

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF MOUNTAIN WATER)
DISTRICT OF PIKE COUNTY, KENTUCKY,)
FOR A CERTIFICATE OF PUBLIC) CASE NO. 97-112
CONVENIENCE AND NECESSITY TO)
CONSTRUCT, FINANCE AND INCREASE)
RATES PURSUANT TO KRS 278.023)

O R D E R

On March 18, 1997, Mountain Water District ("Mountain") requested rehearing of the Commission's Order of March 11, 1997. In that Order the Commission approved a sewer construction project, the financing for the project, and the sewer rates mandated by an Agreement with the Department of Agriculture's Rural Development ("RD"). The Commission denied a general increase in Mountain's water rates included in the Agreement.

The actual construction project is to provide service to 180 additional sewer customers and to connect 147 existing sewer customers. Project funding included a \$176,000 bond issue to be purchased pursuant to an agreement with RD, an Economic Development Administration grant of \$814,600, an Appalachian Regional Commission grant of \$375,000, a Kentucky Infrastructure Authority ("KIA") loan of \$484,800, and an applicant contribution of \$19,200. The RD bonds will be financed for a 40-year period at an interest rate not to exceed 4.5 percent per annum and the KIA loan is to be financed at 1.3 percent per annum.

As part of the agreement between Mountain and RD, Mountain requested not only a sewer rate increase but also a 34 percent increase in its general water rates for existing

water users.¹ Mountain's application was made pursuant to KRS 278.023, which requires the Commission to approve agreements between certain utilities and RD and to issue the necessary orders to implement the terms of such agreements within 30 days of satisfactory completion of the minimum filing requirements.

In its March 11, 1997 Order, the Commission approved all the conditions directly related to the construction of the sewer project. However, the Commission denied the proposed increase in water rates. The Commission determined that the increase in water rates was not related to the sewer construction project, did not involve any other construction project, and that the provisions of KRS 278.023 did not apply. The Commission's position that KRS 278.023 does not apply has not changed and we reaffirm our prior holding on that issue.

The Commission has been aware for some time of Mountain's precarious financial condition. On April 2, 1996, the Commission issued an Order establishing Case No. 96-126, an investigation into Mountain's operations and management. That case was initiated, in part, following a letter from Mountain requesting that the Commission undertake a rate study in order to enable Mountain to achieve financial stability. As part of that investigation, the Commission employed Barrington-Wellesley Group, Inc. ("BWG"), an independent consulting firm, to perform a management and operations audit of Mountain. BWG's report shows that Mountain has incurred net operating losses in

¹ Mountain proposed a change in its rate design for water users as well. Mountain's current customers receive 2,000 gallons for a minimum bill of \$14.25 and each additional 1,000 gallons for \$3.35. Under the rates proposed herein, the minimum bill which includes only 1,000 gallons goes to \$13.00 and usage per 1,000 gallons is set at \$4.90.

excess of \$300,000 for each year from 1992 through 1995. According to BWG, during 1992 through 1995, Mountain's operating expenses rose by 43 percent, its interest expense rose by 50 percent, while the number of customers rose by only 36 percent. BWG stated that "increasing expense per customer has not been matched with corresponding rate increases."²

KRS 278.023 states that agreements between RD and water utilities relating to the financing of construction projects shall be accepted by the Commission because the federal financing entails prior review and oversight by the federal agency. In support of its rehearing, Mountain included a letter from RD which reflects concern over Mountain's financial condition. However, that letter (Exhibit 2 to the Petition for Rehearing, attached as an Appendix hereto) is dated March 17, 1997, six days after the Commission issued its Order denying the proposed water rate increase and the conditions set forth in that letter, seemingly, are not part of the conditions of the original financing agreement.

Exhibit 2 demonstrates that RD is aware of the District's financial plight and is aware that the District is presently generating insufficient revenues from its present rates to meet its current debt service and operating expenses as they come due.³ RD states in the letter that unless Mountain acts quickly to improve its revenue stream, RD may

² Management Audit of Mountain Water District, Final Report, dated October 1996, page II-10.

³ The presently inadequate rates were set by RD in Case No. 95-280, The Application of Mountain Water District of Pike County, Kentucky, for a Certificate of Public Convenience and Necessity to Construct, Finance, and Increase Rates Pursuant to KRS 278.023, Final Order dated July 21, 1995.

have little choice but to place the District in receivership. From our perspective, RD has always had another alternative -- refusing to allow Mountain to become more debt laden unless and until its financial condition improves. As long as the federal agency is willing to loan more money to this District without ensuring there is a reasonable prospect of payment, and as long as Mountain's board aggressively seeks this funding, there is little hope of financial improvement in the near term.

In 1995, RD loaned Mountain over \$1.5 million even though Mountain's financial statements reflected a sustained period of net operating losses. In fact, RD has granted Mountain several loans since 1992. The Commission is not aware of any instance where RD has conditioned approval of such a small loan (\$176,000) for an unrelated sewer construction project to approval of such a significant increase in general water rates.

RD has failed in its prior review and oversight of Mountain's finances, and is now trying to make up for past errors or omissions. It is apparent from Exhibit 2 that RD insists on the increase because the water rates it mandated for prior projects have not been sufficient to support Mountain's operations and debt service.

RD's actions place the Commission in an untenable position. Clearly, KRS 278.023 was not intended for this purpose. Given the historical relationship between RD and Mountain, the Commission questions the sufficiency of the water rates mandated by RD. The Commission will continue to process its rate study as part of Case No. 96-126 and will set sufficient rates for both Mountain's water and sewer operations.

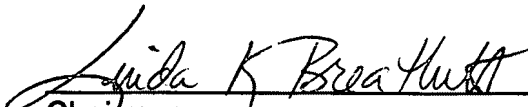
In its rehearing petition, Mountain states that the Commission has violated the terms of the RD agreement and has jeopardized both the water and sewer operations. All parties should be advised that it is RD's past failure in exercising sufficient oversight and its current onerous requirement of an increase in water rates for an unrelated sewer construction project that has placed Mountain's operations in jeopardy. The Commission does not expect RD to place such conditions in any further agreements.


Mountain may, at its discretion, file a motion for emergency rate relief in Case No. 96-126 pursuant to KRS 278.190. Given Mountain's present financial condition and the statements contained in RD's March 17, 1997 letter, such a motion would be favorably received.

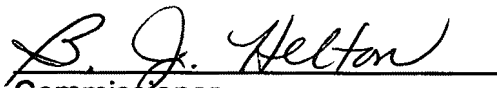
IT IS THEREFORE ORDERED that Mountain's request for rehearing is denied.

Done at Frankfort, Kentucky, this 1st day of April, 1997.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:


Executive Director