

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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|-----------------------------|---|---------------------|
| ELECTRONIC APPLICATION OF |) | |
| SOUTHERN WATER AND SEWER |) | |
| DISTRICT FOR AN ALTERNATIVE |) | CASE NO. 2018-00230 |
| RATE ADJUSTMENT |) | |

ATTORNEY GENERAL'S POST-HEARING RESPONSE BRIEF

Comes now the Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention, and pursuant to the Kentucky Public Service Commission (“Commission”)’s January 9, 2019 Order, hereby tenders his post-hearing response brief in the above-styled matter.

STATEMENT OF THE CASE

Southern Water and Sewer District (the “District” or “SWSD”) is a water utility district organized under KRS Chapter 74, which serves approximately 5,456 customers in Floyd and Knott counties.¹ On July 3, 2018, the District tendered an application with the Commission requesting a revenue increase totaling \$953,409, which would produce \$3,831,896 in total revenues, and would increase the average residential bill, with usage of 4,000 gallons per month, by \$13.20, or approximately 31.88%.²

The District filed its application for rate adjustment pursuant to the Alternative Rate Filing mechanism on July 3, 2018, using a historical test year ending December 31, 2016

¹ *Electronic Application of Southern Water and Sewer District for an Alternative Rate Adjustment*, Case No. 2018-00230 (Ky. PSC July 3, 2018); Southern Water and Sewer District 2016 Annual Report.

² Application, Attachment 1, at 1; Staff Report, *Electronic Application of Southern Water and Sewer District for an Alternative Rate Adjustment*, Case No. 2018-00230, at 2 (Ky. PSC October 24, 2018).

based on its most recently filed Annual Report.³ Following the curing of deficiencies, the Commission accepted the application for filing on July 12, 2018.⁴ The Commission granted intervention to the Attorney General through his Office of Rate Intervention on August 2, 2018.⁵ On September 18, 2018, the City of Pikeville sent a letter to SWSD to inform the utility that it was raising its wholesale water rate for purchased water from \$1.72 to \$2.25 per 1,000 gallons.⁶ On October 24, 2018, the Commission issued its Staff Report.⁷ Shortly thereafter, on October 30, 2018, SWSD submitted a letter accepting the rates recommended in the Staff Report and waiving its right to an evidentiary hearing.⁸

On November 7, 2018, the Attorney General submitted his Comments on the Staff Report.⁹ On its own motion, the Commission initially scheduled an evidentiary hearing for December 18, 2018.¹⁰ On December 14, 2018, counsel for SWSD entered their appearance, and on December 16 moved for a continuance of the hearing due to unforeseen unavailability on the scheduled date.¹¹ The Commission granted the SWSD motion for a continuance, finding good cause, and rescheduling the hearing for January 8, 2019, in its order dated December 17, 2018.¹² A hearing was held on January 8 2019, but was recessed in order to take further testimony from Terry Fyffe, later scheduled for January 24, 2019.¹³

³ Application, ARF-Form 1, Sheet 3 of 5.

⁴ PSC Deficiency Cured Letter, Case No. 2018-00230 (Ky. PSC July 12, 2018).

⁵ PSC Order, Case No. 2018-00230 (Ky. PSC August 2, 2018).

⁶ Letter and Notice from the City of Pikeville Regarding Pikeville's Raising of the Wholesale Water Rate at Which They Charge Southern for Water Purchased, Case No. 2018-00230 (Ky. PSC September 18, 2018).

⁷ See Staff Report.

⁸ Letter from SWSD Chairman Accepting KY PSC Staff Report, Case No. 2018-00230 (Ky. Commission October 30, 2018).

⁹ The Attorney General's Comments on the Staff Report, Case No. 2018-00230 (Ky. Commission November 7, 2018).

¹⁰ Commission Order, Case No. 2018-00230 (Ky. Commission November 15, 2018).

¹¹ SWSD Motion for Continuance, Case No. 2018-00230 (Ky. Commission December 16, 2018).

¹² Commission Order, Case No. 2018-00230 (Ky. Commission December 17, 2018).

