

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

APPLICATION OF SANITATION DISTRICT)	
NO. 1 OF CAMPBELL AND KENTON COUNTIES)	
FOR AUTHORITY TO CONSTRUCT \$23,200,000)	
OF FACILITIES; TO ISSUE REVENUE BONDS)	CASE NO. 9310
IN THE APPROXIMATE AMOUNT OF \$15,475,000;)	
AND TO DEFEASE ALL NOW OUTSTANDING)	
REVENUE BONDS AMOUNTING TO \$20,620,000)	

O R D E R

Procedural Background

On March 27, 1985, the Sanitation District No. 1 of Campbell and Kenton Counties ("Campbell and Kenton") filed an application requesting a Certificate of Public Convenience and Necessity to construct \$23,200,000 of facilities; for approval of the proposed issuance of revenue bonds in the approximate amount of \$15,475,000; and for approval of defeasance of the current outstanding revenue bonds of \$20,620,000.

On April 16, 1985, an informal conference was held at the Commission offices in Frankfort, Kentucky, to clarify some of the major issues. Campbell and Kenton was informed that, in order for the Commission to issue a Certificate of Public Convenience and Necessity to construct, the details of the various projects would have to be submitted for approval.

On April 19, 1985, Campbell and Kenton filed a motion to exclude from this proceeding the 1987-1990 construction projects and thus request only a Certificate of Public Convenience and

Necessity for project D-1, an office building. This motion was filed because Campbell and Kenton stated that it is not feasible or possible to classify and process the 1987-1990 projects. Campbell and Kenton proposed to request a Certificate of Public Convenience and Necessity for project B-3, Standby Generators, and project C-3, Additional Primary Tanks, in a subsequent proceeding. It was also stated in the motion that the other 20 scheduled construction items for the 1985-1986 period do not require a Certificate of Public Convenience and Necessity under KRS 278.020.

A hearing was held in the offices of the Public Service Commission, at Frankfort, Kentucky, on June 7, 1985. There were no intervenors and no protests were entered. During the hearing, counsel for Campbell and Kenton stated that the request was being further revised to include a request for general approval of the \$23 million capital improvements program without requesting a certificate. In the alternative, counsel stated that Campbell and Kenton's position was the same as that set forth in the April 19, 1985, motion. Should the Commission not view that alternative favorably, counsel stated that Campbell and Kenton was relying upon its original application and sought whatever relief to which the Commission found it was entitled. Campbell and Kenton still sought, in addition to any certificate required for construction, authority to issue \$16 million in additional debt, and to defease its outstanding bond issues.

An Interim Order was issued in this case on July 5, 1985, wherein a Certificate of Public Convenience and Necessity to construct the new office building was granted.

On September 24, 1985, Campbell and Kenton filed a brief setting forth its position on the issues in the case. Several conferences with Commission staff were held in an effort to achieve a settlement of those issues. The staff discussed its concerns at both the October 4, 1985, and November 8, 1985, conferences. On November 13, 1985, oral arguments were heard by the Commission.

Discussion

The additional \$22 million in construction projects would be approximately a 25 percent increase in plant-in-service. Due to the magnitude of the capital outlay for the project, which could materially affect Campbell and Kenton's financial condition, the Commission is of the opinion that this construction project cannot be considered an extension in the ordinary course of business within the meaning of 807 KAR 5:001, Section 8(3). Thus, a Certificate of Public Convenience and Necessity is required. Since the application is materially deficient in that sufficient information regarding the construction plans and specifications has not been submitted, a Certificate of Public Convenience and Necessity for these projects cannot be granted.

Campbell and Kenton presented three primary reasons for its proposal to issue approximately \$16 million of revenue bonds to defease its existing bonds now outstanding in the amount of approximately \$20 million. First and foremost, the results of a study performed by Merrill-Lynch Capital Markets ("Merrill-Lynch") indicated that, over the 20-year defeasance program, Campbell and Kenton would realize a net savings in debt service of

approximately \$1.8 million. The second stated advantage of defeasance was that the existing bond indentures are obsolete and excessively restrictive with regard to utilization of money contained in required special reserve funds. Finally, Campbell and Kenton contends that it will incur higher interest costs if it is required to borrow money for constructing in the future, since the regulations of the Federal Treasury may be revised to limit or totally eliminate tax exempt financing.

Upon its review of the evidence of record in this case, the Commission is not convinced that Campbell and Kenton has thoroughly explored all available options for the restructuring of its capital. Mr. Gary R. Richardson, General Manager, stated that other alternatives were considered by management; however, no studies or reports on the alternatives considered were prepared. Furthermore, no studies of the short- and long-run cost effects of the proposed or alternative means of capital restructuring were conducted and no alternative capital restructuring proposals were presented to the Board of Campbell and Kenton.

A study of the short- and long-run effects of capital restructuring should very basically include future capital needs and capital sources. In this instance, Campbell and Kenton has not substantiated its capital needs over the short- and long-term. The application for approval of its capital construction program was qualified upon the suggestion that the Commission would require detailed plans and specifications for the construction project before it could be approved. As to the capital sources,

Campbell and Kenton has only considered issuing additional long-term debt to defease its existing bonds.

