends regulatory commission expense for the test year of \$82.

Miscellaneous Expense (675/775) – S&L recorded miscellaneous expense of \$7,642. Staff recommends the following adjustments.

Table 6-2

MISCELLANEOUS EXPENSE (775)	WASTEWATER
1. To reflect 5-year amortization of the wastewater permit (\$3,505/5).	\$701
2. To reclassify plant operator expense to contractual services – other.	(1,840)
3. To reclassify repairs to contractual services – other.	(2,961)
4. To reclassify expense for lawn services to contractual services – other.	(650)
5. To reflect correct allocation for Utility phone services.	(1,489)
6. To reclassify license fees to taxes other than income.	(300)
7. To reflect cost for postage and postcards for billing.	260
Total	(\$6,279)

Based on staff's net adjustment of \$6,279, staff recommends a miscellaneous expense balance of \$1,363.

Operation and Maintenance Expense (O&M Summary) – Based on the above adjustments, O&M expense should be increased by \$22,272. Staff's recommended adjustments to O&M expenses are shown on Schedule Nos. 3-A, 3-B and 3-C.

Depreciation Expense (Net of Amortization of CIAC) – The Utility did not record depreciation expense. Staff has calculated depreciation expense using the prescribed rates set forth in Rule 25-30.140, F.A.C. Staff's calculated depreciation expense is \$1,594. S&L has no amortization of CIAC. Therefore, staff recommends net depreciation expense of \$1,594.

Taxes Other Than Income (TOTI) – S&L recorded a TOTI balance of \$1,697. Staff has increased TOTI by \$113 to reflect the appropriate property taxes. In addition, staff has increased TOTI by \$477 to reflect the appropriate payroll taxes associated with the president's salary. In addition, staff reclassified the license fee of \$300 from miscellaneous expense to TOTI. Furthermore, staff has increased TOTI by \$129  $[(\$40,577 \times 4.5\%) - \$1,826]$  to reflect the appropriate RAFs for the test year revenues recommended in Issue 5. As will be discussed in Issue 7, revenues have been increased by \$19,356 to reflect the change in revenue required to cover expenses and allow an opportunity to earn the recommended return on investment. As a result, TOTI should be increased by \$871 to reflect RAFs of 4.5 percent on the change in revenues. Therefore, staff recommends TOTI of \$3,588.

Income Tax – The Utility recorded income tax of \$0. S&L is an 1120C corporation; however, the Utility has a large amount of tax-loss carry-forwards recorded on its books. This tax-loss carry-forward is in excess of the income tax provision going-forward and is expected to continue to be so over the next few years. In this instance, it is Commission practice to allow no provision for income tax. <sup>[51]</sup> Therefore, staff recommends no provision for income taxes.

Operating Expenses Summary – The application of staff's recommended adjustments to S&L's test year operating expenses result in operating expenses of \$54,955. Operating expenses and adjustments are shown on Schedule Nos. 3-A and 3-B, respectively.

Issue 7:

Should the Commission, on its own motion, utilize the operating ratio methodology as an alternative means to calculate the revenue requirement for S&L, and if so, what is the appropriate margin?

Recommendation:

Yes, the Commission, on its own motion, should utilize the operating ratio methodology for calculating the revenue requirement. The margin should be 10.00 percent of O&M expenses. (Roberts)

Staff Analysis:

Section 367.0814(9), F.S., provides that the Commission may, by rule, establish standards and procedures for setting rates and charges of small utilities using criteria other than those set forth in Sections 367.081(1), (2)(a) and (3), F.S. Rule 25-30.456, F.A.C., provides, in part, an alternative to a SARC as described in Rule 25-30.455, F.A.C. As an alternative, utilities with total gross annual operating revenues of less than \$250,000 per system may petition the Commission for staff assistance in alternative rate setting.

Although S&L did not petition the Commission for alternative rate setting under the aforementioned rule, staff believes that the Commission should exercise its discretion to employ the operating ratio methodology to set rates in this case. The operating ratio methodology is an alternative to the traditional calculation of revenue requirements. Under this methodology, instead of applying a return on the utility's rate base, the revenue requirement is based on the margin of S&L's O&M expenses. This methodology has been applied in cases where the traditional calculation of revenue requirements would not provide sufficient revenues to protect against potential variances in revenues and expenses.

By Order No. PSC-96-0357-FOF-WU, the Commission, for the first time, utilized the operating ratio methodology as an alternative means for setting rates.<sup>[6]</sup> This order also discussed criteria related to the use of the operating ratio methodology and a guideline margin of 10 percent of O&M expense. This criteria was applied again in Order No. PSC-97-0130-FOF-SU.<sup>[7]</sup> Most recently, the Commission approved the operating ratio methodology for setting rates in Order No. PSC-10-0167-PAA-WU.<sup>[8]</sup>

In Order No. PSC-96-0357-FOF-WU, the Commission described criteria to determine whether to utilize the operating ratio methodology for those utilities with low or non-existent rate base. The qualifying criteria outlined in Order No. PSC-96-0357-FOF-WU, and how they apply to the Utility, is discussed below:

1) Whether the Utility's O&M expense exceeds rate base. In the instant case, the rate base is substantially less than the level of O&M expense. Based on staff's recommendation, the adjusted rate base for the test year is \$27,394, while adjusted O&M expenses are \$49,773.

2) Whether the Utility is expected to become a Class B utility in the foreseeable future. According to Chapter 367.0814(9), F.S., the alternative form of regulation being considered in this case only applies to small utilities with gross annual revenues of \$250,000 or less. S&L is a Class C utility and the recommended revenue requirement of \$59,932 is substantially below the threshold-level for Class B status (\$200,000 per system). The Utility's service area has not had any growth in the last five years and is essentially built out. Therefore, the Utility will not become a Class B utility in the foreseeable future.

3) Quality of service and condition of plant. As mentioned earlier, a condition of S&L's permit is to have its percolation ponds cleaned. DEP has required the Utility to complete the cleaning within 90 days of the issuance of its permit dated, February 15, 2010. To date, the pond cleaning has not been completed. As discussed in Issue 1, staff is recommending the quality of service be found to be marginal. The quality of service was found unsatisfactory in the

Utility's last rate case.<sup>[9]</sup> S&L still has an outstanding compliance issue with DEP. However, staff does not believe the Utility should be disqualified from the operating ratio method because it has not completed the percolation pond cleaning.

4) Whether the Utility is developer-owned. The current Utility owner is not a developer. The service territory is not in the early stages of growth, and there has not been any customer growth in the last five years.

5) Whether the Utility operates treatment facilities or is simply a distribution and/or collection system. S&L operates a wastewater treatment plant and collection system.

By Order Nos. PSC-96-0357-FOF-WU and PSC-97-0130-FOF-WU, the Commission determined that a margin of 10 percent shall be used unless unique circumstances justify the use of a greater or lesser margin. The important question was not what the return percentage should be, but what level of operating margin will allow the utility to provide safe and reliable service and remain a viable entity. The answer to this question requires a great deal of judgment based upon the particular circumstances of the utility. In these cases, the Commission applied a 10 percent margin.

Several factors must be considered in determining the reasonableness of a margin. First, the margin must provide sufficient revenues for the Utility to cover its interest expense. In this case, the interest expense is approximately \$1,012. The Utility's return on rate base results in \$2,146 of operating income.

Second, use of the operating ratio methodology rests on the contention that the principal risk to the utility resides in operating cost rather than in capital cost of the plant. The fair return on a small rate base may not adequately compensate the utility owner for incurring the risk associated with covering the much larger operating cost. Therefore, the margin should adequately compensate the utility owner for that risk. Under the rate base method, the return to S&L amounts to only \$2,146 which is enough to cover only a 4.3 percent variance in O&M expenses. Staff believes \$2,146 is an insufficient financial cushion.

Third, if the return on rate base method were applied, a normal return would generate such a small level of revenues that in the event revenues or expenses vary from staff's estimates, S&L could be left with insufficient funds to cover operating expenses. Therefore, the margin should provide adequate revenues to protect against potential variability in revenues and expenses. The return on rate base method would provide the Utility only \$2,146. After deducting interest expense, S&L would only have \$1,134 of operating income to cover revenue and expense variances. If the Utility's operating expenses increase, S&L may not have the funds required for day-to-day operations.

