

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF SOUTH HOPKINS WATER	)	
DISTRICT FOR APPROVAL OF A PROPOSED	)	CASE NO. 2010-00074
INCREASE IN RATES FOR WATER SERVICE	)	

ORDER

On April 28, 2010, the Commission established rates for South Hopkins Water District ("South Hopkins") that produced annual revenues from water sales of \$1,296,757. Alleging the Commission erred in adjusting its rates for wholesale water service, South Hopkins petitioned for rehearing. By this Order, the Commission modifies our earlier Order and takes further steps to ensure the water district's financial integrity.

BACKGROUND

South Hopkins, a water district organized pursuant to KRS Chapter 74, owns and operates facilities that distribute water to approximately 3,014 customers in Caldwell and Hopkins counties, Kentucky.<sup>1</sup> It also provides wholesale water service to the cities of Mortons Gap and Earlington, Kentucky and to Caldwell County Water District.<sup>2</sup> South Hopkins does not own any water production or treatment facilities but purchases its

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<sup>1</sup> *Annual Report of South Hopkins Water District to the Public Service Commission of Kentucky for the Year Ended December 31, 2009* at 5 and 27.

<sup>2</sup> *Id.* at 30.

water requirements from the cities of Dawson Springs (“Dawson Springs”) and Madisonville, Kentucky.<sup>3</sup>

#### PROCEDURE

On February 19, 2010, South Hopkins applied for an adjustment of rates. It proposed to adjust its retail rates to increase its annual operating revenues from water sales by \$137,188, or approximately 11.83 percent, over normalized water sales of \$1,159,614. In its application, South Hopkins made no reference of an increase to its wholesale water customers.

On March 19, 2010, the Commission issued a report of Commission Staff’s findings and recommendations regarding the proposed rate adjustment. In its report, Commission Staff agreed with the water district’s proposed revenue requirement of \$1,296,757 and proposed an across-the-board adjustment of South Hopkins’ rates, including its wholesale service rates, to produce this revenue requirement. In the same Order in which we issued Commission Staff’s report, we directed South Hopkins to submit any comments regarding the report to us within 10 days. South Hopkins did not submit any comments within this period. In the absence of such comments, the Commission, on April 28, 2010, ordered that Commission Staff’s proposed rates be made effective for service.

On May 11, 2010, South Hopkins petitioned for rehearing of the Commission’s Order of April 28, 2010. Noting that it had not requested any adjustment in its wholesale water service rates and that such rates are calculated independently based upon annual audits that Dawson Springs conducts, South Hopkins alleged that the

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<sup>3</sup> *Id.* at 29.

Commission had erroneously adjusted its wholesale rates and that only the water district's retail service rates should have been adjusted. On May 28, 2010, we granted rehearing to consider South Hopkins' arguments.

On June 22, 2010, Commission Staff and South Hopkins conducted a conference call. In addition to their contentions regarding the rates contained in the Commission's Order of April 28, 2010, South Hopkins' representatives requested that the Commission reconsider its interpretation of South Hopkins' water supply contract with Dawson Springs and permit a rate mechanism that would allow South Hopkins to recover its annual payments to Dawson Springs for underpayments related to purchased water.

## DISCUSSION

### Adjustment to Wholesale Rate

In our Order of April 28, 2010, we failed to consider the existing contracts between South Hopkins and its wholesale customers. In these contracts, which are on file with the Commission, South Hopkins agreed to furnish water to its wholesale customers under the following formula: 1.25 multiplied by the sum of actual production cost of water, pumping cost and amortization cost of South Hopkins' facilities. South Hopkins recalculates the product of this rate formula annually using the results of an audit that Dawson Springs conducts to determine the cost of producing water at its water treatment plant.<sup>4</sup>

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<sup>4</sup> To determine its pumping cost and amortization cost, South Hopkins uses the amounts reported in its most recent annual report to the Commission. See Memorandum from Gerald Wuetcher, Executive Advisor, to Case File (June 25, 2010) at 2.

South Hopkins argues that its contracts with its wholesale customers should control in establishing its rate for wholesale water service. It argues that the parties to these contracts, having premised their operations on these contracts, should be afforded the benefit of these contracts and rates contained in those operations. It further argues that the contracts better reflect the cost to provide service to these customers than the across-the-board increase that Commission Staff proposed.

Having reviewed the record and carefully considered South Hopkins' arguments, we find that South Hopkins' wholesale rates should be determined by the formulas set forth in the wholesale contracts and that the adjustment necessary to produce a revenue requirement of \$1,296,757 should be limited to its retail rates. We further find that the rates set forth in Appendix A to this Order will produce that revenue requirement and should be assessed for water service that South Hopkins provides on and after the date of this Order.

