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August 19, 2013

Hon. Jeff R. Derouen
Executive Director
Kentucky Public Service Commission
211 Sower Blvd.
Frankfort KY 40601-8294

RE: In the Matter of Investigation into the Proposed Water Purchase Agreement between Louisville Water Company and Hardin County Water District No. 2, Case No. 2013-00252

Dear Mr. Derouen:

With this letter I have enclosed one (1) original and ten (10) copies of Louisville Water Company's Response to the Commission's Order dated July 3, 2013 in the above-referenced matter.

Please return a file stamped copy to our courier.

Thank you and if you have any questions, please call me.

Very truly yours,

DINSMORE & SHOHL LLP

Edward T. Depp

ETD/kwi

cc: Barbara Dickens, Esq. (w/enclosure)

Enclosure

1093412v1

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

INVESTIGATION INTO THE PROPOSED WATER	)	
PURCHASE AGREEMENT BETWEEN	)	**CASE NO. 2013-00252**
LOUISVILLE WATER COMPANY AND	)	
HARDIN COUNTY WATER DISTRICT NO. 2	)	

LOUISVILLE WATER COMPANY'S RESPONSE TO THE PUBLIC SERVICE COMMISSION'S ORDER DATED JULY 3, 2013

INTRODUCTION AND BACKGROUND

Louisville Water Company ("LWC") and Hardin County Water District No. 2 ("HCWD2") have been working together for several years to address the growing water needs of HCWD2. LWC has excess treatment capacity and an abundant supply from the Ohio River. LWC's treatment capacity is 240 MGD. It has produced as much as 205 million gallons daily (MGD), although average daily water production is significantly less than that. In contrast, HCWD2 has been challenged at times to have an adequate supply available for its customers' water demands. During drought years, HCWD2 been unable to draw as much water as it needs from Nolin River, HCWD2's supply source, without violating its withdrawal permit from the Kentucky Division of Water ("DOW"). In response to this serious concern, HCWD2 has requested an increase in its withdrawal permit, but the DOW has denied it. The DOW renewed HCWD2's existing permit without changing the permitted withdrawal amount.

HCWD2, proactively and responsibly planning for the future of its customers, sought other available options. It began discussions with LWC due to, among other things, LWC's reliable source in the Ohio River and available excess treatment capacity. In April of 2008, the

two utilities signed a letter of intent for LWC to provide supplemental wholesale water to HCWD2. The letter of intent was the culmination of a long process on the part of HCWD2, which had conducted various studies in order to determine what its future water needs would be and all feasible sources to address those needs. The parties reached a Wholesale Water Purchase Agreement (the "Agreement") on March 19, 2013.

Of critical importance to this Agreement is the guarantee on LWC's part to make available certain quantities of water on a certain schedule, and HCWD2's guarantee to purchase certain quantities of water according to that schedule, also referred to as a "take or pay" provision. Before LWC can make the water available to HCWD2, LWC is committing to construct certain water transmission facilities in order for it to connect to HCWD2 at a delivery point, all at a substantial cost to LWC and its existing ratepayers. The Agreement contains other guarantees in terms of the quality, pressure and reliability of the water to be delivered to HCWD2. The Agreement also commits to rates that are based on the American Water Works Association's M1 Manual of Water Rates, Charges and other Fees standard cost of service methodology, just as they are now for all LWC's wholesale customers, whether regulated by the Commission or not. HCWD2 agrees to pay LWC's then-wholesale rate for the minimum purchase quantity set forth each year of the Agreement.

In response to the filing of the Water Purchase Agreement, the Commission issued its Order stating that it should conduct an investigation into the reasonableness and lawfulness of the proposed Agreement pursuant to KRS 278.040 and KRS 278.250, and specifically compelling LWC and HCWD2 to file a written memorandum addressing whether HCWD2 is required by KRS 278.300(1) to apply for Commission approval prior to executing the Agreement. Although both LWC and HCWD2 concur on the issues before the Commission, they each offer unique viewpoints as buyer and seller in the Agreement and, therefore, have chosen to submit separate memoranda in support of their positions.