*In conclusion, staff believes the above factors show that the Utility needs a higher margin of revenues over operating expenses than the traditional return on rate base method would provide. Therefore, in order to provide S&L with adequate cash flow to satisfy environmental requirements and to provide some assurance of safe and reliable service, staff recommends application of the operating ratio methodology at a margin of 10 percent of O&M expenses.*

Issue 8:

*What is the appropriate revenue requirement?*

Recommendation:

*The appropriate revenue requirement is \$59,932. (Roberts)*

Staff Analysis:

*S&L should be allowed an annual increase of \$19,355 (47.70 percent). This will allow the Utility the opportunity to recover its expenses and a 10.00 percent cushion over its O&M expenses. The calculations are as follows:*

Table 8-1

Adjusted O&M Expenses	\$49,773
Rate of Return/Operating Margin	10.00%
Operating Margin	\$4,977
Adjusted O&M Expense	49,773
Depreciation expense (Net)	1,594
Amortization	0
Taxes Other Than Income	3,588
Income Tax	0
Revenue Requirement	\$59,932
Less Adjusted Test Year Revenues	\$40,577
Annual Increase	\$19,355
Percent Increase/(Decrease)	47.70%

Issue 9:

*What are the appropriate rates and rate structure?*

Recommendation:

The recommended rates should be designed to produce revenue of \$59,638, excluding miscellaneous service charges. The Utility's current wastewater rate structure which consists of a flat rate should remain unchanged. The Utility should file revised tariff sheets and a proposed customer notice to reflect the Commission-approved rates. The approved rates should be effective for service rendered on or after the stamped approval date on the tariff sheet, pursuant to Rule 25-30.475(1), F.A.C. In addition, the approved rates should not be implemented until staff has approved the proposed customer notice and the notice has been received by the customers. The Utility should provide proof of the date notice was given within 10 days of the date of the notice. (Bruce, Roberts)

Staff Analysis:

Staff's recommended revenue requirement is \$59,932. However, after excluding miscellaneous service revenues of \$294, the revenue to be recovered through rates is \$56,638. The Utility's current rate structure consists of a flat rate structure. The Utility's flat rate is \$44.17 per month for residential service. The Commission's preferred wastewater rate structure is a base facility charge (BFC)/uniform rate structure. However, the customers purchase their water service from Marion County. Commission policy has been to allow the use of flat rate for wastewater service in situations where metered water

consumption is not possible. <sup>[10]</sup> For this reason, staff recommends a continuation of the flat rate structure.

Since metered consumption is not available, staff recommends the revenue requirement increase be applied as an across-the-board increase to the wastewater system's current flat rate. To determine the appropriate percentage increase to apply to the service rates prior to filing, miscellaneous service revenues should be removed from the test year revenues.

Wastewater

1.	Total Test Year Revenues	\$40,577
2.	Less: Miscellaneous Revenues	<u>\$294</u>
3.	Test Year Revenues from Service Rates	\$40,283
4.	Revenue Increase	<u>\$19,355</u>
5.	% Service Rate Increase (Line 4/Line3)	<u>48.05%</u>

Therefore, the across-the-board increase of 48.05% should be applied to the Utility's current flat rate of \$44.17. This results in a flat rate charge of \$65.39.

Furthermore, as discussed in Issue 13, staff recommends a Phase II revenue requirement associated with pro forma plant improvements. Also, staff recommends that the Phase II revenue requirement increase of 5.03 percent be applied as an across-the-board increase to the wastewater system's Phase I flat rate of \$65.39. This results in a flat rate charge of \$68.68 after S&L has completed the pro forma additions and after Phase II rates have been implemented.

The Utility should file revised tariff sheets and a proposed customer notice to reflect the Commission-approved rates. The approved rates should be effective for service rendered on or after the stamped approval date on the tariff sheet, pursuant to Rule 25-30.475(1), F.A.C. In addition, the approved rates should not be implemented until staff has approved the proposed customer notice and the notice has been received by the customers. The Utility should provide proof of the date notice was given within 10 days of the date of the notice.

A comparison of the Utility's rates prior to filing and staff's recommended rates is shown on Schedule No. 4.



Issue 10:

*What is the appropriate amount by which rates should be reduced four years after the established effective date to reflect the removal of the amortized rate case expense as required by Section 367.0816, F.S.?*

Recommendation:

*The wastewater rates should be reduced as shown on Schedule No. 4, to remove rate case expense grossed-up for RAFs and amortized over a four-year period. The decrease in rates should become effective immediately following the expiration of the four-year rate case expense recovery period, pursuant to Section 367.0816, F.S. The Utility should be required to file revised tariffs and a proposed customer notice setting forth the lower rates and the reason for the reduction no later than one month prior to the actual date of the required rate reduction. If S&L files this reduction in conjunction with a price index or pass-through rate adjustment, separate data should be filed for the price index and/or pass-through increase or decrease and the reduction in the rates due to the amortized rate case expense. (Roberts)*

Staff Analysis:

*Section 367.0816, F.S., requires that the rates be reduced immediately following the expiration of the four-year period by the amount of the rate case expense previously included in the rates. The reduction will reflect the removal of revenues associated with the amortization of rate case expense, the associated operating margin and the gross-up for RAF's which is \$94. Using the Utility's current revenues, expenses, capital structure and customer base, the reduction in revenues will result in the rate decrease shown on Schedule No. 4.*

*S&L should be required to file revised tariff sheets no later than one month prior to the actual date of the required rate reduction. The Utility also should be required to file a proposed customer notice setting forth the lower rates and the reason for the reduction.*

*If S&L files this reduction in conjunction with a price index or pass-through rate adjustment, separate data should be filed for the price index and/or pass-through increase or decrease and the reduction in the rates due to the amortized rate case expense.*

Issue 11:

Should S&L's request for approval of a Non-Sufficient Funds fee be granted?

Recommendation:

Yes. The Utility's request for a Non-Sufficient Funds (NSF) fee should be approved. The NSF fee should be effective on or after the stamped approval date on the tariff sheets pursuant to Rule 25-30.475(1), F.A.C. In addition, the rates should not be implemented until staff has approved the proposed customer notice. The Utility should provide proof of the date the notice was given within 10 days of the date of the notice. (Roberts)

Staff Analysis:

Section 367.091, F.S., requires that rates, charges, and customer service policies be approved by the Commission. The Commission has authority to establish, increase, or change a rate or charge. S&L has requested an NSF fee in accordance with Section 832.08(5), F.S.

Staff believes that S&L should be authorized to collect an NSF fee. Staff believes the NSF fee should be established consistent with Section 68.065, F.S., which allows for the assessment of charges for the collection of worthless checks, drafts, or orders of payment. As currently set forth in Sections 68.065(2) and 832.08(5), F.S., the following fees may be assessed:

- 1) \$25, if the face value does not exceed \$50,
- 2) \$30, if the face value exceeds \$50 but does not exceed \$300,
- 3) \$40, if the face value exceeds \$300, or
- 4) five percent of the face amount of the check, whichever is greater.

Approval of an NSF fee properly assigns costs to the cost causer and is consistent with prior Commission decisions. <sup>(111)</sup> As such, staff recommends that S&L's proposed NSF fee be approved. This fee should be effective on or after the stamped approval date on the tariff sheets pursuant to Rule 25-30.475(1), F.A.C.

Issue 12:

*Should S&L be authorized to collect late payment fees, and if so, what are the appropriate charges?*

Recommendation:

*Yes. S&L should be authorized to collect a \$5 late fee. The late fee should be effective on or after the stamped approval date on the tariff sheets pursuant to Rule 25-30.475(1), F.A.C. The revised tariff sheets should be approved upon staff's verification that the tariffs are consistent with the Commission's decision. If revised tariff sheets are filed and approved, the late payment fee should become effective for connections made on or after the stamped approval date of the revised tariff sheets, if no protest is filed and provided customers have been noticed. (Roberts)*

Staff Analysis:

*S&L is not currently authorized to collect late payment charges. The Utility requested to implement a late payment charge. Staff believes that the purpose of a late payment charge is not only to provide an incentive for customers to make timely payment, thereby reducing the number of delinquent accounts, but also to place the cost burden of processing such delinquencies upon those who are the cost causers.*

*In the past, late payment fee requests have been handled on a case-by-case basis. The Commission has approved late fees in the amount of \$5.<sup>[12]</sup> Presently, Commission rules provide that late payers may be required by the utility to provide an additional deposit. However, the Commission found that<sup>[13]</sup> there is no further incentive for either delinquent or late paying customers to pay their bills on time after the additional deposit. In that same Order, the Commission also found that the cost causer should pay the additional cost incurred by the utility due to late payments, rather than the general body of the utility's rate payers. Staff believes that the goal of allowing late fees to be charged by a utility is two-fold: first, to encourage current and future customers to pay their bills on time; and second, if payment is not made on time, to insure that the cost associated with the late payments is not passed on to the customers who do pay on time.*

*Staff believes there is a need for this incentive. As noted above, a late payment charge of \$5 is consistent with prior Commission practice and orders. A late payment charge of less than \$5 would not allow S&L to recover its costs of processing delinquent accounts, nor would it send the appropriate signal to delinquent payers. In the majority of cases, the Commission has approved a late fee charge of \$5. The utilities that have higher charges have provided adequate documentation in support of those higher fees. Staff believes that \$5 is a reasonable fee for S&L.*

*Therefore, staff recommends that a \$5 late payment should be approved. The late fee should be effective on or after the stamped approval date on the tariff sheets pursuant to Rule 25-30.475(1), F.A.C. The revised tariff sheets should be approved upon staff's verification that the tariffs are consistent with the Commission's decision. If revised tariff sheets are filed and approved pursuant to Rule 25-30.475, F.A.C., the late payment charge should become effective on the stamped approval date of the tariff sheets, if no protest is filed and provided customers have been properly noticed.*

Issue 13:

Should the Commission approve pro forma plant and expenses for the Utility, and if so, what is the appropriate return on equity, overall rate of return, revenue requirement and date for implementing the new rates?

