

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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COMMISSION

In the Matter of:

ALTERNATIVE RATE FILING OF)
COOLBROOK UTILITIES, LLC)

Case No. 2011-00433

ATTORNEY GENERAL'S POST-HEARING BRIEF

The Attorney General hereby tenders this post-hearing Brief in support of his recommendations to the Kentucky Public Service Commission ("the Commission") relating to the application of Coolbrook Utilities, LLC, ("Coolbrook") for an increase in its rates for sewer service.

SUMMARY OF THE CASE

On October 31, 2011, Coolbrook Utilities, LLC applied to increase its rates for sewer service pursuant to 807 KAR 5:076, the Commission's alternative rate filing procedure. The Attorney General filed its motion to intervene on November 30, 2011, and the Commission by Order dated December 2, 2011, granted intervention.

The Commission granted extensions to Coolbrook regarding data production. Thereafter, Commission Staff's Report and Recommendations were timely filed on March 5, 2012. Coolbrook filed its Objections to Commission Staff's Report and Recommendations on March 20, 2012. In its Objections to the Staff's Report and Recommendations, Coolbrook identified two (2) primary issues of dispute: (1) the proposed surcharge for an inflow & infiltration study and (2) amortized recovery of its rate case expenses, including legal fees incurred and to be incurred in this matter. The Attorney General filed its notice of no objections to the Staff Report and Recommendations on March 23, 2012. A public hearing was held on May 10, 2012.

ARGUMENT

In its application, Coolbrook proposes to increase its rates from \$30.15 per customer per month to \$36.80, representing an increase of \$6.65 or 22 percent. Coolbrook also requests the authority to impose a surcharge of \$6.75 per customer per month for a twelve (12) month period to fund the cost of an inflow and infiltration study (“I&I study” or “study”). Coolbrook’s proposed general rate increase, combined with the surcharge, would result in a total increase of more than 44 percent in Coolbrook customers’ monthly rates. Coolbrook has the burden of proving that the general rate increase and surcharge are just and reasonable,¹ and that the corresponding ratemaking mechanism strikes the proper regulatory balance between Coolbrook’s owner-shareholders and its ratepayers.

A. The Inflow and Infiltration Study

1. The Surcharge Mechanism Unreasonably Shifts the Costs and Risk of the Study to Ratepayers

The Attorney General agrees with the Commission Staff that the proposed surcharge unreasonably shifts risk and costs of the proposed I&I Study from the utility to the ratepayers.² Under accepted ratemaking principles, a utility’s owners/shareholders bear the costs of a capital expenditure, such as the I&I study proposed, and the risk and necessary oversight for such an expenditure. Once the investment is made, a utility may seek recovery of prudently incurred capital costs through its rates. Ratemaking principles direct that the opportunity to earn a return for the investment is through rate recovery over the useful the useful life of the assets.

The Commission Staff has previously advocated this method of accounting for assets with long lives in case number 2006-00028, *Application to Request Commission Approval for an*

¹ KRS 278.190(3) (1992).

² See Public Service Commission Staff Report (hereinafter “Staff Report”) at pg. 4 (Mar. 5, 2012).

Increase in Farmdale Development Corporation Sewage Treatment Plant's Rate Pursuant to the Alternative Rate Filing Procedure for Small Utilities ("Farmdale"). In that case, the Staff indicated that the most fair and equitable means to recover the costs of projects with long useful lives is to recover the costs "through general rates in the form of depreciation expense."³ Under this recovery method, the utility bears the cost and the risk that the asset will not be fully used up front, and the recovery takes place over the useful life of the asset. Coolbrook proposes to upset this balance by forcing customers to bear the full risk and the full cost of the study in the first year with the proposed surcharge. If Coolbrook is allowed to shift this cost, and thus the risk, to customers so early on, the utility will bear virtually none of the risk over the life of the asset. Coolbrook will have far less incentive to exercise diligence and proper management upon the approval of a surcharge.

