

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF SOUTHERN WATER AND)	
SEWER DISTRICT FOR AN ADJUSTMENT IN)	CASE NO. 2012-00309
RATES PURSUANT TO THE ALTERNATIVE RATE)	
FILING PROCEDURE FOR SMALL UTILITIES)	

ORDER

On December 21, 2012, the Commission established interim rates for water and sewer service that Southern Water and Sewer District ("Southern District") provides, but deferred certain issues for further review and consideration. By this Order, the Commission addresses those deferred issues and grants final approval of the interim rates.

BACKGROUND

Southern District, a water district organized pursuant to KRS Chapter 74, owns and operates facilities that produce and distribute water to 7,377 customers in Floyd and Knott counties, Kentucky¹ and facilities that provide sewer service to 198 customers in Floyd County, Kentucky.²

PROCEDURE

On August 8, 2012, Southern District tendered an application for an adjustment of its water and sewer service rates. On September 14, 2012, after Southern District

¹ *Annual Report of Southern Water and Sewer District (Water Division) to the Public Service Commission for the Calendar Year Ended December, 31, 2011 ("Annual Water Report")* at 27.

² *Annual Report of Southern Water and Sewer District (Sewer Division) to the Public Service Commission for the Calendar Year Ended December, 31, 2011* at 8.

supplemented its application to comply with 807 KAR 5:076, the Commission accepted this application for filing.

After reviewing the application and Southern District's records, Commission Staff issued a report containing its findings and recommendations on November 1, 2012. It recommended approval of Southern District's proposed rates for sewer service.³ Unable to reach a conclusion regarding the reasonableness and lawfulness of the water district's annual payment of \$100,000 to Floyd County Fiscal Court to assist Floyd County in servicing certain long-term debt, Commission Staff provided alternative recommendations regarding rates for Southern District's water service.⁴ It further recommended that the Commission direct Southern District to revise its method for calculating and recording depreciation expense for accounting and ratemaking purposes and to revise certain accounting procedures and internal controls.⁵

In accordance with the established procedural schedule, the Attorney General ("AG")⁶ and Southern District submitted comments on Commission Staff's findings and recommendations. In his comments, the AG questioned the lawfulness and reasonableness of Southern District's payments to Floyd County Fiscal Court. He also expressed concern regarding the level of Southern District's water loss and recommended that the Commission direct the water district to submit a plan for reducing

³ Commission Staff Report on Southern Water and Sewer District ("Commission Staff Report") at 3 (filed Nov. 1, 2012).

⁴ *Id.* at 3. Commission Staff provided two schedules of water rates for the Commission's consideration. One schedule would produce revenues sufficient to meet reasonable operating expense, service Southern District's outstanding debt, and make the annual payment. The other would generate a level of revenues that excluded any revenues to cover the annual payment.

⁵ Commission Staff Report Attach. A at 10.

⁶ On October 10, 2012, the AG moved to intervene in this matter. The Commission granted his motion the following day.

its water loss. The AG did not request a hearing and stated that the matter may be submitted for decision without a hearing.⁷

In its response to Commission Staff's report, Southern District made no comment on Commission Staff's alternative rate proposals. Neither did it address the question of the lawfulness and reasonableness of its annual payments to Floyd County Fiscal Court. Southern District stated its "agreement with the Commission's Staff report," requested that a decision be made on the existing record, and expressly waived any right to a hearing.⁸

On December 21, 2012, the Commission established interim rates for Southern District. In our Order, we approved on an interim basis Southern District's proposed rates for sewer service and established interim water rates that would produce additional revenues of \$551,732. We expressly excluded recovery of Southern District's annual \$100,000 payment to Floyd County Fiscal Court and directed Commission Staff to prepare and file a detailed report on the payment and to include in such report all documents and other evidence that was gathered regarding such payments. We deferred any action on issues pertaining to depreciation, accounting procedures, internal controls and water loss.

