JOHN N. HUGHES
ATTORNEY AT LAW
PROFESSIONAL SERVICE CORPORATION
124 WEST TODD STREET
FRANKFORT, KENTUCKY 40601

TELEPHONE: (502) 227-7270 JNHUGHES@fewpb.net TELEFAX (502) 875-7059

September 14, 2005

Beth O'Donnell
Executive Director
Public Service Commission
211 Sower Blvd.
Frankfort, KY 40601

Re: Case No. 2005-00348

Dear Ms. O'Donnell:

Please file the attached supplemental information to Kentucky Frontier's pro forma adjustments, which were filed as exhibit 6 of the Application.

Submitted by:
John N Hughes
124 West Todd St.
Frankfort, KY 40601
502 227-7270
Attorney for Kentucky Frontier Gas, LLC

Certificate of service:

I certify that a copy of this filing was served on the Attorney General, 1024 Capital Center Dr., Frankfort, KY 40601 by first class mail on the 14h day of September, 2005.

John N. Hughes

Kentucky Frontier Gas, LLC

Kentucky Frontier Gas, LLC is a new utility with a plan to consolidate small natural gas utilities in Eastern Kentucky.

Frontier has studied about 10 small gas distribution companies in eastern Kentucky. These utilities are all similar: they serve 400 to 1100 customers, mostly small residential and commercial accounts; annual gas volume has not reached a "critical mass" to achieve profitability; and most have negative equity and large debts. Due to chronic operating losses, these utilities are unable to pay their loans or form capital to market their services or expand systems; they are only marginally able to comply with federal and state regulations for pipeline safety, training and utility reporting; and there is little or no prospect for significant change in their financial outlook.

Frontier has entered into purchase contracts with four gas utilities: Belfry Gas, Elam Utility, Floyd County Gas, and Mike Little Gas Company. These 4 entities have about 2,800 customers spread over Floyd, Pike and Morgan counties.

These three counties have a total population of about 125,000 spread among many small communities. Natural gas has been produced from local gas wells for more than 50 years, so most settlements along or near pipelines are served with natural gas.

From the 2000 Census, about 27% of all homes in these 3 counties were heated by Natural Gas; with 61% by electricity and 12% with propane, heating oil and wood. This contrasts with 44% gas and 39% electric for all of Kentucky and much of the Southeast, and 51 / 30% for the USA.

However, very few of these customers are served by large utilities. The towns are too small and the cost-per-meter is too high for a metropolitan utility to justify without subsidies from existing city ratepayers. These small Eastern Kentucky communities received natural gas, as did many towns in the West, through the efforts of small entrepreneurial entities that were willing to take a moderate risk for a good return on investment. The 4 target utilities were founded in 1969, 1969, 1936 (for water) and 1964, respectively.

These utilities have always been subject to the Kentucky Public Service Commission (PSC) for rates and tariffs. In 1970, the US Department of Transportation (DOT) began enforcing natural gas pipeline safety regulations for gas transmission and distribution companies. With continual changes in DOT regulations for safety, and with constant contact with PSC over rates and gas cost recovery, these tiny utilities struggle to keep up with regulatory requirements.

For a company of 50 meters, or 500 or 500,000, the DOT and PSC rules are virtually the same. From our experience and research in small gas utilities, a gas utility in this Eastern Kentucky

region needs about 2500 customers or annual sales of 150 million cubic feet to achieve a critical mass needed for a successful business.

In the initial 4 combined companies, Kentucky Frontier Gas expects to start with 2,800 meters. The Company expects to invest about $3.5 million in the initial systems with about 200,000 decatherms of annual gas sales. The utility will be financed with 35% equity and 65% long term debt.

Road Map to the Financial Model

This pro forma was based on a program developed by Steven Shute of PSI to model the performance of a startup gas utility. The entire model is a MS Excel workbook with spreadsheets for system cost, operating expenses, rate averaging calculations, Census data, current financials and a pro forma model for the consolidated utility. The latter is a hybrid financial model including line items from the predicted income statement, cash flow calculation, and balance sheet.

Kentucky Frontier Gas - 7 year Pro Forma

The pro forma assumes only a mildly successful marketing effort. Frontier has intentionally stated a conservative case with its constituents and the PSC. Frontier wants to make sure that cost estimates, customer counts and gas volumes are adequate to make a viable business, and not to continue the present cycle of struggling utilities.

Cumulative Investment is the total amount of money invested in utility plant, at cost and before depreciation. Frontier plans to spend about $3.5 million to purchase and improve 4 entities with distribution systems in towns and rural communities, and with isolated "farm taps". This includes investment funded with about $1 million in equity and $2.4 million debt.

Sales section: The number of customers is taken from the **P&L** spreadsheet. The 4 utilities list about 2,540 residential and commercial meters, and Belfry controls at least 300 farm taps.

In these 3 counties are 30,000 electric homes and 4,000 propane or heating oil homes. Although most aren't included in our service territory, Frontier expects to convert or get new homes to add about 25 residential meters per year.

