COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

CITY OF PIKEVILLE, KENTUCKY	)	
	)	
COMPLAINANT	)	
	)	
v.	)	CASE NO. 95-296
	)	
MOUNTAIN WATER DISTRICT	)	
	)	
DEFENDANT	)	

O R D E R

On July 10, 1995, the city of Pikeville filed its complaint against Mountain Water District ("Mountain") alleging that pursuant to the parties' Memorandum of Agreement dated November 4, 1986; the Water Purchase Contract dated January 12, 1987; and the Amendment to the contract dated March 26, 1990 (respective Exhibits A, B, and C to the Complaint), Mountain is indebted to the city for the sum of $578,047 for water purchases from July 1, 1991 through July 1, 1995.

Mountain filed its Answer and Counterclaim to the complaint on August 3, 1995 denying that it was indebted to Pikeville for the sum of $578,047.04 ($0.46 per 1,000 gallons). Mountain further alleged that Pikeville acted unilaterally, without input from Mountain, to increase its rate for wholesale purchases. Mountain cites to correspondence between it and Pikeville illustrating the fact that Mountain raised its concerns prior to the rate becoming effective. Mountain admits that it declined to execute an Amended Water

Purchase Agreement because Pikeville did not use all relevant information in determining its rate.

For its counterclaim, Mountain asserts that in the event the Commission determines that Mountain's rate should have been lower than the initial rate of $1.31/1,000 gallons, the Commission should order refunds of the excess amounts paid by Mountain.

During the discovery phase of this case, on November 8, 1995, Pikeville filed a Motion in Limine and Motion for an Extension of Time to File Specific Objections to Expected Testimony of Defendant's Witnesses. The specific objections to the prefiled testimony of Mountain's witnesses were filed on November 15, 1995. Mountain responded to the motion on November 27, 1995 and Pikeville filed its reply on November 29, 1995. By Order issued December 15, 1995 the Commission denied the Motion in Limine and specifically framed the issues in this case with the following language:

> [t]he Commission is not bound by either party's characterization of this proceeding. The contract at issue in this proceeding was executed by the parties in 1986 and amended by agreement of the parties in 1990. The question before this Commission is whether the rate in question was adjusted consistent with the contractual agreement of the parties. Necessarily included in that review will be whether the "Umbaugh" formula was correctly applied. If both those questions are answered in the affirmative, the Commission will enforce the contract. If not, modifications to the contractual rate may be necessary.

The Commission further allowed additional time for discovery prior to the public hearing which was held on March 18 and 19, 1996. Briefs have been filed by both parties.

The Commission finds the following facts to be relevant to its resolution of this complaint. On November 4, 1986, Pikeville and Mountain entered into a Memorandum of Agreement ("Memorandum") wherein Pikeville agreed to sell and Mountain agreed to

purchase potable water at wholesale for $1.31/1,000 gallons. The Memorandum established the term at 40 years; contained a maximum contractual limit of 1.5 million gallons per day ("MGD"); and, further provided that the "[p]urchase rate may be adjusted at such time as both parties are satisfied that cost of production has risen sufficiently to require a higher rate." Memorandum, Article 1.

Paragraph 9 of the Memorandum contained the parties' agreement to enter into a more comprehensive water purchase agreement the form of which was to be approved by the Farmers Home Administration.[1] The Water Purchase Contract ("Contract") referred to in the Memorandum was executed by the parties on January 12, 1987. Paragraph B.1.d. provides for a flat wholesale rate of $1.31/1,000 gallons. Paragraph C.5. regarding subsequent modification of the contractual rate specifically incorporates Article 1. of the Memorandum previously quoted herein.