The *Farmdale* case also illustrated two other risks with using a surcharge to recover these types of costs. The Commission Staff indicated that:

A surcharge would allow recovery of these assets in a much shorter period and require current ratepayers to absorb expenses that are more appropriately allocated to future ratepayers. Moreover, use of a surcharge requires considerable Commission resources to review the utility's conduct to ensure that proceeds are used solely for their intended purposes and that the utility does not engage in unreasonable and potentially costly transactions with affiliated entity to the ratepayers' detriment.⁴

The surcharge would shift the costs of the study from the group who will benefit from the study, Coolbrook's future ratepayers, to Coolbrook's current ratepayers and the Commission. While it is probable that some of the current ratepayers will remain Coolbrook's ratepayers long enough to see their full share of the benefits of the study, others may not remain ratepayers long enough to share the full benefits. Forcing current ratepayers to absorb the cost of the study means that

³ Case No. 2006-00028, *In re Farmdale*, Public Service Commission Staff Report at pg. 4 (Feb. 26, 2007).

⁴ *Id.* at pg. 4-5.

the ratepayers that bear the cost may not be the same as those that receive the benefits of the study. It is, therefore, an improper matching of costs and benefits.

Coolbrook proposes such a shift in risk sharing before the owners of Coolbrook have explored the possibility of obtaining financing for the study by bearing at least some of the risk themselves, through personal guarantees of a bank loan. Mr. Cogan went so far as to say he did not think it prudent to personally guarantee payment of a new loan, obtained to fund the study, without an income stream to ensure any personal guarantee he gives is not jeopardized.⁵ It is clear from this testimony from the hearing that Coolbrook is trying to avoid bearing the risk that funding the I&I study entails and is instead trying to fully shift that risk to the customer. Given that this abrupt change in risk allocation is so far outside the usual method for sharing the risk between the customer and the utility, the Attorney General recommends that the Commission deny Coolbrook's requested surcharge.

2. There is no Order Requiring an I&I Study

The circumstances of this case are distinguishable from the prior cases in which the Commission has approved stipulations by Staff to allow a surcharge mechanism.⁶ Specifically, in this case there is no evidence that Coolbrook has been ordered to conduct an I&I study. Coolbrook has tried to claim as evidence of a requirement a post-enforcement conference letter from the Kentucky Division of Water ("DOW"). This letter memorializes the remedial measures discussed in the conference and that may be included in a future agreed order.⁷ However, Coolbrook admits that DOW has not issued an Order requiring Coolbrook to conduct an I&I

⁵ See May 10, 2012 Hearing Video, Witness - Martin Cogan, 10:53 am; see also Coolbrook Response to Post-Hearing Data Requests at p. 36 of 61, Letter from Lawrence Smither to the Division of Water at Paragraph (5) in which Mr. Smither states: "When we assumed the ownership and operation of the Coolbrook wastewater treatment plant and the two lift stations they were in a state of disrepair. I can understand why the previous owner wanted to get this off his hands."

⁶ The Commission speaks by and through its Orders, and therefore, stipulated matters while binding on the parties, are not binding on the Commission.

⁷ See May 10, 2012 Hearing, Applicant Exhibit 1.

study,⁸ so there is no binding order, stipulation or agreement requiring Coolbrook to conduct the study.

Coolbrook has cited *In re: Application of Ridgelea Investments, Inc. for Alternative Rate Adjustment*⁹ (“Ridgelea”) as authority for its request for a surcharge to fund the study.¹⁰ However, the Ridgelea case is distinguishable from the instant case. In Ridgelea, the I&I study was required by an Order of the Kentucky Division of Water.¹¹ Ridgelea’s Agreed Order was signed¹² by the sewer company at least four months prior to the company’s application for a rate adjustment.¹³ The DOW Order was already issued and binding on Ridgelea when the company asked for the surcharge to fund the study; there is no similar binding requirement on Coolbrook in this case, because no Order has been issued by DOW. While undertaking an I&I study may be a desirable course of action for Coolbrook, in light of the lack of a DOW Order requiring Coolbrook to do such a study, the proposed surcharge is not the appropriate way to fund this study. If the sequence of events in the Ridgelea case is overlooked and Coolbrook’s proposed surcharge is allowed, the Commission would be making a significant change in how this type of cost is typically recovered.¹⁴

Further, in response to post-hearing data requests, Coolbrook has produced letters confirming that while it has been subject to notices of violation (“NOV”) issued by DOW, it has negotiated extensions of time to complete the I&I study as well as a suspension of possible fines

⁸ See May 10, 2012 Hearing Video, Witness - Lawrence Smither, 9:23 am.

