COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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PUBLIC SERVICE COMMISSION

In the Matter of:

EXAMINATION OF THE OPERATION AND REASONABLENESS OF THE OFFSETTING IMPROVEMENT CHARGE OF HENRY COUNTY WATER DISTRICT NO. 2	))))	CASE NO. 2006-00191

BRIEF
RESPONDING TO ISSUES PRESENTED BY ORDER OF JANUARY 5, 2007 AND AS A RESULT OF HEARING CONDUCTED SEPTEMBER 13, 2007

RESPECTFULLY SUBMITTED,

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TETRA TECH, INC.

LETTER OF TRANSMITTAL

DATE: October 31, 2007

TO: Ms. Beth O'Donnell, Executive Director
Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40602

RE: *Case No. 2006-00191*
Henry County Water District No. 2
Written Brief as Ordered January 5, 2007

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COMMENTS:

As directed, we submit herewith one original and eight copies of the above referenced document in response to Order issued January 5, 2007 and reaffirmed by Order of July 13, 2007.

Signed Tom Green
Thomas Green

Copies to:

Honorable Mark David Goss, Chairman, Public Service Commission
Honorable David Spenard, Office of the Attorney General
Merle Brewer, Chairman, HCWD2
Honorable D. Berry Baxter
Central Files – 07124

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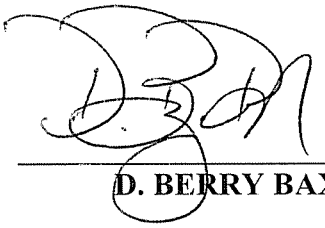
CERTIFICATION

I HEREBY CERTIFY THAT PRIOR TO FILING THE ATTACHED BRIEF, THAT I CAUSED A TRUE AND CORRECT COPY OF SAME TO BE DEPOSITED IN THE UNITED STATES MAIL, FIRST CLASS POSTAGE PREPAID ON THE 31 DAY OF OCTOBER, 2007, FOR DELIVERY TO HON. DAVID SPENARD, ASSISTANT ATTORNEY GENERAL, OFFICE OF THE ATTORNEY GENERAL, UTILITY & RATE INTERVENTION DIVISION, 1024 CAPITAL CENTER DRIVE, SUITE 200, FRANKFORT, KENTUCKY 40601-8204.



D. BERRY BAXTER

Six Issues from Order of January 5, 2007

1. Whether, in determining the reasonableness of the proposed Offsetting Improvement Charge ("OIC"), the Commission should consider the level of Henry County Water District No. 2's ("Henry District") existing rates for general water service?

The following is an excerpt from pages 5 and 6 of the "Statement of Consideration" in the LRC proceedings through which the Public Service Commission promulgated 807 KAR 5:090 for System Development Charges:

> "(6) The Proposed Regulation should require applicant to demonstrate that the proposed charge is not a substitute for a general increase in rates.
>
> (a) Comment:
> David Spenard, AG's Office, commented that the proposed regulation should require a demonstration that the proposed charge is not simply a substitute for a general increase in rates to ensure that a utility is not merely imposing a one-time charge on new customers to avoid a general rate increase to all customers.
>
> (b) Response:
> The Commission disagrees. The requirement that applicant demonstrate that the system development charge is not a substitute for a general rate adjustment is impractical. Most commentators have long recognized that a system development charge is a substitute for general rate adjustments. See e.g., American Water Works Association, Principles of Water Rates, Fees and Charges (AWWA Manual Ml) (5th Ed. 2000) 205. Rather than have all ratepayers pay for system improvements for new growth through a general rate adjustment, system development charges permit the cost of new development to be assessed directly to the new customer who is the cost causer. The need for general rate adjustments is thus reduced. Under the Proposed Regulation, the principal issue is not whether a general rate adjustment is avoided, but whether the costs to be recovered through the proposed system development charge are related to new customer growth and the construction or expansion of system capacity to serve that growth."

At the September 13, 2007 hearing, Mr. Wuetcher, having noted earlier that Henry County hadn't had a rate increase since 1996, asked if it wasn't easier just to levy a charge on new customers than to raise rates on all customers (please see transcript page 198 at line 4) .

It is important to remember that the Henry District's OIC was developed and proposed in 1999, only three years after our general rates had been increased very substantially. The District was not seeking an easy way to avoid the pressing need for a general increase in 1999. Our only motivations then were fairness and reasonableness, as they are now.

But as the Public Service Commission made clear in its response to Mr. Spenard, a system development charge which recovers the costs of growth and expansion may thereby also appropriately delay or diminish the magnitude of future general rate increases. This is a sensible and straightforward principle which can be disregarded only by incorrectly presupposing that SDC revenues will be improperly used.

To the precise extent that OIC proceeds are spent to expand capacity to accommodate the needs of growth, general revenues are freed up from that purpose and are available to address the general needs of the district. There is therefore no double recovery of growth costs between the OIC and general rates. There is no "double counting" of projects that are covered in the rate design and the OIC. Although the Henry District's existing rates may warrant examination, they are not an appropriate factor within the context of the review of the reasonableness of the OIC.

2. Whether, as a condition to the assessment of a charge such as the OIC, a water utility must be assessing rates for general service that fully recover the cost of providing water service?

The question again implies that the proceeds of the impact fee will be expended improperly to supplement otherwise inadequate revenues. But the OIC has built-in reporting mechanisms which eliminate that possibility by insuring that its proceeds can only be spent on specific growth-necessitated improvements.

Whether the District's general rates are adequate, whether more depreciation needs to be taken into account, whether a rate case is called for, all these considerations may, in themselves, be entirely valid. However, they are separate issues from the review of a system development charge. According to the Commission, the principle issue is "whether the costs to be recovered through the proposed system development charge are related to new customer growth and the construction or expansion of capacity to serve that growth." Henry District has clearly demonstrated, first in Case 2001-00393 and again in Case 2006-00191, that this condition is met.

We have researched the Case 375 guidelines, and the SDC regulation 807 KAR 5:090, including the associated PSC comments. We can find no requirement or stipulation that the status of existing rates be a prerequisite consideration to the approval of an impact fee. In accepted practice, SDCs are commonly developed apart from rate studies, and are considered a separate issue. This was affirmed by the testimony of Andy Woodcock. More importantly, the Kentucky Public Service Commission itself has acknowledged the separation of these issues in its response to Mr. Spenard during the LRC proceedings.

3. Whether the use of the proposed OIC is more equitable and reasonable and less administratively burdensome than the use of a fee based upon either the equity and incremental cost methodologies that the American Water Works Association recognizes?

The AWWA is an invaluable advisory body; however it does not regulate water utilities in Kentucky. Case 2006-00191 concerns what is recognized by the Kentucky Public Service Commission. And in Kentucky, the Commission recognizes that "Because of the geographic and demographic diversity of the state and its water utilities, the use of rigid and inflexible standards for SDCs is not in the public interest" and that "public and municipal utilities should be afforded sufficient latitude to craft SDCs to meet their unique needs and conditions." (emphasis added)

It is very difficult to reconcile these clearly stated Case 375 principles with the repeated focus in Case 2006-00191 on "recognized" AWWA methodologies, or to understand how this focus serves the Commission's stated view of the public interest and system development charges.

It is reasonable to assume the Commission chooses its words conscientiously in composing its orders. The dictionary defines "craft" as meaning "to make by hand" or "to make with great care and ingenuity." It is unreasonable to think this word would have been used in the Commission's phrase "latitude to craft SDCs" if they had intended water districts in Kentucky to be limited to the duplication of a methodology from the AWWA manual. From the May 15, 2001 Order in Case 375:

> "Finally, North Shelby and U.S. 60 Water District urge the Commission to be flexible in its approach to SDCs. They note that while such organizations as the American Water Works Association recognize the Equity Method and the Incremental Method, other methods for developing SDCs exist. They caution the Commission against limiting the opportunities for other SDC methodologies. We agree. As we noted in the Guidelines, '[w]ater utilities should be permitted to use other methodologies to develop their SDCs.'" (emphasis added)

This final order in Case 375, noting that an SDC regulation would be promulgated, stated that in the meantime, applications would be reviewed on the basis of the Case 375 SDC Guidelines. It was under this condition that Henry District submitted its OIC, and it was under this condition that it was approved as being *in compliance* with those SDC Guidelines, which state:

> "Use of other methodologies. Water utilities should be permitted to use other methodologies to develop their SDCs. However, where such methodologies are used, or where combinations of the two methodologies set forth above are used, the water utility must clearly demonstrate the need for using the different methodology and that the methodology's use will achieve a more reasonable result."

Therefore Case 2001-00393 determined both that the Henry District had demonstrated the need for using its methodology, and that the charge itself, within the specific circumstances and policies of the Henry District, achieved a more reasonable result than the two AWWA methodologies set forth in the SDC Guidelines. Since its approval in 2002, the efficient, responsible, and effective operation of the Henry District's OIC program has only served to underscore the equitable and reasonable nature of the charge. It is a good example of a district being "afforded sufficient latitude to craft SDCs to meet their unique needs and conditions."

At the end of the September 13, 2007 hearing (please see transcript page 248 at line 4), it was asked if the "...expense, and time for examination of such a charge might be significantly less if it were modeled totally on one of the two accepted methods that are set forth in the M1 manual and that the Commission recognized in its Order in Administrative Case 375?"

This question suggests that the AWWA methodology is not only "accepted" and "recognized," but also simple. We do not agree.

The Henry District's charge looks at proposed developments in the past four years and their specific offsetting costs. It divides the total costs by the total new customers that can be served. It is as straightforward as an Excel spreadsheet.

By comparison, the AWWA incremental methodology as recognized by the PSC is based on the multiple ten year predictions of a capital improvement plan. It begins by estimating the total number of new customers and their proportionate allocation to usage categories such as residential, high and low use commercial, high and low use industrial, public schools, etc. It then assigns an estimate of gallons per day of future demand to each specific usage class. It also predicts where in the system these various growth components will occur, because the extent of the need to upsize transmission facilities and construct storage tanks is location-specific.

The AWWA methodology then predicts a future inventory of all new infrastructure necessitated by growth. The remaining estimate is cost. Engineers experienced in compiling water project cost estimates would generally be pleased to be within 5% of the cost of a major project to be bid next week. If the work is to be bid a year from now, 10% would be very impressive. But an estimate of the cost of infrastructure to be constructed over the next ten years would have a much wider range of inaccuracy.

