

**MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION  
BEFORE THE PUBLIC SERVICE COMMISSION**

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**Operating Ratio Methodology Instructions**

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Introduction

These instructions apply to the Small Water Operating Ratio Methodology spreadsheet available online at the Commission’s website. They provide a step-by-step process for determining a utility’s operating ratio. If you have any questions or concerns with this process, please contact the Commission. We are here to assist in any manner possible.

In 2014, the Commission adopted two simplified regulatory treatment options for small water and sewer utilities.<sup>1</sup> One of these options, the Operating Ratio Methodology, permits a utility to establish tariffs (i.e. rates) based on prudently incurred operating expenses. The total revenue requirement (target revenue to be recovered through rates on an annual basis) is predicated on the notion that the utility will be allowed to earn total revenues equal to 125% of these expenses as long as they are “reasonable and legitimate.”<sup>2</sup> (Follow and complete Mont. Admin. Rules stated in the footnote).

In order to file an application pursuant to this methodology please fill out the Operating Ratio Methodology spreadsheet (found on the PSC website) along with the following additional documents: respective federal and Montana tax statements; employee W-2’s; mileage logs for transportation expenses; copies of contracts related to expenses or revenues; most current Public Water Supply Monitoring Schedule from the Montana Departmental Quality. Additionally, be able to provide the following if requested: copies of invoices for all expenses that recovery is requested; a general ledger showing all transactions for the period, related to your application; and check register and cancelled checks.

Instructions

The operating ratio methodology involves four steps. First, the utility lists its operating expenses, categorized as either normal or related party expenses to establish the utility’s Revenue Requirement.<sup>3</sup> Second, the utility lists its Total Revenue received from each customer class. Third, the utility’s Total Revenue is subtracted from its Revenue Requirement to determine whether rates need to be revised: if the difference is positive, a net rate increase is necessary; if the difference is

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<sup>1</sup> See Mont. Admin. R(s). 38.5.2526 through .2532.

<sup>2</sup> See Mont. Admin. R. 38.5.2529.

<sup>3</sup> *Id.* 38.5.25.29(2). Utilities can recover dollar-for-dollar costs associated with most related party expenses, while a 25% is permitted above costs for normal expenses and certain related party expenses.

negative, a net rate decrease is necessary.<sup>1</sup> Finally, rates are designed to allow the utility to recover the product of the expense-to-revenue operating ratio.

If a utility's actual revenues or expenses differ from the figures included in the applicable annual reports (see pages 4, 6), the utility may request the Commission to consider the corrected figures in determining its revenue requirement. The request must: 1) include the corrected amount; 2) explain the circumstances which led to the difference; and 3) substantiate the corrected amount (i.e., invoices, etc.). The Commission will decide whether to include the corrected amounts based on the facts and circumstances of each request.

It is important to note that each step of the Operating Ratio Methodology is subject to scrutiny by the Public Service Commission, Montana Consumer Counsel, or other interested parties. However, the ORM is intended to streamline the ratemaking process and corresponding administrative burden.

### *Expenses*

Utilities must provide normal and related party expenses from the past three years to determine their total revenue requirement. Normal expenses are those incurred at an 'arms-length' with unrelated parties. Expenses are averaged over a three year period, with normal expenses and market-rate related party expenses receiving a 25% return above cost, and related party non-market rate expenses may receive only dollar-for-dollar cost recovery.

Any expenses associated with a related party is a related party expense. Related parties include: family members (including brothers, sisters, spouses, ancestors, lineal descendants, half-brothers, half-sisters, in-laws, and step relations); taxpayer and a corporation controlled directly or indirectly by the taxpayer; a partner and a controlled partnership; a trust and its grantor; a trust and its beneficiary; a personal services company and any shareholder-employee.<sup>2</sup> It is important to note that related-party, non-market rate transactions are likely to receive extra scrutiny—requiring substantiation—in the application process, and may be disallowed altogether. Accordingly, best practices suggest payment of market rates in all circumstances.

When listing normal expenses, record the total expenses for each account for the respective year. To aid in proper recording of expenses, descriptions of each account can be found below. The spreadsheet will automatically average the expenses over three years, and apply the Commission approved 25% profit on qualified expenses.

When listing related party expenses, record the total expenses amount for each account for the respective year. If the expense was incurred at a market rate, indicate 'Yes' Column M. If you are unable to substantiate that market rates were paid, indicate 'No' in Column M. The spreadsheet will automatically average and sum the expenses over three years, and apply either the Commission approved 25% return above cost for market rate related party expenses, or dollar-for-

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<sup>1</sup> *Id.*

<sup>2</sup> Examples of related parties can be found in 26 U.S.C. § 267(b). See IRS Publication [542](#) and [544](#) for more detailed explanations.

dollar recovery of related party expenses that are not market rate. If you list a related party expense as a market rate, you shall provide supporting evidence that the expense aligns with industry standards. Please see the definitions for each expense account below to determine examples for industry standards of market rates.

