

**FINDINGS AND RECOMMENDATION REGARDING THE MARTIN  
COUNTY WATER DISTRICT**

KENTUCKY OFFICE OF THE ATTORNEY GENERAL  
December 2018

ANALYSIS

On May 30, 2018, a local advocacy group, the Martin County Concerned Citizens (“MCCC”) joined by Food and Water Watch and the Appalachian Citizens’ Law Center, sent a letter to the Office of the Attorney General’s requesting the AG investigate Martin County Water District (“MCWD” or the “District”) for “gross financial mismanagement” and “alleged misuse of public funds.” Specifically, MCCC raises three allegations: 1) The District is unable to account for a \$3 million grant from the Coal Severance Fund; 2) Residents consistently report that the water district is extremely lax in its employee spending policies allowing workers and managers to charge personal expenses to the District; and, 3) Certain public officials and private entities may be receiving free water service. On June 4, 2018, the Attorney General announced an inquiry into the past and present management of the District and tasked the Department of Criminal Investigations (“DCI”) and the Office of Rate Intervention (“ORI”) to perform an investigation of the allegations.

DCI has an ongoing investigation into the above allegations concerning the Coal Severance Fund, alleged use of District funds for personal expenses, and claims that officials received “free water.” Any findings from that investigation will be presented to the Martin County Commonwealth Attorney for his review.

This report addresses the operational and management issues affecting the District. Based on our findings of decades of gross mismanagement, the Attorney General has concluded

that the District can no longer be trusted to run its water system. The Attorney General therefore strongly recommends a receiver be appointed to manage the District.

### BACKGROUND

MCWD has been consistently unable to provide potable water to many of its customers for a number of years. Media reports are plentiful documenting the District's failure to provide clean, safe, reliable water service to Martin County residents, i.e., *The Kentucky County Where the Water Smells Like Diesel*,<sup>1</sup> and *The Water Runs Milky and Can Feel Like Fire*.<sup>2</sup> Customers report being without water for days at time, limiting their use of the water to flushing toilets, and spending their very limited funds on bottled water for cooking and drinking. Many do not feel safe bathing in it. In January 2018, residents struggled to maintain normalcy as water service was interrupted for days because distribution mains and an intake valve froze during a cold snap. In addition, many are furious that they pay monthly for water that is only suitable for flushing toilets.<sup>3</sup>

The District's service territory is located solely in Martin County, KY. In 2017, Martin County had a projected population of 11,452.<sup>4</sup> The number of households in the county for 2017 is estimated at 5,281.<sup>5</sup> As of the filing of the current rate case, MCWD served 3,517 water accounts<sup>6</sup> in Appalachia, one of the country's poorest regions.<sup>7</sup>

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<sup>1</sup> <https://www.cnn.com/2018/03/30/health/kentucky-water-crisis/index.html>

<sup>2</sup> <http://www.latimes.com/nation/la-na-kentucky-water-20180212-story.html> (LA Times).

<sup>3</sup> *Id.*

<sup>4</sup> <https://www.census.gov/quickfacts/fact/table/martincountykentucky,US/PST045217>.

<sup>5</sup> <https://www.census.gov/quickfacts/fact/table/martincountykentucky,US/PST045217>.

<sup>6</sup> Application, ARF Form-1, *Electronic Application of Martin County Water District For An Alternative Rate Adjustment*, Case No. 2018-00017, at 3 of 5 (Ky. Commission January 16, 2018).

<sup>7</sup> See <https://www.usnews.com/news/healthiest-communities/articles/2018-09-25/majority-white-kentucky-county-struggles-on-decades-after-war-on-poverty>; <https://www.usnews.com/news/healthiest-communities/kentucky/martin-county#economy> (noting that the rankings were adjusted on November 20, 2018 "due to previously incorrect scoring calculations"); see also <https://www.kentucky.com/news/state/article218946835.html>.