On February 15, 2013, Commission Staff filed a report on the water district's payments to Floyd County Fiscal Court. The report included all documents and other evidence gathered during the course of the review. On March 1, 2013, the Commission directed the parties to file any written comments or objections to the report and any

⁷ AG's Written Comments on Report of Commission Staff at 1 (filed Nov. 15, 2012).

⁸ Letter from Paula Johnson, Chairperson, Southern Water and Sewer District, to Jeff Derouen, Executive Director, Public Service Commission (filed Nov. 5, 2012).

request for a hearing within 20 days. The AG filed comments on March 19, 2013 in which he maintained that Southern District had no legal obligation to make annual payments to Floyd County Fiscal Court, and that absent Commission authorization of any agreement between Southern District and Floyd County Fiscal Court, no recovery of the annual payment through rates should be permitted. Southern District filed no response or objections to the report's findings or made any request for hearing.

ANNUAL PAYMENTS TO FLOYD COUNTY FISCAL COURT

Southern District proposes to recover in its rates for water service an annual payment of \$100,000 to Floyd County Fiscal Court to assist Floyd County in meeting its annual lease payments on a general obligation lease agreement that Floyd County Fiscal Court entered with the Kentucky Area Development Districts Financing Trust in May 2005. Floyd County Fiscal Court used the \$2.6 million of proceeds from this lease agreement to finance several Southern District waterworks improvements.⁹

When Southern District first presented the waterworks improvements project to the Commission for approval in 2002, it represented to the Commission that Floyd County Fiscal Court was contributing, not lending, approximately \$2,474,000 towards the cost of the project.¹⁰ Rural Development loan documents also reflected that Floyd County Fiscal Court's funds were a contribution.¹¹

⁹ These improvements consisted of approximately 27 miles of water distribution main, six new water storage tanks, six pumping stations and a telemetry system. They cost approximately \$6,172,900. See Case No 2002-00166, *The Application of Southern Water and Sewer District of Floyd and Knott Counties, Kentucky, for a Certificate of Public Convenience and Necessity to Construct, Finance and Increase Rates Pursuant to KRS 278.023* (Ky. PSC received May 8, 2002). In September 2001, Floyd County Fiscal Court issued bond anticipation notes of \$2,175,000. It issued new bond anticipation notes in 2003 to refund the earlier issuance. The proceeds of the 2005 Lease Agreement retired the second series of bond anticipation notes. The proceeds of the first bond anticipation note issuance went towards Floyd County Fiscal Court's contribution to the water improvements project. Commission Staff Report on Southern Water and Sewer District ("Second Commission Staff Report") at 3 - 5 (filed Feb. 15, 2013).

¹⁰ Case No. 2002-00166, Application ¶ 5.

Southern District states that in 2004 Floyd County officials approached the water district and suggested that the water district bear a portion of the debt-service payments associated with the "contribution."¹² It further states that on August 23, 2004, its Board of Commissioners voted to make annual payments of \$100,000 to defer a portion of the debt-service payments. Subsequently an official of the firm managing Southern District's operations wrote in December 2004 to the Floyd County Judge/Executive to advise that "[a]t your request, the District recently agreed to assist the Floyd County Fiscal Court in repaying the debt on the bond issue, in the amount of \$100,000.00 per year."¹³

While Southern District's general manager states that Southern District and Floyd County Fiscal Court executed an agreement in 2005 or 2006 requiring Southern District to make annual payments of \$100,000,¹⁴ former and current Floyd Court officials dispute the existence of any written agreement regarding the payments, but instead

¹¹ Letter from Kenneth Slone, State Director, Rural Development, to Hubert Halbert, Chairman, Southern Water and Sewer District (May 31, 2001) at 1. See also Letter from Paul Hunt Thompson, Floyd County Judge/Executive to Robert L. Meyer, Project Manager, U.S. Filter Operating Services, Inc., (Feb. 7, 2002) (stating Floyd County Fiscal Court had \$2,000,000 in bond funds available for use in Southern District and that the funds were earmarked for construction projects in the water district).