⁹ PSC Case 2009-00500, *In re: Application of Ridgelea Investments, Inc. for Alternative Rate Adjustment* (Order entered Apr. 8, 2011).

¹⁰ See May 10, 2012 Hearing Video, Witness - Jack Kaninberg at 11:18 am.

¹¹ Ridgelea (2009-00500), PSC Order, Apr 8, 2011, pg. 2.

¹² Ridgelea (2009-00500), Staff Report, Nov 24, 2010, pg. 3 (Agreed Order signed Aug. 1, 2009).

¹³ Ridgelea (2009-00500), PSC Order, Apr 8, 2011, pg. 1 (Application initially filed Dec. 14, 2009).

¹⁴ See May 10, 2012 Hearing Video, Witness - Jack Kaninberg at 12:11 am; *See also* Staff Report at pg. 4 (Utilities generally finance this type of cost through internal funds or debt and Coolbrook may recover the cost of borrowing through its general rates).

associated with the NOV's until such time as it secures the necessary financing to perform the I&I study and recommended repairs to its system.

3. Coolbrook has not Demonstrated Reasonable Efforts to Secure Financing for the Study

Coolbrook has claimed that a surcharge is the only way for it to fund the I&I study,¹⁵ but has not provided sufficient evidence that it has made reasonable attempts to fund the study through other means. Commission Staff indicated that “[r]easonable efforts require the submission of applications to several lending institutions,”¹⁶ and the Attorney General supports this definition. Coolbrook has only submitted evidence of one application for a bank loan to fund the study, a denial from Bedford Bank,¹⁷ and this request was made at the last minute and in a summary fashion with no evidence that upon submission of a more thorough application financing might be possible.¹⁸ Coolbrook admitted that it consulted, but did not complete the loan application process, with another lender, PNC Bank.¹⁹ The only other evidence that Coolbrook offers of its efforts to obtain a bank loan is a letter from Old National Bank discussing that bank’s view on lending to a sewer company.²⁰ However, this letter does not pertain directly to Coolbrook. Rather, the Old National letter was written in regards to a rate filing for a different sewer company and is dated over one (1) year prior to Messrs Smither and Cogan purchasing Coolbrook’s utility.²¹

¹⁵ See May 10, 2012 Hearing Video, Witness - Lawrence Smither at 9:28 am; See also May 10, 2012 Hearing Video, Witness - Martin Cogan at 10:49 am (Coolbrook does not have the financial wherewithal to undertake the I&I study, and without a stream of income to pay back the loan, a bank will not lend Coolbrook the loan).

¹⁶ Staff Report at pg. 4.

¹⁷ May 10, 2012 Hearing, Applicant Exhibit 3.

¹⁸ See May 10, 2012 Hearing Video, Witness - Lawrence Smither at 10:09 am (Loan application was made recently).

¹⁹ See May 10, 2012 Hearing Video, Witness - Lawrence Smither at 9:29 am.

²⁰ May 10, 2012 Hearing, Applicant Exhibit 4.

²¹ May 10, 2012 Hearing, Applicant Exhibit 4. See also May 10, 2012 Hearing Video, Witness - Lawrence Smither at 9:08 am (Coolbrook has owned the plant and system since November 2008).

Coolbrook has only provided evidence of one attempt to secure financing of the I&I study, the Bedford Bank application, which was made just prior to the hearing. Coolbrook knew about the need for an I&I study not long after the purchase of the utility was complete,²² and had even stronger evidence of this need after DOW indicated in its June 2011 letter that a study may be a remedial measure included in a future agreed order,²³ but Coolbrook did not attempt to secure bank financing until the week of May 7, 2012.²⁴ It is unclear how Coolbrook could assert this was a reasonable effort to obtain financing.