ARGUMENT

The Commission says in its order that the "proposed contract requires [HCWD2] to assume significant financial obligations that may affect price and quality of the water service that [HCWD2] provides to its customers. Moreover, these obligations appear to render the proposed water purchase agreement an evidence of long-term indebtedness that would require Commission approval pursuant to KRS 278.300(1)." If the foregoing is accepted as correct, then the Commission has authority pursuant to KRS 278.300(1) to pre-approve the Agreement.

KRS 278.300(1) states:

> No 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.

However, the issue of whether a minimum purchase requirement in such a contract is an evidence of indebtedness is not settled, and LWC submits that such provisions in a wholesale water purchase agreement do not constitute evidences of indebtedness under the applicable statute, common law or in practice and that the Commission cannot consider it an evidence of indebtedness.

I. KRS 278.300 DOES NOT COVER THE AGREEMENT.

In order for this statutory provision to apply, and therefore, for the Commission to have authority to require LWC and HCWD2 to submit the Wholesale Water Purchase Agreement to it for prior approval under KRS 278.300, there has to be an issuance of a security or some other evidence of indebtedness or HCWD2 has to assume an obligation or a liability in respect to the security or evidence of indebtedness. For the reasons stated herein, LWC submits that HCWD2 has issued no security and has assumed no liability or debt for which the Commission may require approval.

A. No Security is Issued.

1. The Wholesale Water Purchase Agreement is Not a Security. "Security" is described in statute and by its basic legal definition as a note, stock, treasury stock, bond, certificate of interest, or other interest that describes someone's ownership rights in something. *See KRS § 292.310(19); Security, Black's Law Dictionary (9TH Ed. 2009).* Certainly, the Agreement is not a "note," a "stock," a "treasury stock," a "bond," or a "certificate of interest." More importantly, however, neither LWC nor HCWD2 is giving the other an ownership interest in anything through the terms of the Agreement. HCWD2 is not issuing anything representing an ownership interest of some amount that interested buyers may then purchase.

Words and phrases in statutes must be given reasonable, rational meanings in order to carry out the intent of the statute and avoid an absurd result. Workforce Dev. Cabinet v. Gaines, 276 S.W.3d 789,795 (Ky. 2008). To interpret a statute, one has to rely upon the common meaning of the particular words chosen "which meaning is often determined by reference to dictionary definitions." Jefferson County Bd. of Ed. v. Fell, 391 S.W.3d 713, 719 (Ky. 2012). The definition of "security" in Black's Law Dictionary and in KRS 292.310 is similar to the description in the implementing regulation of KRS 278.300(1), that is, "securities, notes, bonds, stocks or other evidences of indebtedness." *See 807 KAR 5:001, Section 17 (1).*

A court will also consider that a statute is intended by the General Assembly to compliment other statutes related to it. Fell, at 719. The other related sections in that statute clearly indicate a traditional meaning of security is intended, as do the other statutes in that chapter, e.g. KRS 278.290. Subsections (3), (4) and (7) of KRS 278.300 all refer to the use or the disposition of the proceeds of the indebtedness, a normal expectation in a traditional borrowing transaction.

The additional phrase "evidence of indebtedness" begs the question of what else this phrase could mean if it is not a common security defined in practice or regulation as a note, bond or stock. Kentucky courts have held under general rules of statutory construction that

when a general phrase follows a list of specific things, the general phrase will be interpreted to include only that same type of thing that was listed specifically. Commonwealth v. Plowman, 86 S.W.3d 47, 50 (Ky. 2002). As such, when interpreting KRS 278.300(1), "other evidences of indebtedness" simply means those other instruments that meet the definition of a security. A wholesale water purchase agreement with a minimum purchase requirement does not meet the definition of a security because no ownership interest is granted to anything.

2. Nothing is being issued. The statute specifically prohibits a regulated utility from *issuing* the security or evidence of indebtedness. The common definition of "issue" applicable to securities or evidences of indebtedness is to "put forth or distribute; to send out for sale or circulation." "Issue" Black's Law Dictionary *(9th Ed. 2009).* Clearly, this is the action a utility takes when it issues bonds or what a private company does when it issues stock. The Agreement was not "issued" in any sense of the word. It was agreed upon by the parties, and the terms were bargained for after consideration by both parties of the benefits and risks associated.

