

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ALTERNATIVE RATE FILING OF COOLBROOK) CASE NO. 2011-00433
UTILITIES, LLC)

ORDER

Coolbrook Utilities, LLC ("Coolbrook") has applied pursuant to 807 KAR 5:076 for an adjustment of its rates for sewer service. By this Order, the Commission approves an increase of 7.2 percent in Coolbrook's monthly service rate from \$30.15 to \$32.31 and authorizes the assessment of a monthly surcharge of \$3 for 12 months to partially finance an inflow and infiltration study of Coolbrook's sewer collection system.

BACKGROUND

Coolbrook, a limited liability corporation organized pursuant to KRS Chapter 275, owns and operates sewage collection and treatment facilities that serve approximately 435 customers in the Coolbrook Subdivision of Franklin County, Kentucky.¹ Coolbrook's members are Larry Smither and Martin Cogan. Coolbrook acquired these facilities from Classic Construction, Inc. on October 31, 2008 at the cost of \$60,000.² The sewer collection and treatment facilities were originally constructed in 1971.

On October 31, 2011, Coolbrook applied to the Commission to adjust its monthly rate for sewer service from \$30.15 to \$36.80. The proposed rate would generate

¹ *Annual Report of Coolbrook Utilities, LLC to the Public Service Commission of Kentucky for the Calendar Year Ended December 31, 2010 ("Annual Report")* at 1 and 12.

² See Case No. 2008-00257, *Joint Application of Classic Construction, Inc. and Coolbrook Utilities, LLC For Approval of the Transfer of Wastewater Treatment Plant to Coolbrook Utilities, LLC* (Ky. PSC Oct. 21, 2008) (approving the proposed transfer); Coolbrook Utilities, LLC's Notice of Transfer (filed Nov. 10, 2008).

additional annual revenues of \$34,713, a 22 percent increase over present revenues of \$157,383. Coolbrook based its proposed rate on its operations for the calendar year ending December 31, 2010. Coolbrook also requested authorization to assess a monthly surcharge of \$6.75 for a 12-month period. The proceeds of proposed surcharge, which are estimated to be \$35,200, would be used to fund an inflow and infiltration study.

The proposed increase represents Coolbrook's second request for a rate adjustment in less than 15 months. On August 4, 2010, Coolbrook had applied to increase its monthly rate from \$22.00 to \$35.00.³ On June 6, 2011, the Commission authorized Coolbrook to adjust its monthly service rate from \$22.20 to \$30.15.

PROCEDURE

On October 31, 2011, Coolbrook filed its Application for rate adjustment pursuant to the Alternative Rate Filing Procedure. It proposed to place its proposed rates into effect on December 1, 2011. On November 29, 2011, the Commission suspended the proposed rates for five months and established a proceeding to review the requested rates. Shortly thereafter, the Commission granted the Attorney General ("AG") leave to intervene in this matter.

Pursuant to our directive, Commission Staff reviewed Coolbrook's financial records and prepared a report of its findings and recommendations regarding the proposed rate adjustment, which it filed with the Commission on March 5, 2012. In its Report, Commission Staff found that, based upon Coolbrook's test-period operations as adjusted for known and measurable changes, Coolbrook required annual revenues from

³ Case No. 2010-00314, *Alternative Rate Filing of Coolbrook Utilities, LLC* (Ky. PSC filed Aug. 4, 2010).

sewer rates of \$167,236, an increase in annual revenues of only \$9,903, or 6.29 percent more than normalized test-year revenues from rates. Commission Staff recommended adjusting Coolbrook's monthly rate to \$32.04. It further recommended denial of the requested surcharge.

Coolbrook and the AG filed comments on Commission Staff's findings and recommendations. The AG agreed with Commission Staff's findings. While noting its disagreement with four of Commission Staff's recommended adjustments, Coolbrook specifically objected to only Commission Staff's recommendations regarding the level of legal fees and the proposed surcharge.

On May 10, 2012, the Commission held a hearing in this matter. Evidence was limited to the two contested recommendations: legal fees and the proposed surcharge. Testifying were: Larry Smither and Martin Cogan, Coolbrook members; Jack Kaninberg, President of Small Utility Consulting, Inc.; and Sam Bryant and Eddie Beavers, Commission Staff members. Coolbrook and the AG subsequently filed post-hearing briefs.