How extensive a regulatory review would be necessary to evaluate and endorse such a succession of estimates? The AWWA describes their experience with the long-term accuracy of their methodology at the conclusion of M1 Manual Chapter 28. They state that initial assumptions change and should be reassessed as development occurs, and that SDCs are commonly revised at 3-5 year intervals.

And although 807 KAR 5:090 states that "The water utility may apply for commission approval of an amendment to its capital improvement plan to reflect subsequent developments or new information" the regulation does not *require* such reality-check updates and revisions. Therefore an SDC based on the ten year incremental methodology, even if it were initially calculated with great care, could continue to be charged (overcharged) beyond its reasonableness as a rational nexus to the costs of growth.

So in Kentucky, the long-term reliability and reasonableness of this AWWA methodology may primarily depend on whether the water district voluntarily assumes the additional expense and effort of applying for "...commission approval of an amendment to its capital improvement plan..." in order for that district to acknowledge an overestimated CIP, reduce the amount of its SDC, and issue refunds to those who have paid the overestimated charge.

By comparison, the Henry District OIC is cost-based, intentionally conservative, and it is calculated on a self-updating average of the recent past. It is a method which focuses only on reality, and it has already worked very smoothly in our District for over five years. Although a ten year CIP can certainly produce a reasonable charge if its initial predictions of future growth rate and infrastructure costs are accurate, or if it is regularly updated, the Henry District's OIC remains reasonable regardless of growth rate. Moreover, it better meets the specific needs and conditions of the District. And according to the Public Service Commission in Case 375, "These needs and conditions must be considered when reviewing the SDC."

The relative equitableness and reasonableness of the Henry District's charge have been discussed at great length elsewhere in this case (please see Appendix B). But simply ask developers this question: "Assuming that you will be required to pay an SDC for each lot you develop, would you consider it more reasonable to pay an amount based on the actual costs of growth over the past four years, or an amount based on what we estimate the costs of growth will be over the next ten years?"

4. a. Whether the assessment of a charge or fee such as the proposed OIC is reasonable only when the assessing water utility is experiencing significant growth?

The Kentucky Public Service Commission's acceptance of the AWWA equity methodology conclusively establishes that a rate of growth which imposes significant expansion costs is not an SDC prerequisite.

Neither the Case 375 Guidelines nor 807 KAR 5:090 stipulate a minimum growth rate threshold. In our research we could find only one state which requires a minimum growth rate in its SDC statute or regulation. That state is West Virginia, where the threshold SDC growth rate is one percent per year.

113 out of 130 Kentucky water districts and associations responded to the Commission in Case 375 that they needed rate mechanisms like SDCs to deal with the cost of growth. But in the six years since, only one such charge has been authorized.

How can Kentucky water districts afford to gamble (as almost none have) that they will not come home empty-handed from an SDC case? How can districts with limited resources risk the considerable time and expense of first developing and submitting an SDC, and then responding to interrogatories and requests for information, when those districts have no way of knowing in advance whether their proposed charge will be rejected because their district is judged not to have met the subjective and undefined standard of prerequisite growth rate?

In addition to deterring applications for SDCs, a requirement of significant growth will also create significant inequity among Kentucky's rate payers.

Assume that you receive a bill which includes charges for which you were not responsible. But you are still required to pay them *for the sole reason that your monthly installments are judged to be low.* This would be the effect of a "significant" growth requirement for system development charges.

The costs of growth are cumulative, so that a district with 3% growth for 8 years faces the same total expense as a district with 8% growth for 3 years. If it is not considered fair, just, and reasonable to include the costs of growth in the general rates of customers in districts with higher growth, how could it be fair to require customers in lower growth districts to pay *precisely those same costs*, simply because the costs are to be paid on a more extended installment plan?

What is fair for rate payers in Northern Kentucky is fair for rate payers in Eastern Kentucky, and what is fair in Central Kentucky is fair in Western Kentucky.

(For a more complete discussion the "significant" growth requirement, please see Appendix C.)

b. If the assessment is dependent upon a water utility experiencing significant growth, is Henry District experiencing such growth?

N/A

5. What consideration, if any, should the Commission when examining the reasonableness of the proposed OIC, give to the revenues that new customers will generate when they begin receiving water service?

Section 5 of 807 KAR 5:090 directs that

> "The commission shall consider a proposed system development charge reasonable if the applicant demonstrates that the proposed charge:
> (1) Offsets an increase in cost to fund system expansion to accommodate new growth and demand
> (2) Recovers only the portion of the cost of a system improvement that is reasonably related to new demand; and
> (3) Is based upon the cost of a new facility that will increase or expand capacity.

There is no mention in these tests of reasonableness, or elsewhere in the SDC regulation, or in any of the Case 375 Guidelines, of an analysis of revenues from growth. Our response to Item 16 of the December 22, 2006 Order in part discusses the misguided interpretation of "economy of scale" by which new customers are exclusively credited for any improved overall revenue efficiency:

> "If rates are based on 5000 customers, and surplus net income theoretically could result from the customer base expanding to 5500 customers, then the next rate cycle should simply take this new efficiency into account by lowering rates for all customers. Or this theoretical surplus could be used to address the more general needs of a growing system, the training and specialization of personnel, the acquisition of more advanced technology in telemetry, billings, leak detection, GPS mapping, etc., in order to improve service for all customers within the district.
>
> The notion that growth-necessitated capital projects should be funded by whatever surplus net income potentially results from any new revenue efficiency is misguided. The 500 new customers, in and of themselves, would constitute a highly *inefficient* customer base. It is only because the new customers have 5000 existing customers with whom to join forces that any new efficiency could possibly occur.

> The very fact that SDCs are acceptable to the PSC means that the concept of growth paying for growth has been determined to be reasonable. Using the theoretical proceeds of an expanded customer base solely to fund growth-necessitated infrastructure instead of either reducing rates or improving services systemwide, is a theoretical scenario in which all customers subsidize the additional costs of serving new demand.
>
> In its Case 375 SDC guidelines, the Commission states that:
>
> > 'The goal is to charge a fee for new customers sufficient to allow customer user rates to be revenue neutral with respect to growth of the system.'
>
> It would contradict this principle to use any 'net income surplus' to fund growth-necessitated projects, because it would mean that it is acceptable to have inflated rates by which *all* customers pay for growth."

The Henry District OIC has already purposefully deducted (not "ignored," as several questions suggested at the September 13, 2007 hearing) the growth-necessitated costs of raw water intake, pumping, water treatment, and storage tanks. This adjustment, now estimated at about $700 per new customer, was made in consideration of all the incidental benefits of growth, and to achieve fairness from the perspective expressed in the Attorney General's comments in Case 375, that it is not reasonable to charge the new customer the cost of all infrastructure exclusively needed to serve him, and also charge him rates which include costs associated with infrastructure not needed to serve him.

Concern that an SDC might possibly result in some minor level of subsidy from new customers to existing customers is appropriate. But *without* an SDC, there exists the absolute certainty that existing customers are providing major levels of subsidy to growth.

6. Whether Henry District's certification to a local planning and zoning commission of the availability of water service to unoccupied and unserved real estate tracts may serve as a proper basis for denying water service to applicants for water service who meet the published conditions of service and are ready to take such service?

A closely related question is whether the fact that plat certification is the permanent commitment of capacity serves as a proper basis for a water district's refusal to make such certifications.

Henry District petitioned the Public Service Commission in April of 2003, arguing that a request for plat certification is not an application for service. In presenting our arguments we made it clear that:

> "Certification obligates the District to hold in reserve a portion of its hydraulic capacity in order to provide potential future customers adequate service. The plat certification has no time limitation, so the District's obligation extends indefinitely into the future."

We explained that "Planning commissions create and enforce these plat certification policies." And we further stated:

> "It is the position of Henry District that an applicant for service is one who requests that he himself become a customer. A customer, by the District's bylaws, is a member of the District who has entered into a non-assignable user's agreement. This agreement is a mutual exchange of commitments, unlike plat certification requests. Whatever we call a plat certification, it clearly cannot be considered an assurance of "service," because KRS 278.101(14) stipulates a one year time frame for determining such sufficiency, and plat certifications are unlimited. Further, it cannot have been "service" the developer requested, because the District's By-Law tariff would bar him from assigning his service to anyone else. Simply put, the applicant *for* service must be the recipient *of* service. This is clearly not the case when a developer presents a plat to the District. It is therefore our position that state regulations pertaining to the interaction of utilities and customers are misapplied in such cases."

The Commission did not agree with us, and in its June 6, 2003 Order in Case 2001-00393 instructed us that a refusal to certify plats amounted to a refusal of service. This interpretation was consistent with other instances in which the Commission has told the District we were obligated to certify plats. (Please see our responses to two relevant interrogatories in Appendix D.)

Because a water district cannot refuse an application for service where capacity exists, and because the Commission has instructed us that a request for plat certification is equivalent to a request for service, we therefore cannot refuse plat certification. But when we provide certification of a subdivision plat, we must then honor the obligation of capacity it requires. How is that obligation defined, and by whom?

From our response to Item 4 of the August 11, 2006 Order in the current case:

> "The Planning Commission requires unconditional plat certification that service *is* available, not that service will be provided contingent upon future improvements. And there is no expiration date on plat certifications."

And in response to Item 23 of the December 22, 2006 Order:

> "Henry County Planning Commission has told us that plat certification *unconditionally* means that our capacity is, and will remain, both adequate for and available to, a platted subdivision."

Yet, because it was questioned at such great length in the September 13, 2007 hearing, it is evident that this central point remains unclear:

> It is not the policy of the Henry District that plat certification represents a permanent commitment of capacity; it is the policy of the Henry County Planning Commission.

The "black and white rule" we were questioned about was established by the Planning Commission. We have specifically asked them if the availability of water could be contingent upon some future infrastructure improvements as needed at the time lots were actually developed. We were told no. We were told that the certification is unconditional, and means that water is *and will remain* available.

The PSC's issued its June 6, 2003 Order despite having been informed that "Certification obligates the District to hold in reserve a portion of its hydraulic capacity in order to provide potential future customers adequate service. The plat certification has no time limitation, so the District's obligation extends indefinitely into the future."

That our obligations of capacity may preclude providing service to subsequent applicants is no more than the logical consequence of three things: the specific and very unambiguous meaning the Planning Commission assigns to the plat certification, the PSC's interpretation that a request for plat certification holds the status of an application for service, and the self-evident imperative that a water district honor its signed and legally recorded commitments.