Furthermore, the issued stock or bond is sent out for sale to generate funds for the issuer. The very idea of a security means an investor will earn profit through the efforts of others instead of his own efforts. Smith v. Wedding, 303 S.W. 2nd 322, 323 (Ky. 1957). All of the security examples that are described in the applicable statute are similar in that they provide an ownership interest, they can be traded, and profit can be garnered through the work of other's efforts. Logic and plain meaning demand that there is no security being issued – in fact, nothing at all is being *issued* -- with the Agreement between HCWD2 and LWC.

B. No Debt is Assumed.

1. A Minimum Purchase Requirement is Not a Debt by Law. Since no security is issued, the key provisions of the contract in question – namely, the obligation to pay a certain amount of money for a certain minimum amount of water taken – would have to be interpreted as an assumption of debt. Traditionally a "debt" is created in a transaction when one party receives an immediate benefit and has the opportunity to pay for it over time, oftentimes for more than the value of the original benefit. There is nothing in KRS 278.300(1) indicating the General Assembly intended anything other than the traditional notion of a borrower receiving proceeds immediately in order to pay for something later. KRS 278.300 (3), (4) and (7) require the utility to describe the use of the proceeds. In fact, even the Commission's own regulations regarding approval of indebtedness support this position insofar as they require a utility to describe the use to be made of the proceeds of the securities, notes, bonds, stocks or other evidences of indebtedness. 807 KAR 5:001(17)(c). It is apparent that not only the General Assembly, but also the Commission, intends this to apply only to traditional debt instruments.

Kentucky courts have held that a debt exists only where the creditor has an unconditional right to receive and the debtor has an obligation to pay. Preston v. Clements, 232 S.W.2nd 85, 90 (Ky. 1950). The reason the creditor deserves the *unconditional* right to receive is because the creditor has already given the debtor something, such as the proceeds of a loan or the proceeds of a bond sale. This is not the situation at hand. HCWD2 will not be receiving anything in advance or paying in advance. There are no proceeds it is receiving from the minimum purchase requirement. Certainly, it is an obligation of HCWD2, but it is not a debt of HCWD2. Likewise, LWC (as the putative creditor) has obligations – *conditions* – imposed on it. There is nothing unconditional about LWC's rights under the wholesale water purchase agreement.

Rather, LWC is required to make a certain minimum quantity of water available at a certain quality, pressure and flow. HCWD2 will be expected annually to take a minimum

amount, an amount supported by years of study indicating its water usage needs. For that minimum amount, it will be expected to pay a rate based on a widely recognized cost of service ratemaking methodology. If such agreements, or specifically such take or pay provisions within agreements, are considered evidences of indebtedness for which a regulated utility must get Commission prior approval, the application of this rule might be limitless. It would be very difficult for a utility to determine what types of contractual commitments fell under such a rule, such as long term lease agreements with monthly service charges, long term licensing or agreements for software, or long term pool cellular agreements, to name a few. One thing all of these long term arrangements have in common is that they are operating expenses common to a utility, but they are not "debt" in the traditional sense of a note, bond or a security.

2. A Minimum Purchase Requirement is not a Debt in Practice. Neither LWC nor HCWD2 treats the minimum purchase requirement as a debt of HCWD2 or an asset of LWC in their respective financial statements. In order for HCWD2 to treat this as a debt on its balance sheet, it would have to be offset with proceeds received upon incurring the debt, which proceeds it never received. Rather, this is an operating expense to HCWD2 in the period in which it actually purchases the commodity, and it is revenue to LWC in the period in which LWC actually receives the payment for the water. This is consistent with matching the expense and the revenue for both entities in the period for which the benefit is received. HCWD2 would be overstating their liabilities and LWC would be overstating their assets with an accounting entry to treat the event as indebtedness.