¹² Application Attach. H at 2. As proof of this action, Southern District provided not a copy of the minutes of the Board of Commissioners' meeting of August 23, 2004, but of September 2, 2004 in which the Board voted on a budget that included "\$100,000.00 additional debt service per year to assist Floyd County Fiscal Court with retirement of a bond issue by the fiscal court [sic] to assist with the District's expansion program." *Id.* Attach. H-4. Southern District has not provided the minutes of the August 23, 2003 meeting.

¹³ Letter from Robert L. Meyer, Project Manager, Veolia Water, to Paul Hunt Thompson, Floyd County Judge/Executive (Dec. 8, 2004).

¹⁴ Second Commission Staff Report at 9.

state that the parties had a general expectation or "gentlemen's agreement" that Southern District would bear a portion of the debt-service payments.¹⁵

Southern District did not make any payments to Floyd County until 2010, when it made a partial payment. Thereafter, it paid varying amounts every year for total of \$250,415.02.¹⁶ Southern District's current chair stated that Southern District began making payments only after the publication of numerous negative newspaper articles regarding the water district's failure to pay its alleged debt.¹⁷

The Commission finds no credible evidence in the record of any legal obligation on the water district's part to make payments to Floyd County Fiscal Court. Neither officials from Southern District nor Floyd County Fiscal Court have presented any documentary evidence that Southern District and Floyd County Fiscal Court prepared or executed a written agreement or debt instrument obligating Southern District to make annual payments. While Southern District's General Manager has stated such an agreement exists, he has been unable to produce the agreement. No other Southern District or Floyd County official has contended that any written agreement exists.

None of the legal documents surrounding any of the transactions refer to an agreement between Southern District and Floyd County Fiscal Court. The documents included in Southern District's application to the Commission for a Certificate of Public

¹⁵ *Id.* at 10-12. The Floyd County Judge/Executive advised the State Local Debt Officer in May 2005 that the "County expects the Water District to pay a portion of the debt service." Letter from Paul Hunt Thompson, Floyd County Judge/Executive, to Cordell Lawrence, State Local Debt Officer (May 23, 2005). *See also* Letter from Terrell Ross, Ross Sinclair & Associates, to Paul Hunt Thompson, Floyd County Judge/Executive (Mar. 16, 2005) (stating that "[i]t is my understanding that the intention of the County was to ultimately loan this money [proceeds from the Lease Agreement] to a water district in your County, and that the water district, in turn would pay for all or a portion of the debt service of the permanent bond financing.").

¹⁶ *Id.* at 9 and Ex. S.

¹⁷ *Id.* at 9.

Convenience and Necessity for the waterworks improvement projects and for approval of the financing plan do not mention any agreement. Rural Development's letter of conditions for the grant and loan to Southern District for the water improvements project expressly labels the Floyd County funds as a contribution. When Floyd County Judge/Executive Paul Thompson informed Rural Development that the funds were available for dispersal, in 2002, no reference was made to repayment. The Floyd County Fiscal Court resolutions related to the two issuances of bond anticipation notes and to the 2005 Lease Agreement are silent on the existence of any agreement with Southern District. The Floyd County Fiscal Court minutes addressing the approval of these debt instruments fail to reference any agreement.

The case against the existence of any agreement is further strengthened by the absence of any application by Southern District for required regulatory approval for such an obligation. KRS 278.300(1)¹⁸ requires prior Commission approval of any evidence of indebtedness. Despite Southern District's having sought Commission approval of the issuance of evidences of indebtedness on several occasions,¹⁹ it made no application for approval of the alleged agreement. KRS 65.117 further required Southern District to notify the State Local Debt Officer by July 15, 2009 of any long-term debt obligation entered into prior to July 15, 2008. There is no evidence in the record that Southern

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No utility shall issue any securities or evidences of indebtedness, or assume any obligation or liability in respect to the securities or evidences of indebtedness of any other person until it has been authorized so to do by order of the commission.