After initial startup, the Residential and Commercial load will grow by a modest 1% per year at a cost of $700 per meter, with service lines from existing mains. Funding is from earnings. With no resources for marketing, these little companies have slowly lost ground over the years to electrical heat, even though the cost per BTU is significantly higher.

There will be other opportunities for growth: Frontier has identified at least 5 other target utilities for consolidation. There are several potential short pipeline extensions to outlying residential and commercial areas. These acquisitions and extensions would likely come at a cost per meter similar to the average Frontier customer. These investments would be funded through new capital and are not shown on this model.

Sales are forecast by customer type. Total **Residential** sales will be about double **Commercial** sales. The **Meters** count is stated at year-end.

Sales **Volume** is stated in MCF (1,000 cubic feet, roughly 1.1 million BTU). From the **P&L** spreadsheet, the average 4-company customer will use 61 MCF per year. All customers added in a year will use about 2/3 of a year's normal use.

Existing Residential **Margin** or Rates are calculated as a weighted average on the **Rates** spreadsheet. These companies charge a minimum bill of 1 or 2 MCF, plus a charge for each additional MCF. This is difficult to model, but is equivalent to Monthly **Meter Fees** of $2.50 to all active customers, plus $4.50 per MCF. **Commercial** sales are calculated the same as Residential customers, with 220 MCF per year average use and the same monthly meter fees and MCF rates.

In this model, **Margin** can be adjusted to balance the **Allowable Return** calculation. The PSC sets an Allowable **Return on Investment** (as calculated below), and the resulting rates to achieve that return. This model shows that Frontier could operate on existing rates for a year or two, at the present meter count, sales volume and allowed Return. This model can be used to calculate a new rate if needed..

The **Income Statement** includes interest received from the Capital Fund, which will be funded at startup with enough capital for the initial startup.

Gas Commodity Cost is set to zero for this model. Frontier will create a unified Gas Cost Balancing Account, so customers will pay Frontier's exact cost of gas over the long run. The model (when activated) includes a calculation for Lost & Unaccounted for (L&U) gas on the pipelines and distribution systems. Fixed **Gas Costs** are monthly demand charges for firm transport capacity on a pipeline such as Columbia or Kentucky-West Virginia.

The estimate for **PSC Assessment** is taken from recent financial records. The Kentucky PSC assesses its distribution and transmission companies for safety and financial oversight. The annual charge appears to be about $2 per meter.

The line for **Operating & Maintenance Costs** include salaries and benefits, vehicle and office costs, materials and repairs. This figure is detailed in the **O&M** spreadsheet, and can be compared with historical 2003-04 costs in **O&M Hist** spreadsheet.

The estimate for **Property Taxes** is taken from recent financial records. Utility companies are usually state-assessed based on assets and profits. Floyd County Gas has been a municipal-type entity and has not been taxed. This figure includes an estimate for Floyd County Gas.

The utility's corporate **Income Taxes** are calculated below, at the 40% expected C Corp. rate for state and federal. Frontier is an LLC, so income taxes (if any) are paid by individual members. The **Deferred Taxes** calculation is based on the difference between **Tax Depreciation** vs **Book Depreciation**. With 20-year accelerated tax depreciation vs 30-year straight-line book depreciation, early-year taxes are lowered and deferred until the later years. Early rates must be high enough to accumulate this deferral for later payment.

Return on Investment is calculated with the typical utility formula: cost of capital, cost of debt, and a modest profit. Book **Depreciation** is shown as straight line for 30 years, and is slightly less than the Principal Payment. The **Interest** paid on debt on low-cost State loans and bank debt is expected to be a blended 5.5% APR for 20 years; this is passed directly through to rates. **The Return on Equity** includes the profit to the investors, and is usually several points higher than the commercial loan rate.

The total **Allowable Return** for a utility should match its **Operating Income** after taxes (but before calculation of depreciation or interest and principal payments). In this method, the investor receives the stated return on equity investment, after taxes, *plus* direct pass through of principal and interest payments to finance the project.

Results

The utility model shows positive cash flow in its first year. The equity investors would receive **Dividends** at 5% (Year 1) then 10% payout on original equity.

After about Year 5, the utility has some important decisions to make. It should keep the equity level at 35 to 40% to realize a leveraged return on equity. It can do that by:

1) Investing to expand the system (and allowable income).
2) Paying out higher dividends to reduce equity.
3) Borrowing to increase its debt-equity ratio.

...or a combination of all three. A healthy utility needs to be leveraged for the benefit of its investors and to its ratepayers (who pay less for debt service than they would for return on equity). The derogative phrase "borrowing to pay the dividend" is actually the best case for a healthy utility. This model shows the **Beginning Capital Account Balance** growing. This won't actually happen, because the utility will do some or all of these three items.

The model shows 7 years of financial forecasts. At the end of 7 years, with 3,000 customers and paying off debt with positive returns, Kentucky Frontier Gas will be a vital company with an excellent future.