II. THE ELECTRIC UTILITIES' SUBMISSION OF SUCH CONTRACTS AS EVIDENCE OF INDEBTEDNESS IS IRRELEVANT.

A. The Commission Never Determined Minimum Purchase Requirements in Wholesale Electric Agreements Were Evidences of Indebtedness under KRS 278.300(1). The Commission wrestled with this issue in a prior case involving wholesale electric power in the early 1990s. In PSC Administrative Case No. 350 involving long-term wholesale power by electric utilities,[1] the Commission said those contracts "***may*** well require prior approval under KRS 278.300 *if they constitute evidences of indebtedness.*" (emphasis added). As stated previously, the minimum purchase requirement does not constitute a security, and does not constitute a debt, and by its plain and reasonable meaning does not therefore constitute an evidence of indebtedness. Consequently, this October 25, 1993 Order by the Commission does not constitute a prior holding applicable to the matter at hand.[2]

B. The Commission Cannot Expand Its Statutory Authority. Subsequent to the Order issued in Administrative Case No. 350, many electric utilities began voluntarily submitting minimum purchase requirements to the Commission for approval. Despite such acts, the Commission did not gain greater power than it had before. "The PSC is a creature of statute and has only such powers as have been granted to it by the General Assembly." Boone Cty Water and Sewer Dist. V. Pub. Serv. Comm'n, 949 S.W.2d 588, 591 (Ky. 1997). As a result, only the General Assembly may expand the express powers of the Commission. Further, even if a court would determine that the Commission's inclusion of minimum purchase requirements in the definition of indebtedness is merely an issue of interpretation and not an expansion by the

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[1] *In the Matter of The Consideration and Determination of the Appropriateness of Implementing a Ratemaking Standard Pertaining to Power by Electric Utilities as Required by Section 712 of the Energy Policy Act of 1992.*

[2] The Commission's July 17, 2013 order in *In the Matter of Petition and Complaint of Grayson Rural Electric Cooperative Corporation for an Order Authorizing Purchase of Electric Power ... and East Kentucky Power Cooperative Inc.*, 2013 Ky. PUC LEXIS 629 (Case No. 2012-00503) is also distinguishable because the take-or-pay Magnum contract in that case directly impacted certain take-or-pay obligations in a Rural Utilities Service ("RUS") loan that falls within the Commission's jurisdiction. The Agreement at issue in this case does not implicate any existing loan obligations of HCWD2. Therefore, the Commission's July 17, 2013 order in Case No. 2012-00503 is inapplicable.

Commission, the Court would still require such interpretation to be reasonable and according to the intent of the statute. Such an interpretation simply is not supported when general rules of statutory construction are applied. [*Supra, Section I*].

III. THE COMMISSION IS ESTOPPED FROM CONSIDERING THE MINIMUM PURCHASE REQUIREMENT AS AN EVIDENCE OF INDEBTEDNESS.

LWC, although not regulated by the Commission, deals with water utilities that are regulated by the Commission. LWC has negotiated and entered into many wholesale water purchase agreements over the past several years with regulated utilities. In all cases, LWC has filed for approval of its wholesale water rates and has filed with the Commission the contract representing the agreement between the regulated utility and LWC. There has already been one of these that has included a "take or pay" or minimum purchase requirement. LWC's wholesale purchase agreement with the North Nelson Water District was filed with the Commission, which has accepted it. Other utilities have done the same, including the Frankfort Electric Water and Plant Board's prior agreements with the South Anderson Water District. Never has the Commission stopped the approval of the rates or questioned the contracts with these utilities because it had determined the minimum purchase requirement was an indebtedness requiring prior approval. As a result, the Commission is estopped from ruling on the same provision under the same statute now.