¹⁹ See, e.g., Case No 2002-00166, *The Application of Southern Water and Sewer District of Floyd and Knott Counties, Kentucky, for a Certificate of Public Convenience and Necessity to Construct, Finance and Increase Rates Pursuant to KRS 278.023* (Ky. PSC received May 8, 2002); Case No. 2006-00327, *The Joint Application of Sandy Valley Water District, Southern Water and Sewer District and the City of Pikeville for Approval of the Transfer of Facilities and for the Assumption of Debt by Southern Water and Sewer District* (Ky. PSC received June 29, 2006); Case No. 2007-00099, *Application of Southern Water and Sewer District for Authority to Borrow Funds for Property Acquisition* (Ky. PSC received Mar. 8, 2007).

District provided such notification to the State Local Debt Officer regarding an agreement with Floyd County Fiscal Court.

The existence of a "gentlemen's agreement" between the two governmental entities, moreover, is so removed from sound government and business practices to strain credulity. Public officers are presumed to act in a reasonable, competent, and honest manner. The Commission questions whether such officers would obligate their organization to pay \$2,000,000 over a 20-year period or to lend such an amount to another with the expectation of repayment over a similar period without reducing the terms of the agreement or arrangement to a legally enforceable writing. To do so places their organization at significant financial risk.

Assuming for purposes of argument that Southern District and Floyd County Fiscal Court entered an oral agreement or understanding in which Southern District agreed to assume a portion of Floyd County Fiscal Court's debt-service obligation, such agreement or understanding would be legally unenforceable. The lack of any written document would be contrary to the Statute of Frauds' prohibition on oral contracts that cannot be performed within one year.²⁰ Such an agreement also lacks any consideration and, therefore, cannot constitute a valid and enforceable contract.

Assuming the existence of an agreement, Southern District's failure to obtain Commission approval of such agreement limits recovery of such payments for ratemaking purposes.²¹ KRS 278.300(1) is clear that no utility may issue any evidence

²⁰ *Williamson v. Stafford*, 190 S.W.2d 859, 860 (Ky. 1945); KRS 371.010.

²¹ The AG takes a similar position. See AG's Written Comments for Order of 1 March 2013 (filed Mar. 19, 2013) at 3 ("With regard to KRS Chapter 278, the payments consequent to an indebtedness that is not authorized by or exempted from Commission Order are unlawful with regard to KRS Chapter 278.") The Commission makes no finding as to whether the failure to obtain prior Commission approval renders an evidence of indebtedness void or legally unenforceable.

of indebtedness or assume another's obligation or liability without prior Commission approval. Based upon the evidence contained in the existing record, we find insufficient evidence to conclude that Southern District's assumption of Floyd County Fiscal Court's debt-service obligations would meet the requirements set forth in KRS 278.300(3) to permit the Commission to approve such assumption.²²

In the absence of any legal obligation to pay a portion of Floyd County Fiscal Court's debt-service obligations, Southern District's payments are tantamount to a donation or contribution to Floyd County Fiscal Court. As presented in its application, Southern District suggests that the payments were made to assist a financially strapped county government.²³ "As a creature of statute, a water district created pursuant to KRS Chapter 74 may expend funds only in keeping with its statutory purpose, or express statutory authorization."²⁴ KRS Chapter 74 does not authorize a water district to make fund transfers to a local government entity for the sole purpose of providing financial assistance.²⁵

²² By this Order, we make no ruling on or restrict Southern District's ability to negotiate and execute future agreements with Floyd County Fiscal Court regarding to Southern District's assumption of debt-service payments under the 2005 Lease Agreement in exchange for the use or ownership of certain tracts of land or facilities that Floyd County owns and that Southern District presently uses to provide utility service. Such agreement would require prior Commission approval. KRS 278.300(1). In our review of the agreement, we would consider whether the agreement "is for some lawful object within the corporate purposes 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(2).

²³ Application Attach. H at 1 ("At the time it committed to the contribution, the fiscal court had no intention of seeking payment of the bonds from Southern District; however, in early 2004, the fiscal court began suffering great financial hardship and sought relief from Southern District . . .").

²⁴ OAG 92-43 (Mar. 19, 1992).