Additional Issues

OVERVIEW

The Public Service Commission will soon decide whether to reauthorize the only system development charge in Kentucky, a charge which was initially approved under Administrative Case 375 SDC Guidelines in 2002. This charge has functioned very well in the Henry District, reasonably assigning a share of the costs of growth to the new customer. Only one letter of complaint has been received in the five year operation of the program. The charge has generated over $420,000 to date, of which $270,000 has been used cost-effectively to expand system capacity.

We began the formulation of the Offsetting Improvement Charge in 1999 by contacting the Public Service Commission and requesting their direction. Our computer model had projected pressure readings below 30 psi if proposed subdivisions were served without offsetting improvements. We asked Commission staff for guidance in developing a uniform development charge, and we followed their guidance carefully by visiting the tariff library and searching for examples of charges on which to model our own. No suggestion was made to us that we consider using the AWWA incremental or equity methodologies.

When we discussed with staff the reasons why the existing charge in the PSC tariff library seemed inappropriate to our purposes, and explained that the direction we were considering was a database of actual proposed development and offsetting costs, we were told our approach sounded reasonable. After waiting for the completion of Case 375, which stressed flexibility for SDCs and established guidelines which would be used to review such charges until a KAR was promulgated, we submitted our charge.

The 2002 Order approving the OIC said that "The Commission agrees with Henry District that the proposed charge may reasonably be used to avoid rate increases to finance water main extensions and upsizing." Despite general agreement with our rationale, the Commission listed specific concerns which were addressed in a revised version of the OIC, approved in 2003.

The Henry District's charge does not attempt to fully recover all the costs of growth. But a decision by a water district to apportion growth expenses between its new and existing customers by charging an SDC which recovers a significant portion of such costs, is certainly as much within that district's policy-making prerogative as a decision by another district to include the entire cost of growth in an SDC, or a

decision by a third district not to levy an SDC at all, thereby requiring its existing customers to continue to bear those growth expenses. It is not a mark of the incompleteness or inconsistency of the OIC that it intentionally excludes the growth components of intake, treatment, and storage. It is the informed intent of the District that growth pay a fair share of its overall costs.

The OIC is reasonable because it is based only on those developments which have actually been proposed in our District, and the improvements which would specifically restore that capacity, and the recent cost basis of actual projects. Total costs divided by total new customers gives a systemwide average "offsetting improvement charge."

Case 375 provided the results of a Public Service Commission survey in which 113 out of 130 water districts and associations responded that they needed mechanisms like SDCs to deal with the costs of growth. That was six years ago, and many districts understandably have been waiting to see how such SDC applications are actually reviewed, and whether they are approved, before those districts commit the considerable resources needed to develop, submit, and comply with the review of their SDCs.

Considering that the customers of regulated water utilities throughout Kentucky are currently paying within their general rates millions of dollars each year* which is used to expand capacity as necessitated solely by growth and development, it is an important question of the public interest statewide whether these costs should more properly be paid by those who cause them.

In the current review of our charge, questions have been raised which have only limited relevance to what the Public Service Commission identified as the "principal issue" during its promulgation of the SDC regulation. That principal issue is "...whether the costs to be recovered through the proposed system development charge are related to new customer growth and the construction or expansion of system capacity to serve that growth." In the Henry District's Offsetting Improvement Charge, this is very clearly the case.

* In 2006, according to data from the PSC website, there were about 628,000 total residential customers in Kentucky's 118 water districts, 21 water associations, and 9 investor owned water utilities. Five years ago in 2001, this number was about 554,000, reflecting 121 districts, 22 associations, and 15 investor utilities. For the sake of a conservative analysis, we will assume 1.5% annual growth among the residential customers of Kentucky's regulated water utilities, a lower percentage than the above totals would indicate. 628,000 growing by 1.5% would produce about 9400 new residential customers per year.

Conservatively assuming capacity expansion costs per new residential customer of $1000 (2/3 of the $1550 national average water utility SDC from the 2004 AWWA/RFC Rate Survey) would result in an estimate of total annual residential growth costs statewide exceeding $9 million. Adding a very conservative estimate of $1 million for the costs of capacity expansion for commercial and industrial development brings the total costs of growth to a minimum of $10 million.

BALANCE

Because of time constraints, several issues at the September 13, 2007 hearing were discussed only partially, or from a single perspective, or absent context. Time limitations were noted at several points by Chairman Goss, who asked that questioning be compressed, and directed that closing arguments be waived, stating that the parties would have opportunities to file written briefs.

Mr. Simpson, who took his position as HCWD2 Chief Operating Officer only after the development, review, and approval of the OIC was complete, nevertheless was asked over two hundred questions and testified for about 3 hours. Mr. Woodcock, who evaluated the OIC only in preparation for the hearing, testified for over an hour and a half. Mr. Green, who in 1999 was involved in the original development of the OIC methodology; who has extensive first-hand knowledge of its rationale, methods of calculation, history, and operation; and who has prepared the majority of responses to staff interrogatories in the current case, testified for about 20 minutes at the end of the day.

We will therefore attempt to provide a more complete and contextual view of some of the issues which were raised at the hearing, and address other issues which were not discussed.

The Hearing Itself:

The January 5, 2007 Order followed a series of three other orders containing a total of 79 interrogatories. It listed six final questions which the District was directed to address in a written brief (we respond to those questions herein). But the Henry District decided to request a hearing, and to bear its considerable additional expense, in order to have an opportunity to present the background, rationale, purpose, and actual functioning of the OIC directly to the Commissioners themselves. It was also our understanding that the general issue of SDCs was of interest to the Commissioners.

This hearing was voluntarily requested by the District. Six final questions were all that remained to be answered in the January 5, 2007 Order, but at the hearing over two hundred additional questions were posed to Mr. Simpson alone. These questions, and the time they consumed, largely negated the District's real purpose in requesting the hearing, and to a degree displaced the central issues of our case, precluding a broader examination of the principles and concepts of SDCs.

Statements of Clarification

Please see Appendix E for the statements of Andy Woodcock and Jimmy Simpson clarifying their testimony at the September 13, 2007 hearing.

Plat Certifications:

Beginning on hearing transcript page 58 at line 9 and extending for 15 minutes through page 68 at line 25, Mr. Simpson is asked about the "District's position" that plat certification represents the permanent commitment of capacity. But, as our written responses to several previous interrogatories had made clear, this is not the District's rule at all, but the unambiguous position of the Henry County Planning Commission. We address this issue more fully in response to Question 6 of the January 5 2007 Order herein.

Studies of Growth:

On transcript page 78 at line 3 and elsewhere, Mr. Simpson is asked about conducting planning studies, growth projections, and long term capital improvement plans. Such studies and projections would be critical elements of AWWA incremental methodology, but they are neither the justification for, nor the cost calculation basis of, the OIC. When applied to the historically cost-based approach of the Henry District's charge, the repeated focus on such studies of future growth is what the Commission in Case 375 has described as "the use of rigid and inflexible standards for SDCs."

Line Replacement:

Mr. Simpson acknowledges in his statement in Appendix E that he was mistaken about the useful life and need to replace existing 3" lines which will be paralleled by OIC projects. (Please see hearing transcript page 96 at line 25 and elsewhere.) It is the District's position that the exclusion of about $700 in intake, treatment, and storage costs is a reduction in the OIC which more than compensates new customers for the value of the line replacement component of OIC projects. Nevertheless, we have developed a calculation which actually determines the value of this component, which we include as Appendix F).

Rates and Depreciation:

Both the adequacy of our current rates and the extent to which we recover depreciation expense were discussed at great length at the hearing. We had previously acknowledged in two interrogatory responses that there appears to be a need to raise our rates (please see Appendix G). As part of any future rate case, there may also be a mandate from the PSC that we include more depreciation expense, although our CPA has recently reaffirmed that we are in compliance with all our current bond requirements (Appendix H).

Cross-examination of Mr. Simpson at the hearing presupposed that the resolution of the HCWD2 Board in June of 2006 enacted a new depreciation policy. But the resolution only clarified the reasons for the district's long-standing policy, and it was passed by the Board only as a courtesy to the PSC in its investigation of the OIC. It was prepared by Mr. Green based on information and direction from the Chairman of the District's Board of Commissioners, Merle Brewer.

According to Mr. Brewer, who has continuously served as a Commissioner since his role as a founding member of the Board in 1968, the District's depreciation policy has always permitted rates to include some reasonable infrastructure replacement allowance, but has never recaptured major or full depreciation expense. Please also see herein the statement of Daniel Shoemaker, P.E. (Appendix I), regarding the extent to which depreciation expense was budgeted in the 1996 rates (Appendix K).

But questioning at the hearing did not address the larger issue of whether depreciation is pertinent to SDCs. Depreciation deals with funding the cost of replacing *existing* capacity, whereas system development charges deal with funding the additional costs of *expanding* capacity. As Mr. Woodcock stated in his prefiled testimony:

> "Depreciation is considered the loss of value in an asset that cannot be recovered through routine maintenance. However, since it is based upon the original cost of the assets already in service the amount of funds received through depreciation will never ultimately fully fund the replacement of existing assets much less address the additional capital needs of a utility such as those required by regulatory changes, increases in level of service, or growth."

Therefore, the level of depreciation in rates is not relevant to the funding of the *additional* costs of capacity expansion necessitated by growth. It is only these additional costs the SDC addresses. It is not reasonable to presuppose that its proceeds will improperly supplement other possible revenue shortfalls, particularly since the OIC has very strict requirements on, and oversight of, its allowable expenditures.

Cross-examination of Mr. Simpson also challenged the HCWD2 Board's reasoning that

> "...existing customers have already paid the rates which over the years have built the system. Charging these same customers again for depreciation imposes a double burden on them in order to provide new facilities as required by future customers."

This cross-examination, concluding on transcript page 113 at line 19, was built around the example of the 1996 treatment plant, which has not yet been fully paid for. It therefore stands in contrast to the bulk of the system, which *has* been built and paid for by the rates existing customers have paid over the years. By selecting a single and atypically recent infrastructure component, the questioning obscured the more generally correct reasoning of the HCWD2 Board's policy.

But almost none of the many questions at the hearing addressed the primary issue regarding existing rates, and the depreciation within those rates: how and why the status of rates is pertinent to an SDC case, particularly when the Public Service Commission itself has stated that rates are not the principle issue.