IV. THE MINIMUM PURCHASE REQUIREMENT IS A REASONABLE, BARGAINED-FOR TERM IN A BILATERAL AGREEMENT AND IS LAWFUL.

LWC and HCWD2 have negotiated the terms of the Agreement over considerable time, after several studies and analyses, after multiple meetings among key personnel, with updates on progress to both boards of directors, and with the benefit of separate legal counsel representing the interest of each utility. The Agreement they reached and they filed with the Commission is a fair agreement that represents risks and benefits to both parties, but which are

balanced with the best interests of each utilities' ratepayers in mind. The reality of the situation is that Louisville has an abundant supply of water and excess treatment capacity and represents a reliable source of high quality potable water to the region. HCWD2 needs a reliable and large source of water to meet the needs it has identified in years of study. To get the water to HCWD2 requires an outlay of capital expenditure to build transmission capacity. LWC's ratepayers should not bear that risk without a promise of the future sales that will come from that water connection. That simply is the reality of the water business today. It is true not just for Louisville Water and HCWD2, but it is true in many parts of the United States where the water supply has not kept pace with growth or where drought has threatened supplies that were previously thought to be sufficient.

LWC agrees that the cost of that minimum purchase requirement should be reasonable and justified. As such, LWC's rates and fees are always based on a Cost of Service model that is standard in the water industry. LWC meets with and communicates its Cost of Service Study to its wholesale customers, who it considers valuable business partners. LWC's Schedule of Rates and Fees are published in advance and considered at a public board meeting. Rates for regulated utilities are contingent upon approval by the Commission. All of these are practices LWC believes promote transparency and foster customer trust, confidence and satisfaction.

CONCLUSION

This is not a difficult issue or one that needs to be addressed. The minimum purchase requirement is a standard negotiated term of a wholesale water purchase contract given the realities of today's regional water business. Even the Commission, in its Small Utility Assistance Division website, at the Legal section under "Wholesale Contract Negotiations" recognizes the need for such a provision when facilities have to be built or a guarantee of available supply is being promised, because it suggests that suppliers should consider

incorporating a Take or Pay provision into the Wholesale contract.[3] Nowhere in the legal guidance does it suggest that this may render such a requirement "debt" subject to the Commission's prior approval.

This minimum purchase requirement, while certainly a contractual obligation, is merely setting forth the buyer's negotiated commitment in response to the seller's negotiated commitment to set aside a guaranteed supply. The cost of supply to the purchasing utility is an operating expense for the purchase of a commodity. That explanation is the practical, logical conclusion being arrived at by not only water utilities, but also the Commission. One need not go much farther than the Small Utility Assistance Division website or the regulations implementing KRS 278.300 to know that a take or pay provision is an acceptable manner in which to purchase a wholesale water supply that has nothing to do with indebtedness. However, if those references are not enough, common law does not support fitting this contractual provision into the unlikely category of indebtedness. To do so is to reach beyond reasonableness and to create a chilling effect on water utilities trying to do the right thing for their customers by ensuring a long term reliable supply of water.

Therefore, Louisville Water Company respectfully requests the Commission find that KRS 278.300(1) does not apply to its Agreement with Hardin County Water District 2, and further, that the parties may move forward implementing the Agreement without further delay.

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[3] **Excerpt from the Negotiating Wholesale Contracts Section of the Website**

I. Quantity.

A. Minimum Quantity ("Take or Pay Provision")

1. Suppliers should consider establishing a minimum amount that the Purchaser must purchase when a portion of the Supplier's facilities must be available to supply the Purchaser's demand and such sales are factored into the Supplier's decisions regarding repayment of debt incurred to finance the construction of water treatment or distribution facilities necessary to supply the Purchaser. Suppliers should consider minimum quantity provision when additional facilities must be constructed to serve Purchaser's demand.

2. Specifying a minimum quantity obligates a Purchaser to purchase a minimum amount regardless of whether it has actual need for that amount. The Purchaser must pay for minimum volume regardless of whether it actually takes that amount. Such provision also requires the Supplier to maintain sufficient capacity to meet this quantity.

capacity to meet this quantity.

Respectfully Submitted,

Barbara K. Dickens
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Counsel for LWC

CERTIFICATE OF SERVICE

It is hereby certified on this 19th day of August, 2013 a copy of this Brief of Louisville Water Company was served by mail to Hon. Damon R. Talley, PSC, 112 North Lincoln Blvd, P. O. Box 150, Hodgenville, KY 42748-0150 and an original and ten copies served by hand delivery to Mr. Jeff Derouen, Executive Director, Kentucky Public Service Commission, 211 Sower Blvd, Frankfort, KY 40601.

Barbara K. Dickens