DISCUSSION

As both parties have stated their general agreement and acceptance of the findings contained in Commission Staff's report, we direct our attention at the two issues in dispute: rate case expense and the proposed monthly surcharge.

Rate Case Expense. Coolbrook requested a three-year amortization of rate case expense totaling \$9,270. This amount included estimated legal fees and other actual expenses incurred to prepare, file, and litigate its Application. In its Report, Commission Staff agreed that rate case expenses should be amortized over a three-year period, but

found that the proposed rate case expense be reduced by \$6,600 to reflect the removal of legal fees. At the time of the Commission Staff Report's issuance, the sewer utility had yet incurred any legal fees. Commission Staff found that the estimated expense of \$6,600 was neither known nor measurable and recommended denial of the proposed adjustment. Following the hearing, Coolbrook provided invoices for legal services that totaled \$3,690. The hourly rate for these legal services was \$150. We find these fees should be included in rate case expense and should be amortized over a three-year period. This action will result in an adjusted amortization expense of \$2,120.

Coolbrook also indicated that consulting fees included in its original proposed adjustment did not include fees of \$425 for its consultant's appearance at the hearing. Coolbrook has not provided any evidence to support the incurrence or payment of these fees. We find that, in the absence of supporting evidence, the additional consultant fees should not be included in our calculation of Coolbrook's revenue requirement.

Surcharge for Inflow and Infiltration Study. Coolbrook requests authority to assess a monthly surcharge of \$6.75 for a 12-month period to finance an inflow and infiltration study. Based upon test-period customer level, the proposed surcharge would generate \$35,235.⁴ Coolbrook asserts that the Kentucky Division of Water ("DOW") has

⁴ 435 customers x \$6.75 x 12 months = \$35,235.

directed the utility to conduct the study⁵ and estimates the cost of such study at approximately \$35,000.⁶

Coolbrook contends that the proposed surcharge is the only viable means to fund the study. Coolbrook states that it lacks the available cash reserves to finance such study and that revenues from general rates are insufficient to directly fund the study or to assure prospective lenders of an adequate revenue stream to repay any loan to finance the study's cost. Mr. Cogan and Mr. Smither testified that their efforts to obtain a loan for such study have proven unsuccessful⁷ and that no financial institution has shown any interest in lending the necessary funds without a personal guarantee from Coolbrook's members.

Coolbrook also contends that the proposed surcharge is the less costly means of financing an inflow and infiltration study. It currently pays a fee equal to 15 percent of its sewer revenue to Farmdale Water District for billing and collection services. The

⁵ The study is intended to address the problems of inflow and infiltration into Coolbrook's sewer collection system. Inflow is generally any extra water flowing into the collection system from above ground sources. It is usually a result of storm activity and can enter the system by sheet flow of water over leaky manhole covers and uncovered cleanouts or through private property rain downspouts or cellar, yard, area or foundation drains illegally connected to the sanitary sewer system. Infiltration is generally any extra water that enters the wastewater flow from the surrounding soil. Groundwater flows or seeps into the system through cracked pipes and service laterals, separated joints in the pipe, and unsealed or leaky manholes. Pipes in the ground crack for a number of reasons. Coolbrook's sewer collection system was initially constructed in the 1970s when clay tile was commonly used for sewer main construction. Clay tile is a fairly brittle pipe and ground movement (due to seismic activity, expansive soils and settling) tends to promote joint separation and cracks in the pipe. Once the pipe has hairline cracks, roots will seek out the moisture inside the pipe and expand the cracks. Aggressive water seeking roots will intrude into a pipe enough to remove pieces and clog the pipe. The additional water entering the sewer collection system increases the cost of sewage treatment and can impair and significantly reduce the effective operation of sewage treatment facilities. An inflow and infiltration study identifies areas of a sewer collection system where cracks and openings have occurred. Using the results of such study, utility management can then plan and make repairs to problem sewer mains or replace entire sections of sewer mains.

⁶ App. at 103. Coolbrook provided two price quotes for the inflow and infiltration study. See Coolbrook's Response to Commission Staff's First Request for Information, Item 27 (filed Feb. 13, 2012). These price quotes listed prices of \$35,200 and \$38,400.

⁷ Coolbrook made inquiries to three financial institutions: Old National Bank; Bedford Loan and Deposit Bank; and PNC Bank. Coolbrook's Post-Hearing Brief at 3.

water district, however, has agreed to exempt the proposed surcharge from this fee. If the cost of the study is funded through general rates, Coolbrook argues, the higher rates necessary to fund the study would be subject to the 15 percent collection fee.

