

MEMORANDUM

TO: Jim Russo
Case Coordinator

THROUGH: Cary Featherstone
Auditing Department Staff

CC: Jaime Ott
Staff Counsel

FROM: Bret Prenger/Bill Harris
Auditing Department Staff

SUBJECT: Auditing Department's Findings
Case No. SR-2010-0320
Timber Creek Sewer Company

DATE: August 2, 2010

BACKGROUND

The Timber Creek Sewer Company (Timber Creek or Company) filed informally for a small sewer utility rate increase of approximately \$63,500 on May 10, 2010.

The Auditing Department subsequently conducted an audit using a 12-month test year ending December 31, 2009, with an update period ending June 30, 2010. On June 30, the Company was serving 1,526 residential customers. At the time of the Company's prior rate filing in Case No. SR-2008-0080, the Company was serving approximately 1,192 residential customers. The Company filed its original certificated case in Case No. SA-95-110, when it was serving only 47 customers. The substantial customer growth over this period has required the Company to make capital investments in major plant additions resulting in the subsequent rate cases. Timber Creek indicated the primary drivers behind the filing of this rate case (Case No. SR-2010-0320) were to offset an increase in the yearly PSC Assessment and to offset increases in electric utility rates.

There were a few significant plant additions in the years 2008 and 2009 leading into this rate case filing. In 2008, the Company had a major plant addition, the remodeling of the interior of the office building. Those capital additions carried over into 2009, where the Company continued to improve the plant and office areas. The 2009 capital plant additions were as follows: the installation of an irrigation system; the installation of a retaining wall to protect the office building's foundation; an addition to the treatment plant; the extension of sewer main to Johnson Ridge; the purchase of additional grinder pumps; and the purchase of a Company truck.

The Company serves three separate sewer systems: the largest sewer system is in Platte County and has approximately 1,499 customers; Timber Creek also serves two smaller sub-divisions in Clay County each with its own stand-alone sewer systems, serving 27 customers collectively.

Timber Creek recently expanded its certificate area in Case No. SA-2010-0063 approved by the Commission on April 21, 2010 with an effective date of May 3, 2010. This expansion is expected to increase the future customer count for Timber Creek. None of this expansion of the Company is included in this rate case.

The Auditing Staff is recommending a rate increase that would result in an additional revenue requirement of \$22,122 as outlined below for the Platte and Clay counties sewer systems.

RATE BASE

As of June 30, 2010, the Staff determined that the Company's total net plant in service was \$2,277,514 and the net contributions-in-aid-of-construction (CIAC) was \$2,090,620. Since CIAC-related plant is not financed by the Company's investors, ratepayers should not be required to pay a return on it. Accordingly, the Staff used the CIAC amount as an offset (reduction to) in the rate base calculation resulting in a net original cost rate base of \$186,894 (\$2,277,514 - 2,090,620).

CIAC for Timber Creek is derived from the service connection fees charged by the Company. Currently, the Company has approved Commission tariffed rates for these service connection fees at \$2,650 for the Platte County customers. However, per the stipulation and agreement filed in Case No. SR-2008-0080, Timber Creek customer, Hunt Midwest, maintains a Commission approved connection fee of \$1,600. The service connection fee is charged to each customer who connects to the Platte County sewer system for initial service. The customers in the two sub-divisions in Clay County, which represents approximately 27 residential customers as of June 30, 2010, were not charged a service connection fee.

CAPITAL STRUCTURE

The Company's capital structure consisted of \$46,724 of common equity and \$140,171 of long-term debt. Staff (Shana Atkinson of the Financial Analysis Department) calculated a rate of return of 7.67 percent with a weighted-cost-of-debt of 6.53 percent.

DEPRECIATION

Staff member Arthur Rice of the Commission's Engineering and Management Services Department provided the recommended depreciation rates to be submitted for approval by the Commission and be used on an on-going basis. The Audit Staff has applied those rates to the individual plant in service accounts in this case, pending Commission approval.

The Auditing Staff calculated the amortization of CIAC as an offset to depreciation expense. Since CIAC-related plant is not financed by the Company's investors and is removed from the calculation of net rate base, it must also be removed from the calculation of depreciation expense. The Staff's Accounting Schedule model automatically calculates depreciation expense on all plant-in-service including the portion relating to contributed plant--the CIAC amount of rate base. Thus, it was necessary for the Staff to calculate the amortization of CIAC and make an adjustment to offset depreciation expense. This adjustment removes the portion of CIAC plant calculated as depreciation in the revenue requirement model. Adjustment E-204 reflects the difference between Staff's annualized CIAC amortization expense and the 2009 per book depreciation expense.