During the course of this inquiry, our office conducted interviews, reviewed public documents, Public Service Commission (“Commission”) case files, exhibits and hearing transcripts, water quality reports available online from the Division of Water, accounting ledgers and expense reports, and media reports. We requested project applications and associated documents from the Energy and Environment Cabinet - Division of Water, Big Sandy Area Development District (“Big Sandy ADD”), MCWD, and Martin County Fiscal Court. These documents were requested to examine the scope and financing of the projects undertaken by the District and fiscal court to expand or improve the District and its service territory. Unfortunately, due to short retention schedules, the agencies produced few relevant documents. We also reviewed the District’s currently filed tariff and met with District representatives regarding day-to-day operations.

#### Managerial Issues

The District has been plagued with management issues for more than two decades. With no comprehensive capital improvement plan in place, it operates in crisis mode on a day-to-day basis. Often, as the District repairs one leak increasing pressure causes other leaks elsewhere. As funds available to conduct day-to-day repairs are exhausted, the District resorts to cheaper, less durable fixes which often necessitate more expensive repairs later on. There is no protocol in place to evaluate and prioritize maintenance and repairs. Likewise, there is no plan to control inventory in order to ensure parts to replace and repair are on hand when needed. The people of Martin County suffer from mismanagement that could have and should have been rectified years ago. Indeed, on numerous occasions, the District was given a “road map” to quality and stability, which the District has failed to follow.

The District's deteriorating infrastructure and mismanagement have been the focus of regional and sometimes national attention since at least 2000. The October 2000 Massey Coal slurry spill brought these problems into focus, after a 2.2 billion gallon coal slurry impoundment gave way creating devastating environmental impacts, the polluting effects of which stretched all the way to the Ohio River.<sup>8</sup> Martin County was the epicenter of the toxic slurry, which contained coal waste, arsenic, lead, and other heavy metals, with residents reporting significant health effects immediately thereafter. The spill focused attention on the water supply and the system's neglected maintenance.

Thereafter, in 2002, the District became the subject of numerous investigative proceedings conducted by the Commission. The Commission opened an investigation (Case No. 2002-00116) regarding the operating capacity of MCWD, but later expanded the scope of that investigation into the management and operations of the District. The Commission and the District reached a settlement in that matter and the resulting agreement contained forty-three (43) discrete mandates designed to improve the overall system.<sup>9</sup> Those mandates provided a complete and comprehensive plan – the first “road map” – with agreed upon completion dates, designed to correct deficiencies in the District's management, increase its financial viability, and provide guidance for maintenance/repair/replacement of aging and deteriorating infrastructure.

As part of the Settlement Agreement, the District executed a management contract with American Water Services on October 1, 2002.<sup>10</sup> That contract would have provided outside expertise to follow the 2002 “road map.” However, in 2003 the MCWD Board sought to

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<sup>8</sup> Geraldine Sealey, *Sludge Spill Pollutes Ky., W. Va. Waters*, ABC NEWS, Oct. 23, 2000, <https://abcnews.go.com/US/story?id=95285&page=1>; Dylan Lovan, *After Decade, Still Signs of Coal Slurry Spill*, WASH. POST, October 17, 2010, <http://www.washingtonpost.com/wp-dyn/content/article/2010/10/15/AR2010101507010.html>; Phillip Babich, *Dirty Business*, SALON, November 13, 2003, [https://www.salon.com/2003/11/13/slurry\\_coverup/](https://www.salon.com/2003/11/13/slurry_coverup/).

<sup>9</sup> Commission Order, Appendix A, *Investigation Of The Operating Capacity Of Martin County Water District Pursuant To KRS 278.280*, Case No. 2002-00116 (Ky. Commission Nov. 17, 2003).

<sup>10</sup> MCWD Final Report, Barrington-Wellesley Group, Inc., Case No. 2006-00303, at I-4-I-5 (Apr. 18, 2007)

renegotiate terms of the arrangement after it became dissatisfied with bills submitted by American Water Services. Eventually, in 2004, the parties agreed to an early termination of the management services agreement. The end-result is that the District failed to take many of the necessary steps laid out in the 2002 Settlement Agreement.