²⁵ The Commission cautions the members of Southern District's Board of Commissioners that any payment of water district funds to any local government entity for the sole purpose of providing financial assistance may be considered as malfeasance and constitute grounds for removal from office. See KRS 74.455(1).

Based upon the above discussion, the Commission finds that Southern District has failed to demonstrate that the annual payment of \$100,000 to Floyd County Fiscal Court is reasonable or lawful. We further find that recovery of the payment through Southern District's rates for water service is not appropriate and that Southern District's proposal for such recovery should be denied.

SUMMARY

Having reviewed the evidence of record and being otherwise sufficiently advised, the Commission finds that:

1. Findings 1 through 24 of the Commission's Order of December 21, 2012 should be affirmed.

2. In its application, Southern District proposed reductions to its reported depreciation expense to reflect a change to the service lives that it assigns to certain assets.²⁶

3. In lieu of conducting a depreciation study to determine the service lives of its water assets or relying upon its own historic plant records, Southern District has relied upon the results of the survey of the National Association of Regulatory Utility Commissioners ("NARUC") that contained "a range of average service lives currently being used by water utilities throughout the country for water facilities designed and installed and maintained in accordance with good water works practice" to make revisions to the service lives of several classes of its assets.²⁷

²⁶ Application, Attach. C at 18-21.

²⁷ National Association of Regulatory Utility Commissioners, *Depreciation Practices for Small Water Utilities* (Aug. 15, 1979) at 10 (referring to the table of typical average service lives upon which Southern District relied).

4. The Commission has previously used the same survey to establish the service lives of water utility assets.²⁸

5. In lieu of conducting a depreciation study to determine the service lives of its sewer assets or relying upon its own historic plant records, Southern District has relied upon guidance from the Commission on Rural Water²⁹ to make revisions to the service lives of several classes of its sewer assets.

6. The Commission has previously used the same survey to establish the service lives of sewer utility assets.³⁰

7. Southern District's use of the NARUC and Commission on Rural Water surveys to determine the service lives of certain classes of its water and sewer assets is reasonable.

8. Southern District compared previously assigned service lives to certain classes of assets and, where these service lives fell outside of or narrowly within the NARUC or Commission on Rural Water survey range for an asset, assigned that asset a new service life within the survey range.

²⁸ See e.g., Case No. 2009-00370, *Application of Henry County Water District No. 2 for Approval to Adjust Water Rates and Charges, Construct and Finance a Proposed Waterworks Project and Implement a System Development Charge* (Ky. PSC Aug. 12, 2010); Case No. 2006-00398, *Application of Northern Kentucky Water District for Approval of Depreciation Study* (Ky. PSC Nov. 21, 2007); Case No. 2001-00472, *Proposed Adjustment of the Wholesale Water Service Rate of the City of West Liberty, Kentucky* (Ky. PSC Sept. 30, 2002). The Commission has also adopted Commission Staff recommendations concerning service lives that were based upon the survey. See e.g., Case No. 2008-00057, *Application of the Grayson County Water District for Approval of a Proposed Increase in Rates for Water Service* (Ky. PSC Oct. 21, 2008); Case No. 2003-00401, *Application of the Lake Village Water Association, Inc. for Approval of a Proposed Increase in Rates for Water Service* (Ky. PSC Feb. 2, 2004); Case No. 92-007, *The Application of Levee Road Water Association, Inc. for a Rate Adjustment Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Ky. PSC July 19, 1992).

²⁹ Commission on Rural Water, *Guide for the Support of Rural Water-Wastewater Systems* (Chicago, Ill 1974) 246-247.

³⁰ See e.g., Case No. 2004-00336, *Joint Application of B & H, Inc. and Richmond Utilities, LLC for Approval of the Transfer of Wastewater Treatment Plant to Richmond Utilities, LLC* (Ky. PSC Dec. 22, 2004).

9. Southern District's reassignment of service lives for ratemaking purposes is reasonable and should be authorized for ratemaking and accounting purposes.

10. Appendix B to this Order sets forth the classes of assets whose service lives Southern District has adjusted; the previously assigned service life to each class; the service life range that the appropriate survey suggests for each class; and the assigned service life that should be used for ratemaking and accounting purposes for all future reporting periods.