On March 26, 1990 the parties executed an Amendment which specifically refers to both prior agreements. The Amendment extends the term of the two prior contractual agreements for an additional seven years and contains provisions for metering and additional purchase points. Of most significance in this case is paragraph 3 of the Amendment, which provides in pertinent part:

> [p]aragraph 5 of the Water Purchase Contract concerning "modification of contract" and Paragraph 1 of the Memorandum of Agreement is (sic) hereby amended . . . to provide that the provisions of these contracts pertaining to the scheduled rates to be paid by the Purchaser . . . shall be adjusted in accordance with the formula provided by H.J. Umbaugh and Associates, but such adjustments shall not

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[1] Farmers Home Administration is now known as the Rural Utility Service.

> consider any increase (sic) capitalization of the Seller's system with the exception of any capital improvements to the Seller's system which are made solely at the request of the Purchaser or which are needed to increase water sales solely to the Purchaser.

The "Umbaugh" formula referred to above is found in the Revised Accounting Report on Wholesale Cost of Service Study dated April 7, 1986 and is attached as Exhibit D to Pikeville's complaint initiating this case.[2] This initial study considered the costs to provide wholesale water service to Sandy Valley Water District, Mud Creek Water District and Chaney Water Supply. At the time the initial Umbaugh study was performed, Mountain was not listed as a wholesale customer of the city.

Mountain began purchasing water from the city in 1987. On November 26, 1990, Umbaugh and Associates ("Umbaugh") notified the city of revisions to its cost of service study to include Mountain as a wholesale customer and determined a wholesale rate to Mountain of $1.77/1,000 gallons.[3] Despite Mountain's protest and refusal to execute a second amendment to its water purchase agreements, Pikeville adopted the rate by Ordinance 0-91-010 on May 29, 1991 which established the effective date for the increase as July 1, 1991.[4] Pikeville advised Mountain of the new rate on May 30 and June 3, 1991.[5]

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2 Umbaugh revised its study again in 1990 to include Mountain as a wholesale customer; Exhibit E to Pikeville's complaint.

3 Exh. E to the Complaint at 1.

4 Exh. F to Complaint.

5 Exh. G to Complaint.

By letter dated June 12, 1991, Pikeville sent Mountain an Amended Water Purchase Contract for execution which contained the $1.77/1,000 gallon rate.[6] Pikeville notified Mountain that failure to execute the Amended Water Purchase Contract would result in termination of the Water Purchase Contract between the parties.[7] From July 1, 1991 forward, Mountain has refused to pay the $1.77 rate to the city and instead applies the old rate of $1.31/1,000 gallons to its purchases.

The city filed suit in Pike Circuit Court, Pikeville v. Mountain Water District, 92-CI-1370, seeking to recover arrearages owing to it for sales to the district at the $1.77 rate. That case was dismissed by the Pike Circuit Court due to the Kentucky Supreme Court's decision regarding the Commission's jurisdiction over such a rate in Simpson County Water District v. City of Franklin, Ky., 872 S.W.2d 460 (1994). Neither party to this case disputes that jurisdiction is proper before this Commission.

The issues presented here are questions of first impression for the Commission since Simpson was decided. In resolving the issues in this case, the Commission must construe the three agreements as a whole since the two subsequent agreements specifically refer to the prior executed documents.[8] These agreements are neither vague nor ambiguous. Accordingly, all terms contained therein should be given effect by the Commission pursuant to the express terms. No express revocations or rescissions are found in any of the three documents to nullify Article 1 of the

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6 Mountain's response to data request Item I filed October 16, 1995, Letter from City Attorney, Russell H. Davis, Jr. dated June 12, 1991.

7 Id.

8 17A Am.Jur. 2d Contract §385, 400.

Memorandum or Paragraph 5 of the Contract, thus, the parties intended those provisions to be operative.