Our review of existing Commission records, including South Hopkins' filed rate schedules, indicates that South Hopkins has not kept the Commission apprised of its annual recalculation of the product of the rate formulas in its wholesale contract. While KRS 278.180(1) does not require notice to the Commission,<sup>5</sup> we find that South Hopkins should file revised tariff sheets with the Commission prior to placing the results of the recalculation into effect to ensure that the Commission has notice of the calculated rate.

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<sup>5</sup> See, e.g., Case No. 2007-00299, *Purchased Water Adjustment of Bath County Water District* (Ky. PSC Sep. 26, 2007) (finding that the formula contained in a wholesale water service contract was a rate and that KRS 278.180 does not require a supplier to notify the Commission of the result of the recalculation of the formula prior to placing that result into effect).

### South Hopkins' Status as a Joint Water Producer

South Hopkins has requested that the Commission reexamine our decision in Case No. 10098,<sup>6</sup> in which we declared that, based upon our interpretation of the 1978 Water Purchase Contract between South Hopkins and Dawson Springs, South Hopkins is a joint producer of water. It contends that this decision threatens the water district's financial integrity.

Since its inception in 1964, South Hopkins has obtained most of its water from Dawson Springs.<sup>7</sup> In their original agreement, South Hopkins contracted with Dawson Springs to provide all its water requirements at the "prevailing rate charged single commercial establishments within the corporate limits of Dawson Springs." As both utilities' demand for water increased, Dawson Springs' existing water treatment facilities were inadequate to keep pace.

The need for a larger water filtration plant led Dawson Springs and South Hopkins to enter a water purchase agreement in 1978.<sup>8</sup> The Farmers Home Administration expressly conditioned its loan to Dawson Springs upon Dawson Springs obtaining a long-term water purchase contract with South Hopkins. The water district, in

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<sup>6</sup> Case No. 10098, *The Application of South Hopkins Water District for a Rate Adjustment Under the Purchased Water Adjustment Clause* (Ky. PSC May 24, 1988).

<sup>7</sup> Until 1994, Dawson Springs was South Hopkins' sole source of water. In that year, South Hopkins entered into a water purchase contract with Madisonville to supply certain sections of its territory. It purchases only a small portion of its total water requirements from Madisonville.

<sup>8</sup> Dawson Springs and South Hopkins have amended the 1978 Water Purchase Contract three times. In 1990, they agreed to modifications in the debt service and water supply facility reserve fund factors that are used to calculate the cost of water. In 1993, they extended the term of the agreement until July 29, 2033. In 1994, they extended the term of the agreement until June 17, 2039.

turn, had plans to add an additional 500 households to its system and required a source of water sufficient to support this additional demand.

Under the terms of the 1978 Water Purchase Contract, South Hopkins agreed to purchase its total water requirements from Dawson Springs for a term of 45 years.<sup>9</sup> The Contract established a detailed methodology for determining the rate for purchased water. The rate was to cover the operation and maintenance expense of the new facilities, the debt service allocated to these facilities, and a water supply facility reserve fund. All costs were to be based upon the actual cost of water produced and the actual usage of South Hopkins and Dawson Springs. A certified public accountant, whom Dawson Springs selected annually, was to conduct an audit to ascertain the actual cost of water for the operating year.

Based upon the results of the audit, a new rate for water service is determined. For the 12 months following the audit, South Hopkins will make monthly payments to Dawson Springs at this rate. When the next annual audit is performed, the precise cost of the water that South Hopkins used during the previous 12 months will be determined. If the total cost of water exceeds South Hopkins' total payments, South Hopkins must pay the difference to Dawson Springs. If total payments exceed total cost, the overpayment is refunded to South Hopkins. The rate is then adjusted to reflect the results of the recent audit. South Hopkins' monthly payments for the following 12 months are based on this new rate.

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<sup>9</sup> Under the terms of the agreement, South Hopkins could obtain water from another supplier if South Hopkins expanded its service area and Dawson Springs lacked sufficient capacity to serve the addition. South Hopkins' purchases, however, were limited to meeting the needs of the new area only.