In 2006, the Commission opened another investigation to identify and correct management and operational deficiencies, eventually finding that “[s]ome of Martin District’s current practices prevent the provision of adequate and reasonable water service.”<sup>11</sup> The final order in that investigation, Case No. 2006-00303, provided a second “road map,” setting out twenty-five (25) required actions with associated deadlines in order to place MCWD back on the path to sustainability.<sup>12</sup> Many of those duplicated the mandates contained in the 2002 Settlement Agreement, re-affirming that the District had failed to complete the work previously ordered by the Commission.

Following this second set of instructions to achieve comprehensive change and improvement both financially and operationally, the District was unwilling or unable to accomplish the proscribed actions, which led to further deterioration of its system.

As a result, in 2007, the Commission engaged The Barrington-Wellesley Group to perform a Management and Process Audit. The audit produced a 78-page action plan – a third “road map” – for the District, which agreed to implement all but one recommendation. Ultimately, however, the District completed only one recommendation.<sup>13</sup>

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<sup>11</sup> Commission Order, *An Investigation Into The Management And Operation Of Martin County Water District*, Case No. 2006-00303, at 2 (Ky. Commission Apr. 2, 2008).

<sup>12</sup> *Id.* at 5–7.

<sup>13</sup> Commission Order, Concurring Opinion of Chairman Michael J. Schmitt, Case No. 2018-00017, at 5–7 (Nov. 5, 2018).

The Commission opened its most recent investigation in 2016 and it is ongoing.<sup>14</sup> In addition to making various compliance filings with the Commission related to the investigation, the District filed an Alternative Rate Filing requesting an expedited review and interim emergency rate relief on January 16, 2018 (Case No. 2018-00017).<sup>15</sup>

In an interim order, dated March 16, 2018, the Commission approved a “debt service surcharge” specifically to pay off debt and reduce past due accounts to creditors. In its November 5, 2018 order, the Commission has placed an additional requirement on the District as to the use of those funds.<sup>16</sup> MCWD is now required to secure an agreement from either a private company or neighboring water system to provide outside management services. Following a hearing on December 20, 2018, the Commission issued an order revising its original schedule for compliance and allowing the District until April 30, 2019 to obtain outside management services.<sup>17</sup> If the District fails to comply with the terms of the order, or if it chooses a proposal deemed by the Commission not to be in the best interests of MCWD or its customers, the surcharge will cease and any remaining funds will have to be returned to the customers.<sup>18</sup>

Between the announcement of the AG inquiry and the issuance of this report, the Commission entered an order ruling on the District’s requested rate relief. The Commission approved a base rate increase for MCWD of 23.70 percent and a temporary “management and infrastructure surcharge”<sup>19</sup> collectible only after the District submits an infrastructure improvement plan to the Commission for approval. The Commission has given the District one year from the date of the order, November 5, 2019, to secure new management and file such a

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<sup>14</sup> See generally Case No. 2016-00142.

<sup>15</sup> The Office of Rate Intervention did not intervene in either the current rate case or the investigative case.

<sup>16</sup> Commission Order, *Electronic Application of Martin County Water District For An Alternative Rate Adjustment*, Case No. 2018-00017, at 12 (Ky. Commission Nov. 5, 2018).

<sup>17</sup> Case No. 2018-00017 (Ky. Commission Dec. 20, 2018). The Commission also instituted incremental deadlines and set formal conference dates for the review of the proposals and of the final proposed contract.

<sup>18</sup> *Id.* at 3. Case No. 2018-00017, at 12 (Ky. Commission Nov. 5, 2018).