¹³ Commission Order, Case No. 2018-00230 (Ky. Commission January 16, 2018).

ARGUMENT

SWSD has requested that the Commission grant its request for a full rate increase “to continue its work in detecting water loss, replacing aging infrastructure, and repairing certain water assets that could pose a danger to residents.”¹⁴ At the hearing, prior to the taking of evidence, Chairman Schmitt described that the Commission had, earlier in the year, received correspondence and information from representatives of the District and then Judge-Executive of Floyd County, which indicated that an expedited increase was needed and that SWSD may be six months from insolvency due to the effects of the prior approved Asset Purchase Agreement between SWSD, the City of Prestonsburg, and the Prestonsburg City Utilities Commission (“PCUC”) (the “Asset Purchase Agreement”).¹⁵ Dire as the situation may now be, the award of the full increase of over 30% is not justified when the requestor is playing both the arsonist and the firefighter.

I. SWSD Failed To Perform Proper Due Diligence of The Asset Purchase Agreement

In its post-hearing brief, SWSD notes that the Attorney General did not intervene in the prior case where SWSD and Prestonsburg jointly requested approval of the asset transfer.¹⁶ It should be noted that the lack of intervention by the Attorney General does not mean he approves of the outcome of an individual case. However, in that prior case the parties made representations that due diligence was performed and that both parties had negotiated with equal bargaining strength.¹⁷ At the hearing, Mr. Campbell confirmed that he still felt this to be the case.¹⁸

¹⁴ Southern’s Post-Hearing Brief, Case No. 2018-00230, at 20 (Ky. Commission January 17, 2019).

¹⁵ VTE at 8:58:00—9:01:07.

¹⁶ *See generally Electronic Joint Application of Southern Water and Sewer District; Prestonsburg City’s Utility Commission; and the City of Prestonsburg for an Order Approving the Transfer of Ownership of the Wastewater System and Certain Portions of the Water System of Southern Water and Sewer District*, Case No. 2017-00044 (Ky. Commission January 23, 2017).

¹⁷ Joint Applicants’ Response to First PSC Information Request, Case No. 2017-00044, 1-1 at 1 (Ky. Commission March 13, 2017).

¹⁸ VTE at 10:30:50—10:30:59.

Further, SWSD made a point in its post-hearing brief that PCUC made the deal with its own self-interest in mind.¹⁹ But there was no claim that the transfer was simply an altruistic offer by PCUC. Rather, the bulk of the evidence shows that both sides *planned on* the transaction being equally beneficial to both.²⁰ The actual result appears rather one sided, and the transaction now seems to be measured not so much by the relative benefits accruing to each party, but by the detriment accruing to the District. As SWSD has acknowledged, it did not have the available funds to make the necessary capital improvements to the wastewater system in order to avoid impending fines and enforcement action from the Kentucky Department of Water.²¹ Without these improvements, SWSD would not have been able to operate its wastewater system effectively and at the necessary revenue level. For the utility to now claim that the asset transfer was a mistake and base its requested increase on the lost revenue from that transfer seems disingenuous.²²

Testimony later demonstrated that prior to the closing of the deal, SWSD neglected to perform any true cost-benefit analysis on the effects—especially that of the transfer of water customers, the asset transfer would have on its system—and its board members could not point to any specific analysis or figures evidencing justification for the transfer.²³ Almost all of the board members testified that they harbored reservations over the transaction, and now allege that influence from the Floyd County Fiscal Court, and especially the Judge-Executive was the primary driver behind the transfer being completed.²⁴ Board members now say that Asset Transfer was a mistake, but could not provide any feasible way to unwind the deal, and did not offer any feasible or workable alternative solutions to the District’s wastewater operations other than PCUC’s

¹⁹ Southern’s Post-Hearing Brief, Case No. 2018-00230, at 1 (Ky. Commission January 17, 2019).

²⁰ Commission Order, Case No. 2017-00044, (Ky. Commission May 2, 2017) (noting *inter alia*, that due to proximity PCUC was better able to serve the transferred water customers).

²¹ Southern’s Post-Hearing Brief, Case No. 2018-00230, at 3 (Ky. Commission January 17, 2019).