As set forth previously, there are two issues to be addressed by the Commission. The first issue - whether the rate was adjusted consistent with the contractual agreements of the parties' must be answered in the negative. The parties' agreements, to wit: the Memorandum, the Contract, and the Amendment, when read together, leave no doubt that the parties agreed from the outset that rates could only be adjusted when both parties were "satisfied that cost of production had risen sufficiently" to warrant a rate adjustment. This language was specifically incorporated in the Contract executed in 1987. Although the 1990 Amendment contains a modification to the literal paragraphs in which that language either appears or is incorporated, there is no express revocation or rescission of the language. A literal reading indicates that the modification contained in the Amendment relates to how the rates should be adjusted (i.e., using the Umbaugh formula) while the language regarding the rising cost of production relates to when the rates may be adjusted. Based upon the foregoing, Pikeville's passage of a rate ordinance in 1991 raising the wholesale rate to $1.77/1,000 gallons must be reviewed by this Commission from the perspective of whether the parties were mutually satisfied that production costs had risen sufficiently to warrant an increase. Obviously, Mountain was not. Mountain notified Pikeville by letter dated March 15, 1991, of its concerns regarding the need to verify and revise data related to the calculation of the rate by Umbaugh. Mountain states in its letter that while the Umbaugh methodology appears acceptable, certain details [of the study] need to be reviewed in-depth with input from

both sides. The city referred Mountain's letter to Umbaugh for a response. On May 10, 1991 the city provided Mountain with a copy of the Umbaugh response dated April 9, 1991.

It is most disturbing that Umbaugh was unaware of certain facts relevant to the parties' agreements which should have been taken into account in preparing its revised cost of service study. Umbaugh stated that it was unaware of any material benefit to the city from the joint use of facilities owned by Mountain. Umbaugh was unaware of the contractual capacity of 1.5 MGD which had been agreed to by the parties some four years earlier. Umbaugh suggested that the two parties agree on a capacity amount to include expected growth so the "city will not be paying debt service to finance capacity for the future growth of the District and vice versa." Umbaugh was unaware of proposed construction being undertaken by Mountain and whether, as a result of the construction, Mountain would be relying less on the city's transmission system. In fact, Umbaugh requested further information from Mountain on that point.

The concerns expressed by Mountain were then and remain now relevant to the determination of a wholesale rate and involved matters which should have been known to and considered by Umbaugh in revising its cost of service study in 1990. Mountain clearly and unequivocally expressed its concerns with the data, and Pikeville all but ignored those concerns. Pikeville acted unilaterally despite Mountain's protests, and we

think arbitrarily, in refusing to address Mountain's concerns and setting the rate by ordinance.[9]

Other evidence of record exists to demonstrate that Pikeville has failed to adhere to the terms of its own agreement with Mountain. The fact that Pikeville sent an amended contract to Mountain for execution in June 1991 in itself indicates Pikeville knew some affirmative action on Mountain's part was required to change the rate.

Further, the Amendment at paragraph 6 provides that ". . . if additional pump stations, transmission lines and/or upgrading of existing lines is necessary to provide the desired purchase point, both parties shall share in the proportionate expense of such additional pump stations, lines or upgrade of existing lines based on the benefit to be gained by both parties." Pikeville testified that both Mountain and Pikeville received benefits from a capital construction project undertaken by Mountain which included a 16 inch main and a 1 MGD tank,[10] yet Umbaugh did not reflect these benefits in its rate calculation.

Similarly, the agreements specify that only capital costs incurred solely to benefit Mountain should be included in the calculation of the wholesale rate. Umbaugh allocated to Mountain the cost of various capital improvement projects undertaken by

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9 We must note in reaching this conclusion that the factual dispute present in this case is remarkably similar to the factual dispute which led to the Kentucky Supreme Court's decision in Simpson.

10 Sykes Testimony, Transcript ("Tr."), Vol.I at 158-60. Commission records reflect that Mountain primarily funded the project with Pikeville contributing approximately one-tenth of the project costs; Case No. 91-008, The Application of Mountain Water District of Pike County, Kentucky, for Order Approving Construction, Financing, Certificate of Public Convenience and Necessity, and Water Rates.