The spreadsheet will automatically sum the sub-totaled expenses for each account, and produce your revenue requirement, found in B:31. This amount represents your total revenue requirement, and will automatically populate to I:42 in the Operating Ratio Methodology Summary.

The listed expense accounts are drawn directly from your annual reports, on file with the Commission. The expense accounts listed in A4:A30 generally follow the Water Operation and Maintenance Expense Accounts found in the 1996 NARUC Uniform System of Accounts for Water Utilities.<sup>3</sup> The definitions for each expense account, and examples of industry standards for determining the market rate of a related party expense, include:

- Salaries and Wages - Employee (601). This account shall include the compensation (salaries bonuses and other consideration of services) paid or accrued to employees of the utility company for work related to operation and maintenance of that utility company. This account shall not include the salaries and wages of officer, directors or majority stockholders of the utility company.
- Salaries and Wages - Officers, Directors and Majority Stockholders (603). This account shall include the compensation (salaries, bonuses and other consideration for services) paid or accrued to officers, directors or majority stockholders of the utility company.
- Purchased Water (610). (A) This account shall include the cost at the point of delivery of water purchased for resale. (B) The records supporting this account shall be so kept as to show for each supplier from which water is purchased, point of delivery, quantity purchased, basis of charges, and the cost of water purchased.
- Purchased Power (615). This account shall include the cost of all electric power expense incurred to operate the utility.
- Fuel for Power Production (616). This account shall include the cost of fuel used in the production of power to operate the pumps. Records shall be maintained to show the quantity and the cost of each type of fuel used.
- Chemicals (618). This account shall include the cost of all chemicals used in the treatment of water. Include also the cost (except salaries and wages includible in accounts 600 - 603) of any chemicals manufactured by the utility and used to provide water services to its customers.
- Materials and Supplies (620). This account shall include all materials and supplies used in operation and maintenance of the water system, other than materials and supplies charged to Contractual Services Accounts.
- Contractual Services - Engineering (631). This account shall include costs paid to outside engineers or engineering firms to perform ongoing, recurring work for the utility. Engineering

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<sup>3</sup> Available online here: <https://www.utc.wa.gov/regulatedIndustries/utilities/Documents/Water%20-%20NARUC%20COA%20A-B.pdf>

services for plant items are properly includible in the appropriate plant account. Engineering services for rate relief filings shall be included in account 667 - Regulatory Expense – Other.

- Contractual Services - Accounting (632). This account shall include costs paid to outside accounting companies to maintain or audit the books and records of the utility. Accounting expenses for rate relief filings shall be included in account 667 - Regulatory Expense – Other.
- Contractual Services - Legal (633). This account shall include costs paid to outside legal firms to perform legal services for the utility. Legal services for rate proceedings before the Commission shall be included in account 667 - Regulatory Expense – Other.
- Contractual Services - Management Fees (634). This account shall include contractual costs (other than those properly included in accounts 600 - 603 - Salaries and Wages) paid for the performance of management functions.
- Contractual Services - Water Testing (635). This account shall include costs paid to outside laboratories for testing.
- Contractual Services - Other (636). This account shall include those operations' costs contracted for which are not included in accounts 631, 632, 633, 634, or 635.
- Meter Reading Services.
- Repairs and Maintenance. Costs to maintain an asset in its normal state of repair are considered ordinary repairs and replacements. Such items are reported as operating expenses and are not capitalized. Examples include: replacement or repair of floor covering or roofs, reconditioning by replacing small parts, painting, or regular maintenance costs. NOTE: Costs to replace an existing asset, or asset portion, with an improved or superior asset, usually at a cost materially in excess of the replaced item as well as major repairs and replacements made, not to keep an asset in its normal state of repair, but to extend its useful life beyond that originally estimated are considered improvements. Improvements are considered capital outlay and are not to be included in this total.
- Building/Property Rent (641). This account shall include costs associated with the rental of buildings and/or real property that are properly treated as period costs.
- Equipment Rental (642). This account shall include costs associated with the rental of equipment, except vehicles, used in the operation of the utility. Vehicle rentals and leases are properly included in account 650 - Transportation Expenses.
- Transportation Expense (650). This account shall include all truck, automobile, construction equipment, and other vehicle expense chargeable to utility operations, except depreciation and insurance.
- Insurance (656-659). This account shall include costs associated with: insurance of automobile and trucks used for utility purposes; general liability coverage of the utility; insurance costs associated with workers' compensation coverage for employees of the utility; and other insurance costs associated with coverage of the utility.
- Regulatory Expense - Other (667). This account shall include all expenses (except salaries of regular utility employees) incurred by the utility in connection with formal cases before regulatory commissions, except for rate case expenses which are accounted for as described above. This account shall not include payment of taxes which shall be reported in the Taxes Other Than Income accounts.