PLANT

Timber Creek has incurred substantial growth since its initial certification, Case No. SA-95-110. As result of the increased customer levels and corresponding growth in revenues, the class size of the sewer company has changed according to the Uniform System of Accounts (USOA) guidelines. Timber Creek was considered a Class D sewer company but the increase in the size of the Company the Company has moved to an "A" Company. This change results in the Company having use of a more detailed description of plant-in-service accounts. Staff decided to revise Company accounts and titles to be in accordance with USOA requirements for class "A" sewer utilities. The new USOA accounts Staff utilized in this case were:

- Account 371: Structures and Improvements at a recommended annual depreciation rate of 3.3%
- Account 390: Structures and Improvements at a recommended annual depreciation rate of 2.5%
- Account 391.1 Office Electronic and Computer Equipment at a recommended annual depreciation rate of 14.3%
- Account 397: Communication Equipment at a recommended annual depreciation rate of 6.7%

With additional input from Company Management, Staff determined the amounts of plant to reclassify to the new accounts. Staff also made one plant adjustment, adjustment P-20, to include two formerly-expensed control panels in the plant balance so that they could also be depreciated over time.

REVENUES

Staff annualized revenues based on the current June 30, 2010 customer levels of 1,499 for the Platte County Service area at the current monthly charge of \$34.74 and the \$26.97 rate for the 27 Clay County Customers. Adjustment Rev-5 reflects the difference between Staff's annualized revenues and the 2009 test year per book revenues.

EXPENSES

Miscellaneous

The Staff has made several adjustments to annualize various expenses that the Company has provided updated information on. The adjustments include:

- Annualization of lab testing (E-94)
- Annualization of ground maintenance (E-121)
- Annualization of postage expenses (E-168)
- Reflect most current PSC Assessment (E-169)
- Remove payroll taxes from salary expense (E-175.1)
- Include a 3% cost-of-living increase to salaries (E-175.2)
- Reduction of meal expenses deemed excessive by Staff and adjustment to 50% in accordance with IRS guidelines for meal/travel expenses (E-179.1 and E-179.2)
- Board Member compensation annualization (E-185)
- Increase in health care premiums (E-190)
- Increase in electric utility rates (E-191)
- Increase in wireless expenses (E-192)
- Increase in water rates (E-197)
- Remove CIAC related depreciation expense (E-204)
- Annualize payroll taxes (E-210)
- Showcase payroll taxes reflecting the 3% cost-of-living increase (E-210.2)

Payroll Expense

The Company has four full-time employees (FTEs) dedicated exclusively to the Platte County sewer system and the two stand-alone sewer sub-divisions in Clay County. The General Manager, Derek Sherry, is responsible for the general management oversight for the day-to-day operations of the Company as well as:

General Manager

- Mr. Sherry is one of the owners of the Company and on the Board of Directors
- Interface with customers of the Company
- Acquiring necessary financial needs to operate the sewer system (Oversight on annual revenue and expense budget, develop capital improvement plan, secure funding)
- The Company contact with Commission Staff personnel
- Supervisory responsibility of all other Timber Creek personnel
- Set guidelines for policies and practices regarding customer service issues

- Promote company growth by exploring business development opportunities (New service area possibilities and possible revenue generation ideas)
- Oversight on effective plant operations and maintenance
- Oversight on engineering and construction principles and practices
- Ensure good standing between all regulatory entities, not just the MPSC

Timber Creek also has an Operations Manager (Jeffry Jochim) (who has Class A operator's license), an Office Manager (Emma Farris) and a Systems Operator (Steven Smiley) (who has Class B operator's license). The Operations Manager is responsible for providing operations duties and activities to maintain the sewer systems for the Company's Platte County and Clay County operations. The Systems Operator also works with the Operations Manager to ensure Timber Creek's sewer system has 24-hour, seven days a week coverage of the sewer operations. Other duties and tasks for the Operations Manager and Systems Operator include:

Operations Manager

- Ensure effective plant operations, collection system operations, and maintenance by meeting DNR rules and regulations and company direction for operating sanitary sewer facilities including pump stations, collections systems, and solids processing and disposal
- Assure sound construction principles and practices (Enforcement of company standard engineering and construction specifications for treatment plant, pump stations, and collection systems design and construction, Review submitted engineering plans and as-builts for compliance with company specifications, Perform on-site inspections and diligently record and document issues or concerns and communicate with accountable party for timely resolution, Repairs) Provide professional customer service
- Assist in keeping the company in good standing with regulatory agencies
- Assist in company administration by providing budgetary and personnel oversight