Recommendation:

Yes. The Commission should approve a Phase II revenue requirement associated with pro forma items. S&L's appropriate ROE should be 11.16 percent with a range of 10.16 to 12.16 percent. The appropriate overall rate of return is 7.17 percent. The Utility's Phase II revenue requirement is \$62,929 which equates to an increase of 5.00 percent over the Phase I revenue requirement. S&L should complete the pro forma items within 12 months of the issuance of the consummating order. The Utility should be allowed to implement the resulting rates once the pro forma items have been completed and documentation provided showing that all improvements have been made to the system. Once verified, the rates should be effective for service rendered on or after the stamped approval date on the tariff sheets, pursuant to Rule 25-30.475(1), F.A.C. The rates should not be implemented until notice has been received by the customers. S&L should provide proof of the date notice was given within 10 days of the date of the notice. If the Utility encounters any unforeseen events that will impede the completion of the pro forma items, the Utility should immediately notify the Commission in writing. (Simpson, Roberts)

Staff Analysis:

The Utility requested recognition of additional pro forma plant items that it intends to complete. The following is a chart summarizing the pro forma plant items, the cost, and staff's recommended treatment:

Table 13-1

	Pro forma Plant Items	Utility Requested	Staff Recommended
1.	Replace two air blowers	\$15,997	\$15,997
2.	Pond clean	35,000	35,000
3.	Videography of lines in the collection system	5,000	5,000
	Total	\$55,997	\$55,997

As discussed in Issue 1, S&L was required by DEP to clean its percolation pond as a condition for renewal of its wastewater operating permit. The Utility requested to recover the cost associated with cleaning the percolation pond, replacing air blowers at the wastewater plant, and having a videography of the collection system. Staff believes S&L's proposed pro forma plant items are reasonable and prudent because it would allow the Utility to improve its quality of service. The Utility should be required to submit a copy of the final invoices and cancelled checks for all pro forma plant items.

Staff is recommending a Phase II revenue requirement associated with the pro forma plant items for a number of reasons. First, it assures that the pro forma items are completed prior to the Utility's recovery of the investment in rates. In the past, there have been instances when the Commission approved revenue requirements associated with pro forma items only to have the utility in question fail to complete the pro forma investments. In addition, addressing the pro forma items in a single case saves additional rate case expense to the customers because the Utility would not need to file another rate case or limited proceeding to seek recovery for them. The Commission has approved a Phase-In approach in Docket Nos. 080668-SU and 090072-WU. [14]

The Utility's Phase II revenue requirement should be \$62,929. Phase II rate base and adjustments are shown on Schedule Nos. 5-A and 5-B, respectively. The capital structure for Phase II is shown on Schedule No. 6. The revenue requirement and adjustments are shown on Schedule Nos. 7-A and 7-B, respectively. The resulting rates are shown on Schedule No. 8.

S&L should be required to complete the pro forma items within 12 months of the issuance of the consummating order. The Utility should also be required to submit a copy of the final invoices and cancelled checks for all pro forma plant items within 15 days of the completion. The Utility should be allowed to implement the above rates once all pro forma items have been completed and documentation provided showing that the improvements have been made. Once verified, the rates should be effective for service rendered on or after the stamped approval date on the tariff sheet, pursuant to Rule 25-30.475 (1), F.A.C. The rates should not be implemented until notice has been received by the customers. S&L should provide proof of the date notice was given within 10 days of the date of the notice. If the Utility encounters any unforeseen events that will impede the completion of the pro forma items, the Utility should immediately notify the Commission in writing.

Issue 14:

Should the recommended rates be approved for the Utility on a temporary basis, subject to refund, in the event of a protest filed by a party other than the Utility?

Recommendation:

Yes. Pursuant to Section 367.0814(7), F.S., the recommended rates should be approved for the Utility on a temporary basis, subject to refund, in the event of a protest filed by a party other than the Utility. S&L should file revised tariff sheets and a proposed customer notice to reflect the Commission-approved rates. The approved rates should be effective for service rendered on or after the stamped approval date on the tariff sheet, pursuant to Rule 25-30.475(1), F.A.C. In addition, the temporary rates should not be implemented until staff has approved the proposed notice, and the notice has been received by the customers. Prior to implementation of any temporary rates, the Utility should provide appropriate security. If the recommended rates are approved on a temporary basis, the rates collected by the Utility should be subject to the refund provisions discussed below in the staff analysis. In addition, after the increased rates are in effect, pursuant to Rule 25-30.360(6), F.A.C., the Utility should file reports with the Commission's Division of Economic Regulation no later than the 20th of each month indicating the monthly and total amount of money subject to refund at the end of the preceding month. The report filed should also indicate the status of the security being used to guarantee repayment of any potential refund. (Roberts)

Staff Analysis:

This recommendation proposes an increase in rates. A timely protest might delay what may be a justified rate increase resulting in an unrecoverable loss of revenue to the Utility. Therefore, pursuant to Section 367.0814(7), F.S., in the event of a protest filed by a party other than the Utility, staff recommends that the recommended rates be approved as temporary rates. S&L should file revised tariff sheets and a proposed customer notice to reflect the Commission-approved rates. The approved rates should be effective for service rendered on or after the stamped approval date on the tariff sheet, pursuant to Rule 25-30.475(1), F.A.C. In addition, the temporary rates should not be implemented until staff has approved the proposed notice, and the notice has been received by the customers. The recommended rates collected by the Utility should be subject to the refund provisions discussed below.

The Utility should be authorized to collect the temporary rates upon staff's approval of an appropriate security for the potential refund and the proposed customer notice. Security should be in the form of a bond or letter of credit in the amount of \$14,538. Alternatively, the Utility could establish an escrow agreement with an independent financial institution.

If the Utility chooses a bond as security, the bond should contain wording to the effect that it will be terminated only under the following conditions:

- 1) The Commission approves the rate increase; or
- 2) If the Commission denies the increase, the Utility shall refund the amount collected that is attributable to the increase.

If the Utility chooses a letter of credit as a security, it should contain the following conditions:

- 1) The letter of credit is irrevocable for the period it is in effect, and,
- 3) The letter of credit will be in effect until a final Commission order is rendered, either approving or denying the rate increase.

If security is provided through an escrow agreement, the following conditions should be part of the agreement:

- 1) No monies in the escrow account may be withdrawn by the Utility without the express approval of the Commission
- 2) The escrow account shall be an interest bearing account;
- 3) If a refund to the customers is required, all interest earned by the escrow account shall be distributed to the customers;
- 4) If a refund to the customers is not required, the interest earned by the escrow account shall revert to the Utility;
- 5) All information on the escrow account shall be available from the holder of the escrow account to a Commission representative at all times;
- 6) The amount of revenue subject to refund shall be deposited in the escrow account within seven days of receipt;
- 7) This escrow account is established by the direction of the Florida Public Service Commission for the purpose(s) set forth in its order requiring such account. Pursuant to Cosentino v. Elson, 263 So. 2d 253 (Fla. 3d DCA 1972), escrow accounts are not subject to garnishments;
- 8) The Commission Clerk must be a signatory to the escrow agreement; and
- 9) The account must specify by whom and on whose behalf such monies were paid.

In no instance should the maintenance and administrative costs associated with the refund be borne by the customers. These costs are the responsibility of, and should be borne by, the Utility. Irrespective of the form of security chosen by the Utility, an account of all monies received as a result of the rate increase should be maintained by the Utility. If a refund is ultimately required, it should be paid with interest calculated pursuant to Rule 25-30.360(4), F.A.C.

The Utility should maintain a record of the amount of the bond, and the amount of revenues that are subject to refund. In addition, after the increased rates are in effect, pursuant to Rule 25-30.360(6), F.A.C., the Utility should file reports with the Commission's Division of Economic Regulation no later than the 20th of each month indicating the monthly and total amount of money subject to refund at the end of the preceding month. The report filed should also indicate the status of the security being used to guarantee repayment of any potential refund.

Issue 15:

*Should the Utility be required to provide proof, within 90 days of an effective order finalizing this docket, that it has adjusted its books for all applicable National Association of Regulatory Utility Commissioners Uniform System of Accounts (NARUC USOA) primary accounts associated with the Commission-approved adjustments?*

Recommendation:

*Yes. To ensure that the Utility adjusts its books in accordance with the Commission's decision, S&L should provide proof, within 90 days of the final order in this docket, that the adjustments for all applicable NARUC USOA primary accounts have been made. (Roberts)*

Staff Analysis:

*To ensure that the Utility adjusts its books in accordance with the Commission's decision, S&L should provide proof, within 90 days of the final order in this docket, that the adjustments for all applicable NARUC USOA primary accounts have been made.*

Issue 16:

Should this docket be closed?