In February 1988, South Hopkins petitioned the Commission for a declaration that, as a result of its 1978 Water Purchase Contract with Dawson Springs, South Hopkins was a producer of water and that the Commission's Purchased Water Adjustment Regulation<sup>10</sup> did not apply to South Hopkins. In our Order in Case No. 10098, we set forth the reasoning behind South Hopkins' requested relief:

Commission Regulation 807 KAR 5:068 does not allow South Hopkins to recover from its customers any additional payments to Dawson Springs to cover underpayments. It covers only prospective increases in suppliers' rates, not retroactive increases. South Hopkins must, therefore, absorb these retroactive increases. Because the regulation requires a water district to refund to its customers any refund received from a supplier, 807 KAR 5:068, Section 2(4), these absorbed increases cannot be offset by any refunds from Dawson Springs for overpayments.

Since 1984, the regulation has failed to prevent South Hopkins from having to absorb approximately \$21,000 in increases in the cost of water. In October 1984, the Commission granted a general rate increase to the water district. After an audit was conducted in July 1985, South Hopkins was required to pay \$11,453 to Dawson Springs for underpayments. After the audit of July 1986, the district was required to make an additional \$9,502 payment to Dawson Springs. Neither payment could be recovered under the regulation. In October 1986, South Hopkins sought and was granted an increase in rates pursuant to the regulation. After the July 1987 audit, Dawson Springs refunded \$22,546 to South Hopkins and lowered its rates to reflect lower costs of water production. Under the terms of the regulations, South Hopkins may not retain this refund but must pass it through to its ratepayers. South Hopkins must also lower its rates, making it vulnerable to another underpayment should water costs rise to their historic levels.<sup>11</sup>

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<sup>10</sup> 807 KAR 5:068.

<sup>11</sup> Case No. 10098, Order of May 24, 1988 at 6-7.

In essence, South Hopkins believed that, as a producer of water, it would be better positioned to address changes in the cost of purchased water if not subject to the Commission's Purchased Water Adjustment Regulation.

Sympathetic to South Hopkins' position, the Commission concluded that South Hopkins and Dawson Springs were involved in a joint venture to construct and operate Dawson Springs' new water filtration plant and declared South Hopkins a joint producer of water. We based our conclusion upon our finding that "both parties have a mutual interest in and some degree of control over the water filtration plant's operation," had "contributed their money and effort to the plant," and shared "the burdens and benefits of the plant's operation."<sup>12</sup>

The Commission's action proved no panacea for South Hopkins. Underpayments generally exceeded overpayments to Dawson Springs. Between 2001 and 2009, South Hopkins made additional payments of \$107,850 to Dawson Springs because the wholesale rate that Dawson Springs charged was insufficient to recover the actual cost of water. During that period, South Hopkins adjusted its rates just once.<sup>13</sup> South Hopkins officials contend that the water district's inability to use the procedures of 807 KAR 5:068 threatens its financial integrity.<sup>14</sup>

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<sup>12</sup> *Id.*

<sup>13</sup> Case No. 2007-00458, *Application of South Hopkins Water District for an Adjustment of Rates for Water Service and Non-Recurring Charges* (Ky. PSC Dec. 21, 2007).

<sup>14</sup> The Commission's declaration of South Hopkins as a joint producer of water did not affect the water district's right to use the procedures of 807 KAR 5:068 to adjust its rates to reflect increases in the cost of water purchased from Madisonville.



While the record is unclear as to whether South Hopkins' financial integrity is threatened because of its inability to use the procedures of 807 KAR 5:068, our finding that South Hopkins and Dawson Springs are engaged in a joint venture is highly suspect. We find no evidence to support the finding that the 1978 Water Purchase Contract created "a more involved relationship than that of purchaser and seller." No provision of the 1978 Water Purchase Contract confers any authority upon South Hopkins to control the operation or maintenance of the water filtration plant or any right to object to or to demand modification of the water filtration plant's operation and maintenance practices. The Contract confers no ownership interest in the water filtration plant to South Hopkins. It does not impose any legal responsibility on South Hopkins for the debt issued to finance the construction of the water filtration plant or afford South Hopkins any special status should Dawson Springs be unable to meet its obligations on its debt instruments. While the Contract permits South Hopkins to question items in the annual audit, it does not allow the water district any role in the selection of the auditing firm or any recourse if it objects to any of the audit's findings.

Given the lack of any ownership interest in or right to control the operation of the water filtration plant on South Hopkins' part, we are of the opinion that no joint venture exists. While Dawson Springs and South Hopkins have some common interests in the successful operation of the water filtration plant, these interests are no different than those of other water producers and purchasers. This relationship is insufficient to support the finding of a joint venture and to declare South Hopkins a joint producer of water.