Finally, Coolbrook argues that the improvements that are likely to result from the inflow and infiltration study should reduce the amount of flow treated at the plant and, thus reduce operating costs.

In its Report, Commission Staff recommends that the request for the proposed surcharge be denied. It questions the need for the proposed inflow and infiltration study. It notes that Coolbrook had produced no evidence of any DOW mandate other than a letter in which a DOW enforcement official suggested possible terms of an Agreed Order and that Coolbrook had acknowledged in response to its requests for information that no Agreed Order with DOW currently exists.⁸

Commission Staff further found that Coolbrook had offered no evidence that the proposed surcharge was necessary to finance an inflow and infiltration study. It states that a utility will generally finance this type of expenditure through internal funds or through the issuance of debt. It notes that Coolbrook could borrow the funds and then seek recovery of the cost of borrowing through its general rates. Commission Staff recommends that prior to the authorization of a surcharge, Coolbrook should be required to demonstrate reasonable efforts to obtain outside funding. Commission Staff found that Coolbrook had not presented such evidence.⁹

Commission Staff also raises concerns regarding the effects of the proposed surcharge on the allocation of risks between utility ratepayers and the utility. The inflow

⁸ Commission Staff Report at 3.

⁹ *Id.* at 4.

and infiltration study, it found, represents a construction overhead that generally would be recovered over the useful lives of any construction projects resulting from the study. Such a major capital expenditure is generally funded by the utility and recovered through general rates over the utility plant's service life. Utility ratepayers pay for the expenditure as the capital asset depreciates. Coolbrook's proposed surcharge, Commission Staff asserted, requires ratepayers to pay these capital expenditures in advance before using the asset. Instead of the utility bearing the risk that the asset will be fully used, the proposed surcharge transfers that risk to ratepayers.

The AG raised similar concerns. He argued that “[u]nder accepted ratemaking principles, a utility’s owners/shareholders bear the costs of a capital expenditure, such as the I&I [inflow and infiltration] study proposed, and the risk and necessary oversight for such an expenditure. Once the investment is made, a utility may seek recovery of prudently incurred capital costs through rates. Ratemaking principles direct that the opportunity to earn a return for the investment is through rate recovery over the useful life of the assets.”¹⁰ If Coolbrook is allowed to shift this cost of the inflow and infiltration study, the AG argues, “the utility will bear virtually none of the risk over the life of the asset . . . [and] Coolbrook will have far less incentive to exercise diligence and proper management upon the approval of a surcharge.”¹¹

The AG further argued that Coolbrook has failed to demonstrate that the proposed surcharge is necessary to obtaining financing for the study. He notes that Coolbrook has never formally applied for any loans and that its evidence related to the position of lenders is dated and does not expressly involve a loan to Coolbrook. To the

¹⁰ AG's Post-Hearing Brief at 2.

¹¹ *Id.* at 3.

extent that Coolbrook's members may be required to provide a personal guarantee for Coolbrook to obtain a loan, he finds no legal authority that requires the Commission to establish a rate to avoid that result.¹²

Finally, the AG asserts that the present case is readily distinguishable from prior Commission cases in which a surcharge was authorized. He notes that in some of those prior Commission proceedings the sewer utility was under an Order from the DOW to make immediate repairs and the proposed surcharge was essential to require the mandated repairs. In the present case, the AG states, DOW has not mandated any repairs. As to the Commission proceedings in which no DOW directive was presented, he notes that a surcharge was the result of an agreement with Commission Staff and the agreement has no weight as precedent.¹³

Based upon our review of the evidence, we find that Coolbrook's proposal to commission an inflow and infiltration study is not unreasonable. While the DOW has not mandated such study, its enforcement officials apparently believe that such study is necessary. Moreover, Coolbrook has been the subject of several notices of violations related to excessive inflows into its sewage treatment facilities. Given the age of Coolbrook's collection system, which is in excess of 40 years, conducting an inflow and infiltration study appears consistent with accepted management and operation practices and with 807 KAR 5:071, Section 5(2), which requires a sewer utility to "make all reasonable efforts to eliminate or prevent the entry of surface or ground water . . . into its sanitary sewer system."

¹² *Id.* at 6-7.

¹³ *Id.* at 4-6.

We generally agree with Commission Staff that the cost of an inflow and infiltration should be accounted for as part of the total cost of constructing the system improvements that result from the study. The entire cost of the improvements should be depreciated and recovered from ratepayers over the estimated life of the assets. This method ensures that all ratepayers who benefit from the assets pay their appropriate share of the costs of the assets.

The Commission also recognizes that the financial condition of the sewer utility must be taken into consideration. The record indicates that Coolbrook has limited financial reserves and cannot finance the proposed study with internal funds.¹⁴ Moreover, the record strongly suggests that Coolbrook lacks the ability to obtain financing without its members' personal guarantees. While Coolbrook's members appear to have had reasonable notice of the sewer utility's potential problems and deficiencies at the time of Coolbrook's acquisition of the sewer collection and treatment facilities and were well aware of the likelihood that a personal guarantee of some of the utility's financial requirements might be required,¹⁵ we find it unreasonable under the circumstances to place the burden of financing the study on their shoulders alone.

The Commission finds that, in this instance only, Coolbrook should be permitted accelerated recovery of some of the costs of the inflow and infiltration study. We further find that Coolbrook should be permitted to assess a monthly surcharge of \$3.00 for 12 months. Collection of the surcharge should begin only after the study has been performed and a copy of the study filed with the Commission. Coolbrook must still obtain interim financing for the cost of the study and must recover the remaining cost of

¹⁴ As of December 31, 2010, Coolbrook had a cash balance of two dollars. *Annual Report* at 12.

¹⁵ Video Transcript of 5/10/2012 Hearing, 10:04:26 - 10:08:24.

the study¹⁶ only through general rates.¹⁷ The Commission is of the opinion that the surcharge authorized in this Order should assist in obtaining short-term and longer term financing.

By this Order, the Commission places Coolbrook on notice that surcharges are generally disfavored. Recovery of the costs of providing service should generally be through general service rates. Only in extraordinary circumstances should surcharges be authorized. In developing its plan for financing for the inflow and infiltration study, Coolbrook should explore all available options and should not expect or rely upon future surcharges as a source of funding.

SUMMARY

Having considered the Stipulation and the other evidence of record and being otherwise sufficiently advised, the Commission finds that:

1. Except where they conflict with the findings contained in this Order, the findings contained in Commission Staff's Report are supported by the evidence of record, are reasonable, and should be adopted.
2. The calendar year ending December 31, 2010 should be used as the test period to determine the reasonableness of Coolbrook's existing and proposed rates.
3. Based upon pro forma test-period operations, Coolbrook's pro forma annual revenues are \$157,383.

¹⁶ Nothing contained in this Order should be construed as a finding on the reasonableness of the cost of the proposed inflow and infiltration study. In any future rate proceeding in which Coolbrook seeks recovery of any unrecovered costs related to the inflow and infiltration study, Coolbrook must demonstrate the reasonableness of the total cost of the study.

¹⁷ In any future rate proceeding, Coolbrook may also request recovery of depreciation and interest costs related to permanent financing of the cost of the inflow and infiltration study.

4. Based upon pro forma test-period operations, Coolbrook's pro forma total operating expenses, after adjusting for known and measurable changes, are \$148,398.

5. Coolbrook's pro forma amortization expense of \$2,120 includes the amount of legal expenses that Coolbrook had incurred as of May 30, 2012 to pursue its rate adjustment application. These expenses are amortized over a three-year period.

6. Given that no basis exists to determine an appropriate rate of return for Coolbrook, the use of an operating ratio¹⁸ to determine its total revenue requirement is appropriate.¹⁹

7. An operating ratio of 0.88 will permit Coolbrook to meet its reasonable operating expenses and provide a fair and reasonable return for equity growth and should be used to determine Coolbrook's total revenue requirements.

8. Applying an operating ratio of 0.88 to Coolbrook's pro forma total operating expenses of \$148,398 produces a total revenue requirement of \$168,634,²⁰ or \$11,251 more than Coolbrook's current rates produce.

9. Given Coolbrook's end of test-period customer level of 435 customers and considering the effects of rounding, a monthly rate of \$32.31 will produce the required total revenue requirement.²¹

¹⁸ Operating Ratio is defined as the ratio of expenses, including depreciation and taxes, to gross revenues. It is illustrated by the following equation:

$$\text{Operating Ratio} = \frac{\text{Operating Expenses} + \text{Depreciation} + \text{Taxes}}{\text{Gross Revenues}}$$

¹⁹ See, e.g., Case No. 8468, *An Adjustment of the Rates of Plantation Hill Sewage Treatment Plant, Inc.* (Ky. PSC Jun. 25, 1982); 1 A.J.G. Priest, *Principles of Public Utility Regulation* (Michie 1969) 220-224.

²⁰ \$148,398 ÷ 0.88 = \$168,634.

²¹ \$168,634 (Total Revenue Requirement) ÷ 12 months ÷ 435 customers = \$32.3053.

10. Coolbrook's proposed rate will produce revenues in excess of those found reasonable herein and should be denied.

11. Coolbrook proposes to commission an inflow and infiltration study of its sewer collection system.

12. Given the age and general condition of Coolbrook's collection system and its inability to comply with state environmental laws, conducting such study is consistent with accepted engineering and management practices and is consistent with 807 KAR 5:071, Section 5(2), which requires a sewer utility to "make all reasonable efforts to eliminate or prevent the entry of surface or ground water . . . into its sanitary sewer system."

13. The cost of an inflow and infiltration study is generally a capital expenditure, should generally be accounted for as part of the total cost of system improvements that result from the study, and should be recovered from ratepayers through general rates as the cost of those system improvements are depreciated. When an inflow and infiltration study is conducted and does not result in any system improvements, the cost of the study should be amortized over an appropriate period.

14. Given Coolbrook's numerous violations of environmental laws related to the inflow and infiltration, the age of Coolbrook's facilities, and its limited financial resources, Coolbrook should be permitted accelerated recovery of some of the costs of the inflow and infiltration study through the use of a monthly surcharge.

15. Coolbrook should be permitted to assess a monthly surcharge of \$3.00 for a period of 12 months subject to the following conditions:

a. Assessment and collection of the surcharge shall not begin until the inflow and infiltration study has been performed and a copy of that study has been filed with the Commission.

b. No more than 45 and no less than 30 days prior to the first billing of the surcharge, Coolbrook shall file with the Commission a revised tariff sheet that reflects the monthly surcharge.

c. The surcharge shall be billed as a separate line item on customer bills.

d. Upon commencement of the billing of the surcharge, Coolbrook shall file with the Commission semi-annual reports of its surcharge billings and collections.

e. Within 120 days of the date of this Order, Coolbrook shall enter into a contract for the performance of the inflow and infiltration study and work on the study shall begin.

IT IS THEREFORE ORDERED that:

1. Coolbrook's proposed monthly rate for service is denied.
2. Coolbrook's proposed monthly surcharge is denied.
3. Coolbrook is authorized to assess a monthly fee of \$32.31 for service provided on and after the date of this Order.
4. Coolbrook is authorized to assess a monthly surcharge of \$3.00 for a period of 12 months subject to the conditions set forth in ordering paragraphs 5 through 10.

5. Coolbrook shall not commence assessment and collection of the surcharge until the inflow and infiltration study has been performed and a copy of that study has been filed with the Commission.

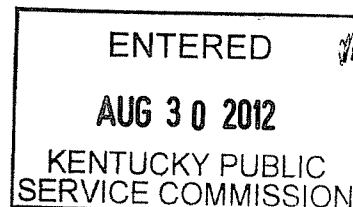
6. Coolbrook shall file with the Commission no more than 45 days and no less than 30 days prior to the first billing of the surcharge a revised tariff sheet that reflects the monthly surcharge.

7. Coolbrook shall bill the surcharge as a separate line item on customer bills.

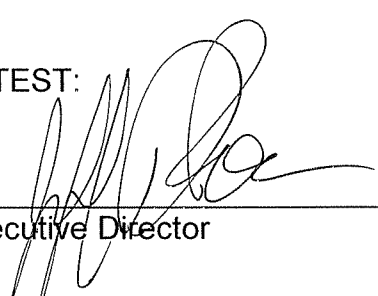
8. Every 90 days following commencement of the billing of the surcharge, Coolbrook shall file with the Commission a written report stating the amount of the surcharge billed and collected monthly while the surcharge has been in effect.

9. If, within 180 days of the date of this Order, Coolbrook has not entered into a contract for the performance of an inflow and infiltration study and that study has not begun, authorization for the monthly surcharge is vacated and Coolbrook shall immediately notify the Commission in writing.

By the Commission



ATTEST:



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