Recommendation:

No. If no person whose substantial interests are affected by the proposed agency action files a protest within twenty-one days of the issuance of the order, a consummating order should be issued. The docket should remain open for staff's verification that the revised tariff sheets and customer notice have been filed by the Utility and approved by staff. Also, the docket should remain open to allow staff to verify that the pro forma items have been completed and the Phase II rates properly implemented. Once these actions are complete, this docket should be closed administratively. (Robinson)

Staff Analysis:

If no person whose substantial interests are affected by the proposed agency action files a protest within twenty-one days of the issuance of the order, a consummating order should be issued. The docket should remain open for staff's verification that the revised tariff sheets and customer notice have been filed by the Utility and approved by staff. Also, the docket should remain open to allow staff to verify that the pro forma items have been completed and the Phase II rates properly implemented. Once these actions are complete, this docket should be closed administratively.

S & L UTILITIES, INC.		SCHEDULE NO. 1-A	
TEST YEAR ENDED 12/31/10		DOCKET NO. 100471-SU	
SCHEDULE OF WASTEWATER RATE BASE			
DESCRIPTION	BALANCE PER UTILITY	STAFF ADJUSTMENTS TO UTIL. BAL.	BALANCE PER STAFF
UTILITY PLANT IN SERVICE	\$152,328	\$6,083	\$158,411
LAND & LAND RIGHTS	12,955	(12,955)	0
NON-USED AND USEFUL COMPONENTS	0	0	0
CIAC	(100,088)	0	(100,088)
ACCUMULATED DEPRECIATION	(134,728)	(2,511)	(137,239)
AMORTIZATION OF CIAC	100,088	0	100,088
WORKING CAPITAL ALLOWANCE	0	6,222	6,222
WASTEWATER RATE BASE	<u>\$30,555</u>	<u>(\$3,161)</u>	<u>\$27,394</u>



S & L UTILITIES, INC. TEST YEAR ENDED 12/31/10 ADJUSTMENTS TO RATE BASE		SCHEDULE NO. 1-B DOCKET NO. 100471-SU
		WASTEWATER
<b>UTILITY PLANT IN SERVICE</b>		
1.	To reflect 2008 plant additions to Acct. No. 370 for installing new pumps at lift station.	\$4,247
2.	To reflect 2008 plant retirements to Acct. No. 370 for installing new pumps at lift station.	(3,185)
3.	To reflect 2009 plant additions to Acct. No. 382 for building the return line and main blower line.	1,049
4.	To reflect 2009 plant additions to Acct. No. 360 for installing new motors at lift station.	2,575
5.	To reflect 2009 plant retirements to Acct. No. 360 for installing new motors at lift station.	(1,368)
6.	To reclassify plant recorded as expense to Acct. No. 360 for costs of pool pumps, motor starter, and clock.	2,265
7.	To reclassify plant recorded as expense to Acct. No. 365 for new sewer line.	1,094
8.	To reflect an averaging adjustment.	(1,680)
9.	To reflect pro forma plant additions to Acct. No. 370 for installing new pumps at lift station.	4,426
10.	To reflect pro forma plant retirement to Acct. No. 370 for installing new pumps at lift station.	(3,320)
	Total	<u>\$6,083</u>
<b>LAND AND LAND RIGHTS</b>		
	To reflect the appropriate land value.	<u>(\$12,955)</u>
<b>ACCUMULATED DEPRECIATION</b>		
1.	To reflect accumulated depreciation per Rule 25-30.140, F.A.C.	(\$6,700)
2.	To reflect averaging adjustment.	957
3.	To retire accumulated depreciation for retired plant.	3,320
4.	To reflect accumulated depreciation for pro forma plant.	(89)
	Total	<u>(\$2,511)</u>
<b>WORKING CAPITAL ALLOWANCE</b>		
	To reflect 1/8 of test year O & M expenses.	<u>\$6,222</u>

S & L UTILITIES, INC. TEST YEAR ENDED 12/31/10 SCHEDULE OF CAPITAL STRUCTURE							SCHEDULE NO. 2 DOCKET NO. 100471-SU	
CAPITAL COMPONENT	PER UTILITY	SPECIFIC ADJUST- MENTS	BALANCE BEFORE PRO RATA ADJUSTMENTS	PRO RATA ADJUST- MENTS	BALANCE PER STAFF	PERCENT OF TOTAL	COST	WEIGHTED COST
1. COMMON STOCK	\$1,000	\$0	\$1,000					
2. RETAINED EARNINGS	<u>37,710</u>	<u>(11,387)</u>	<u>26,323</u>					
TOTAL COMMON EQUITY	\$38,710	(\$11,387)	27,323	(\$11,583)	15,740	57.46%	9.93%	5.71%
LONG TERM DEBT								
3. LTD - SHAMROCK SECURITY SYSTEM	<u>(21,384)</u>	<u>41,614</u>	<u>20,230</u>	<u>(8,576)</u>	<u>11,654</u>	<u>42.54%</u>	5.00%	2.13%
4. TOTAL	<u>\$17,326</u>	<u>\$30,227</u>	<u>\$47,553</u>	<u>(\$20,159)</u>	<u>\$27,394</u>	<u>100.00%</u>		<u>7.83%</u>
RANGE OF REASONABLENESS						<u>LOW</u>	<u>HIGH</u>	
RETURN ON EQUITY						<u>8.93%</u>	<u>10.93%</u>	
OVERALL RATE OF RETURN						<u>7.26%</u>	<u>8.41%</u>	

S & L UTILITIES, INC. TEST YEAR ENDED 12/31/10 SCHEDULE OF WASTEWATER OPERATING INCOME			SCHEDULE NO. 3-A DOCKET NO. 100471-SU		
	TEST YEAR PER UTILITY	STAFF ADJUSTMENTS	STAFF ADJUSTED TEST YEAR	ADJUST. FOR INCREASE	REVENUE REQUIREMENT
1. OPERATING REVENUES	<u>\$35,650</u>	<u>\$4,927</u>	<u>\$40,577</u>	<u>\$19,355</u> 47.70%	<u>\$59,932</u>
OPERATING EXPENSES:					
2. OPERATION & MAINTENANCE	\$27,501	\$22,272	\$49,773	0	\$49,773
3. DEPRECIATION (NET)	0	1,594	1,594	0	1,594
4. AMORTIZATION	0	0	0	0	0
5. TAXES OTHER THAN INCOME	1,697	1,020	2,717	\$71	3,588
6. INCOME TAXES	0	0	0	0	0
7. TOTAL OPERATING EXPENSES	<u>\$29,198</u>	<u>\$24,886</u>	<u>\$54,084</u>	<u>\$871</u>	<u>\$54,955</u>
8. OPERATING INCOME/(LOSS)	<u>\$6,452</u>		<u>(\$13,507)</u>		<u>\$4,977</u>
9. WASTEWATER RATE BASE	<u>\$30,555</u>		<u>\$27,394</u>		<u>\$27,394</u>
10. OPERATING MARGIN*	<u>21.12%</u>		<u>-49.31%</u>		<u>10.00%</u>
(*UTILITY AND STAFF TEST YEAR ARE BASED ON RATE OF RETURN METHOD)					