Again, from pages 5 and 6 of the "Statement of Consideration" in the LRC promulgation proceedings of 807 KAR 5:090 System Development Charge regulation:

> "(6) The Proposed Regulation should require applicant to demonstrate that the proposed charge is not a substitute for a general increase in rates.
>
> (a) Comment:
> David Spenard, AG's Office, commented that the proposed regulation should require a demonstration that the proposed charge is not simply a substitute for a general increase in rates to ensure that a utility is not merely imposing a one-time charge on new customers to avoid a general rate increase to all customers.
>
> (b) Response:
> The Commission disagrees. The requirement that applicant demonstrate that the system development charge is not a substitute for a general rate adjustment is impractical. Most commentators have long recognized that a system development charge is a substitute for general rate adjustments. See e.g., American Water Works Association, Principles of Water Rates, Fees and Charges (AWWA Manual Ml) (5th Ed. 2000) 205. Rather than have all ratepayers pay for system improvements for new growth through a general rate adjustment, system development charges permit the cost of new development to be assessed directly to the new customer who is the cost causer. The need for general rate adjustments is thus reduced. Under the Proposed Regulation, the principal issue is not whether a general rate adjustment is avoided, but whether the costs to be recovered through the proposed system development charge are related to new customer growth and the construction or expansion of system capacity to serve that growth."

Nevertheless, at the hearing much of the day was spent questioning HCWD2's depreciation, general rates, and the budgeting and planning processes which determine them. Only the *last* question of the day to Mr. Woodcock inquired whether a complete review of a utility's finances should be done in conjunction with an SDC (please see hearing transcript page 199 at line 19).

Mr. Woodcock responded "No," confirming on the basis of his professional training and considerable experience what the Public Service Commission had said in its response to Mr. Spenard. This last question could have served well as the first.

Benefits to Existing Customers:

On hearing transcript pages 97 and 98, the question is raised whether closing loops between dead-end lines creates a benefit to existing customers in terms of water quality, less flushing, and system redundancy. Such closures do produce these benefits.

In the listing of proposed OIC projects (included as Appendix J) loop closure projects include the Giltner Connector, which is actually an interconnection *between* two major existing loops, and which neither fits the description nor achieves the water quality benefits of closing a gap between dead-end lines. Nor does the "Radcliff Road to KY 712" line. The remaining three loop closures, which actually do connect dead-end lines, represent less than 5% of the proposed OIC project expenditures ($172,000 of $3,622,000), and they represent less than 7% of the total proposed OIC project line lengths (19,000' of 282,000').

In the vast majority of both dollars and linear feet, OIC projects simply install larger lines. Larger lines have the unfortunate side effect of causing water turnover rates to decrease. A line with double the diameter has four times the volume; therefore water spends four times longer traveling the same distance through the larger pipe. And a 16" line has seven times the volume of a 6" line, so the residence time of the water increases sevenfold. As residence time increases, water quality diminishes, and the need to flush increases. Therefore, on balance, the overall effect of OIC projects will definitely produce no *net* benefit to existing customers in terms of water quality.

On hearing transcript page 196 at line 20, Mr. Woodcock is asked whether these loop closures had been added to the OIC list solely to achieve better water quality. Mr. Woodcock says he has no knowledge,

and Mr. Wuetcher replies that he will ask another witness. Time did not allow him that opportunity, but the answer is no.

In the three loop closure project areas which connect dead-end lines, the District's regularly scheduled flushing program has maintained water quality in compliance with all state requirements, and therefore no pre-existing deficiency is being remedied. But among all hydraulic improvement options, closing a loop is one of the most cost-effective ways to increase minimum pressures.

System redundancy is also enhanced when dead-end lines are looped, but it comes at a cost. Dead-end lines actually make it much easier to locate leaks. We have done loop closures for hydraulic purposes in numerous locations in our system, and our experience confirms that the more loops within a distribution system, the more time-consuming it becomes to locate leaks, and the more water is lost before initiating repairs. Loop closure is therefore a mixed blessing in terms of redundancy versus leak detection.

Higher pressure as a benefit to exiting customers was also discussed at several points throughout the hearing. We have argued that any pressure within the state-mandated range properly fulfills the District's responsibility to its customers. But even assuming higher pressure to be a benefit, there are only 13 OIC projects. In these areas hydraulic improvements will result in higher pressure for existing customers. On *every other* road in the District's 700 mile system, growth will cause lower pressures for existing customers. The OIC is calculated as a systemwide average cost, and its "benefits" must also be evaluated on a systemwide basis.

OIC hydraulic improvement projects do not produce uniformly higher pressures throughout the 24 hour usage period. In fact, *average* pressures may increase by an amount not generally perceptible to customers. The OIC improvements primarily increase the level of *minimum* daily pressures, which only occur for an hour or less during the morning peak demand period when everyone takes showers and gets ready for work, and again for a similar brief period during the early evening.

But in any event, existing customers will not receive a windfall OIC bonus in terms of higher pressure. They will receive a *restoration* of their pressure to the levels which they experienced prior to growth.

Considering the entire list of OIC projects from the perspective of water quality, flushing, redundancy, and pressure, there is no overall *net benefit* to existing customers systemwide. It is net benefit the OIC tariff addresses.

Quid Pro Quo:

On hearing transcript page 124 at line 13, the question is posed to Mr. Simpson whether inclusion of water treatment costs in the OIC should be required from the standpoint of "fairness." On transcript page 157 at line 2, Mr. Woodcock is asked about the "consistency" of "ignoring" treatment and storage costs.

We have attempted to make this point several times: Intake, treatment and storage costs are not being ignored; they are being intentionally excluded.

In Case 375 the Attorney General's written comments of October 24, 2000 observed that with incremental methodology, the "quandary" was the reasonableness of charging the new customer for all the infrastructure exclusively necessary to serve him, and then to charge that same customer general rates which contained costs related to system infrastructure not necessary to serve him. The AWWA gives no guidance in how to quantify and remedy that situation. The specific set of infrastructure elements not necessary to serve any specific new customer would be very different depending on the location of that new customer in the system.

Henry District excludes from the OIC all the growth- necessitated costs of supply, treatment, and storage. This significant reduction to the OIC is made in order to be fair to the new customer, not only from the standpoint expressed by the AG's office, but from the standpoint of any other incidental benefits from growth.

When we are questioned whether the costs of intake, treatment, and storage should be included in the OIC because of fairness and consistency, we are in effect being told our charge is too low. When we are questioned whether we have failed to account for service benefits to existing customers, or the replacement value of existing lines, or economy of scale from growth revenue, etc., we are in effect being told our charge is too high. Only by preventing the two halves of this criticism from coming into direct contact with each other can the logic of either argument be sustained. A complete and correct understanding of the interrelated context of these issues reveals that the OIC contains a *reasonable and intentionally generous exchange* of these considerations.

In our response to Item 15b in the December 22, 2006 Order we stated in part:

> "According to the 2004 AWWA/RFC Water and Wastewater Rate Survey, the national average water utility SDC for a residential 5/8" meter is $1550. Therefore our OIC, however much it is perceived to have deviated from standard AWWA and PSC incremental methodology, would also appear to have arrived at a reasonably correct result. And the *reduction* we offer in order to treat our new customers fairly would appear to be a generous one, assuming that the average $1550 SDC has also taken the same issues into account."

Subdivision Refunds

On hearing transcript pages 125 through 128, Mr. Simpson is asked a series of questions regarding HCWD2's position on subdivision refunds. But in the context of the investigation of a system development charge, the larger question is how 807 KAR 5:090, and PSC Case 375, and the AWWA guidelines heavily cited by Case 375, address or pertain to subdivision refunds.

807 KAR 5:090 states that an SDC is reasonable if it "(1) Offsets an increase in cost to fund system expansion to accommodate new growth and demand; (2) Recovers only the portion of the cost of a system improvement that is reasonably related to new demand; and (3) Is based upon the cost of a new facility that will increase or expand capacity."

It is difficult to imagine any cost which more fully and directly meets these criteria than lines internal to a new subdivision. The rational nexus between growth and cost is inarguable.

Case 375 makes frequent reference to the AWWA incremental methodology. In its illustration of the incremental calculation, the AWWA assumes that local subdivision distribution mains will be contributed by the developer (please see Appendix A).

The PSC examined water extension policies in Administrative Case 386 and determined that refunds for internal subdivision lines were not only widely regarded as unfair by water districts in Kentucky, but in its Order of August 15, 2002 the Commission stated:

> "We also note that the current regulation's provisions appear overly generous when compared to those of most other states. A majority of states do not require any refunds for a water main extension to a real estate development..."

This Case 386 Order also contained the Commission's Notice of Intent to promulgate an administrative regulation which, in part, would "...eliminate the requirement that a water utility refund the cost of water main extensions within a real estate subdivision development..."

The Henry District, like most other districts, would welcome the Commission's fulfillment of its stated intent. The principles and positions established by the Commission in SDC Case 375 also fully support the elimination of such subdivision refunds.

CONCLUSION

Dollars and Sense

On hearing transcript page 199, the question is posed whether a system development charge is a major event, more significant than a bad check charge or a late payment fee. Although the SDC dollar amount is certainly higher, the real significance of the lesser charges is identical to that of the SDC.

The real significance of these separate charges, whether large or small, is the basic principle of fairness: those who actually cause these costs are being reasonably held accountable for them, rather than being exempted from their responsibility by simply passing on such costs to all customers through general rates. A Henry District customer is charged an additional $1.13 to use a credit card to pay a $40 monthly bill. If it fair, just and reasonable for even such a small charge to be separately assessed in this way, how can it be argued that it is not necessary to properly allocate $950 in expense caused exclusively by growth?

The costs of accommodating growth are very real and must be paid by someone. Therefore the question of whether to approve the OIC is really twofold. A decision that development will not bear the capacity expansion costs of $950 per lot is also a decision that our existing customers must.

For all the reasons presented herein and provided throughout Case 2006-00191, we urge the Commission to reauthorize the Henry District's Offsetting Improvement Charge.

Table 28-4 Illustrative determination of system development charge using the incremental cost method

	Five-Year Capital Improvements Plan,* *$thous*	Maximum-Day Design Capacity, *mgd*	Unit Cost, *$/mgd*
Plant			
Source of supply	7,500	25	300,000
Treatment and pumping	8,000	15	533,000
Transmission system	3,000	10	300,000
Distribution mains	2,000	N/A	N/A
Services, meters, and hydrants	1,800	N/A	N/A
General structures	500	50	10,000
Subtotal	22,800		1,143,000
Less net cost of			
distribution mains	(2,000)	N/A	N/A
Services, meters, and hydrants	(1,800)	N/A	N/A
Net Investment in Plant	19,000		1,143,000

NOTES: Maximum-day demand for average equivalent 5/8-in. customer: 1,100 gpd.

Average investment per equivalent 5/8-in. customers ($1,143,000 × 1,100/1,000,000): $1,257.

*Current-year cost levels.

N/A-not applicable; assumed to be contributed by developer for purposes of this example.

Appendix A

Appendix B

From RESPONSES TO INTERROGATORIES Ordered May 22, 2006

3. Henry District's existing Offsetting Improvement Charge rate schedule provides: "It is the policy of the District that development should pay to offset its hydraulic impact on the water distribution system, rather than such costs being paid by the District's customers." Explain why, in light of this policy statement, Henry District has not applied for authority to assess a system development charge in lieu of an extension of the Offsetting Improvement Charge.

By the phrase "hydraulic impact on the water distribution system" we mean only the capacity of the pipelines themselves to provide adequate flow and pressure. Our OIC, which incorporates only the cost of installing larger lines, is therefore more consistent with our policy statement than would be the broader-range cost calculations of the equity or incremental SDC methodologies as proposed in PSC Administrative Case 375, "Guidelines on the Development and Administration of System Development Charges."

Nevertheless, HCWD2 does consider its OIC tariff to be a system development charge, as did the Brief of the Attorney General, filed in Case 2001-00393 (April 15, 2002), which stated "It is clear the District is seeking approval of a system development charge tariff under an existing regulation addressing this type of mechanism."

Although PSC Administrative Case 375 proposes two standard methodologies for structuring system development charges, the guidelines also state, "Water utilities should be permitted to use other methodologies to develop their SDCs." Similarly, in 807 KAR 5:090 (System Development Charges for Water Utilities), Section 14 states, "In special cases, for good cause shown, the commission may permit deviations from this administrative regulation." Case 375 states that if alternative SDC methodologies are to be approved in place of those outlined, the utility must demonstrate "that the methodology's use will achieve a more reasonable result." It is our goal to show this to be the case.

The OIC functions fairly and well because it can determine, with reasonable certainty, the recent average system-wide cost of adding one gallon per minute of peak flow to the existing distribution system, and also because our estimate of peak flow per new residence is reasonable by the standards of the Kentucky Division of Water (KyDOW) and the American Water Works Association (AWWA). By focusing on only the cost of installing larger waterlines, our tariff intentionally understates the overall costs of growth, which is appropriate for reasons we will address later in our discussion of "incremental" methodology.

The OIC identifies a cost which is clearly and specifically associated with growth, one which would not be incurred if no growth took place. Our tariff thereby fully complies with the rational nexus test. Ours is a streamlined, straightforward, and commonsense mechanism, well-adapted to the needs and capabilities of our District. Having begun working on it in May of 1999, and having used it since its approval in 2002, we feel strongly that the Offsetting Improvement Charge is both equitable and effective.

The AWWA, cited as the source for the two system development charge methodologies proposed in PSC Case 375, suggests using the "equity" methodology "where current system facilities adequately serve existing and future customers, where no new significant investment is anticipated, and where existing facilities are not scheduled for replacement in the near future." The equity methodology is therefore not appropriate for the Henry County system.

In principle our OIC is a form of "incremental" methodology as proposed in Case 375, but it differs in two basic ways: the OIC does not include the full range of costs proposed in the incremental SDC guidelines, and it does not require the District to speculate as to the scope, location, and expense of future infrastructure, or to predict growth in the number of customers the system will serve.

The OIC is limited to the cost of installing larger diameter waterlines; HCWD2 is willing to accept that the increased costs of treatment and storage due to growth will be paid through the future water rates of all customers. Ours is a compromise approach which functions as a shorthand solution the following problem regarding incremental SDC methodology: Is it reasonable to levy a system development charge on new customers for the *entire* cost of improvements necessary to serve only that group, and also to charge that same group water rates which include a component for the maintenance, operation, debt service, etc., of those existing facilities which are *not* necessary to serve that group? By excluding from our OIC calculation the future costs of new treatment and storage capacity, our tariff tends to counterbalance this double jeopardy effect, and, we believe, achieves a more reasonable result.

Our second deviation from the guidelines is that our methodology calculates and charges what growth *does* cost, instead of what we estimate growth *may* cost. The Henry County OIC is not based on a ten year capital improvement plan (CIP), which determines the dollar value of an incremental SDC by dividing an estimate of the scope of anticipated future improvements and their estimated costs by a third estimate of customer growth. The OIC instead uses the costs of our most recent four year system-specific experience.

Therefore, whether our system grows more slowly or more rapidly than we might project in a CIP, whether specific improvements rise or fall in hydraulic priority, whether unexpected projects become necessary because of growth in areas unanticipated in a CIP, whether future costs of material and labor are much more or less than we might estimate, whether new and more efficient technologies become available, and regardless of changes in the expense of compliance with future KyDOW regulations, our District will be charging a conservative and reasonable fee for system development, a fee which incorporates all the above changes by means of a self-adjusting biennial recalculation.* Those who pay the OIC are not subject to, nor does the Public Service Commission have to endorse, our ability to see the future. And, as a more reasonable result, our tariff reflects the most recent average cost of providing one gallon per minute peak flow to one new customer in the real world of the Henry County system.

Case 375 guidelines state that an SDC "should not be collected in areas where improvements are in place to provide service and no improvements are required." But in citing the suggested AWWA incremental methodology, the guidelines also state that "this method is used most commonly to finance capital expansion as well as to recoup investments creating excess capacity." The utility could only recoup such investments if the SDC were levied in areas with adequate capacity.

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* Assuming that some or all of the above variables could render substantially inaccurate the predictions in a ten-year capital improvement plan, then to whom should the surplus or shortfall of SDC collections be refunded or billed? Is a rebate due the developer or landowner who initially paid an overestimated SDC, or is it owed to the subsequent purchaser of the new lot who claims his purchase price included the cost of the SDC, or to the current owner who bought from that initial purchaser and makes the same claim? Which of them is billed for a shortfall if the SDC is underestimated, and by what mechanism does the water district locate these parties and enforce the collection of growth-related costs exceeding its underestimated SDC in order to mitigate the impact of growth on the system's water rates? The trailing average cost methodology of the Henry OIC eliminates these issues.

The Henry District tariff establishes the system development charge in a manner very similar to the reasonable determination of water rates. A customer who lives next to the treatment plant pays the same rates for water as does a customer who lives 25 miles of pipeline away, and whose water requires several intermediate pumps and tanks to get there. Although the actual cost of providing service to these two customers is radically different, it is the system-wide average cost of providing water service which forms the basis of a uniform water rate. This is considered reasonable simply because each customer receives precisely the same benefit: service in compliance with state regulations. The OIC similarly determines the average cost, system-wide, of providing one gpm of additional peak flow, so that development, regardless of location, pays the same OIC and receives precisely the same benefit: service in compliance with state regulations. We feel this is more reasonable than allowing growth with no SDCs in areas where existing facilities are adequate, and levying high development charges in areas where existing facilities are at capacity.

By means of the OIC, the Henry District treats all its prospective customers equally and without discrimination, regardless of their location within our service area. We can avoid the "last straw" syndrome in which development freely consumes excess capacity without contributing to its replacement until pressures fall to the regulatory minimum. At this moratorium point the next developer becomes the last straw and faces significant SDC expenses.

Being prohibited from charging an SDC in areas with adequate capacity is a disincentive to the creation of that excess capacity, contrary to sound fiscal and engineering judgment. Because the OIC is uniform throughout the HCWD2 system, it does not unfairly enhance or depress property values by charging nothing here and a great deal there. Nor does it encourage overdevelopment in "free" areas and underdevelopment in "SDC zones."

In Case 2001-00393 the Commission expressed concern that existing customers could receive benefits due to improvements funded by the Henry County OIC. We would like to offer our understanding of this issue and further explain our policy.

It is not feasible to continually make small-scale pipeline improvements which return pressures to the hydraulic status quo each time new customers reduce pressure by increasing flow. It is far more cost-effective to make infrequent but large-scale improvements which produce excess capacity. Therefore, in most OIC-funded improvement areas, higher pressures will result for existing customers. There will also be many areas where development occurs without OIC improvements, and existing customers in those areas will experience lower pressures. But as long as a customer receives service within the pressure range prescribed by state regulations, he has received exactly what HCWD2 is authorized and obligated to supply, no more and no less.

We do not offer grades of service. Water rates are uniform regardless of whether a customer receives minimum daily pressure of 80, 60, or 40 psi, and it can reasonably be concluded that higher pressure is not considered objectively "better" from a regulatory standpoint. HCWD2 does not install fire hydrants or certify flowrates to insurers, which means that a larger, newly installed 6" line provides no additional benefit to existing customers in regard to fire protection. And water quality is not improved due to the larger diameter of new lines; smaller lines provide faster volume turnover and lower travel times.

There is no additional benefit or detriment to existing customers whose pressures may rise or fall within the required range. They, like the new customers, receive the one and entire benefit the District can offer, service in compliance with all regulatory parameters.

We have regularly researched the PSC website, but in the four years since the promulgation of KAR 5:090, we have not seen an SDC approved, whether structured by equity or incremental methodology. We may be mistaken, but the only pending submittal we are aware of is a recent application by Jessamine-South Elkhorn Water District, which addresses the growth-related cost of a single proposed storage tank in a specific geographic portion of the water system. This absence of SDCs may mean that throughout Kentucky there are no other water districts which need to employ them, or that the awareness of SDCs has grown very slowly. It may also indicate that AWWA methodologies proposed in Case 375, and the promulgated requirements of 807 KAR 5:090, may need to afford greater flexibility, particularly for the rural water systems that comprise the majority of Kentucky districts.

The HCWD2 Offsetting Improvement Charge is what 807 KAR 5:090 describes as a special case. It was first developed seven years ago out of the experience of the District in using a computer hydraulic model to determine those system improvements which specifically offset the demand of proposed subdivisions. It was the first engineering-based impact fee to be approved by the Commission ("a case of first impression" Case 2001-393), and to our knowledge it is the only such fee to have received PSC approval after having been identified by the Attorney General as a system development charge under the 2002 administrative regulation.

Ours is an alternative methodology similar in principle to incremental SDCs, but which, in the overall context of our policy, our system, and our experience, achieves a more reasonable result. It focuses on only a single component of the cost of development, larger pipelines, clearly satisfying the rational nexus test. And it does not impose upon development our estimate of what growth may cost, but rather our calculation of what it does cost.

We respectfully request that the Commission, for "good cause shown" per 807 KAR 5:090, permit as a deviation from that regulation the permanent approval of the HCWD2 Offsetting Improvement Charge. In the following pages many of the Interrogatories evaluate our tariff in terms of standard SDC methodology; however, it is not as a standard methodology that we have applied for approval.

Appendix C

(From the pre-filed testimony of Tom Green, as authenticated and adopted at the September 13, 2007 hearing in Case 2006-00191)

Growth:

There appears to be held among some members of the Commission staff the conviction that SDCs are appropriate only if they have determined growth to be "significant." However the PSC has endorsed the general principle of SDCs in Kentucky without establishing, either in Administrative Case 375 or in the consequent promulgation of 807 KAR 5:090, any minimum growth rate threshold for SDCs, or any definition of "significant growth." The three criteria for reasonableness in KAR 5:090 do not mention growth rate. Requiring some specific level of growth might impose precisely the kind of "rigid and inflexible standard" which the Commission in Case 375 deemed contrary to the public interest.

Further, the acceptability of the equity methodology to both the AWWA and to the PSC in Case 375 must mean that a growth rate which outpaces the district's conventional funding mechanisms is clearly not a prerequisite for an SDC.

But even assuming that "normal" growth is intended by the PSC to be covered by general rates, how can the PSC approve or deny SDCs without first defining "significant" growth? Will growth be deemed normal if it represents the statewide or regional average, or if, despite being high relative to other districts, it is normal growth for the applicant district? Is it reasonable to require water districts to risk the considerable expense of preparing applications for SDCs and responding to PSC interrogatories and requests for documentation, when those districts cannot possibly know in advance whether their SDC will be denied by the imposition of the undefined standards of "significant" growth?

If the PSC requires a "significant" growth rate threshold for SDCs, it will create two unequal classes of water districts and customers in Kentucky. Districts without SDCs will require their existing customers to pay for growth in general rates, while districts with SDCs will exempt their existing customers from those same charges. But the impact of growth on a utility is cumulative. A system with annual growth of 3% for 8 years will be faced with the same overall growth-necessitated infrastructure costs as a similar system with 8% growth for 3 years.

The actual costs of growth are not a direct function of growth rate. The need to expand capacity often depends entirely on where growth occurs within a system. And even identical growth rates in different systems can produce very different growth-necessitated expenses. A system with surplus capacity could incur no costs at all from growth, but a system nearing capacity (as many KY systems are) could incur high costs from much lower growth levels.

If "significant" growth is a requirement, what policy will the PSC follow if an SDC is approved, but the district's growth rate subsequently diminishes? Will the PSC monitor growth and revoke an SDC if the district is only experiencing growth comparable to other districts whose SDCs were denied?

An SDC is a reasonable and prudent way for the district to be prepared for *potential* growth, cited as an appropriate reason for SDCs by the AWWA in Chapter 28 of their M1 Rates Manual. Except for the time and expense of obtaining PSC approval, no harm is done by having an SDC in place in advance of "significant" growth.

Finally, imposing threshold growth requirements is particularly inappropriate regarding the OIC. The mechanism by which the HCWD2 charge is calculated provides a reasonable offsetting cost per unit of usage, and does not rely on a growth-sensitive 10 year capital improvement plan to calculate or to justify its charge. It treats all levels of growth equally and proportionately, and it is based on the recent average cost of increasing capacity, not on projections of the future. It is self-adjusting, and it remains fair and reasonable.

Appendix D

From RESPONSES TO INTERROGATORIES Ordered December 22, 2006

23. Provide all statutory and regulatory authority for the requirement that Henry District must certify the availability of water service to local planning commissions.

As a regulated utility, we must assume that the orders, directives, and advisory opinions we receive from the PSC have a sound statutory and regulatory basis. Several of our experiences have left little doubt that the Commission considers us under an obligation to certify plats.

We argued in our petition of April 7, 2003 in Case 2001-00393 that a request for plat certification is not an application for service. But in its June 5, 2003 Order the Commission ruled that a request for plat certification *does* constitute an application for service:

> "On April 7, 2003, Henry County Water District #2 ("Henry District") filed a motion requesting that the Commission clarify the meaning of its statement in the July 25, 2002 Order that "the Offsetting Improvement Charge may not be required of applicants who have applied for service prior to the effective date of the Offsetting Improvement Charge tariff." Henry District asks whether a developer who submitted his plats to be certified is to be considered an "applicant" as contemplated in the July 25, 2002 Order. The Commission hereby clarifies its Order to state that developers who submitted plats for certification prior to the tariff's effective date are, in fact, "applicants" whose requests predate the effective date of the Offsetting Improvement Charge tariff." (emphasis added)
>
> "Henry District's refusal to certify plats during the course of the case at bar amounted to a refusal of service..."

In the above order the Commission clarifies the equivalency of applications for service and requests for plat certification. Because water districts cannot refuse applications for service which their capacity can accommodate, we are therefore obligated to honor *equivalent* requests to certify plats.

In Case 2002-00045, the Commission ordered us to certify plats, saying that unless our filed tariff stipulated the basis for our refusal, we could not do so. Our tariff contained several plat certification requirements specific only to the design and construction of subdivision water lines, but the Commission said we could not refuse to certify plats for any *other* reasons. We were therefore effectively under a pre-existing obligation to certify plats which only our filed rules could modify; the default mode required us to certify plats.

If we were under no obligation to certify plats, then why were we not able to require of developers a reasonable payment in exchange for our assurance that hydraulic capacity would be held in reserve indefinitely for their developments? The Commission prohibited us from requiring such contracts after already having approved several which we had submitted in order to confirm that the terms were reasonable. We required these contracts only in exchange for the hydraulic commitment of plat certification itself; in no case did these contracts impose unfiled rates, terms, or requirements on real customers requesting real service at real meters. We therefore understood the PSC's rejection of our right to require such contracts to be an assertion of our obligation to certify plats.

Henry County Planning Commission has told us that plat certification *unconditionally* means that our capacity is, and will remain, both adequate for and available to a platted subdivision. If we agree to make this record plat certification, then obviously our commitment must be taken into account and our capacity held in reserve. The PSC has indicated that we cannot refuse to certify plats. If it also says that we cannot deny service to subsequent prospective customers because of capacity we have certified as being held in reserve, we then encounter a classic regulatory non-sequitur.

If the PSC feels that plat certification is an unreasonable obligation on the part of water districts, it is not simply an issue to be resolved between the Commission and Henry District, but rather on a statewide basis. We have been unable to find any PSC-approved tariff in which a water district states that it does *not* certify subdivision plats.

From RESPONSES TO INTERROGATORIES Ordered August 11, 2006

4 Refer to Letter of Tom Green to Thomas Dorman (April 21, 2004).

a. Explain how Henry District's certification to the Henry County Planning and Zoning Commission of the availability of water service to a lot "creates hydraulic impact on the system."

In our letter to Mr. Dorman, we are referring to the hydraulic impact which, like actual connections, either necessitates the construction of hydraulic improvements to the system, or brings that necessity incrementally closer. In this sense, a certification of service is identical in impact to service itself.

Assume a person has $800 in his bank account, and writes a check for $500. Because that check has yet to clear the bank, his official balance is still $800. Can he therefore write a second check for $500? Or would he first need to deposit at least $200 into his account?

Assume HCWD2 certifies to a landowner or developer that water service is available for Green Acres Subdivision. The certified plat is recorded, and after a delay of several years due to the ups and downs of the real estate cycle (or the developer's personal finances), he builds and sells homes. If the hydraulic capacity of the system has not been held in reserve, if HCWD2 has instead permitted other development in the vicinity which has consumed system capacity and reduced minimum pressures to near 30 psi, then when new homeowners from Green Acres request their meter connections, they will have to wait until the District has the time and resources to install the necessary line upsizes. This would clearly be unfair to these homeowners, who purchased property for which water service had already been certified available on their subdivision plat of record.

The Planning Commission requires unconditional plat certification that service *is* available, not that service will be provided contingent upon future improvements. And there is no expiration date on plat certifications. So when the Henry District certifies the availability of water service, we permanently commit that specific capacity, and cannot then reassign the same capacity to other subsequent customers. We must refuse service (and make hydraulic improvements) when our actual demand, plus our certifications of service, bring pressures to their regulatory minimum. We maintain a hydraulic model which allows us to "balance our checkbook" by taking these commitments into consideration. We would consider it unfair and irresponsible to do otherwise.

c. State whether it is Henry District's position that it may refuse water service to an applicant where actual usage, combined with certified commitments of usage, would result in pressures below state regulations even if the applicant's connection would not result in actual pressures below state regulations upon or after his connection.

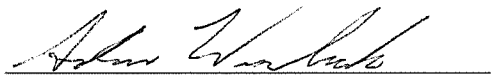
It is not simply our position that we may refuse service; it is our position that we, or any other responsible water district, must. We would fully expect the PSC to require this level of integrity in hydraulic accounting, just as it does in financial accounting. A certification of service is not an irrelevant prelude to a first come, first served free-for-all, and there is no expiration date on a plat certification. The Planning Commission requires unconditional certification that service *is* available, not that service will be provided contingent upon future improvements. It is only reasonable that we either be obligated to honor that commitment, or that we refuse to make it in the first place.

Appendix E

Statement of Clarification by Andy Woodcock, MBA

I misspoke in my testimony at the September 13 hearing, as documented on page 159 of the transcript at line 7. Instead of the term "rate revenues" at the end of my response, I intended to say "SDC revenues" so that the entire sentence would correctly read:

> "The moment that a system development charge is used to pay for a growth-related project that would otherwise be paid for by rates, that rate revenue is not used and that cost is avoided trough the use of SDC revenues."



Andrew Woodcock, MBA
Tetra Tech, Inc.

10/29/07
date

Statement of Clarification by James Simpson

At the September 13, 2007 hearing I attempted to be forthright and to answer as many questions as possible, but I testified for three hours, and because I did not have long-term familiarity with some of the issues, my responses were either incomplete or incorrect in several instances.

I responded to questions regarding the District's policy that subdivision plat certification represents a permanent commitment of capacity, but I did not make it clear in my answers that this is the policy of the Planning Commission, not HCWD2. The "black and white" rule is the Planning Commission's.

I misunderstood the questions regarding a goal of about $250,000 of hydraulic improvements per year. This is only our engineer's estimated goal, based completely on whether funding becomes available. It is not part of our budgeting process.

I was mistaken in my responses regarding the 40-year useful life of the KY 193 line and other 3" lines to be paralleled by OIC projects. According to our fixed asset schedule, these 3" lines were originally installed in our system around 1970 with a useful life of 60 years (except the KY 1360 line, 1989, with a useful life of 33 years). We have not used 40 year rule-of-thumb to remove lines from service, in fact our oldest original HCWD2 lines are less than 40 years old today. It is not our practice to remove a line from service unless maintenance issues require it, so lines may remain in service beyond their scheduled life.

In discussing water quality as a benefit to existing customers where loops are closed by OIC projects, I didn't explain that in most cases, the OIC projects don't close a loop, but just put a larger line on a road. The larger line capacity means that water turnover rates and freshness decrease, which makes water quality more of a concern in a majority of OIC projects. There is no net water quality benefit for existing customers from the OIC projects overall.

In responding to questions about the District's depreciation policy, I didn't realize that it was not a new depreciation policy being enacted at the June 2006 meeting, but that the resolution was only to explain the existing policy that has been in effect for many years. That is why there was no discussion at the meeting. The resolution was only to give the PSC a better understanding of reasons for the existing policy.

I was asked if it was fair not to include water treatment costs in the OIC. I didn't explain that fairness is exactly the reason we don't. We are excluding those costs in exchange for all benefits from growth, to be fair to the new customer.

I was incorrect in stating that a change in general rates might possibly affect the cost charged in our line extension policy. These things are not related.

Our system consumes about 2 MGD and our ten distribution system tanks also total about 2,000,000 gallons storage. (The additional ground storage at the treatment plant is at a considerable distance from the distribution system, and its overflow elevation is not high enough to provide flow into the system under gravity feed conditions.) We plan to replace two of the distribution system tanks with larger tanks for several different reasons, but one reason is that the increased capacity in the two tanks will serve the purpose of satisfying the future one-day storage requirement within our distribution system as we experience growth. I was mistaken in saying that the expansion of capacity of these two tanks was unrelated to growth.

James Simpson, C.O.O., Henry County Water District No. 2 — 10-29-07 date

Appendix F

Existing Line Replacement Adjustment

The existing lines to be paralleled in the OIC projects are an average of about 37 years old, almost two-thirds of the way through their scheduled 60 year useful life. We will assume that they present maintenance problems at that time requiring them to be removed from service.

The OIC listing (please see Appendix J herein) includes total project costs of $3,622,000. We have determined the percentage of each new pipe's capacity (and cost) which could be attributed to the eventual replacement of the existing smaller line. Please note that pipe capacities vary with the square of their diameters; therefore a 3" line has capacity equivalent to 25% of a 6" line.

16" OIC lines (14% of 16" capacity = 6")	$980,000= all 16" paralleling 6"	14%=$137,200
12" OIC lines (25% of 12" capacity = 6")	$630,000= all 12" paralleling 6"	25%=$157,500
10" OIC lines (36% of 10" capacity = 6")	$300,000= all 10" paralleling 6"	36%=108,000
10" OIC lines (11% of 10" capacity = 3")	$390,000= all 10" paralleling 3"	11%=$42,900
6" OIC lines (25% of 6" capacity = 3")	$1,052,280= all 6" paralleling 3"	25%=$263,070
OIC loop closures (no replacement value)	$270,360= all loops	0%=$0

Total replacement adjustments are $708,670 or 19.6% of total project costs of $3,622,000. We could therefore reduce the OIC by 19.6% for this replacement function if all smaller lines were in immediate need of replacement. But because these existing lines will remain in service with about one-third of their useful life still remaining, the OIC line does not serve to replace them during that remaining fraction, but replaces only the two-thirds of expended useful life. The adjustment of 19.6% would therefore be reduced by one third so that the resulting 13% adjustment represents the actual proportion of useful life replacement. Under the most recent recalculation OIC is at $950. The 13% replacement adjustment would bring it down by $125 to about $825.

However, it remains a very fair question whether our intentional exclusion of over $700 in growth-necessitated costs for intake, treatment, and storage (in exchange for all benefits of growth) should be considered to have more than compensated the new OIC-paying customer for this $125 line replacement adjustment. It is our position that it surely does.

If we are correct, the line replacement adjustment is an unnecessary and inappropriate reduction.

Appendix G

From RESPONSES TO INTERROGATORIES As Ordered May 22, 2006

17. State when Henry District expects to apply for a general rate adjustment.

Discussions have begun among our staff, accountant, engineer, attorney, and board members regarding the possible need for a moderate rate increase. We have concerns about our rising costs and expenses in several areas, but we are hesitant to raise general rates until we are more certain of the necessity and the extent. We have yet to set a firm timeframe for such an increase.

From RESPONSES TO INTERROGATORIES As Ordered December 22, 2006

22. Refer to Henry District's Response to the Commission's Order of May 22, 2006, Item 17. State whether, under present conditions, Henry District's position remains unchanged. If no, provide Henry District's current position.

We have not reached a decision, except that we seem to be coming into general agreement that in the next several years, a modest rate increase may be needed. Additionally we would note that without the OIC, a rate increase becomes more likely in order to continue providing service to areas where higher demand requires larger water lines. To the extent that rates finance growth, our existing customers are required to subsidize development.

RAISOR, ZAPP & WOODS, P.S.C.

Certified Public Accountants

513 HIGHLAND AVENUE
P.O. BOX 354
CARROLLTON, KENTUCKY 41008
(502) 732-6655 FAX (502) 732-6161

October 22, 2007

Tetra Tech
Tom Green
800 Corporate Drive
Suite #200
Lexington, KY 40503

RE: Bond Covenants – Henry County Water District #2

Dear Tom,

After our conversation today, I have reviewed our work papers regarding Henry County Water District #2's compliance with their outstanding bond issues (1998, 2001 & 2003). Henry County Water District #2 is properly transferring monies to bond and interest sinking accounts and maintaining proper balances regarding the depreciation funds of the above mentioned bond issues. I have attached certain excerpts from these issues for your files. I hope this will be helpful.

Sincerely,

Dennis S. Raisor

Appendix H

2001 Issue

C. **Depreciation Fund.** Pursuant to the provisions of the Prior Bond Legislation, there shall next be transferred from the Revenue Fund a sum sufficient, each month, to maintain a balance in said Depreciation Fund of at least the sum required by the Prior Bond Legislation, which shall be deposited into the Depreciation Fund.

Moneys in the Depreciation Fund may be withdrawn and used by the Governmental Agency, upon appropriate certification of the Governing Body, in accordance with the provisions of the Prior Bond Legislation, for the purpose of paying the cost of unusual or extraordinary maintenance, repairs, renewals and replacements not included in the annual budget of current expenses and/or of paying the costs of constructing future extensions, additions and improvements to the System which will either enhance its revenue-producing capacity or will provide a higher degree of service, and when necessary, for the purpose of making payments of principal and interest on the Bonds if the amount on deposit in the Sinking Fund is not sufficient to make such payments.

D. **Operation and Maintenance Fund.** There shall next be transferred monthly from the Revenue Fund and deposited into said Operation and Maintenance Fund, sums sufficient to meet the current expenses of operating and maintaining the System. The balance maintained in said Operation and Maintenance Fund shall not be in excess of the amount required to cover anticipated System expenditures for a two-month period pursuant to the Governmental Agency's annual budget.

E. **Surplus Funds.** Subject to the provisions for the disposition of the income and revenues of the System as set forth hereinabove, which provisions are cumulative, and after paying or providing for the payment of debt service on any subordinate obligations, there shall be transferred, within sixty days after the end of each fiscal year, the balance of excess funds in the Revenue Fund on such date, to the Depreciation Fund for application in accordance with the terms of this Assistance Agreement or to the Sinking Fund to be applied to the maximum extent feasible, to the prompt purchase or redemption of Outstanding Bonds.

Provided, however, notwithstanding anything to the contrary in any Prior Bond Legislation, the Governmental Agency shall be allowed a credit to the extent of moneys on deposit in the Program Reserve Fund for the purpose of meeting any parity requirements in any Prior Bond Legislation; subject however, to the limitation that moneys in the Program Reserve Fund may only be used to make payments of the Government Agency due under this Assistance Agreement, if necessary, and; provided further, that the Trustee may not seek payment for any reserve funds held by the Governmental Agency under any Prior Bond Legislation for payment of any amounts due from the Governmental Agency under this Assistance Agreement.

Section 8. Disposition of Proceeds of the Obligations; Governmental Agency Account. Upon (i) the execution of this Assistance Agreement, (ii) the deliverance of this Assistance Agreement to the Trustee, (iii) certification of the Compliance Group that the Loan is to be accepted in the Program and (iv) upon receipt by the Governmental Agency of the proceeds of the Obligations, the proceeds shall be applied as follows:

(a) Disposition of the Proceeds. There shall first be deducted and paid from the proceeds of the Obligations the fees and costs incurred by the Governmental Agency and any other pertinent

time to time shall be used and disbursed and applied, and are hereby irrevocably pledged, solely for the purpose of paying the principal of and interest on the Outstanding Bonds and any Parity Bonds hereafter issued and outstanding pursuant to the provisions of this Assistance Agreement.

There shall be set aside and transferred on or before the 20th day of each month from the Revenue Fund, as a first charge thereon, and deposited in the Sinking Fund Sums sufficient to pay when due the principal and interest requirements on the Outstanding Bonds. Specifically, there shall be paid into the Sinking Fund on or before the 20th day of each month, on account of the Outstanding Bonds, not less than the following:

(1) An amount equal to one-sixth (1/6) of the next succeeding six-month interest payment to become due on the Outstanding Bonds [provided that for the first seven payments one-seventh (1/7) of the interest due on the Obligations on the next succeeding interest due date], plus

(2) A sum equal to one-twelfth (1/12) of the principal of any Outstanding Bonds maturing on the next succeeding principal payment date [provided that for the first seven payments one-seventh (1/7) of the principal due on the Obligations].

In the event additional Parity Bonds are issued pursuant to the conditions and restrictions hereinafter prescribed, the monthly deposits to the Sinking Fund shall be increased to provide for payment of interest thereon and the principal thereof as the same respectively become due.

If for any reason there should be a failure to pay into the Sinking Fund the full amounts above stipulated, then an amount equivalent to such deficiency shall be set apart and paid into the Sinking Fund from the first available income and revenues of the System, subject to the aforesaid priorities.

No further payments need to be made into the Sinking Fund if and when the amount held therein and in any other available fund is at least equal to the amount required to retire all Outstanding Bonds and Parity Bonds and paying all interest that will accrue thereon.

C. Depreciation Fund. Pursuant to the provisions of the Prior Bond Legislation, there shall next be transferred from the Revenue Fund a sum sufficient, each month, to maintain a balance in said Depreciation Fund of at least the sum required by the Prior Bond Legislation, which shall be deposited into the Depreciation Fund.