11. In its annual financial and statistical reports for the year ending December 31, 2010, Southern District improperly assigned or allocated between its operating divisions revenue, expenses and debt payments. These improper assignments and allocations resulted in inaccurate reporting of Southern District's financial condition and required numerous correcting entries to properly determine the pro forma operations for each division.

12. Southern District should revise its accounting procedures and internal controls to include methods and practices that reasonably and fairly allocate and assign revenues and expenses between its water and sewer operations.

13. During the test year, Southern District reported unaccounted-for water of 44.35 percent the total water produced and purchased.³¹

14. As 807 KAR 5:066, Section 6(3), limits a water utility's unaccounted-for water loss to 15 percent of the total water produced and purchased, Southern District is experiencing excessive unaccounted-for water loss and should take measures to reduce the level of this loss.

³¹ Application, Attach. C at 13.

IT IS THEREFORE ORDERED that:

1. The findings 1 through 24 of the Commission's Order of December 21, 2013 are affirmed.

2. Southern District's proposed rates for water service are denied.

3. Southern District's proposed rates for sewer service are approved.

4. Southern District shall charge the rates set forth in Appendix A to this Order for water and sewer service rendered on and after the date of this Order.

5. Within 20 days of the date of this Order and using the Commission's Electronic Tariff Filing System, Southern District shall file with the Commission revised tariff sheets that contain the rates set forth in Appendix A.

6. Southern District shall for, accounting and ratemaking purposes, use the "PSC Approved Service Life" set forth in Appendix B to this Order for the listed classes of assets when calculating and reporting depreciation for all reporting periods after the date of this Order, but shall make no retroactive adjustment to its books to account for the cumulative effect of this change in accounting estimate.

7. Within 90 days of the date of this Order, Southern District shall revise its accounting procedures and internal controls to include methods and practices that reasonably and fairly allocate and assign revenues and expenses between its water and sewer operations and shall file with the Commission a copy of these revised procedures and controls and documentary evidence that its Board of Commissioners has formally adopted such procedures and controls.

8. Within 90 days of the date of this Order, Southern District shall file with the Commission a comprehensive unaccounted-for water loss-reduction plan that identifies the sources of unaccounted-for water loss, the amount of water loss from each source

and establishes priorities and a time schedule for eliminating each source of unaccounted-for water loss.

By the Commission
ENTERED
JUL 12 2013
KENTUCKY PUBLIC
SERVICE COMMISSION

ATTEST:



Executive Director

Case No. 2012-00309

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 2012-00309 DATED **JUL 12 2013**

The following rates and charges are prescribed for the customers in the area served by Southern Water and Sewer District. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of the Commission prior to the effective date of this Order.

MONTHLY WATER RATES

First	2,000 gallons	\$23.48 Minimum Bill
Over	2,000 gallons	8.13 per 1,000 gallons

MONTHLY SEWER RATES

First	2,000 gallons	\$28.38 Minimum Bill
Over	2,000 gallons	9.52 per 1,000 gallons

APPENDIX B

**APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 2012-00309 DATED JUL 12 2013**

Asset Classification	Guide Used	Recommended Range	Previous Assigned Service Life	PSC Approved Service Life
Water Tanks	NARUC	30 – 60 years	20 years	45 years
Water Treatment Plant	NARUC	20 – 35 years	20 years	35 years
Water Meters	NARUC	35 – 45 years	30 – 50 years	40 years
Water Mains	NARUC	50 – 75 years	20 – 40 years	50 years
Buildings	NARUC	35 – 40 years	20 years	50 years
Wayland Treatment Plant	Com.on Rural Water	20 years	30 years	25 years
Eastern Treatment Plant	Com.on Rural Water	20 years	30 years	35 years
Sewer Collection Mains	Com.on Rural Water	20 – 50 years	30 years	50 years
Sewer Pump Stations	Com.on Rural Water	20 – 50 years	30 years	35 years

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