<sup>19</sup> Case No. 2018-00017, at 12 (Ky. Commission Nov. 5, 2018).

plan. As clarified in the December 20, 2018 order, if MCWD successfully contracts with an outside management service, the November 5, 2019 deadline to submit a capital improvement plan may be extended upon motion for good cause.<sup>20</sup> If the District fails to submit a plan, or if the Commission determines the plan to be insufficient, the infrastructure surcharge will be voided.<sup>21</sup>

The final rates approved by the Commission will increase the monthly bill of an average residential customer, with usage of 4,000 gallons per month, by an additional \$3.30 over the earlier approved interim emergency increase, resulting in a total increase of \$14.47, or 36.27 percent, over the prior average monthly bill of \$39.90.<sup>22</sup> Furthermore, if MCWD completes the conditions necessary to institute the management and infrastructure surcharge within one year of the Commission's order, then that \$3.16 per customer per month surcharge will increase the average residential customer's bill to \$57.53, or 44.19 percent.<sup>23</sup> In addition to having to absorb these rate increases, customers continue to have to pay for less than safe, adequate, and reliable service to which they are entitled, an ongoing breach of the regulatory obligation.

The Commission has repeatedly indicated the most pressing need for the District is 'qualified management' capable of developing a long range capital improvement plan,

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<sup>20</sup> Case No. 2018-00017, at 1 (Ky. Commission Dec. 20, 2018).

<sup>21</sup> *Id.* at 1–2.

<sup>22</sup> Commission Order, Case No. 2018-00017, at 20 (Ky. Commission Nov. 5, 2018). *Id.* at Appendix A.

<sup>23</sup> Under KRS 278.030, the Public Service Commission is bound to approve utility rates that are fair, just, and reasonable. This charge, more than any other, guides the Commission in ratemaking decisions. However, courts have interpreted the language "fair, just and reasonable" more broadly as to include the context of the relationship between utility and consumer, and have more readily applied the principle of equity in rates on behalf of the consumer, resulting in an analysis of affordability. See *Nat'l—Southwire Aluminum Co. v. Big Rivers Elec. Corp.* 785 S.W.2d 503, 506–509 (Ky. App. 1990); *Federal Power Comm'n v. Hope Nat. Gas Co.* 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1944); *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942), 62 S.Ct. 736, 743, 86 L.Ed. 1037; *Kentucky Industrial Utility Customers, Inc. v. Kentucky Pub. Serv. Comm'n*, 504 S.W.3d 695, 705-709 (Ky. App. 2016); *Kentucky Pub. Serv. Comm'n v. Com. ex rel. Conway*, 324 S.W.3d 373, 377 (Ky. 2010).

prioritizing District needs, and directing scarce resources to high priority items. Nevertheless, the District has so far continued to have current staff and management continue to run the operation.

Exacerbating its other problems, the District has failed to develop policies to handle theft and unaccounted-for water appropriately. The District recently installed a new billing system to help eliminate billing confusion and collect delinquencies in a timely manner.<sup>24</sup> The District has also begun pulling meters more often and more quickly after nonpayment of arrearages and disconnect notices are sent. This has allowed the District to discover more instances of theft and remove more “cheater bars.”

Although the quality of treated water has been an issue in the past, the District has received no Notices of Violation (“NOV”) relating *directly* to the treatment of water from the Kentucky Department of Water since 2017.<sup>25</sup> Even though “treated” water is within acceptable tolerances, *the quality of water as delivered is not*. Line breaks on the system permit ground water to seep in leading to localized contamination from dirt and other ground contaminants. Likewise, the inability to maintain adequate pressure on the system leads to water quality issues. Those issues subsequently lead to serious widespread system outages and the issuance of boil water advisories.

Currently, the District keeps teams of field workers in rotation to detect and find leaks on a constant, day-to-day basis. However, leak detection on a reactionary basis is not sustainable long-term, and the inherent weakness in the current system means fixing one leak may contribute to or cause another. Although the District has made limited improvements to the system to

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<sup>24</sup> In the past, the bills would overlap with delinquency notices that led to customer confusion regarding precisely what was owed.

<sup>25</sup> Kentucky Energy and Environment Cabinet, Department for Environmental Protection, Division of Water, Drinking Water Branch, available at: [http://dep.gateway.ky.gov/DWW/JSP/Violations.jsp?tinwsys\\_is\\_number=1358&tinwsys\\_st\\_code=KY](http://dep.gateway.ky.gov/DWW/JSP/Violations.jsp?tinwsys_is_number=1358&tinwsys_st_code=KY) (showing that MCWD has had two subsequent violations for public notice requirements, and one for failure to submit a monthly operating report).



strengthen the service lines, it must institute a system for future detection that will allow for proactive, immediate and prolonged remediation. Until the District has a systematic plan for identifying and repairing leaks and flushing lines as needed, these water quality issues will continue to plague customers.

