GREENEBAUM
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VIA HAND DELIVERY

RECEIVED
AUG 2 6 2005
PUBLIC SERVICE COMMISSION

August 26, 2005

Beth O'Donnell
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40602-0615

Re: In the Matter of: Proposed Adjustment Of The Wholesale Water Service Rates Of Hopkinsville Water Environment Authority, Case No. 2005-00174

Dear Ms. O'Donnell:

Enclosed herewith please find for filing with the Commission the original and ten (10) copies of the Prefiled Direct Testimony of Lennis Franklin Hale and Jennings Rowe McKinley II for Hopkinsville Water Environment Authority ("HWEA") in the above styled matter. By copy of this letter to counsel for the Christian County Water District, we are providing a service copy of HWEA's Prefiled Direct Testimony.

Please do not hesitate to contact the undersigned should you have any questions concerning this filing.

Sincerely,

Quint McTyeire

Holland N. McTyeire, V

HNM/jh

Enclosure

cc: Gerald E. Wuetcher
James Owen
John N. Hughes
Lennis F. Hale
J. Rowe McKinley II
Andrew C. Self
Carl W. Breeding

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

PROPOSED ADJUSTMENT OF THE WHOLESALE WATER SERVICE RATES OF HOPKINSVILLE WATER ENVIRONMENT AUTHORITY	CASE NO. 2005-00174

PREFILED

DIRECT TESTIMONY

OF

LENNIS FRANKLIN HALE

FOR

HOPKINSVILLE WATER ENVIRONMENT AUTHORITY

WRITTEN TESTIMONY FOR PSC

LEN HALE

PLEASE STATE YOUR NAME AND BUSINESS ADDRESS. My name is Lennis Franklin Hale, 401 East Ninth Street, Hopkinsville, