Reducing bad-debt expenses

Utilities should terminate bankrupt nonresidential customers and seek payment rather than tolerating nonpayment as an allowed operating expense.

Gilbert L. Hamberg

Water utilities should implement aggressive credit and collection strategies to minimize bad-debt expenses from nonresidential customers. Before customers file for bankruptcy, utilities should have favorable laws and tariff provisions in effect and should implement such provisions for each customer. When customers file for bankruptcy, utilities should intervene and protect their pre- and postpetition interests. In a competitive economic climate, such a policy would make sense for utilities.

Data at one public utility commission reflected bad-debt expenses in 1992 and 1993 for its major electric and gas utilities' nonresidential customers ranging from several hundred thousand dollars to nearly $18 million. These expenses, although relatively low compared with gross operating expenses, are not insignificant, especially if they are indicative of a trend among utilities. Data about water utilities were unavailable from that commission, but water utilities should also be concerned about maintaining low bad-debt expenses.

In today's economy many nonresidential customers file for bankruptcy. Utilities should implement all prudent measures to collect the

full amounts of prepetition (before bankruptcy) and postpetition (after bankruptcy) bills from each nonresidential customer. By reducing bad-debt expense, cost-conscious utilities can reduce one allowed operating expense and thereby improve their rates of return.

Utilities design the prices for their services (i.e., operating revenues) to recover their operating expenses, including bad-debt expense. Therefore, when a nonresidential customer owes a utility $5,000, for example, and fails to pay, all other customers pay the $5,000. This article assumes that utilities, customers, state commissions, and consumer advocates want the delinquent customer, not the other customers, to pay the full amount owed.

Utilities should implement all prudent measures to collect the full amounts of prepetition and postpetition bills.

Bankruptcy filing should trigger alarms

When a customer files for bankruptcy, it may be too late for a utility to do anything about the prepetition debt other than to file an accurate proof of claim in a timely way. A bankruptcy filing by a customer should trigger alarms at the utility to have its postpetition bills paid in full on the dates due, obtain adequate assurance of payment (often through payment of a postpetition security deposit), and terminate service for nonpayment of postpetition bills after giving notice according to state laws.

These measures should mirror the credit and collection practices already in effect for a utility's nonbankrupt nonresidential customers. Utilities routinely file tariff provisions for approval from their state commissions. Such provisions should provide that (1) the utility can collect a security deposit equal, perhaps, to some multiple of the highest estimated monthly bill and (2) the utility can terminate service on due notice for nonpayment of bills on time.

Utilities should offer alternate billing and payment options to customers who are unwilling or unable to pay security deposits; e.g., advance payments or billing cycles of less than 30 days.[1,2] Nonetheless, before offering any such alternate billing arrangement, a regulated utility should ascertain whether its state statutes and regulations permit such options. If these kinds of pro-utility credit and collection laws do not exist, utilities should lobby for their passage.

When such tariff provisions are in effect, they should be enforced for all nonresidential customers. A utility without favorable credit and collection provisions (e.g., security deposits, advance payments, and termination procedures) should issue them as long as they are consistent with state laws. Because a customer can file for bankruptcy at any time, a utility can prevent prepetition debts by offsetting them with a security deposit or advance payment or terminating for nonpayment according to state law. Offsetting a prepetition security deposit against a prepetition debt generally is permissible.[3] Because protection under the US Bankruptcy Code is not triggered until the bankruptcy filing, prepetition termination for nonpayment is unaffected by the Bankruptcy Code.

On approval by the state commission, tariff provisions of regulated utilities became the equivalent of state laws. This applies to commission-regulated utilities.[4–6] This also applies to municipal utilities, which can issue and enforce rules and regulations to conduct their businesses.[7,8]

When a customer files for bankruptcy, the Bankruptcy Code takes effect. The relationship between the utility and the customer suddenly becomes subject to the jurisdiction of bankruptcy courts. The bankruptcy court has jurisdiction over all of a debtor's assets and property, wherever located.[9,10] Other parties (e.g., secured creditors and the unsecured creditors committee) may intervene in the relationship. Three key statutes become operative: 11 USC §366(a), 11 USC §366(b), and 28 USC §959(b).