Coolbrook also did not provide evidence that it fully explored the possibility of obtaining a loan with personal guarantees by the owner supporting the collateral. At least one of the owners of Coolbrook has personally guaranteed business loans in the past and indicated that such guarantees are probably a common practice.²⁵ This owner, Mr. Smither, also indicated that he was aware at the time that Coolbrook purchased the utility that personal guarantees of loans might be necessary.²⁶

One of the exhibits Coolbrook introduced at the hearing even notes that personal guarantees can be an important part of the collateral. In the letter from Old National Bank, the bank indicates that "...a lending institution will not typically accept a wastewater treatment plant as the *sole collateral* to secure a loan. The financial institution could also require guarantees from qualified individuals or entities owning the company that owns the wastewater treatment plant."²⁷ The owners of Coolbrook have made no showing that they are not such qualified individuals. As such, it seems clear that they cannot meet the burden of showing that the

²² See May 10, 2012 Hearing Video, Witness - Lawrence Smither at 9:09 am (Coolbrook first became aware of need for the study almost immediately after taking over the utility).

²³ May 10, 2012 Hearing, Applicant Exhibit 1.

²⁴ See May 10, 2012 Hearing Video, Witness - Lawrence Smither at 10:10 am.

²⁵ See May 10, 2012 Hearing Video, Witness - Lawrence Smither at 10:04 am.

²⁶ See May 10, 2012 Hearing Video, Witness - Lawrence Smither at 10:08 am.

²⁷ May 10, 2012 Hearing, Application Exhibit 4 at pg. 2 (emphasis added).

surcharge is just and reasonable without evidence that financial institutions do not consider the owners to be of the aforementioned class of qualified individuals.

B. Amortization of Legal Fees

Coolbrook objects to Staff's Recommendation²⁸ that the Commission deny its request to amortize and recover its rate case expenses, specifically the legal fees it has incurred and will incur in this rate case. With regard to this dispute by Coolbrook, the Attorney General agrees with Commission Staff that the Coolbrook should be held to its prior stipulation, which was silent on the recovery of legal fees for the prior rate case, and that the legal fees incurred or to be incurred in this matter are not known or measurable. Coolbrook has presented no evidence to the contrary.

CONCLUSION & RECOMMENDATIONS

The Attorney General supports the Commission Staff's report on Coolbrook's proposed rate increase and surcharge. In particular, the Attorney General agrees that Coolbrook's anticipated legal fees are not known or measurable, and therefore should be disallowed.²⁹ The Attorney General also supports the Staff's position on Coolbrook's proposed increase in the owner/manager fee and recommends that the Commission limit this fee to \$3,600, which the Commission has consistently found to be a reasonable amount.³⁰ The Attorney General further recommends that the Commission adopt the Staff's recommended monthly rate of \$32.04³¹ and deny Coolbrook's proposed surcharge.

Respectfully submitted,

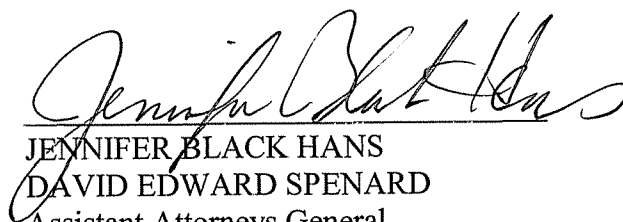
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²⁸ See Staff Report, Attachment A at p. 9

²⁹ Staff Report at pg 10.

³⁰ Staff Report at pg. 3.

³¹ *Id.*



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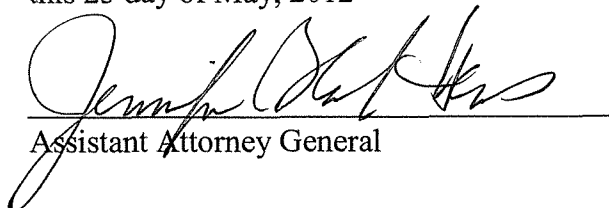
Certificate of Service and Filing

Counsel certifies that an original and ten photocopies of the foregoing were served and filed by hand delivery to Jeff Derouen, Executive Director, Public Service Commission, 211 Sower Boulevard, Frankfort, Kentucky 40601; counsel further states that true and accurate copies of the foregoing were mailed via First Class U.S. Mail, postage pre-paid, to:

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