S & L UTILITIES, INC.		SCHEDULE NO. 3-B
TEST YEAR ENDED 12/31/10		DOCKET NO. 100471-SU
ADJUSTMENTS TO OPERATING INCOME		Page 1 of 2
		WASTEWATER
<b>OPERATING REVENUES</b>		
1. To increase residential revenues based on ERCs and the authorized tariff.	-	\$5,327
2. To remove the Utility's recording of salvage value as income.	-	(400)
Subtotal	-	\$4,927
<b>OPERATION AND MAINTENANCE EXPENSES</b>		
Salaries and Wages - Officers (710)		
a. To reflect the appropriate officer's salary.	-	\$6,240
1. Contractual Services - Professional (631/ 731)		
a. To capitalize plant recorded as expense to Acct No. 360.	-	(\$708)
b. To reclassify plant operator expense to contractual services -- other.	-	(3,680)
	-	<u>\$4,388</u>
2. Contractual Services - Other (636/ 736)		
a. To capitalize plant recorded as expense to Acct. No. 360.	-	(\$1,559)
b. To capitalize plant recorded as expense to Acct. No. 365.	-	(1,093)
c. To reclassify plant operator expense from miscellaneous expense.	-	1,840
d. To reclassify repairs from miscellaneous expense.	-	2,961
e. To reclassify lawn services from miscellaneous expense.	-	650
f. To reclassify plant operator expense from contractual services -- professional.	-	3,680
g. To reflect management fee.	-	14,040
h. To reflect pro forma adjustment for increase operator fee.	-	<u>3,120</u>
	-	<u>\$23,639</u>
3. Rent Expense (640/ 740)		
a. To reflect appropriate office expense.	-	\$1,255
4. Insurance Expenses (655/ 755)		
a. To remove personal homeowner insurance.	-	(\$819)
b. To include commercial Insurance for Utility.	-	<u>2,543</u>
	-	<u>\$1,724</u>
5. Regulatory Expense (665/ 765)		
a. To amortize rate case expense over 4 years (\$328/4).	-	<u>\$82</u>
6. Miscellaneous Expense (675/ 775)		
a. To reflect 5-year amortization of wastewater permit (\$3,505/5).	-	\$701
b. To reclassify plant operator expense to contractual services -- other.	-	(1,840)
c. To reclassify repairs to contractual services -- other.	-	(2,961)
d. To reclassify expense for lawn services to contractual services --other.	-	(650)
e. To reflect correct allocation for Utility phone service.	-	(1,489)
f. To reclassify license fees to taxes other than income.	-	(300)
g. To reflect cost for postage and postcards for billing.	-	<u>260</u>
	-	<u>(\$6,279)</u>
<b>TOTAL OPERATION &amp; MAINTENANCE ADJUSTMENTS</b>		<u>\$22,272</u>
(OPERATING EXPENSES CONTINUED ON NEXT PAGE)		

S & L UTILITIES, INC.		SCHEDULE NO. 3-B
TEST YEAR ENDED 12/31/10		DOCKET NO. 100471-SU
ADJUSTMENTS TO OPERATING INCOME		Page 2 of 2
		<u>WASTEWATER</u>
DEPRECIATION EXPENSE		
To reflect test year depreciation calculated per 25-30.140, F.A.C.		\$1,594
TAXES OTHER THAN INCOME		
1.	To reflect the appropriate RAFs.	\$129
2.	To reclassify license fees from miscellaneous expense.	300
3.	To reflect the appropriate property taxes.	113
4.	To reflect the appropriate payroll taxes.	477
Total		<u>\$1,020</u>

S & L UTILITIES, INC.		SCHEDULE NO. 3-C	
TEST YEAR ENDED 12/31/10		DOCKET NO. 100471-SU	
ANALYSIS OF WASTEWATER OPERATION AND MAINTENANCE EXPENSE			
	TOTAL PER UTILITY	STAFF ADJUST- MENT	TOTAL PER STAFF
(701) SALARIES AND WAGES - EMPLOYEES	\$0	\$0	\$0
(703) SALARIES AND WAGES - OFFICERS	0	6,240	6,240
(704) EMPLOYEE PENSIONS AND BENEFITS	0	0	0
(710) PURCHASED SEWAGE TREATMENT	0	0	0
(711) SLUDGE REMOVAL EXPENSE	1,800	0	1,800
(715) PURCHASED POWER	6,758	0	6,758
(716) FUEL FOR POWER PRODUCTION	105	0	105
(718) CHEMICALS	1,381	0	1,381
(720) MATERIALS AND SUPPLIES	0	0	0
(730) CONTRACTUAL SERVICES - BILLING	0	0	0
(731) CONTRACTUAL SERVICES - PROFESSIONAL	4,748	(4,388)	360
(735) CONTRACTUAL SERVICES - TESTING	0	0	0
(736) CONTRACTUAL SERVICES - OTHER	4,248	23,639	27,887
(740) RENTS	0	1,255	1,255
(750) TRANSPORTATION EXPENSE	0	0	0
(755) INSURANCE EXPENSE	819	1,724	2,542
(765) REGULATORY COMMISSION EXPENSES	0	82	82
(770) BAD DEBT EXPENSE	0	0	0
(775) MISCELLANEOUS EXPENSES	7,642	(6,279)	1,363
	<u>\$27,501</u>	<u>\$22,272</u>	<u>\$49,773</u>

S & L UTILITIES, INC.		SCHEDULE NO. 4	
TEST YEAR ENDED 12/31/10		DOCKET NO. 100471-SU	
MONTHLY WASTEWATER RATES			
	UTILITY'S EXISTING RATES	STAFF RECOMMENDED RATES	MONTHLY RATE REDUCTION
<u>Residential Service</u>			
Flat Rate	\$44.17	\$65.39	\$0.09
-			

S & L UTILITIES, INC.		SCHEDULE NO. 5-A	
TEST YEAR ENDED 12/31/10		DOCKET NO. 100471-SU	
SCHEDULE OF WASTEWATER RATE BASE (PHASE II)			
DESCRIPTION	BALANCE PER UTILITY	STAFF ADJUSTMENTS TO UTIL. BAL.	BALANCE PER STAFF
UTILITY PLANT IN SERVICE	\$158,411	\$55,997	\$214,408
LAND & LAND RIGHTS	0	0	0
NON-USED AND USEFUL COMPONENTS	0	0	0
CIAC	(100,088)	0	(100,088)
ACCUMULATED DEPRECIATION	(137,239)	(965)	(138,204)
AMORTIZATION OF CIAC	100,088	0	100,088
WORKING CAPITAL ALLOWANCE	<u>6,222</u>	0	<u>6,222</u>
WASTEWATER RATE BASE	<u>\$27,394</u>	<u>\$55,032</u>	<u>\$82,425</u>



S & L UTILITIES, INC.		SCHEDULE NO. 5-B
TEST YEAR ENDED 12/31/10		DOCKET NO. 100471-SU
ADJUSTMENTS TO RATE BASE (PHASE II)		
<u>UTILITY PLANT IN SERVICE</u>		<u>WASTEWATER</u>
1.	To reflect pro forma plant addition for blowers to Account No. 380.	\$15,997
2.	To reflect pro forma plant addition to clean pond to Account No. 380.	35,000
3.	To reflect pro forma plant addition to install the video graphing to account No. 389.	<u>5,000</u>
	Total	<u>\$55,997</u>
<u>ACCUMULATED DEPRECIATION</u>		
	To reflect pro forma accumulated depreciation.	<u>(\$965)</u>

S & L UTILITIES, INC. TEST YEAR ENDED 12/31/10 SCHEDULE OF CAPITAL STRUCTURE						SCHEDULE NO. 6 DOCKET NO. 100471-SU		
CAPITAL COMPONENT	PER UTILITY	SPECIFIC ADJUST- MENTS	BALANCE BEFORE PRO RATA ADJUSTMENTS	PRO RATA ADJUST- MENTS	BALANCE PER STAFF	PERCENT OF TOTAL	COST	WEIGHTED COST
1. COMMON STOCK	\$1,000	\$0	\$1,000					
2. RETAINED EARNINGS	<u>37,710</u>	<u>(11,387)</u>	<u>26,323</u>					
TOTAL COMMON EQUITY	\$38,710	(\$11,387)	27,323	(\$5,574)	21,749	26.39%	11.16%	2.94%
LONG TERM DEBT								
3. LTD - SHAMROCK SECURITY SYSTEM	(\$21,384)	\$41,614	\$20,230	(\$4,127)	\$16,103	19.54%	5.00%	0.98%
4. LOAN FOR PRO FORMA PLANT	<u>55,997</u>	<u>0</u>	<u>55,997</u>	<u>(11,424)</u>	<u>44,573</u>	<u>54.08%</u>	<u>6.00%</u>	<u>3.24%</u>
TOTAL LONG TERM DEBT	<u>\$34,613</u>	<u>\$41,614</u>	<u>\$76,227</u>	<u>(\$15,551)</u>	<u>\$60,676</u>	<u>73.61%</u>		
4. TOTAL	<u>\$73,323</u>	<u>\$30,227</u>	<u>\$103,550</u>	<u>(\$21,125)</u>	<u>\$82,425</u>	<u>100.00%</u>		<u>7.17%</u>
RANGE OF REASONABLENESS						<u>LOW</u>	<u>HIGH</u>	
RETURN ON EQUITY						<u>10.16%</u>	<u>12.16%</u>	
OVERALL RATE OF RETURN						<u>6.90%</u>	<u>7.43%</u>	