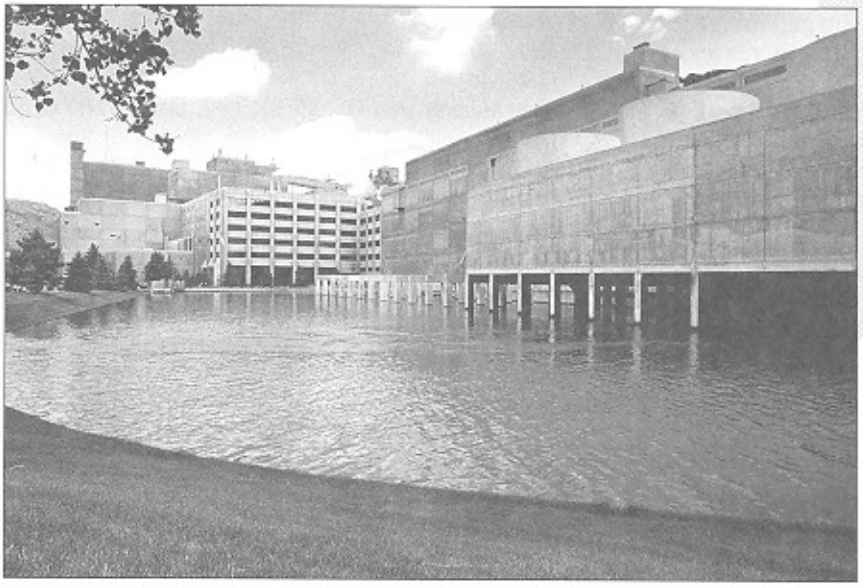
Section 366(a) reads:

> Except as provided in subsection (b) of this section, a utility may not alter, refuse, or discontinue service to, or discriminate against, the trustee or the debtor solely on the basis of the commencement of a case under this title or that a debt owed by the debtor to such utility for service rendered before the order for relief was not paid when due.

Section 366(a) was designed to end the practice that existed before the enactment of the Bankruptcy Code in 1978 whereby some utilities required customers to pay prepetition debts as a condition for receiving postpetition service. The message behind §366(a) is clear: regardless of the amount of a customer's prepetition debt, a utility still must provide postpetition service, at least for the first 20 days.

Section 366(b) reads:

> Such utility may alter, refuse, or discontinue service if neither the trustee nor the debtor, within 20 days after the date of the order for relief, furnishes adequate assurance of payment, in the form of a deposit or other security, for service after such date. On request of a party in interest and after notice and a hearing, the court may order reasonable modification of the amount of deposit or other security necessary to provide adequate assurance of payment.



Many nonresidential customers file for bankruptcy in today's economy, but cost-conscious utilities can reduce bad-debt expense and thereby improve their rates of return.

Section 366(b) defines how a utility is to supply postpetition service. A utility must provide service during the first 20 days postpetition. Thereafter, if the debtor has not tendered "adequate assurance of payment" and if no party has obtained an order from the bankruptcy court, a utility may terminate service[11,12] on compliance with state laws governing such termination.[12–14]

Section 959(b) reads:

> [A] trustee, receiver or manager appointed in any cause pending in any court of the United States, including a debtor in possession, shall manage and operate the property in his possession as such trustee, receiver or manager according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor would be bound to do if in possession thereof.

Assuming a utility has tariff provisions and (or) can rely on state laws for the two keys it should seek when involved in §366(b) litigation—i.e., a security deposit (possibly twice the highest estimated monthly bill) or advance payment and a termination remedy not involving the bankruptcy court (assume a given number of days' written notice for nonpayment)—then §959(b) should be observed by the bankruptcy judge, and both keys should be granted.