- Water Resource Conservation Expense (668). (A) This account shall include costs incurred to promote conservation efforts within a utility's service area. This account shall also include any amounts charged by governmental entities for conservation purposes. (B) This account shall include amounts required by a regulatory authority to be paid to other utility systems, such as wastewater systems to defray the costs of the wastewater utility in supplying reclaimed water for reuse purposes.
- Bad Debt Expense (670). This account shall be charged with amounts sufficient to provide for losses from uncollectible utility revenues.
- Miscellaneous Expenses (675). This account shall include all expenses not includible in other operating expense accounts. Items 1. Industry association dues for company memberships. 2. Contributions for conventions and meetings of the industry. 3. Communication service not chargeable to other accounts. 4. Trustee, registrar, and transfer agent fees and expenses. 5. Stockholders meeting expenses. 6. Dividend and other financial notices. 7. Printing and mailing dividend checks. 8. Directors' fees and expenses. 9. Publishing and distributing annual reports to stockholders. 10. Public notices of financial, operating and other data required by regulatory statutes, not including, however, notices required in connection with security issues or acquisition of property. 11. Write off of expenditures for preliminary surveys, plans, investigations, etc., included in account 183 - Preliminary Survey and Investigation on Charges, relative to projects that have been abandoned.
- Property Taxes. This account shall include ad valorem taxes related to utility property.
- Other Taxes & Fees (Permits, Bank Fees). This account shall include all other taxes and fees related to utility operating expenses not properly accounted for elsewhere.

*Revenue*

Utilities must provide revenue for each customer class from the previous three years, as found within your annual report for the respective year. The spreadsheet will automatically sum the totaled revenue from each account, and produce your total revenue, found in B:47. This amount represents your total revenue, and will automatically populate to I:43 in the Operating Ratio Methodology Summary.

The definitions for each customer class include:

- Metered Revenue.
  - Residential, Commercial, and Industrial Customer Classes. Include the net billing for measured water supplied for residential, commercial or industrial (except irrigation) purposes where the total charge is, or may be, in any way dependent on the quantity of water delivered. Records shall be maintained so that the quantity of water sold, and amount of revenue for each customer class are readily available.
  - Fire Protection Revenue. Include all revenue from public agencies and others for hydrant charges, private fire protection service, street sprinkling, sewer flushing, and similar sources.
  - Bulk Sales
  - Sale of Materials

- Other. Include revenue received from developers or other persons for a period of time prior to water service being established. Normally, this type of revenue is usually received to reserve or guarantee the availability of plant capacity when needed. This also includes revenues derived from water operations not includable in any of the preceding accounts. This would include but is not limited to NSF charges, reconnect fees, and late fees charged to customers. If there are other revenue sources, please list.
- Unmetered Revenue. Include the net billing for water supplied for residential, commercial and industrial purposes (except irrigation) where the charge is not dependent in any way on the quantity of water delivered but is based on diameter of service pipe, room, foot of frontage or other similar unit. Records shall be maintained so that the estimated quantity of water sold, and amount of revenue for each customer class are readily available.

### *Summary*

The spreadsheet will automatically populate the revenue, expenses, and usage totals, and determine your Operating Ratio in I:45. If your Revenue Requirement exceeds your Total Revenue, your Operating Ratio will return a positive number, formatted in green. A positive Operating Ratio represents the amount by which your utility is allowed to recover from customers. If your Revenue Requirement does not exceed your Total Revenue, your Operating Ratio will return a negative number, formatted in red. A negative Operating Ratio represents the amount by which your utility should decrease rates.

### *Rate Design*

If your Operating Ratio is positive, you shall provide the Commission with a rate structure—and proposed tariffs—that you deem to be just and reasonable that recovers the determined amount from your customers. The Commission will determine on a case-by-case basis whether the rate structure is just and reasonable.

In designing rates it is important to consider system-specific characteristics such as the need for volumetric charges (i.e. metered systems), usage characteristics and total water right as allowed by the DNRC, customer mix, customer type usage characteristics etc. Please provide all necessary documents to substantiate your proposed tariffs, including but not limited to: a copy of the DNRC water right; Water Measurement Flow Meter reports; and copies of Annual Reports provided to the PSC. Clearly illustrate how your proposed tariffs will result in total revenues equal to the revenue requirement calculated in cell B31 of the spreadsheet.