The Commission finds that the declaration set forth in our Order of May 24, 1988 should be revoked and that South Hopkins should be permitted to use the procedures

set forth in 807 KAR 5:068 to adjust its water service rates when Dawson Springs adjusts its wholesale rates. We further find that, as South Hopkins and Dawson Springs are not joint producers of water, Dawson Springs should be required to file with the Commission the calculations upon which the recalculated rate is based and a revised rate schedule prior to placing the results of its annual recalculation of the cost of water into effect to ensure that the Commission has notice of the calculated rate.

#### Water Audit Recovery Charge

Authorizing South Hopkins' use of the procedures set forth in 807 KAR 5:068 is not likely to resolve completely the financial challenges that the 1978 Water Purchase Contract poses. These procedures do not allow South Hopkins to recover from its customers any additional payments to Dawson Springs to cover underpayments. It covers only prospective increases in suppliers' rates, not retroactive increases. South Hopkins must either absorb these retroactive increases or implement a rate mechanism that will permit recovery of the additional payments.

Having reviewed the record, we find that a rider to South Hopkins' existing rate schedule that permits recovery of these payments over a 12-month period in the form of a surcharge is such a mechanism. Under such a rider, South Hopkins would assess a separate charge to all retail and wholesale customers based upon the amount of the underpayment for the prior year and the total number of gallons that South Hopkins sold. To ensure a complete recovery of the underpayment and no amount in excess of the underpayment, the surcharge mechanism would also make provision for the over- or under-collection of the surcharge.

As reflected in Appendix B, this surcharge mechanism would not be used to refund any overpayments that South Hopkins makes to Dawson Springs. 807 KAR

5:068, Section 2(4), requires a refund of such amounts within two months of receipt of the refund. Any refunds under the surcharge mechanism, therefore, would be limited to the refund of over-collections made through the surcharge.

The Commission is of the opinion that, given South Hopkins' unusual purchased water arrangements with Dawson Springs, this rate mechanism is the best means to protect the financial integrity of the water district and to ensure complete recovery of purchased water expenses in a reasonable time period. While the recovery is not as swift as that permitted for prospective rate adjustments under 807 KAR 5:068, it is the best alternative and recognizes that any underpayment accrued over a 12-month period. Furthermore, as we are not authorized to permit retroactive application of the surcharge, the full effect of this surcharge will not occur until mid-2011, when Dawson Springs conducts an audit for its current operating year.<sup>15</sup>

The rate mechanism established by this Order is an extraordinary measure to address a very unusual and difficult problem. We do not foresee the need for nor do we encourage the use of this type of mechanism for most wholesale water transactional relationships. While the rate mechanism should adequately address the concerns that South Hopkins has expressed to us, the Commission encourages South Hopkins and Dawson Springs to review their Water Purchase Contract and consider whether modifications to it would better resolve the identified concerns.

#### SUMMARY

Having carefully reviewed the evidence of record and being otherwise sufficiently advised, the Commission HEREBY ORDERS that:

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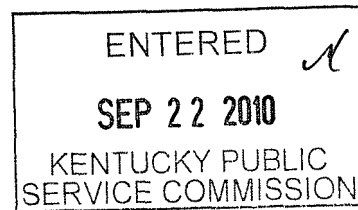
<sup>15</sup> Dawson Springs operates on a fiscal year that begins on July 1. Its current fiscal year ends June 30, 2011.

1. The record of Case No. 10098 is incorporated by reference into the record of this proceeding.
2. The rates set forth in the Commission's Order of April 28, 2010 are modified.
3. South Hopkins shall charge the rates set forth in Appendices A and B to this Order for water service rendered on and after the date of this Order.
4. Within 30 days of the date of this Order, South Hopkins shall file revised tariff sheets with the Commission reflecting the rates authorized in this Order.
5. The Commission's Order of May 24, 1988 in Case No. 10098 is revoked.
6. South Hopkins is authorized to use the procedures set forth in 807 KAR 5:068 to adjust its rates to reflect increases in the cost of its purchased water.
7. South Hopkins shall place in its tariff sheets the present rates that are assessed to its wholesale customers for water service.
8. After recalculating its wholesale water rates pursuant to the terms of its wholesale water contracts and prior to assessing the recalculated rates, South Hopkins shall file with the Commission the calculations upon which the recalculated rates are based and revised tariff sheets that state the recalculated wholesale rates.
9. Within 30 days of receiving notice from Dawson Springs of the results of the annual audit regarding the cost of water produced at its water filtration plant, South Hopkins shall recalculate its Water Audit Recovery Charge and file with the Commission revised tariff sheets to reflect the recalculation.
10. After recalculating its wholesale water service rate pursuant to the terms of its wholesale water contract with South Hopkins and prior to assessing the recalculated rate to South Hopkins, Dawson Springs shall file with the Commission the