Systems Operator

- Ensure effective plant operations, collection system operations, and maintenance by meeting DNR rules and regulations and company direction for operating sanitary sewer facilities including pump stations, collections systems, and solids processing and disposal (Perform plant operations duties for effective utilization of resources while meeting or exceeding water quality permit standards for treatment plant effluent, Take and transport routine, scheduled samples for lab testing and analysis in accordance with prescribed timelines, parameters, and guidelines, Monitor and record daily flows and other plant parameters to ensure effective water treatment is operating within design thresholds, Appropriately respond and take necessary steps and actions to correct any anomalies discovered during plant operations in accordance with company guidelines and as directed by the operations manager, Perform solids management by monitoring sludge levels, reporting, complete dewatering, transporting, and applying solids in accordance

with state regulations and company direction, Perform routine lift station inspections and record necessary monitoring data and observations to ensure lift stations are operating within design parameters. Take necessary actions to correct deficiencies as outlined by company direction, Perform routine manhole and sewer line inspections and record necessary observations to ensure infrastructure is sound and operating within guidelines. Take necessary actions to correct deficiencies as outlined by company direction, Ensure buildings, grounds, and related equipment are presentable and professionally maintained and in good working order. Complete routine maintenance as scheduled and as needed)

- Assure sound construction principles and practices
- Provide professional customer service

Office Manager

The Office Manager, Emma Farris, is responsible for the book keeping of the Company's accounting records. Ms. Farris is also responsible for the following responsibilities:

- Manages company general office administration by completing accounts payable, payroll, office surroundings, and office supplies
- Manages company account receivables, credits, and collections activities
- Provide exceptional customer service
- Ensure accurate, timely, and complete customer billing
- Assist in effective plant operations and maintenance by providing support functions

Staff reviewed the Company's current level of payroll expense, which is based on the level established in the Company last rate case-- Case No. SR-2008-0080. The payroll level included in the revenue requirement calculation for Case. No. SR-2010-0320 was based on existing salary levels and also contains an additional 3% raise to represent a cost-of-living increase. This 3% payroll increase is conditioned upon the Company actually authorizing such an increase for existing employees.

Staff obtained additional documentation to support its decision that the current payroll levels are reasonable based on the location and size of the Company. Staff considered utility salaries and wages paid to other Missouri water and sewer companies which had recently completed rate cases. Also documentation provided by the Company was reviewed which allowed a comparison of the Timber Creek's General Manager salary and benefits with the salary levels for the County Sewer District's regional manager. The Company provided information for salaries of similar job positions currently employed by Timber Creek (This information includes charts for salaries based upon 2008 calendar year). Staff also examined the Missouri Economic Research and Information Center (MERIC) salary summary chart, (based on 2007) to substantiate the salary levels of the Company's salary compensation levels. When viewing the MERIC survey, Staff compared similar or like positions with those of Timber Creek ranging from executive assistant (Ms. Farris), multiple management positions (Mr. Sherry), and multiple maintenance, grounds work, and construction jobs (Mr. Jochim and Mr. Smiley). Staff

concluded that the salary levels paid to Timber Creek employees are conservatively priced in relationship to salaries paid for other similar positions for other entities. An example of the survey viewed would be the following:

- Management Occupations (Kansas City region for General Manager position), Median Annual Salary \$94,529
- Executive Secretary/Admin. Assistant (Office Manager position), Mean Annual Salary \$41,142
- The system operator information identified a mean salary level of \$49,290. The salary level paid to Timber Creek's system operator is a conservative level compared to information reviewed
- The plant operations manager is paid more than the mean of the salary shown in the survey but given all of his duties and responsibilities, Staff considered this salary level to be reasonable. Mr. Jochim is actually considered a "plant manager" but no specific salary base was available for an exact comparison.

Based on this additional documentation, Staff believes it is appropriate to include a modest 3% cost-of-living increase in this case conditioned on the increase being granted to Timber Creek's employees.

AUDITING DEPARTMENT STAFF RECOMMENDATION

For the reasons outlined above, the Auditing Staff is recommending a rate increase that would result in an additional revenue requirement of \$22,122.

- 1) The Auditing Staff recommends Timber Creek Sewer Company keep a detailed time log, identifying the amount of time each employee spends working on activities strictly related to the regulated sewer utility company. This recommendation would aid Staff in future payroll analysis and discussions.
- 2) The Auditing Staff recommends that Timber Creek Sewer Company keep a detailed list of invoices regarding future purchases within the USOA Accounts for Laboratory Equipment and Tools, Shop Equipment etc. Following this recommendation would allow the Staff to provide the Commission with a more accurate plant number, which would then result in a better depiction of the "true" Rate Base dollar amount.
- 3) Timber Creek Sewer Company is to maintain its financial and accounting records using the Uniform System of Accounts (USOA) guidelines for a Class A sewer company, for its revenues, expenses, and investment costs.
- 4) The Auditing Staff recommends Timber Creek employees receive a 3% salary increase over existing salary levels conditioned upon this increase actually

being authorized and granted to the each employee.