²² *Id.*

²³ VTE at 2:00:32—2:02:23; 4:32:00—4:33:00.

²⁴ VTE at 2:17:19—2:17:53; 11:52:49—11:53:50; 4:32:04—4:32:17; 4:44:25—4:45:03.

takeover of the system.²⁵ Regardless of any perceived or actual pressure from the fiscal court to approve the transaction, SWSD's utter lack of due diligence mattered more. The District's board members' duty is to the water district and the citizens of Floyd County, they are not beholden to the fiscal court or the Judge-Executive.

II. The District's Appraisal Of Lost Revenue Is Flawed

SWSD engaged Mr. Terry Fyffe, CPA, ABV, to perform a business valuation analysis on the lost revenue to the District as a result of the transfer of customers and associated assets in the Asset Purchase Agreement, which was later filed into the record after Commission Staff requested the same.²⁶ The final conclusion of the report estimated a fair market value on a controlling interest, marketable basis for lost revenues and transferred assets in the Asset Purchase Agreement at \$4,020,000.²⁷ According to his report, Mr. Fyffe based the annual lost revenues figure of \$656,122, on a number contained in the Staff Report.²⁸ As clarified during testimony, Staff relied on the figure provided in SWSD's rate application, which was prepared by Ms. Holly Nicholas based on historical usage figures provided by the District.²⁹ Later testimony showed that Holly Nicholas holds the title of Project Administrator at Kentucky Engineering Group ("KEG"), is not an engineer by training, and received only minimal legal assistance in preparing the District's ARF application—she did note that she may have directed some general legal questions to Damon Talley.³⁰ Ms. Nicholas confirmed that the annual lost revenues figure has neither been audited nor

²⁵ VTE at 4:49:38—4:50:05.

²⁶ Appraisal Report as Requested by Commission Staff in Second Request for Information dated 12/13/2018, Case No. 2018-00230 (Ky. Commission December 14, 2018).

²⁷ *Id.* at 2.

²⁸ *Id.* at 11.

²⁹ VTE at 5:35:11—5:36:22; 5:37:43—5:38:59.

³⁰ VTE at 5:36:30—5:37:38.

questioned.³¹ Mr. Fyffe’s apparent neglect in proving out this number, which is the basis for the entire valuation is concerning.

Further, Mr. Fyffe’s analysis also employed a wholly improper use of the discount rate in the calculation of the capitalization rate.³² The use of a “Specific Company and Size Premium” of 2% is especially egregious, since Mr. Fyffe notes that large utilities listed on the New York Stock Exchange “enjoy an average cap rate of 10%.”³³ However, SWSD relies on government subsidized debt or grants to fund ongoing projects, making this an apples to oranges comparison. Finally, no equity risk should be factored in since there is no equity. Rather, the discount rate should be properly calculated using the District’s weighted average cost of debt.

Regardless of whether board members truly considered obtaining a second valuation on the lost revenue, one was never completed. The valuation as provided is simply not as credible as SWSD claims, especially without a second independent valuation to prove out the relevant assumptions. These assumptions and the lack of any further confirmation show that the District did not perform the required due diligence, even on an after the fact appraisal.

III. The District Must Correct Its Issues Regarding Non-revenue Water

The District has a longstanding issue with water loss.³⁴ The Board chair, Ms. Paula Johnson, confirmed as much, but also seemed unaware of the sheer amount of lost revenue the District is unable to recoup due to its current water loss levels.³⁵ SWSD attributes much of its difficulty in combating water loss to the terrain of the District’s service territory, a declining population, and the economically depressed nature of the region.³⁶ While these are certainly all

³¹ VTE at 5:37:43—5:38:59.

³² Appraisal Report, Case No. 2018-00230, at 14–15 (Ky. Commission December 14, 2018).

³³ *Id.*

³⁴ AG Comments, Case No. 2018-00230, at 4 (Ky. Commission November 7, 2018).

³⁵ VTE at 1:17:30—1:18:30 (an estimated \$386,000 annual revenue loss due to non-revenue water).