Pikeville, including booster pumps and tanks, without regard to whether those projects were undertaken solely for Mountain's benefit and without regard to whether Mountain actually used and received any demonstrable benefit from those facilities.[11] Finding that the rate was not adjusted consistent with the contractual agreements of the parties, the Commission could end its inquiry without considering other issues presented in this case. However, since the case presents questions of first impression and Pikeville's wholesale rates will be subject to jurisdiction of this Commission on a prospective basis, it is in the public's and the parties' interest that these issues be addressed.

Approximately six years after the revised Umbaugh study was performed to establish a rate for Mountain as a wholesale customer of Pikeville, Umbaugh again revised its cost of service study. Umbaugh's testimony at the hearing reflects that some actual expenses were not used in 1990 at the time the study was prepared, apparently because they were not known to Umbaugh at the time.[12] In fact, Umbaugh testified it revised the study to include additional 1990 costs and factors which have since become known. However, Umbaugh admits readily now, in response to a hearing question regarding the derivation of an expense figure for billing and collection costs, that "it's an estimated amount."[13] During discovery in this case, no less than five separate sets of cost of service data were presented for the Commission's consideration with a wide disparity in the resulting wholesale rate to Mountain. Yet this record remains woefully

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11 Tr., Vol. I at 154-55.

12 Frederick Testimony, Tr., Vol.I at 99.

13 Id. at 108.

incomplete and does not contain sufficient information related to Pikeville's historic costs to verify the reasonableness of the $1.77 rate, much less to allow a wholesale rate to be determined prospectively. For instance, with respect to allocation of capital costs associated with booster pumps and storage tanks, Summit Engineering testified that 11 booster pumps existed at the time the rate was established and $25,000 per year had been budgeted for maintenance of the pumps.[14] However, Summit could not identify at which particular pump station the money was to be spent.[15] Kenvirons testified that Mountain received a benefit from only two of the eleven pumps.[16] A reasonable allocation of capital improvement costs cannot be made according to the Umbaugh formula or any other acceptable methodology without knowing how many and which pumps and tanks benefit Mountain and its customers.

The Commission is not contractually wedded to the Umbaugh formula as are the parties to this case. The purpose of a cost of service study is to fairly allocate expenses among different customer classes of a utility. It is essential that the expenses reflected in the study not only be accurate but verifiable as well. Furthermore, whatever methodology is used when allocating these expenses to wholesale customers, consideration must be given to facilities that jointly benefit the customers of both the purchaser and the seller. Studies that do not reflect basic ratemaking principles will not produce cost based rates.

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14 Sykes, Tr., Vol. 1 at 154-155.

15 Id. at 155.

16 Griffin Testimony, Tr., Vol. 2 at 15-16.

At the hearing in this case on March 18, 1996, counsel for Mountain indicated that the District had received a termination notice from the city due to nonpayment for any water supplied from July 1995 through the date of the hearing. After discussions, the parties filed a joint stipulation and agreement wherein they agreed that Mountain owed the city $280,529.95 for water purchased at the $1.31/1,000 rate and agreed to a surcharge of $.90/1,000 gallons for all bills rendered after April 1, 1996. The Commission approved the Settlement by Order dated March 22, 1996 and finds no basis for adjusting the surcharge at this time. The surcharge will thus continue pursuant to the terms of our prior Order.

IT IS THEREFORE ORDERED that:

1. Pikeville, having failed to demonstrate that its 1991 rate adjustment was placed into effect pursuant to the parties' contractual agreements, is not entitled to the relief requested and it is therefore denied.

2. Mountain's counterclaim is denied.

3. This case is hereby dismissed.

Done at Frankfort, Kentucky, this 8th day of August, 1996.

PUBLIC SERVICE COMMISSION

Linda K Breathitt
Chairman

Vice Chairman

ATTEST:

Don Mills
Executive Director

Robert M. Davis
Commissioner