Whether service interruptions are planned or unplanned, the District needs to do a better job of managing its message via social media when supply interruptions and water quality are issues for affected customers. The District should eventually upgrade its website to be more functional and to provide more timely and relevant information. District officials have reportedly made a point to attend meetings of the Martin County Concerned Citizens to address such issues, where apparently District officials frequently outnumber the citizens. Again, this is a meaningful step forward to increase transparency and communications between the District and the community, but more progress is required.

Despite numerous directives from the Commission, the District still has not implemented written policies and procedures for inventory purchases and control. The District's failure to keep track of significant inventory on hand contributes to the need for costly, crisis-to-crisis purchases. Adopting those recommendations would have also contributed to improved accountability for purchases.

Training for office and technical staff on new policies and procedures is also paramount. The mere promulgation of new policies and procedures will not prove effective if the implementation of those changes does not include proper training. The District must work to incorporate policy changes through prompt communication to its employees and by holding formal training sessions thereafter.

## Operational Issues

Especially relevant to this report is the report prepared by MCWD consultant, BlueWater Kentucky (“BlueWater”) and filed into the record of Commission Case No. 2016-00142. MCWD previously retained BlueWater to assess its management, operations, annual operating budget, current rates, and capital improvement program. As noted in the BlueWater report, and further confirmed in our conversations with District personnel and Board members, capital improvements to the District’s water system *historically* have been initiated and recommended by engineering consultants directly to fiscal court with very little input from the District. Those projects were approved without benefit of a comprehensive assessment of the system, and identification of the impacts such projects would have on the system. Although the projects frequently were sufficient in scope to address immediate needs to add customers, water storage, or upgrade the distribution system, the impact of the construction on the system as a whole may not have been beneficial. As has been demonstrated several times in the recent past, both normal pressurization and over-pressurization on the system results in main breaks, line loss, contamination of water, and loss of water service until repaired.<sup>26</sup>

The fact that no comprehensive mapping of the system has been undertaken has further jeopardized a fragile infrastructure, contributing to the problems noted previously.<sup>27</sup> The critical

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<sup>26</sup> See <https://www.wyvt.com/content/news/Martin-County-Water-District-customers-may-continue-to-have-water-outages-496056721.html>; <https://www.wsaz.com/content/news/Water-shut-off-in-Martin-County-due-to-water-main-breaks-496282041.html> (discussing the recent water main break which led to water loss as a result of work to integrate the water line being constructed to serve the new high school into the system).

<sup>27</sup> The District has engaged the Kentucky Rural Water Association (“KRWA”) for technical assistance and KRWA will continue working with the District to assist in collection of data to map the system. The District is also working with the University Of Kentucky College Of Engineering, specifically, the Kentucky Water Resource Research Institute (“KWRRRI”), who has provided preliminary mapping information for the District’s water system using public data obtained through the Kentucky Infrastructure Authority. Although a holistic system assessment is a critical need for the District, full mapping and analysis will take considerable time—time which the District does not have before it needs to take action.

condition of the system infrastructure and lack of adequate rates has further hampered the District's operation by compounding issues on the system that require significant labor or capital to address. Although some line breaks and other operational issues this past January and September would not have been critical to other water systems, they were more difficult for the District to both address and absorb because of the fragile nature of its infrastructure and its financial difficulties.