S & L UTILITIES, INC. TEST YEAR ENDED 12/31/10 SCHEDULE OF WASTEWATER OPERATING INCOME			SCHEDULE NO. 7-A DOCKET NO. 100471-SU		
	TEST YEAR PER UTILITY	STAFF ADJUSTMENTS	STAFF ADJUSTED TEST YEAR	ADJUST. FOR INCREASE	REVENUE REQUIREMENT
1. OPERATING REVENUES	<u>\$59,932</u>	<u>\$0</u>	<u>\$59,932</u>	<u>\$2,997</u> 5.00%	<u>\$62,929</u>
OPERATING EXPENSES:					
2. OPERATION & MAINTENANCE	\$49,773	\$0	\$49,773	0	\$49,773
3. DEPRECIATION (NET)	1,594	1,930	3,523	0	3,523
4. AMORTIZATION	0	0	0	0	0
5. TAXES OTHER THAN INCOME	3,588	0	3,588	135	3,723
6. INCOME TAXES	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
7. TOTAL OPERATING EXPENSES	<u>\$54,955</u>	<u>\$1,930</u>	<u>\$56,885</u>	<u>\$135</u>	<u>\$57,019</u>
8. OPERATING INCOME/(LOSS)	<u>\$4,977</u>		<u>\$3,048</u>		<u>\$5,910</u>
9. WASTEWATER RATE BASE	<u>\$27,394</u>		<u>\$82,425</u>		<u>\$82,425</u>
10. RATE OF RETURN	<u>10.00%</u>		<u>3.70%</u>		<u>7.17%</u>

S & L UTILITIES, INC.	SCHEDULE NO. 7-B
TEST YEAR ENDED 12/31/10	DOCKET NO. 100471-SU
ADJUSTMENTS TO OPERATING INCOME	
DEPRECIATION EXPENSE	
To reflect test year depreciation calculated per 25-30.140, F.A.C.	\$1,930

S & L UTILITIES, INC.		SCHEDULE NO. 8
TEST YEAR ENDED 12/31/10		DOCKET NO. 100471-SU
MONTHLY WASTEWATER RATES (PHASE II)		
	UTILITY'S PHASE I RATE	STAFF RECOMMENDED RATE
<u>Residential Service</u>		
Flat Rate	\$65.39	\$68.68

<sup>[11]</sup> See Order No. 18394, issued November 6, 1987, in Docket No. 870322-SU, *In re: Application of S&L Utilities, Inc. for a staff-assisted rate case in Marion County, Florida.*

<sup>[12]</sup> See Order No. 18394, issued November 6, 1987, in Docket No. 870322-SU, *In re: Application of S&L Utilities, Inc. for a staff-assisted rate case in Marion County, Florida.*

<sup>[13]</sup> See Order No. 18394, p. 5.

<sup>[14]</sup> See Order Nos. PSC-11-0287-PAA-WS, issued July 5, 2011, and PSC-11-0326-CO-WS, issued August 2, 2011, in Docket No. 110006-WS, *In re: Water and Wastewater Industry Annual Reestablishment of Authorized Range of Return on Common Equity for Water and Wastewater Utilities Pursuant to Section 367.081(4)(f), Florida Statutes.*

<sup>[15]</sup> See Order Nos. PSC-10-0124-PAA-WU, issued March 1, 2010, in Docket No. 090244-WU, *In re: Application for staff-assisted rate case in Lake County by TLP Water, Inc.*; PSC-09-0790-PAA-WU, issued November 30, 2009, in Docket No. 090170-WU, *In re: Application for staff-assisted rate case in Lee County by Mobile Manor Water Company, Inc.*; and PSC-93-0011-FOF-WS, issued January 5, 1993, in Docket No. 920397-WS, *In re: Application for staff-assisted rate case in Brevard County by CGD Corporation.*

<sup>[16]</sup> Issued March 13, 1996, in Docket No. 950641-WU, *In re: Application for staff-assisted rate case in Palm Beach County by Lake Osborne Utilities Company, Inc.*

<sup>[17]</sup> See Order No. PSC-97-0130, issued February 10, 1997, in Docket No. 960561-SU, *In re: Application for staff-assisted rate case in Citrus County by Indian Springs Utilities, Inc.*

<sup>[18]</sup> See Order No. PSC-10-0167-PAA-WU, issued March 23, 2010, in Docket No. 090346-WU, *In re: Application for a staff-assisted rate increase in Lake County by Brendenwood Water System.*

<sup>[19]</sup> See Order No. 18394, issued November 6, 1987, in Docket No. 870322-SU, *In re: Application of S&L Utilities, Inc. for a staff-assisted rate case in Marion County, Florida.*

<sup>[110]</sup> See Order Nos. 11033, issued July 27, 1982, in Docket No. 810215-S, *In re: Nu-Age Utility Corporation.*; PSC-08-0646-PAA-SU, issued October 6, 2008, in Docket No. 080079-SU, *In re: Application for certificate to provide wastewater service in Highlands County by Utility Corporation of Florida, Inc.*

<sup>[111]</sup> See Order Nos. PSC-08-0831-PAA-WS, issued December 23, 2008, in Docket No. 070680-WS, *In re: Application for staff-assisted rate case in Pasco County by Orangewood Lakes Services, Inc.*; PSC-97-0531-FOF-WU, issued May 9, 1997, in Docket No. 960444-WU, *In re: Application for rate increase and for increase in service availability charges in Lake County by Lake Utility Services, Inc., at p.20*; PSC-10-0168-PAA-SU, issued March 23, 2010, in Docket No. 090182-SU, *In re: Application for increase in wastewater rates in Pasco County by Ni Florida, LLC*; and PSC-94-0036-FOF-TL, issued January 11, 1994, in Docket No. 930901-TL, *In re: Request for approval of tariff filing to increase service connection charges and establish a non-sufficient funds check charge by Vista-United Telecommunications.*

<sup>[112]</sup> See Order Nos. PSC-10-0168-PAA-SU, issued March 23, 2010, in Docket No. 090182-SU, *In re: Application for increase in wastewater rates in Pasco County by Ni Florida, LLC*; and PSC-08-0228-PAA-WS, issued April 7, 2008, in Docket No. 060602-WS, *In re: Application for certificate to provide wastewater service and to establish new water and wastewater rates in Lee and Charlotte Counties by Town and Country Utilities Company.*

<sup>[113]</sup> See Order No. in Order No. PSC-96-1409-FOF-WU, issued November 20, 1996, in Docket No. 960716-WU, *In re: Application for transfer of Certificate No. 123-W in Lake County from Theodore S. Jansen d/b/a Ravenswood Water System to Crystal River Utilities, Inc.*

<sup>[114]</sup> See Order Nos. PSC-09-0628-PAA-SU, issued September 17, 2009, in Docket No. 080668-SU, *In re: Application for staff-assisted rate case in Highlands County by Fairmount Utilities, The 2nd Inc.*; and PSC-09-0716-PAA-WU, issued October 28, 2009, in Docket No. 090072-WU, *In re: Application for staff-assisted rate case in Polk County by Keen Sales, Rentals and Utilities, Inc.*

## **Appendix C**

WATER/SMW:jrb

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

WATER DIVISION

RESOLUTION NO. W-4524

March 17, 2005

R E S O L U T I O N

(RES. W-4524), ADOPTION OF REVISION TO WATER DIVISION  
STANDARD PRACTICE U-3-SM (SP-U-3-SM) REGARDING  
CALCULATION OF RATE OF RETURN AND RATE OF MARGIN  
(FORMERLY OPERATING RATIO) FOR CLASS C AND D WATER  
UTILITIES.

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BACKGROUND

In Phase I of I.90-11-033, the Risk OII proceeding, this Commission addressed concerns regarding the ability of small investor-owned water utilities to earn their authorized return, pay for day to day expenses, and pay for the improvements necessary to comply with water quality regulations. Based on these economic issues, the Commission was concerned about the small water utilities ability to provide safe and clean drinking water to their customers. In an effort to address specific issues, such as the effect of a small staff running these systems in remote areas and the small water utilities view that the rate process was complicated and time-consuming, this Commission developed alternative methods of regulation to simplify and streamline the regulatory process for Class C and D water utilities.

One of the new methods<sup>1</sup> developed in the OII allowed the small water utilities to earn a greater return than had previously been authorized. In the past, the only way to determine a return for a Class C or D water utility was using a rate of return on rate base. Since some of these small utilities had very little rate base, an alternative method, called the Operating Ratio Method, was put forth and authorized for use by this Commission in addition to the traditional rate of return on rate base. The Commission

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<sup>1</sup> D.92-03-093, pg 27-30, 37-38, 54.

March 17, 2005

ordered the staff to calculate the return for a particular company based on both the rate of return and the rate of margin, choosing the higher of the two results.<sup>2</sup>

It should be noted that the term "Operating Ratio" which was used in the OII is more properly called the "Rate of Margin" method.<sup>3</sup> The Rate of Margin is applied to Operating Expenses to determine a reasonable return.

Each year since then, the staff has developed a range of rates of return based on current data, while the rate of margin used on each rate case varied from as low as 6% to as high as 20%.<sup>4</sup>

## DISCUSSION

In 2004, concerns were raised by this Commission regarding the method for developing a rate of margin for Class C and D water utilities. In particular, the Commission was concerned that no specific method was in place to determine the current Rate of Margin each year.