This is in stark contrast to §366(b) relief, which many nonresidential debtors seek—paying no security deposits and requiring the utility to return to the bankruptcy court on many days' notice to seek a termination remedy for nonpayment of postpetition bills.

Once in effect, tariff provisions are the equivalent of state laws.[4–8] Utilities must operate according to their tariffs, rules, regulations, and state laws. Section 959(b), which applies to state laws governing utilities,[13–19] requires debtors to comply with these same state laws. To obtain §366(b) relief, a utility either should file its own §366(b) motion or should intervene in a §366(b) motion filed by its customer or other party. Conservative business practice dictates this decision, even though a utility appears to be able to terminate service on the twenty-first day postpetition, on compliance with state termination procedures—if no party has filed a §366(b) motion either prior thereto or prior to the decision to terminate.

Utilities provide service on credit every minute of every day. However, meters are read and bills are calculated and mailed only periodically.

Section 366(b) singles out utilities

Section 366(b) singles out utilities from other creditors. A nongovernment creditor may be able to discontinue doing business with a debtor that owes it money for prepetition debt; however, an investor-owned utility, because of §366(a), cannot,[20,21] nor can a municipal utility, because of §366(a) and 11 USC §525(a) (ban on discrimination by governmental entities against debtors). Instead, §366(b) was designed to grant to utilities "adequate assurance of payment" to compensate them for the financial risk of selling on credit to debtors, who often owe them prepetition debts.

The typical utility's billing practices probably combine an adequate security deposit or advance payments with a liberal termination procedure. Utilities provide service on credit every minute of every day. However, meters are read and bills are calculated and mailed only periodically (i.e., monthly, quarterly, or other interval). Bills are due perhaps 20 days after the meter-reading date. The gap between the first day's service and the due date of the bill may be about

50 days. If the customer pays late, the gap increases. If a termination notice is sent, the gap increases by even more days.

A utility should not be "unsecured" for postpetition service. "While a public utility has a duty to serve, neither its history of past service nor its franchise to serve in the future may fix on it a duty to provide unsecured future service . . . [and it should not] risk further losses to provide services for the benefit of other creditors."[22] Ample authority exists for the two keys to a utility's demands in §366(b) litigation: (1) payment of a security deposit[11,22–25] or advance payment[1,2] and (2) termination without returning to bankruptcy court for nonpayment.[14,26–28]

Conclusion

The rationale behind §366(b) is the recognition by Congress that unlike nonutilities (which may choose the customers to whom they sell their products), utilities are regulated and must serve all customers in their service territories—even debtors, who by definition are poor credit risks. On the other hand, §366(b) gives utilities—but not other creditors—"adequate assurance of payment."

This is similar to the rates principle, under which in exchange for not being allowed to raise prices at will (as nonutilities do), utilities are guaranteed the opportunity to earn a fair rate of return—i.e., a return on equity in addition to the recovery of all reasonable costs and expenses.[29] Regulated or municipal utilities should argue that "adequate assurance of payment" means that already provided for in their tariffs and other state laws establishing credit and collection practices.

Bankruptcy adds significant complexity to the credit and collection practices between a utility and its customers. Even if an adequate security deposit is minimal in relation to the total bankruptcy matter (bankruptcy cases tend to last a long time, even several years), the cumulative amounts of postpetition bills can increase rapidly, especially when debtors perceive that particular utilities are not concerned about termination for nonpayment.

Water utilities should have security deposits or advance payment arrangements with their nonbankrupt nonresidential customers, terminate such customers for nonpayment of bills after giving the notice required by their state laws, and seek §366(b) relief so that each nonresidential customer pays its own bills in full. If enough utilities did this, the message would be out that utilities will no longer tolerate nonpayment from their nonresidential customers.

