COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF ESTILL COUNTY WATER DISTRICT NO. 1 TO ISSUE SECURITIES IN THE APPROXIMATE PRINCIPAL AMOUNT OF $2,745,000 FOR THE PURPOSE OF REFUNDING AND/OR REAMORTIZING CERTAIN OUTSTANDING OBLIGATION OF THE DISTRICT	)	**CASE NO. 2018-00058**

MOTION FOR RECONSIDERATION AND SUPPORTING MEMORANDUM

Pursuant to KRS 278.400, Estill County Water District No. 1 ("Estill District") moves for reconsideration of the Public Service Commission's Order of March 6, 2018 in which the Public Service Commission denied Estill District's application for authorization to issue evidences of indebtedness to refinance portions of its existing debt obligations. In its Order, the Public Service Commission incorrectly applied KRS 278.300 and ignored the principal purpose of the proposed issuance. The practical effect of this decision, if not amended, is to eliminate any means for Estill District to meet its bond obligations and to increase the likelihood that Estill District will be placed into receivership or required to seek relief under the U.S. Bankruptcy Code.

BACKGROUND

Estill District, a water district organized pursuant to KRS Chapter 74, provides water service to approximately 3,566 customers in the non-incorporated areas of Estill County, Kentucky.[1] In the past 28 years, it has borrowed funds from the United States Department of Agriculture, acting through Rural Development ("RD"), and the Kentucky Rural Water Finance

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[1] *Report of Estill County Water District No. 1 to the Kentucky Public Service Commission for the Year Ending December 31, 2016* ("*2016 Annual Report*") at Ref Pages 5 and 27.

Corporation ("KRWFC") to fund the expansion and improvement of its water distribution system. As of December 31, 2017, it had outstanding bonded or long-term indebtedness of $4,215,970. Of this amount, approximately $3,917,100 represented outstanding loans from RD.

In recent years, Estill District has experienced significant financial difficulties due to its high water loss rate. Estill District does not produce its own water, but purchases its total water requirements. Despite continuing efforts to contain and reduce the level of non-revenue water, Estill District experienced between 2009 and 2016 annual water line losses ranging from 23.6 percent to 36.5 percent of its total purchased water. The significant amount of purchased water expense associated with this level of line loss as well as delays in seeking an adjustment in its rates for service required Estill District on three occasions to borrow funds from a local bank to meet its debt service payments and current operating expenses. Estill District has attempted to reduce its expenses by reducing its workforce as well as implementing other cost-saving measures. The hourly wage rate of most of its employees has not increased in ten years. In 2017, Estill District applied for a 22.5 percent increase in its rates to meet current operating expenses and to cover its debt service obligations.[2] Primarily as a result of its high level of water loss, the Public Service Commission authorized a rate adjustment of only 11.6 percent.[3]

On November 1, 2017, Estill District's commissioners and office manager testified before the Public Service Commission that Estill District no longer possessed adequate funds or sufficient cash flow to meet the upcoming principal and interest payments on most of its RD loans. They further testified that Estill District intended to refinance most of its outstanding debt to avoid default and to provide additional time to rebuild its cash reserves and to correct its water

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[2] *Electronic Application of Estill County Water District No. 1 For Rate Adjustment Pursuant To 807 KAR 5:076*, Case No. 2017-00176 (Ky. PSC filed May 10, 2017).
[3] *Electronic Application of Estill County Water District No. 1 For Rate Adjustment Pursuant To 807 KAR 5:076*, Case No. 2017-00176 (Ky. PSC Dec. 20, 2017).

loss problems. Refinancing these loans was also expected to reduce some of Estill District's interest expense as some of its older loans carried interest rates between 4.1 percent and 5.0 percent.

On February 5, 2018, Estill District filed its application for authorization to borrow approximately $2,745,000 from KRWFC ("the Loan") for the purpose of refunding all of its outstanding long term loans, except for its most recent RD loan which has an interest rate of 2.375 percent per annum. The Loan would have a term of 28 years and an interest rate that varies between 3.3 percent and 3.8 percent per annum. The proposed transaction was expected to produce present value savings of $108,317 and an actual savings over the life of the loan of $(3,100). In its application, Estill District made clear that the primary purpose of the loan was not to produce significant savings, but to allow it to avoid default on its outstanding loans:

> In recent years, the District has experienced significant unaccounted-for water losses that have increased its operating expenses and adversely affected its ability to meet its debt service payments. The District's current financial condition was the subject of a hearing held in Case No. 2017-00176. The proposed KRWFC Loan, in addition to producing substantial debt service savings, will permit the District to restructure its debt payments and afford it additional time to correct its operational problems while remaining current on its debt service obligations. **If the proposed refunding does not occur by late February 2018, the District will be in default on one or more of its existing debt obligations.**[4]

At the time of filing its application, Estill District had informed State RD officials regarding its efforts to restructure its debt and to avoid defaulting on its RD loans. State RD officials had expressed their willingness to postpone any official action against Estill District until the Public Service Commission had addressed Estill District's application for authorization to enter the proposed loan agreement with KRWFC. On February 1, 2018, Estill District made

[4] Application at ¶ 18 (emphasis added).

the required principal and interest payment for the RD loan that it did not intend to refinance with the Loan's proceeds.

On March 6, 2018, the Public Service Commission issued an Order in this proceeding in denying Estill District's application. It found that the Loan was "unreasonable due to the lack of Gross Future Value Benefit savings"[5] and further found "no evidence that obtaining the financing will provide any financial benefit" to Estill District.[6] It concluded that "obtaining financing at a loss simply puts Estill [District] . . . further in debt and will not alleviate its financial distress."[7]

As of March 29, 2018, Estill District has defaulted on six of its RD loans. In his affidavit, which is attached as Exhibit A to this Motion and Memorandum, the RD State Program Director describes the procedures that RD will follow to address Estill District's default. He further states that, based upon Estill District's most recent income statements and balance sheet, it does not appear that Estill District has sufficient cash reserves and cash flow to resolve the loan delinquencies.

ARGUMENT

1. KRS 278.300 does not require that proposed evidence of indebtedness produce a gross future value benefit savings as a condition for authorization.

KRS 278.300(3) sets forth the conditions that the Public Service Commission must find to authorize the issuance of an evidence of indebtedness. It provides:

> The commission shall not approve any issue or assumption unless, after investigation of the purposes and uses of the proposed issue and the proceeds thereof, or of the proposed assumption of obligation or liability, the commission finds that the issue or assumption is for some lawful object within the corporate purposes

[5] Order at 3. The Public Service Commission defines "total gross savings" as "the difference between the Total Principal and Interest Payments for the new debt service and the outstanding debt service." *Id.*
[6] *Id.*
[7] *Id.*

> of the utility, is necessary or appropriate for or consistent with the proper performance by the utility of its service to the public and will not impair its ability to perform that service, and is reasonably necessary and appropriate for such purpose.

KRS 278.300(3) thus requires the Public Service Commission to address whether the proposed issuance (1) is for a lawful object within Estill District's corporate purposes; (2) is consistent with or necessary for the Estill District's proper performance of its duties as a utility; (3) will impair Estill District's ability to provide water service to the public; and (4) is reasonably necessary and appropriate for the performance of its duties. It makes no mention of "gross future value benefit savings" nor does it contain any reference to "financial benefit."

In its Order of March 6, 2018, the Public Service Commission fails to address any of the areas that KRS 278.300(3) provides as a basis for denying authorization to issue evidences of indebtedness. The sole basis for the Public Service Commission's denial of Estill District's application for authorization is the lack of gross future value benefit savings.

Estill District clearly met the requirements set forth in KRS 278.300(3). KRS 74.070[8] and KRS 74.320 authorize it as a water district to issue evidences of indebtedness to refund any bonded debt. The Loan is necessary for Estill District to avoid default on its existing debt obligations and to continue performing its duties as a public utility. Furthermore, the Loan allows Estill District to avoid the costs associated with default, such as interest penalties, attorney's fees, and higher credit costs, and to reduce customer concerns about the water district's stability and reliability of service. It also ensures that Estill District will retain its eligibility for federal grants and loans.[9]

The record contains no evidence that the Loan will impair Estill District's ability to provide water service. To the contrary, the Loan affords Estill District much needed breathing

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8 *See* OAG 83-129.

9 Affidavit of Anthony Hollinsworth at ¶¶ 11-12.

space to improve its cash reserves and to address its water loss problems. To the extent that the Loan will result in negative gross savings, this amount is relatively small, especially when viewed over the Loan's life. The negative gross savings of $3,100 represents an annual cost of $111, or 0.008 percent of Estill District's total operating expenses in 2016.[10] In contrast, the placement of Estill District into receivership or bankruptcy – the likely results of a denial of authorization for the Loan – will have far worse consequences on Estill District's ability to provide water service than the meager annual cost associated the Loan.

Estill District's application is clearly distinguishable from other applications for refinancing in which the Public Service Commission required the applicant "to demonstrate in its application that refinancing produces both a total gross savings and a net present value savings."[11] In those other applications, the sole purpose and only benefit of the proposed transaction was the reduction of interest expense. If the transaction failed to produce a total gross savings and a net present value savings, there was no rational reason for the transaction to proceed. In the present case, the Loan's purpose is to restructure Estill District's debt to avoid default and to allow Estill District time to rebuild its cash reserves and address operational problems. While the Loan will generate a significant net present value savings, those savings are neither the sole nor primary benefit of the transaction. Moreover, avoiding default produces several benefits, such as avoidance of litigation expenses, penalties and additional interest expenses, that cannot be easily quantified. The Public Service Commission failed to consider these benefits when evaluating the financial benefits of the proposed loan.

In summary, Estill District has demonstrated that its proposed loan meets the requirements set forth in KRS 278.300. As the Loan's purpose is not solely a reduction of

[10] *2016 Annual Report* at Ref Page 11.
[11] Order at 3.

interest expense, Estill District is not required to demonstrate that the Loan will produce a gross savings. While the Loan will not produce a gross savings in terms of principal and interest payments, it will produce significant benefits for Estill District by permitting it to avoid the expenses and other costs associated with default. When these benefits are considered, the Loan provides financial benefits to Estill District.

2. In its Order of March 6, 2018, the Public Service Commission fails to consider the limited alternatives available to Estill District and the potential consequences of a default on Estill District's RD loans.

While expressing concern in its Order of March 6, 2018, about "Estill County's history in regard to repaying its current indebtedness," the Public Service Commission fails to discuss or identify any viable alternatives to the Loan. It does not discuss or otherwise consider the potential consequences if the Loan is not authorized and Estill District remains in default on most of its RD loans. It does not consider the likely consequences of its Order of March 6, 2018 – the placement of Estill District under the control a court-appointed receiver or the filing for relief under the Bankruptcy Code.

Estill District has not identified any realistic and viable alternatives to the Loan. Given that Estill District is currently in default on its RD loans and is experiencing significant operational problems, no commercial lender appears willing to make a long-term loan to Estill District that would enable it to avoid default. The Kentucky Infrastructure Authority ("KIA") does not make loans solely for the purpose of refinancing existing debt unrelated to KIA-funded infrastructure projects. RD does not engage in the refinancing of outstanding loans except when the refinancing also involves the construction of new facilities. Moreover, Federal law prohibits any additional loans to Estill District while it remains delinquent on its existing RD loans. While Estill District could possibly persuade a local bank to extend credit on a short-term basis to enable it to meet its current delinquency, this alternative does not provide Estill District with any additional time to build up its cash reserves or solve its operational problems. Furthermore, the Public Service Commission and its Staff has expressed disapproval for such actions.[12]

Unless it is authorized to execute the Loan, Estill District will remain in default on six of its seven RD loans. In his affidavit, Mr. Hollinsworth describes the actions that RD is required to take regarding Estill District. RD will first attempt to reach a workout agreement with Estill District to eliminate the delinquency. If a workout agreement is not possible, RD Staff will consider debt rescheduling or reamortization. That action involves recalculating for each loan the principal and unpaid interest over the remaining life of the delinquent loan at the loan's current interest rate. Given that this process is likely to generate higher principal and interest payments than Estill District is currently paying, it is unlikely to provide any relief to Estill District. Moreover, RD will take this action only if Estill District can demonstrate that it has sufficient cash flow to meet the revised payment schedule and reserve requirements of each loan.

If no agreement is reached within 180 days after the default has occurred, RD will report Estill District's delinquencies to the U.S. Treasury Offset Program. The Treasury Department will then begin withholding any federal funds to which Estill District is entitled to offset amounts owed to the U.S. Government. Potential funds subject to offset include loans and grants from such federal agencies as RD, the Environmental Protection Agency, and the Appalachian Regional Commission. In addition to potential offsets of federal funds, Estill District will be ineligible for further federal loans and grants while the delinquency exists. If RD determines that these efforts will not accomplish payment of the loans, it will commence legal action to obtain the appointment of a receiver to operate or sell Estill District's property.

The appointment of a receiver to operate Estill District will have significantly adverse consequences for Estill District and its customers. The residents of Estill County will lose

[12] Case No. 2017-00176, Commission Staff Report at 21-22.

control over their water supplier. The appointment of a receiver is likely to reduce public confidence in the water utility and increase public concern about its future. Moreover, Estill District is likely to incur significant legal costs related to any legal action seeking the appointment of a receiver and experience higher borrowing costs as potential creditors will request a higher rate of interest to compensate for the greater uncertainty. Similarly, vendors may be less willing to extend credit for goods and services and require payment prior to the delivery of goods and service. Finally, the uncertainty related to the appointment of a receiver is likely to adversely affect employee morale and the provision of service.

Estill District's default and the subsequent appointment of a receiver will affect other water utilities subject to Public Service Commission regulation. Lending institutions are likely to interpret the Order of March 6, 2018 as evidence of an unfavorable and unsupportive regulatory environment and an indicator of a lack of interest on the part of the Public Service Commission to assist troubled water districts. They are likely to become more cautious and circumspect in their lending practices and less willing to extend credit to water districts with weak financial positions. As a result, the ability of these water utilities to expand or replace existing infrastructure and to maintain or improve the quality of their service will likely to suffer.

In performing its statutory duty to regulate utilities, the Public Service Commission cannot ignore the potential effects of the Order of March 6, 2018 on Estill District and on other water utilities in the Commonwealth. Failure to grant authorization for Estill District to enter the proposed loan agreement with KRWFC will have severe consequences for Estill District and potentially adverse effects for other water utilities. Those consequences should be given careful consideration when the application is reviewed.

CONCLUSION

Estill District respectfully requests that the Public Service Commission reconsider its Order of March 6, 2018 and authorize Estill District to execute the proposed loan agreement with KRWFC for the amount and purposes set forth in the Application.

Dated: March 29, 2018

Respectfully submitted,

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Counsel for Estill County Water District No. 1

EXHIBIT A

COMMONWEALTH OF KENTUCKY)
) SS:
COUNTY OF FAYETTE)

AFFIDAVIT OF ANTHONY HOLLINSWORTH

Anthony Hollinsworth, being duly sworn, states as follows:

1. He currently serves as Program Director for Rural Development's ("RD") Water and Waste Disposal Loan and Grant Program and Community Facilities Programs in Kentucky.

2. He has served as Director for these Programs for two years, has served in the RD's Kentucky State Office for approximately 13 years, and has been an employee of the United States Department of Agriculture for 30 years.

3. One of his primary responsibilities as State Program Director for RD's Water and Waste Disposal Loan and Grant Program is the supervision and management of the issuance and servicing of RD loans and grants to water and wastewater systems in Kentucky.

4. Estill County Water District No. 1 ("Estill District") is currently indebted for six RD loans. In his position as State Program Director for RD's Water and Waste Disposal Loan and Grant Program, he is familiar with these loans and their current status.

5. Exhibit A to this Affidavit lists for each of these loans the date of original issuance, maturity date, the original loan amount, principal owed as of February 1, 2018, and the principal and interest payment owed as of February 1, 2018.

6. For each of the loans listed in Exhibit A, Estill District issued revenue bonds to Rural Development (or to its predecessor, the Farmers Home Administration) to evidence the loans. For each bond issuance, Estill District adopted a bond ordinance that authorized the issuance and pledged the water district's revenues as security for the payment of the bonds. These Ordinances required Estill District to make principal and interest payments on the bonds on February 1 and August 1 of each year during the life of the bonds. They further provided that

Estill District would be considered in default on its obligations under the bond ordinance if it failed to pay the principal of the bonds when it became due and payable or failed to pay to RD any installment of interest on the bonds within 30 days of the stated date for those interest payments. These Ordinances further provided that, in the event of default, RD could bring action for the appointment of a receiver to administer Estill District's water system on Estill District's behalf.

7. Estill District was required to make a principal and interest payments on each of the loans listed in Exhibit A on February 1, 2018. Estill District made timely payment of $48,016.56 on February 1, 2018 on Loan 91-19. It failed to make required principal and interest payments totaling $117,534.37 on the other loans listed in Exhibit A. As of the date of this Affidavit, Estill District is in default on its obligations on each of those other loans. RD currently considers Estill District to be a delinquent borrower.

8. Estill District is not incurring any additional penalties at this time as a result of its failure to make timely payment on its loans; however, it is incurring additional interest charges for the scheduled principal payments that it failed to make. If the account is not paid current and RD is forced to take legal action, Estill District could incur additional charges.

9. RD Staff Instructions require Rural Development Staff to meet with a delinquent borrow and attempt to develop a workout agreement to eliminate the delinquency. This workout agreement must include specific actions by the borrower within specified time period.

10. If the delinquent account cannot be paid current through a workout agreement, RD Staff Instructions generally provide only one form of relief for delinquent borrowers – **debt rescheduling or reamortization**. Under this relief, RD will recalculate the principal and interest unpaid balances over the remaining life of the delinquent loan at the loan's existing

interest rate. Since the delinquent interest will be capitalized and added back to the loan principal, and since the interest rate and final maturity will be unchanged, the payments will necessarily increase. This relief, however, is only available if the delinquent debtor can demonstrate that it has sufficient cash flow to meet the revised payment schedule and the reserve requirements of the loan(s).

11. If workout agreement is not reached and the delinquent borrower fails to make current the delinquent loans, RD will report the delinquent borrower to the Treasury Offset Program. Once a delinquent borrower is reported to the Treasury Offset Program, the Treasury Department will withhold any federal funds to which the delinquent borrower is entitled to offset amounts owed to the U.S. Government. Potential funds subject to offset include loans and grants from such federal agencies as RD, the Environmental Protection Agency, and the Appalachian Regional Commission.

12. In addition to potential offsets of federal funds, a delinquent RD borrower will be ineligible for further federal loans and grants while the delinquency exists. 31 U.S.C. § 3720B(a) provides:

> Unless this subsection is waived by the head of a Federal agency, a person may not obtain any Federal financial assistance in the form of a loan (other than a disaster loan or a marketing assistance loan or loan deficiency payment under subtitle C of the Agricultural Market Transition Act (7 U.S.C. 7231 et seq.)) or loan insurance or guarantee administered by the agency if the person has an outstanding debt (other than a debt under the Internal Revenue Code of 1986) with any Federal agency which is in a delinquent status, as determined under standards prescribed by the Secretary of the Treasury.

13. If RD determines that efforts to service a delinquent loan will not achieve the objective of the loan and a voluntary sale of the property cannot be accomplished, it can

commence legal action to obtain the appointment of a receiver to operate the property of the delinquent borrower for the benefit of the bondholders.

13. He has examined Estill District's income statements for January and February 2018 and its balance sheet as of February 28, 2018 and is of the opinion that Estill District will have significant problems demonstrating that it has or can achieve a cash flow sufficient to allow it to meet principal and interest payments if the delinquent loans are reamortized. Because principal and interest payments are rescheduled or reamortized over the remaining life of the loans at the loan's current interest rate, these payments will be higher than the existing payments that Estill District has been unable to meet. Estill District does not appear to have any available cash reserves to support principal and interest payments at currently required levels.

ANTHONY HOLLINSWORTH

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 28th day of March 2018.

Ann S Rankin (SEAL)
Notary Public

My Commission Expires: 11/29/19

Notary ID: 545920

EXHIBIT A
AFFIDAVIT OF ANTHONY HOLLINSWORTH

Loan No.	Initial Amount	Issuance Date	Principal Payment (02/01/2018)	Interest Payment (02/01/2018)	Total Payment (02/01/2018)	Status	Total Unpaid Principal
91-07	$ 521,000	09/03/1992	$16,000.00	$ 7,575.00	$23,575.00	**Delinquent**	$ 303,000
91-09	$ 101,000	09/03/1992	$ 3,000.00	$ 1,490.00	$ 4,490.00	**Delinquent**	$ 59,600
91-10	$ 505,000	01/30/1997	$12,000.00	$ 7,920.00	$19,920.00	**Delinquent**	$ 352,000
91-13	$ 975,000	03/10/2000	$20,000.00	$16,740.00	$36,740.00	**Delinquent**	$ 744,000
91-16	$ 945,000	12/22/2006	$16,000.00	$16,809.37	$32,809.37	**Delinquent**	$ 815,000
91-19	$1,699,000	07/10/2014	$28,500.00	$19,516.56	$48,016.56	Current	$ 1,615,000