At last report, the District's line loss and unaccounted for water is 73.68%.<sup>28</sup> Simply put, for every gallon purchased and treated, the District loses over two-thirds to leaks, theft or free water accounts.<sup>29</sup> The inability to bring line loss under control has the single biggest impact on the District's operations. It results in higher expenses for labor, inventory, treatment chemicals, and purchased water costs, with almost every operating expense category impacted in some way. Historically, the Commission only allows a utility to recover up to 15% line loss, which means the remainder of the expenses not built into rates comes from funds that would otherwise be available to sustain normal operations. Despite the managerial shortcomings noted repeatedly by the Commission and the dismal financial condition of the District, it continues to apply for and receive state and federal funds for ongoing projects.<sup>30</sup>

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<sup>28</sup> Martin County Water District's Notice of Filing Information in compliance with Commission Order of March 16, 2018, Monthly Requirements, Due November 15, 2018, Case No. 2018-00017, at 21 (Nov. 14, 2018).

<sup>29</sup> See Commission Order, *In the Matter of Martin County Water District #2 Furnishing Free Water to the Board of Commissioners*, Case No. 92-292 (Ky. Commission July 23, 1992). Although the Commission denied the request to provide free water to the Board members, we have reason to believe that practice continued well beyond the Commission's 1992 denial.

<sup>30</sup> There are currently four major construction projects in the works. A \$1.2 million ARC grant project to replace 1200 service lines and meters, although the District along with Big Sandy ADD is actively discussing a "re-scope" of the project, to use the total grant to replace service lines instead of meters. An Abandoned Mines Land Economic and Community Development Pilot Program ("AML") for approximately \$3.4 million, is a grant for five capital projects: raw water intake modifications, a secondary intake in the Tug Fork River for necessary redundancy, upgraded piping, pumps and controls, a system wide SCADA system, and a new raw water transmission main. A second AML grant application, for approximately \$2 million, submitted in November seeks funding for a new water tower, pump station, and associated infrastructure on KY 3 to provide consistent water service to a federal penitentiary, a regional airport and a business park. Another project to add a new high school to the water system is currently being funded through the U.S. Army Corp of Engineers Infrastructure Grant Program with an estimated

## RECOMMENDATION

Many specific operational and management deficiencies noted in the record of the ongoing Commission cases are not addressed herein. All directly relate to District's inability, or in some cases unwillingness, to follow the very explicit recommendations and directions to resolve the many critical issues facing the District. Despite being given at least three virtual road maps of actions required to set the District on a better operational and financial footing and being encouraged to seek management assistance in numerous Commission cases, it appears *no effort has been made to comply with those recommendations*. In fact, the District has exhibited a historic pattern of rejecting sound advice to the detriment of its customers.

Further concerning is the appointment of the present Interim General Manager, who recently took over after the resignation of the former manager earlier this year. The Interim General Manager is not new. Indeed, as the Commission has made clear, he was responsible for the failure to implement many of the recommendations discussed herein, in either of his past roles as the General Manager or Chair of the District Board of Commissioners.

The Commission notes it has several options available to it should it wish to take further action, including removal of the District commissioners, merger with another water district, placing restrictive conditions on the collection of revenues, or placing the District in receivership. As the Commission opines, all are time consuming, while some scenarios are not likely to achieve the desired results; all are increasingly punitive to the customers served by the District. Removal of Commissioners does not guarantee the appointment of Board members any

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cost of \$1.1 million. The project includes the construction of ductile iron line, PVC line, a 150,000-gallon ground storage tank, and a booster pump station. The extension of a line to the new high school is underway but not expected to come onto the system until 2019. However, the line is not appropriately sized and the water tank onsite can only be filled during times when water usage is at its lowest.

more qualified *or willing* than those presently serving, and merging the District with another district located in the region is dependent upon identifying a water district that is well managed and can continue its operations while taking on those of MCWD.

The Attorney General therefore concludes that a receivership is required for the District. The failure to follow three “road maps” that provided a path to sustainability has resulted in an untenable situation and the District can no longer be trusted to run its operations as the people of Martin County continue to suffer. KRS 278.021 provides that the Commission may bring an action in Franklin Circuit Court to have a receiver appointed if the utility fails to comply with an order of the Commission where the Commission found the utility was not rendering adequate service or the utility fails to meet its financial obligations to its suppliers. The Commission has repeatedly made these findings. Receivership represents the most expeditious path forward to deliver consistently reliable, potable water to the citizens of Martin County. The Attorney General believes the Commission must take that step.