Campbell and Kenton is in an enviable but highly unusual financial condition. The cash reserves exceed the outstanding debt by approximately \$8 million and are increasing substantially on a regular basis. Campbell and Kenton is of the opinion that a problem exists in that the cash reserves have been placed in special funds which, in its opinion, are restrictive in their availability. Campbell and Kenton contends that these funds cannot be used for any purpose; however, questions exist as to whether this is a matter of improper interpretation and/or a result of placing more money than required in restricted reserve accounts. Obviously, with the level of reserves exceeding the outstanding debt, Campbell and Kenton could retire its entire debt immediately and have a substantial cash reserve for utility capital needs; however, with low interest loans now outstanding, it would not be economically feasible to repay low-interest funds and require financing at higher interest rates for future capital needs. Ignoring the fact that Campbell and Kenton has not proven the need for future capital construction, the Commission finds that immediate early retirement of the \$20 million in outstanding bonds by simply repaying those bonds with existing cash reserves, versus defeasing, is not the best alternative.

Another potential alternative to provide for the existing debt and release the restricted reserves would be to use the current reserve to defease the existing bonds. Based on the information contained in Table 6 of the application, Campbell and

Kenton would have, through internally generated funds, sufficient cash flow to fund the 5-year capital improvement program without issuing additional debt. If Campbell and Kenton used \$16 million of current reserves to defease the existing bonds, funds in excess of \$12 million in current reserves would remain with no intended use.

In considering a total capital restructuring, the total short- and long-term effects on the overall financial condition, including the impact on rates, must be considered. The Merrill-Lynch study referred to previously did not take into account all the possible sources of funds to Kenton and Campbell, and the overall financial impact on the District.

Pursuant to KRS 278.300, the Commission can deny requests for approval of financing when the need for the financing is not proven, or may grant or deny an application in whole or in part, or require modification. The Commission has presented, as a part of its discussion in this Order, alternative methods of defeasing existing bonds and providing for future capital needs that should be considered. There may be other options and Campbell and Kenton should consider all possible options when studying the short- and long-run cost effects of capital restructuring.

Campbell and Kenton stated in the original application that one of the reasons for the proposed financing arrangement is that the present bond indenture is obsolete and impractical with regards to amounts required to be maintained in the special funds accounts. After review of both the existing and proposed bond indentures and the testimony of Spencer Harper, bond counsel, it

is the Commission's opinion that the bond indentures are not materially different and the requirements of the existing bond indenture is not enough to justify the new issuance in order to obtain a new indenture. Since Campbell and Kenton wishes to eliminate the restrictions it perceives in the current bond indenture, defeasance with current reserve funds would apparently accomplish that result.

At the oral argument, Campbell and Kenton argued that their request for a defeasance issue should be granted, as was Kenton County Water District No. 1's ("Kenton County") recent request. Kenton County's request is not comparable to Campbell and Kenton's for several reasons. First, Kenton County's defeasing issue was designed solely to lower the average interest rate on its outstanding debt from 11.13 percent to 8.81 percent, while Campbell and Kenton would replace 6 percent debt with a new issuance at 9.25 percent.¹ Secondly, Kenton County was not in the same position as Campbell and Kenton. Kenton County's reserves were adequate, but represented only a small proportion of their outstanding indebtedness.

In its brief and at oral argument, Campbell and Kenton relied upon Lexington Telephone Company v. PSC, Ky., 224 S.W. 2d 423 (1949). Although that case is acknowledged by Campbell and Kenton to be overruled by Stephens v. Kentucky Utilities, Ky., 569 S.W. 2d 155 (1978), Campbell and Kenton take the position that

¹ Order dated October 21, 1985, in Application of Kenton County Water District No. 1 for Authority to Issue Bonds in Case No. 9408.

portions of Lexington Telephone retain vitality. It is argued that, once a prima facie showing has been made, the Commission must grant the relief sought, unless there is evidence to refute the showing. Although the Commission does not concur with Campbell and Kenton's interpretation of the impact of the decision overruling Lexington Telephone, even if that interpretation were correct, the outcome here would not be affected since neither the appropriateness of the defeasing issue nor the need for the construction projects has been shown.

Campbell and Kenton is also concerned about the possibility of revised federal regulations or legislation which may prohibit defeasance and restrict the issuance of tax-free debt in the future, resulting in higher financing costs. However, the results of the proposed revisions are speculative.

FINDINGS AND ORDERS

After consideration of the application, evidence of record, and being advised, the Commission is of the opinion and finds that:

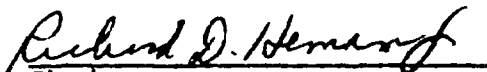
1. The request for issuance of revenue bonds in the amount of \$15,475,000 should be denied.
2. The approval of defeasance of the current revenue bonds outstanding with the issuance of new revenue bonds should be denied.
3. A Certificate of Public Convenience and Necessity is required for the proposed \$22,000,000 construction project.
4. Another proceeding, Case No. 9385, should be established to further investigate the recapitalization options

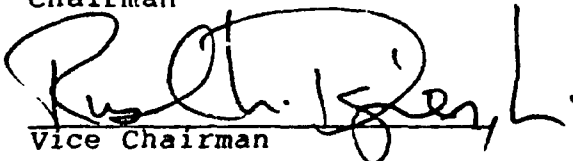
available to Campbell and Kenton, such as defeasing the existing bonds with current reserves and the associated potential for a further rate reduction.

IT IS THEREFORE ORDERED that the application for authority to issue bonds is hereby denied.

Done at Frankfort, Kentucky, this 30th day of December, 1985.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Secretary