As long as bad-debt expenses stay in the category of "allowed operating expenses," utilities will continue to surcharge paying customers to recover the bad debts of delinquent customers. However, competition may end this practice. Facing competition from others who provide the same services, utilities may find it wise to implement "meaner and leaner" credit and collection practices to keep rates lower.

References

1. *In re Monroe Well Service Inc.*, 69 BR 58, ED Pa. (1986).
2. *In re Marion Steel Co.*, 35 BR 188, Bankr. ND Ohio (1983).
3. *In re Brooks Shoe Mfr. Co.*, 39 BR 980, ED Pa. (1984).
4. *McTighe* v. *New England Tel. & Tel. Co.*, 216 F2d 26, 2nd Cir. (1954).
5. *In re Borough of Saddle River*, 362 A2d 552, N.J. (1976).
6. *Carroway* v. *Carolina Power & Light Co.*, 84 SE2d 728, S.C. (1954).
7. *Scotillo* v. *Water Supply Co. of Albuquerque*, 140 P 1056, N.M. (1914).
8. *Middletown Water District* v. *Tucker*, 284 SW2d 666, Ky. (1955).
9. 28 USC §§157 and 1334 (1994).
10. 11 USC §541 (1994).
11. *In re Hanratty*, 907 F2d 1418, 3d Cir. (1990).
12. *In re Whittaker*, 882 F2d 791, 3d Cir. (1989).
13. *Robinson* v. *Michigan Con. Gas Co.*, 918 F2d 579, 6th Cir. (1990).
14. *Begley* v. *Philadelphia Elec. Co.*, 760 F2d 46, 3d Cir. (1985).
15. *In re Nitec Paper Co.*, 43 BR 492, SD N.Y. (1984).
16. *Slenderella Sys. of Berkeley* v. *Pac. Tel. & Tel. Co.*, 286 F2d 488, 2d Cir. (1961).
17. *Midlantic Nat'l Bank* v. *New Jersey Dept. of Env't Protection*, 474 US 494 (1986).
18. *Gillis* v. *California*, 293 US 62 (1934).
19. *In re Briarcliff*, 15 BR 864, D N.J. (1981).
20. *In re Webb*, 38 BR 541, Bankr. ED Pa. (1984).
21. *In re Hennen*, 17 BR 720, Bankr. SD Ohio (1982).
22. *In re Sec. Inv. Properties Inc.*, 559 F2d 1321, 5th Cir. (1977).
23. *In re Lloyd*, 52 BR 653, SD Ohio (1985).
24. *In re Smith*, Richardson & Conroy Inc., 50 BR 5, Bankr. SD Fla. (1985).
25. *In re Deiter*, 33 BR 547, Bankr. WD Wis. (1983).
26. *Johnson* v. *Philadelphia Elec. Co.*, 80 BR 30, ED Pa. (1987).
27. *In re Am. Investcorp & Dev. Co.*, 155 BR 300, Bankr. D R.I. (1993).
28. *In re Carter*, 133 BR 110, Bankr. ND Ohio (1991).
29. *F.P.C.* v. *Hope Nat. Gas Co.*, 320 US 591 (1944).

About the author: *Gilbert L. Hamberg, an attorney, is a sole practitioner at 1038 Darby Drive, Yardley, PA 19067. He concentrates his practice in utility and bankruptcy law and represents utilities in credit and collection disputes. Previously, he was a law clerk and student intern for a bankruptcy judge, a rates attorney with the Pennsylvania Public Utility Commission, in-house counsel, and an attorney with major law firms. Hamberg has a BA degree from Wesleyan University in Middletown, Conn., and a JD from Temple University Law School, Philadelphia, Pa. His work has been published previously by* Electricity Journal *and* Public Utilities Fortnightly.

Reprinted and copyrighted as part of
JOURNAL AMERICAN WATER WORKS ASSOCIATION
Vol. 87, No. 4, April 1995
Printed in U.S.A.