³⁶ Southern’s Post-Hearing Brief, Case No. 2018-00230, at 20 (Ky. Commission January 17, 2019).

factors in being able to sufficiently address water loss, the full scope of the District's problem is better addressed as non-revenue water.

Accordingly, the District's prior inability to explain or validate the Fire department and flushing totals continued for too long without proper acknowledgment of the procedure it now says is standard practice. Further adding to its difficulties in reducing water loss is the fact that SWSD does not have a complete map of its system, although it is working with Kentucky Rural Water Association ("KRWA") to slowly rectify this.³⁷ Additionally, the only current written water loss management plan is the two page leak detection procedure developed by KRWA.³⁸

Despite its claim that SWSD is "better than many" other systems in this regard, Mr. Hall estimated that the District needed 5 years at a minimum to achieve a 30% water loss.³⁹ KRWA regional circuit rider, Mr. Tim Blanton, has worked with SWSD for over ten years, and will continue to work with the District on a hydraulic capacity study to help address "considerable hydraulic issues."⁴⁰ However, even he was unable to provide any projected timeline to 30% water loss, pointing to the unique needs of individual utilities and that the timeline must often remain elastic.⁴¹ Any claim that "substantial improvements in water loss" will be achieved through following a simple two pages of leak detection procedures is overly optimistic.⁴² SWSD must develop a more comprehensive water loss management plan to complement the leak detection procedure and expand upon those recommendations. Likewise, the District currently has no written capital improvement plan, although it is still working with KRWA on this issue and hopes to retain

³⁷ VTE at 2:49:00—2:50:41.

³⁸ SWSD Exhibit 1, Leak Detection Standard Operating Procedure.

³⁹ Southern's Post-Hearing Brief, Case No. 2018-00230, at 21 (Ky. Commission January 17, 2019); VTE at ... 3:50

⁴⁰ VTE at 5:08:00—5:13:00.

⁴¹ VTE at 5:15:30—5:16:02.

⁴² Southern's Post-Hearing Brief, Case No. 2018-00230, at 18 (Ky. Commission January 17, 2019).

Greg Heitzman on contract.⁴³ In order to streamline and properly prioritize its infrastructure needs, the District must develop a written plan.

Early in the hearing, Mr. Campbell testified that after PCUC began servicing the transferred customers, the utility discovered around 40 people had been receiving free water service without bills and without meters.⁴⁴ Mr. Hall later stated that he is unaware of any unmetered customer receiving service on the SWSD system.⁴⁵ Additionally, KRWA representative Mr. Danny Stinson stated that he suspects estimated reads are likely happening after he performed a tank draw down in order to determine the system demand factor.⁴⁶ This is despite Mr. Hall saying meter readers face termination by him if they estimate meter reads.⁴⁷ Based on the information provided by KRWA, the District must do more to determine if there are additional customers receiving free water and correct any such instance.

Ms. Johnson testified that the District routinely brings charges and ensures prosecution for water theft from its system.⁴⁸ However, Mr. Hall later testified that he did not remember any prosecutions for water theft since he has been the general manager, for the last several years.⁴⁹ The Attorney General subsequently requested that SWSD provide documentation for its most recent prosecution for water theft in a post-hearing data request.⁵⁰ SWSD's response provided a prosecution for water theft from September 2016, indicating that none have been pursued since.⁵¹

⁴³ Southern's Post-Hearing Brief, Case No. 2018-00230, at 16 (Ky. Commission January 17, 2019); VTE at ...

⁴⁴ VTE at 9:59:20—10:01:05; 5:26:20—5:32:22 (40/1,160 = 3.4% ratio of unmetered to metered on the transferred customers. Assuming the same ratio is applied to the remaining meters on the SWSD system, .034 x 5400 = 184 possible unmetered customers remaining.)

⁴⁵ VTE at 2:56:54—2:57:35.

⁴⁶ VTE at 5:23:00—5:26:10.

⁴⁷ VTE at 2:47:00—2:47:33.

⁴⁸ VTE at 11:40:05—11:41:02.

⁴⁹ VTE at 4:00:35—4:00:46.