Moneys in the Depreciation Fund may be withdrawn and used by the Governmental Agency, upon appropriate certification of the Governing Body, in accordance with the provisions of the Prior Bond Legislation, for the purpose of paying the cost of unusual or extraordinary maintenance, repairs, renewals and replacements not included in the annual budget of current

2003 Issue

expenses and/or of paying the costs of constructing future extensions, additions and improvements to the System which will either enhance its revenue-producing capacity or will provide a higher degree of service, and when necessary, for the purpose of making payments of principal and interest on the Bonds if the amount on deposit in the Sinking Fund is not sufficient to make such payments.

D. Operation and Maintenance Fund. There shall next be transferred monthly from the Revenue Fund and deposited into said Operation and Maintenance Fund, sums sufficient to meet the current expenses of operating and maintaining the System. The balance maintained in said Operation and Maintenance Fund shall not be in excess of the amount required to cover anticipated System expenditures for a two-month period pursuant to the Governmental Agency's annual budget.

E. Surplus Funds. Subject to the provisions for the disposition of the income and revenues of the System as set forth hereinabove, which provisions are cumulative, and after paying or providing for the payment of debt service on any subordinate obligations, there shall be transferred, within sixty days after the end of each fiscal year, the balance of excess funds in the Revenue Fund on such date, to the Depreciation Fund for application in accordance with the terms of this Assistance Agreement or to the Sinking Fund to be applied to the maximum extent feasible, to the prompt purchase or redemption of Outstanding Bonds.

Provided, however, notwithstanding anything to the contrary in any Prior Bond Legislation, the Governmental Agency shall be allowed a credit to the extent of moneys on deposit in the Program Reserve Fund for the purpose of meeting any parity requirements in any Prior Bond Legislation; subject however, to the limitation that moneys in the Program Reserve Fund may only be used to make payments of the Government Agency due under this Assistance Agreement, if necessary, and; provided further, that the Trustee may not seek payment for any reserve funds held by the Governmental Agency under any Prior Bond Legislation for payment of any amounts due from the Governmental Agency under this Assistance Agreement.

Section 8. Disposition of Proceeds of the Obligations; Governmental Agency Account. Upon (i) the execution of this Assistance Agreement, (ii) the deliverance of this Assistance Agreement to the Trustee, (iii) certification of the Compliance Group that the Loan is to be accepted in the Program and (iv) upon receipt by the Governmental Agency of the proceeds of the Obligations, the proceeds shall be applied as follows:

(a) Disposition of the Proceeds. There shall first be deducted and paid from the proceeds of the Obligations the fees and costs incurred by the Governmental Agency and any other pertinent expenses incident to the issuance, sale and delivery of the Obligations and such other appropriate expenses as may be approved by the Governmental Agency Chief Executive, including but not limited to the Governmental Agency's pro rata share of the Program's fees and expenses.

The balance shall be deposited to the Governmental Agency Account to be used to complete the Project.

1998 ISSUE

The Third Lien Sinking Fund is hereby pledged for the payment of the interest and the principal of the Current Bonds, but subject to the vested rights and priorities of Prior First Lien Bonds and the Prior Second Lien Bonds.

F. **Depreciation Fund.** It is hereby determined that upon the issuance of the Current Bonds, and upon completion of the Project, as certified by the Engineers and by the RD, there shall next be transferred from the Revenue Fund the sum of at least $3,845 (increased from $2,160) each month which shall be deposited into the Depreciation Fund until there is accumulated in such Depreciation Fund the sum of at least $461,400 (increased from $259,200), which amount shall be maintained, and when necessary, restored to said sum of $461,400, so long as any of the Bonds are outstanding and unpaid.

As further security for the Bondowners and for the benefit of the District, it has been and is hereby provided that in addition to the monthly transfers required to be made from the Revenue Fund into the Depreciation Fund, there shall be deposited into said Depreciation Fund all proceeds of connection fees collected from potential customers (except the amounts necessary to pay the actual costs and service connections applicable to said potential customers) to aid in the financing of the cost of future extensions, additions and improvements to the System, plus the proceeds of any property damage insurance (not otherwise used to replace damaged or destroyed property); and any such amounts or proceeds so deposited shall be used solely and only for the purposes intended.

Moneys in the Depreciation Fund may be withdrawn and used by the District, upon appropriate certification of the Commission, for the purpose of paying the cost of unusual or extraordinary maintenance, repairs, renewals and replacements not included in the annual budget of current expenses and/or of paying the costs of constructing future extensions, additions and improvements to the System which will either enhance its revenue-producing capacity or will provide a higher degree of service, and when necessary, for the purpose of making payments of principal and interest on the Bonds if the amounts on deposit in the respective Sinking Funds are not sufficient to make such payments.

G. **Operation and Maintenance Fund.** There shall next be transferred monthly from the Revenue Fund and deposited into said Operation and Maintenance Fund, sums sufficient to meet the current expenses of operating and maintaining the System. The balance maintained in said Operation and Maintenance Fund shall not be in excess of the amount required to cover anticipated System expenditures for a two-month period pursuant to the District's annual budget.

H. **Monthly Principal and Interest Payments if Requested by the RD.** So long as any of the Bonds are held or insured by the RD, the District shall, if requested by the RD, make the payments required by this Section 402, in monthly installments to the RD or to the insured Owners of the Bonds.

I. **Surplus Funds.** Subject to the provisions for the disposition of the income and revenues of the System as set forth hereinabove, and in the Prior Bond Resolution, which provisions are cumulative, and after paying or providing for the payment of debt service on any subordinate obligations, there shall be transferred, within sixty days after the end of each fiscal year, the balance of excess funds in the Revenue Fund on such date, to the Depreciation Fund for

Appendix I

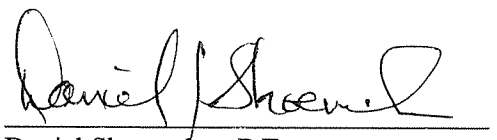
Statement of Daniel Shoemaker, P. E.

In our response to Item 12 of the May 22, 2006 Interrogatories, we stated in part:

> "It is not our policy that general rates should recover the full cost of depreciation, and this expense was not included in the 1996 rate adjustment submittal on which the current rates are based. By recollection of the project engineer, the annual replacement costs then estimated and included in the analysis were $100,000."

I was the project engineer in 1996. My previous response was based on recollection and was incorrect. Since then, we were able to recover project documents from our archive that show the cost budget used to determine rates included renewal and replacement of $250,000 per year. This amount was intended to include both short-lived assets and long-lived assets, respectively described as "5/10 year" and "Capital Improvements" in our Final Engineering Report (Exhibit ATW-2 of the pre-filed testimony of Andy Woodcock, and included herein as Appendix K). This combination of short and long term renewal and replacement constitutes the budgeted depreciation allowance within the 1996 rates.

We did not consider this amount to constitute full recovery of depreciation expense.



Daniel Shoemaker, P.E.
Tetra Tech, Inc.

10/29/07
date

Offsetting Improvement Charge Tariff

Henry County Water District No. 2

Long Term Plan for Proposed Hydraulic Impovement Expenditures - December 2004

Proposed Hydraulic Improvement	Description	Cost Estimate	Comments
			(construction cost estimates revised, notes added -June 2006)
US 421 west of Pleasureville (designed)	Upsize 8500' 6" to 10"	$ 300,000	
KY 153 (Phase 1 in Sligo designed)	Upsize 6400' 6" to 16"	$ 450,000	Total KY 153 project = 14,000' 16" ($980,000) plus 18,000 12" ($630,000)
KY 1861 & KY 22 Smithfield Area	Upsize 28,000' 3" to 6"	$ 280,000	
Giltner-Jackson Rd Connector	Close loop with 7000' 8"	$ 66,360	Built by HCWD personnel 2005 7600' 8"
KY 146 west of Jackson Rd (Phase 1)	Upsize 10,000' 3" to 6"	$ 100,000	Phases 2 & 3 are also approximately 10,000' each
KY 193 from New Castle Tank to Lacie	Upsize 22,000' 3" to 6"	$ 220,000	
KY 202 from US 421 east	Upsize 18,000' 3" to 6"	$ 180,000	
Bunk-Ellis Rd	Close loop with 5000' 4"	$ 40,000	
Martini Lane-Webb Lane	Upsize 13,000 3" to 10"	$ 390,000	amount corrected from error in reponses to May 22, 2006 Order Appdx C
KY 1359 Loop Bellview KY	Close loop with 4000' 4"	$ 32,000	
KY 1360 Bullitt Rd to Pennywinkle Rd	Upsize 7200' 3" to 6"	$ 72,000	
Dawkins/KY 146/Kavanaugh	Close loops w 10,000' 6"	$ 100,000	
Radcliff Rd to KY 712	Close loop with 3200' 6"	$ 32,000	

FILE

FINAL ENGINEERING REPORT
WATER SYSTEM IMPROVEMENTS

for

Henry County Water District No. 2
Post Office Box 219
Campbellsburg, Kentucky 40011

July 12, 1996

COMPLIANCE THROUGH INNOVATION

Commonwealth Technology, Inc.

ENVIRONMENTAL CONSULTING DIVISION

Appendix K

PROPOSED FUNDING

KIA Construction Loan	$5,025,000
KIA Debt Service Reserve (10%)	$575,000
KIA Financing Expense (2.5%)	$145,000
Total KIA Fund "C" Bond Pool at 7%, 30 years	$5,745,000
FmHA Loan at 6%, 38 years	$3,000,000
Rural Business and Cooperative Development Service Loan at 0%, 10 years	$400,000
Budgeted 5/10-yr Capital Improvements Plan (1996 only)	$250,000
Total Funding	**$9,395,000**

RATES

Current Annual Costs:

Operation and Maintenance (O & M)	$955,000
Current Debt (Principal and Interest)	$330,000
Contributed Capital Matching Fund	$100,000
5/10-year Capital Improvements Plan (years following 1996)	$250,000
Subtotal Current Revenue Required	$1,635,000
Projected 1st Year Revenue with Current Rates	($1,313,000)
Subtotal Current Revenue Deficit	**$322,000**

Additional Proposed Annual Project Costs:

Additional O & M	$195,000
KIA Principal & Interest	$461,000
KIA Administration Fee (0.2% principal)	$11,000
FmHA Principal & Interest	$202,000
RBCDS Principal	$40,000
FmHA & RBCDS Reserve (10%)	$24,000
Subtotal Additional Proposed Revenue Deficit	$933,000
Total Additional Revenue Required	**$1,255,000**
Plus Projected 1st Year Revenue with Current Rates	$1,313,000
TOTAL ANNUAL REVENUE REQUIRED	**$2,568,000**