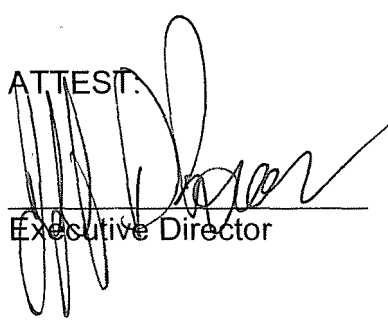
audit report and calculations upon which the recalculated wholesale rate is based and revised tariff sheets that state the recalculated wholesale rate.

11. The Executive Director shall serve a copy of this Order upon Dawson Springs.

By the Commission



ATTEST:

  
Executive Director

## APPENDIX A

### APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2010-00074 DATED SEP 22 2010

#### Monthly Water Rates

##### 5/8" x 3/4" Meter

First 1,000 Gallons	\$9.27 Minimum Bill
Next 9,000 Gallons	4.80 Per 1,000 Gallons
Next 10,000 Gallons	4.44 Per 1,000 Gallons
Next 30,000 Gallons	4.08 Per 1,000 Gallons
Over 50,000 Gallons	3.41 Per 1,000 Gallons

##### 1" Meter

First 10,000 Gallons	\$52.50 Minimum Bill
Next 10,000 Gallons	4.44 Per 1,000 Gallons
Next 30,000 Gallons	4.08 Per 1,000 Gallons
Over 50,000 Gallons	3.41 Per 1,000 Gallons

##### 2" Meter

First 20,000 Gallons	\$96.90 Minimum Bill
Next 30,000 Gallons	4.08 Per 1,000 Gallons
Over 50,000 Gallons	3.41 Per 1,000 Gallons

##### 3" Meter

First 50,000 Gallons	\$219.20 Minimum Bill
Over 50,000 Gallons	3.41 Per 1,000 Gallons

## APPENDIX B

### APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2010-00074 DATED **SEP 22 2010**

#### WATER AUDIT RECOVERY CHARGE

##### Availability

The Water Audit Recovery Charge shall be assessed to each retail and wholesale customer of South Hopkins Water District.

##### Separate Line Item

The Water Audit Recovery Charge shall appear as a separate line on retail and wholesale customers' bills.

##### Calculation of Charge

The Water Audit Recovery Charge (WARC) shall be calculated as follows:

$$\text{WARC} = (\text{UP}_{\text{DS}} + \text{C}_{\text{WARC}}) \div \text{WS}_{\text{SH}} \text{ [per 1,000 gallons rate]}.$$

$\text{UP}_{\text{DS}}$  = Underpayments to the city of Dawson Springs for Last Operating Year  
[Dollars]

= Audited Cost of Water Sold by the city of Dawson Springs to South Hopkins Water District for the Last Operating Year – Cost of water billed to South Hopkins Water District During Last Operating year.

$\text{C}_{\text{WARC}}$  = Over-collection or under-collection of WARC [Dollars]

= Authorized Total Revenue from WARC for Last Operating Year – Actual Total Revenue from WARC Collected During Last Operating Year. [This amount may be positive (if total collected revenues are less than authorized revenues) or negative (if total collected revenues exceed authorized revenues).]

$\text{WS}_{\text{SH}}$  = Total Gallons of Water Sold by South Hopkins Water District During Last Operating Year.

##### Recalculation of Charge

Within 30 days of receiving notice from the city of Dawson Springs of the results of its annual audit regarding the cost of water produced at its water filtration plant, South Hopkins Water District shall recalculate the WARC to reflect the results of the audit and

any over- or under-collections of the WARC for the previous operating year and file a revised tariff sheet setting forth the revised WARC with the Commission. South Hopkins Water District shall also file with Commission its calculations and work papers used to recalculate the WARC.

#### Refunds of Overpayments Received from Dawson Springs

Any refunds received from the city of Dawson Springs for overpayment of the cost of water that South Hopkins Water District purchased during the Last Operating Year shall be refunded in accordance with 807 KAR 5:068, Section 2(4), and not through the WARC.

#### Applicable Underpayments

The WARC be used to recover all underpayments owed to Dawson Springs under the terms of 1978 Water Purchase Contract, as amended, for which South Hopkins Water District received a notice of underpayment on or after the issuance of the Commission's Order on Rehearing in Case No. 2010-00074.



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