⁵⁰ The Attorney General's Post-Hearing Data Requests, Case No. 2018-00230 (Ky. Commission January 10, 2019).

⁵¹ Response of Applicant to Attorney General's Post-Hearing Request for Information, Attachment 1 – Theft Case File (Ky. Commission January 15, 2019).

Finally, Mr. Hall said that he told the board over the course of a couple of years that SWSD was out of compliance in its meter testing and requested that the utility install AMR/AMI meters, but the board took no action on the testing due to funding concerns and denied the request for upgraded meters due to the lack of funds,⁵² despite the fact that the District's meters are all 13-15 years old and many test 15% slow.⁵³ Despite this, SWSD seems to have not seriously considered AMR/AMI meters, or at least has not petitioned the Commission for advanced meters.

SWSD must get a handle on its issues with non-revenue water. It must begin working to prosecute instances of water theft, it must address any proliferation of estimated reads through further work with KRWA, and it must tackle its meter accuracy, which may include the implementation of advanced metering. In order to ensure progress on this front, the Commission should require demonstration of incremental improvement to water loss through periodic reporting. The Attorney General remains hopeful that the proposed, and now on hold, KIA project to replace the Lackey to Wayland water main will help to eventually reduce water loss, but cautions the Commission against granting the full increase as a means to get this project completed. Furthermore, the Attorney General encourages the District to continue discussions with Kentucky-American Water about a possible management contract, especially if PCUC remains uninterested in a merger or operation scenario.

CONCLUSION

The Commission has often acknowledged its long history of reliance on the principle of gradualism in ratemaking in order to mitigate the financial impact of individual rate increases on customers and Kentucky families.⁵⁴ The Attorney General asks that the

⁵² VTE at 2:42:40—2:45:50.

⁵³ VTE at 1:25:08—1:28:00.

⁵⁴ Case No. 2014-00396, *In the Matter of Application of Kentucky Power Company for: (1) A General Adjustment of its Rates for Electric Service; (2) An Order Approving its 2014 Environmental Compliance Plan; (2) An Order*

Commission continue to follow that precedent here and to appropriately consider affordability.

Though the District has acknowledged a myriad of issues in the operation of its system, it has not properly demonstrated that it has fully grasped how to effectively move forward, and should not receive the entirety of the Staff's recommended rate increase. As to the previously obtained unauthorized debt, SWSD has realized its mistake and appropriately apologized.⁵⁵ However, the unauthorized debt is only one of many examples of the past managerial and operational negligence at the District, which must change going forward.

Now, the Commission must equitably balance the needs of the District against the District's demonstrably poor past decisions, which in this case directly generated the need for a rate increase. The Attorney General continues to recommend incremental water loss reporting requirements, a required demonstration of policies and procedures to avoid future unauthorized debt, written water loss management and capital improvement plans, and the consideration of affordability in the final rate increase. The Commission should not expect, nor require ratepayers and Kentucky families to bear such an increase due to mismanagement.

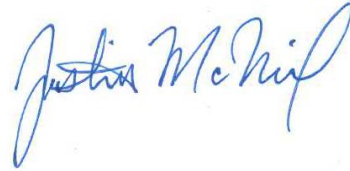
WHEREFORE, the Attorney General requests that the Commission, based upon the evidentiary record, set a fair, just, and reasonable rate for the customers of Southern Water and Sewer District.

Approving its Tariffs and Riders; and (4) An Order Granting All Other Required Approvals and Relief, Order (Ky. PSC June 22, 2014) ("the Commission has long employed the principle of gradualism"); *See also*, Case No. 2000-080, *In the Matter of: The Application of Louisville Gas & Electric Company to Adjust its Gas Rates and to Increase its Charges for Disconnecting Service, Reconnecting Service and Returned Checks*, Order (Ky. PSC September 27, 2000) ("the Commission is adhering to the rate-making concepts of continuity and gradualism in order to lessen the impact of these increases on the customers that incur these charges.").

⁵⁵ Southern's Post-Hearing Brief, Case No. 2018-00230, at 13-14, 21 (Ky. Commission January 17, 2019)

Respectfully submitted,

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