Responding to this concern, the Water Division has developed a method for determining a current Rate of Margin. This proposed method was distributed to all water utilities for comment in August 2004. Comments were received from the California Water Association (CWA), Garrapata Water, Rio Plaza Water, Nacimientos Water, Peerless Water, and Del Oro Water. The Water Division met with representatives from the water industry to discuss their concerns. After meeting with and considering the comments of the water industry representatives, the Water Division staff revised its proposed Rate of Margin method and provided it to the water industry representatives as well as Commissioners' Advisors for further comment. These comments, as well as those comments received from CWA (dated March 2, 2005)

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<sup>2</sup> D.92-03-093, p.54, Interim Order "8. Branch is directed to calculate rates using both return-on-ratebase and operating ratio methods of ratemaking for Class C and Class D water companies requesting new rates and to recommend to the Commission that rate method that produces the higher result."

<sup>3</sup> The Rate of Margin can be calculated in two ways:

Rate of Margin = Net Operating Revenues/Total Operating Revenues, or

Rate of Margin = 1 - Operating Ratio, where the Operating Ratio = Total Operating Expenses/Total Operating Revenue

<sup>4</sup> This number has been used in numerous cases over the years, but staff has been unable to find justification for this figure.



on the draft of this resolution, have been incorporated into the proposed revisions to Standard Practice SP-U-3-SM<sup>5</sup> attached to this resolution (Attachment A).

The method adopted today to determine the Rate of Margin for Class C and D water utilities is calculated based on a comparison with Class B data. Class B data is used instead of Class A data, because the Class B water operations and financial results are more similar to those of the Class C and D water companies than to the much larger Class A water utilities.

An additional revision to Standard Practice SP-U-3-SM is included in this resolution. It provides a voluntary "sinking fund" type savings account for each Class C and D water utility in order to make funds available in case of emergency as well as provide funds for infrastructure improvement. Many of the smaller water utilities find it difficult to increase their investment in rate base or deal with emergencies. In an effort to alleviate, in part, this lack of sufficient funds, we will give the Class C and Class D companies the opportunity to set aside a portion of the rate of margin return received by the company to be saved as a sort of "sinking fund". This will provide the company with increased retained earnings which will provide them dollars to invest in infrastructure improvement and have available in case of emergencies. In order to insure that the owner of the company receives both a reasonable return on their investment and that continued investment in the company occurs, the rate of margin return each company receives would be divided between these two components.

Since the return portion represents the owners return on investment, those funds can be disposed of at the discretion of the owner. If the company decides to take advantage of this program, the sinking fund portion must be kept in a bank account and separately tracked by the company so that Commission staff can identify it on the books of the company. Each year in its annual report to the Commission, the company would report the total sinking fund dollars accrued in a given calendar year as well as how much was spent and on what.

### COMMENTS

Per statutory requirement, a draft of this resolution was mailed to parties for comments at least 30 days prior to consideration by the Commission.

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<sup>5</sup> SP-U-3-SM is the latest version of the California Public Utilities Commission, Utilities Division, Hydraulic Branch Standard Practice U-3-W, issued April 6, 1965, updated with new Commission instructions and policies developed since that time.

Public Utilities Code section 311(g)(1) provides that this resolution must be served on all parties and subject to at least 30 days public review and comment prior to a vote of the Commission. Section 311(g)(2) provides that this 30-day period may be reduced or waived upon the stipulation of all parties in the proceeding.

The 30-day comment period for the draft of this resolution was neither waived or reduced. Accordingly, the draft resolution was mailed to parties for comments on February 11, 2005, with comments due on March 2, 2005. Comments were received from the California Water Association.

### **FINDINGS**

1. Commission D.92-03-093 in I.90-11-033 ordered the CPUC staff to determine returns for Class C and D water utilities based on both the rate of return method and the operating ratio method, choosing the higher of the two resulting returns.
2. The Operating Ratio Method is more appropriately titled the Rate of Margin Method.
3. The recommended Rate of Return is revised by the Water Division every year to consider more current data. A Rate of Margin of 6% to 20% has been used since D.92-03-093 was issued.
4. In 2004, the Commission voiced concern regarding how the Rate of Margin was calculated.
5. Based on this concern, the Water Division developed a proposed method for determining a Rate of Margin utilizing on current data and requested comments on this proposed method from the water industry.
6. Water Division met with water industry representatives regarding their comments and suggestions.
7. Water Division issued a second proposed methodology for comment to the water industry representatives and Commissioners' Advisors.
8. The proposed method for determining Rate of Margin (Attachment A), is reasonable.

**THEREFORE IT IS ORDERED THAT:**

1. The revised section of SP-U-3-SM is adopted and shall be used by Commission staff as well as Class C and D water utilities in their determination of a return for Class C and Class D water utilities regulated by the Commission.

March 17, 2005

2. This resolution is effective today.

I certify that the foregoing resolution was duly introduced, passed, and adopted at a conference of the Public Utilities Commission of the State of California held on March 17, 2005; the following Commissioners voting favorably thereon:

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STEVEN LARSON  
Executive Director

MICHAEL R. PEEVEY  
President

GEOFFREY F. BROWN  
SUSAN P. KENNEDY  
DIAN M. GRUENEICH  
Commissioners

**ATTACHMENT A**  
**(Page 1 of 5)**

The following is a revision of the instructions for processing Small Water Utility GRC's, in particular the discussion of how to calculate the return for Class C and D water utilities, which appears at pages 16 & 17 of Standard Practice U-3-SM:

**35.Determining a reasonable return for Class C and D Water Utilities:** Commission Decision 92-03-093 states in the ordering paragraphs:

"8. Branch is directed to calculate rates using both return-on-ratebase and operating ratio methods of ratemaking for Class C and Class D water companies requesting new rates and to recommend to the Commission that rate method that produces the higher result."

**36.Rate of Return:** The Audit and Compliance Branch (A&C) of the Water Division (WD) will provide the WD staff analyst with the latest values of allowable Rate of Return (ROR) for Class C and D water companies. A high and low value will be provided which have a range of 50 basis points (one basis point is .01%) such as 13.8% to 14.3%. The WD staff analyst will determine a value from this range based upon his or her best determination of the quality of service the utility is providing. If the utility is doing a better than normal job of meeting the needs of its customers, it should receive a return near the high end of the range. If the utility responds poorly to customer complaints and is not meeting its public utility obligations, it should receive the minimum allowable return. For Class B utilities the Audit and Compliance Branch will determine a utility specific reasonable ROR.

**37.Rate of Margin<sup>6</sup>:** This ratemaking method develops a revenue requirement where little or no rate base exists. The method used to determine an average Rate of Margin is discussed below. The average is then applied to Operating Expenses to determine the estimated dollar return that is then compared with the average dollar ROR on rate base (See paragraph 38 below). The Rate of Margin is determined as follows: Starting in 2005, the A&C Branch of the Water Division will issue a memo in March of each year (at the same time it issues the rate of return memo) that provides recommended average Rates of Margin for Class C and D water utilities to be used by staff. The following is the analysis that the A&C Branch will perform:

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<sup>6</sup> It should be noted that in D.92-03-093, the term "Operating Ratio" was used to describe a particular methodology, when, in fact, the method the Commission described and ordered the use of is more properly call the "Rate of Margin" method. The Rate of Margin being "1 - Operating Ratio"

ATTACHMENT A  
(Page 2 of 5)

- A. Since the Rate of Margin for Class C and D water utilities is an unknown figure, WD must estimate it based on the method discussed below.
- B. To determine the Rates of Margin for Class C and D water utilities, the A&C Branch assumes that there is a comparable relationship between Class B and C Authorized Rates of Return and Class B and C Authorized Rates of Margin (the same comparison is made between Class B and Class D figures) as follows:

$$\frac{\text{Avg Class C Rate of Margin}}{\text{Avg Class B Rate of Margin}} = \frac{\text{Avg Class C Rate of Return}}{\text{Avg Class B Rate of Return}}$$

- C. The Class C and D Rates of Margin are determined based on a comparison with Class B data, rather than Class A data, because the Class B water operations and financial results are more similar to those of the Class C and D water companies than with the much larger Class A water utilities.
- D. The most current average authorized figures are used for the known amounts, which include the average Class C and Class D Rates of Return recommended by Water A&C Branch. The authorized Class B Rates of Return are found in each company's most recent general rate case decision or resolution.
- E. The A&C Branch will then calculate each Class B company's equivalent authorized Rate of Margin. The individual authorized Class B Rates of Margin are calculated based on the operating expense and revenue figures in each company's general rate decision or resolution. Operating expenses include operations and maintenance expenses, annual depreciation on non-contributed facilities, amortization of multiyear expenses and applicable taxes (income taxes, property taxes, taxes other than income, payroll taxes).
- F. The formula shown below is then solved for the unknown component, in this example the average Class C Rate of Margin for the current year:

$$\frac{\text{Avg Class C Rate of Margin}}{\text{Avg Class B Rate of Margin}} = \frac{\text{Avg Class C Rate of Return}}{\text{Avg Class B Rate of Return}}$$

Solve for Avg Class C Rate of Margin, so

$$\text{Avg Class C Rate of Margin} = \frac{(\text{Avg Class C Rate of Return}) * \text{Avg Class B Rate of Margin}}{(\text{Avg Class B Rate of Return})}$$

The same method is then used to determine the Class D Rates of Margin.

**ATTACHMENT A**  
**(Page 3 of 5)**

38. **Determining the recommended return using the Authorized Rate of Return:** The calculation is based on the individual Class C or Class D Company's rate base. The company specific Rate Base is multiplied times the Authorized Rate of Return. The pre-tax rate of return on rate base is then grossed up to provide an after-tax rate of return on rate base.
39. **Determining the recommended return using the Authorized Rate of Margin:** The calculation is based on the individual Class C or Class D Company's operating expenses. Operating expenses shall include operations and maintenance expenses, annual depreciation on non-contributed facilities, amortization of multi-year expenses and applicable taxes (income taxes are excluded from the calculation). Applicable taxes include property taxes, taxes other than income and payroll taxes. Total operating expenses are then multiplied by the Authorized Rate of Margin to determine the recommended pre-tax return under the Rate of Margin method. The pre-tax rate of margin is then grossed up to provide an after-tax rate of margin.
40. **Determining the recommended return after comparing the results from the Rate of Return and Rate of Margin calculations:** The grossed up dollar amount returns based on the average Rates of Return on Rate Base for Class C and Class D companies and the average dollar amount returns based on the Rates of Margin for Class C and Class D companies are then compared, choosing the higher one (per D.92-03-093). In the resulting Commission resolution there shall be a summary of earnings that shows both the rate of margin and the rate of return on rate base.
41. **Determining the amount of the Voluntary Profit and Sinking Fund:** The Rate of Margin method is normally chosen to determine the recommended return because it more appropriately reflects a utility's opportunity to earn a reasonable rate of return when the company has minimal rate base. Many of the smaller companies find it difficult to increase their investment in rate base or deal with emergencies. In an effort to alleviate, in part, this lack of sufficient funds, we offer the Class C and Class D companies the opportunity to set aside a portion of the return received by the company to be saved in a type of "sinking fund" or "reserve" in order to provide the company with increased retained earnings which will provide them dollars to invest in infrastructure improvement and have available in case of emergencies. In order to insure that the owner of the company receives both a reasonable return on their investment (profit) and that continued investment in the company occurs (sinking fund/reserve), the following method will be followed by each company on a voluntary basis, to determine the profit and sinking fund/reserve portion of the dollars received.

**ATTACHMENT A**  
**(Page 4 of 5)**

- A. If the Return on Rate Base is greater than the Return on Margin, then the company receives the Return on Rate Base.
- B. If the Return on Margin is greater than the Return on Rate Base, the profit and sinking fund/reserve are calculated as follows:
  - a. Profit Portion = Return on rate base
  - b. Sinking Fund/Reserve Portion = (Rate of Margin \* Operating Expenses) - Return on rate base
- C. Since the Profit Portion represents the owners return on investment, those funds can be disposed of at the discretion of the owner.
- D. The Sinking Fund/Reserve portion must be kept in a bank account and separately tracked by the company so that Commission staff can identify it on the books of the company.
- E. Each year in its annual report to the Commission, the company will report the total sinking fund/reserve dollars accrued in a given calendar year as well as how much was spent and on what.



**ATTACHMENT A**  
**(Page 5 of 5)**

Calculation of Rate of Margin for Class C and D Water Utilities in 2005				
Class B Water Utilities	Decision	Authorized Rate of Return	Equivalent Operating Ratio	Equivalent Rate of Margin (1 - Operating Ratio)
Class B Water Utilities				
East Pasadena	W-4239	10.75%	83.0%	17.0%
Country Estates	W-4301	13.60%	78.9%	21.1%
Ferndale	W-4360	9.84%	76.1%	23.9%
Magalia	W-4442	8.53%	76.2%	23.8%
Paradise Pines	W-4333	9.97%	85.2%	14.8%
Average		10.54%		20.12%
Class C ROR - Average		12.15%		
Class D ROR - Average		12.90%		
Rate of Margin Calculation:				
Average Class C Rate of Margin				23.20%
Average Class D Rate of Margin				24.63%
Example:				
$\frac{\text{Avg Class C ROM}}{\text{Avg Class B ROM}} = \frac{\text{Avg Class C ROR}}{\text{Avg Class B ROR}} = \frac{\text{Class C ROM}}{20.12\%} = \frac{12.15\%}{10.54\%}$				
If we solve this formula for the unknown, Avg Class C ROM, the Calculation is as follows:				
$\text{Avg Class C ROM} = \text{Avg Class B ROM} * (\text{Avg Class C ROR} / \text{Avg Class B ROR})$				
$X = 20.12\% * (12.15\% / 10.54\%) = 23.20\%$				

(End of ATTACHMENT A)

# Appendix D

Berry's Chapel Utility Inc.  
Summary of Revenue Requirement  
For the Attrition Year July 2014-June 2015  
TRA Docket

Rev. Req. Summary

	Test Year 2013	Normalizing Adjustments	Normalized 2013	Attrition Year Adjustments	Attrition Year Amounts
<b><u>Revenues</u></b>					
Residential Revenue	\$ 370,917.63	\$ 13,521.00	\$ 384,438.63	\$ 35,260.02	\$ 419,698.65
Facility Charge Revenue	(147,831.67)	147,831.67	-	-	-
Base Charge Revenue	457,826.79	(151,676.79)	306,150.00	-	306,150.00
Penalty Charge Revenue	2,325.09	-	2,325.09	3,179.26	5,504.35
Application Fee Revenue	-	-	-	3,700.00	3,700.00
Reconnection Fee Revenue	-	-	-	100.00	100.00
Disconnect Fee Revenue	-	-	-	-	-
Non-Residential Revenue	7,669.04	-	7,669.04	-	7,669.04
Non-Residential Base Charge Revenue	720.00	-	720.00	-	720.00
Tap Fees	34,750.00	(34,750.00)	7,000.00	-	7,000.00
Other Miscellaneous Fees	4,765.15	(3,500.00)	1,265.15	500.00	1,765.15
Refunds Due Customers	29,463.02	5,797.00	35,260.02	\$ (35,260.02)	-
<b><u>Total Revenues</u></b>	<b>\$ 760,605.05</b>	<b>\$ (22,777.12)</b>	<b>\$ 744,827.93</b>	<b>\$ 7,479.26</b>	<b>\$ 752,307.19</b>
<b><u>Operating Expenses</u></b>					
Payroll Expense	-	-	-	-	-
Purchased Water	7,616.50	-	7,616.50	-	7,616.50
Sludge Removal	47,776.05	(2,499.43)	45,276.62	-	45,276.62
Electricity	58,878.57	-	58,878.57	-	58,878.57
Chemicals	50,653.15	(8,089.12)	42,564.03	-	42,564.03
Office Supplies	20,601.82	(862.54)	19,739.28	7,086.00	26,825.28
Professional Fees	128,001.42	(37,157.02)	90,844.40	23,728.84	114,573.24
Customer Accounting	86,441.48	(1,120.00)	85,321.48	7,885.32	93,206.80
Billing & Collections	27,374.52	-	27,374.52	(22,125.57)	5,248.95
Operations	164,340.40	(3,010.46)	161,329.94	24,326.68	185,656.62
Administrative	14,350.30	(5,000.30)	9,350.00	850.00	10,200.00
Regulatory Expense	190,434.44	(170,648.44)	19,786.00	(7,950.00)	11,836.00
Rate Case Expense	30,092.01	1,911.99	32,004.00	2,656.33	34,660.33
Insurance	33,416.66	(2,512.25)	30,904.41	-	30,904.41
Injuries & Damages	(900.00)	900.00	-	-	-
Depreciation Expense	216,946.60	(48,699.00)	168,247.60	(36,399.60)	131,848.00
Miscellaneous Expense	5,743.39	(211.22)	5,532.17	-	5,532.17
<b><u>Total Operating Expenses</u></b>	<b>1,081,767.31</b>	<b>(276,997.79)</b>	<b>804,769.52</b>	<b>58.01</b>	<b>804,827.53</b>
<b><u>Taxes Other than Income Taxes</u></b>					
Property Taxes	27,000.00	-	27,000.00	(4,700)	22,300.00
Franchise Taxes	12,000.00	-	12,000.00	(10,395.82)	1,604.18
Other Taxes	2,916.62	(2,916.62)	-	-	-
Payroll Taxes	2,334.28	6,853.34	9,187.62	2,205.40	11,393.02
<b><u>Change in Accounting Estimate</u></b>	<b>72,440.85</b>	<b>(72,440.85)</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b><u>Net Operating Income</u></b>	<b>\$ (437,854.01)</b>	<b>\$ 322,724.80</b>	<b>\$ (108,129.21)</b>	<b>\$ 20,311.67</b>	<b>\$ (87,817.54)</b>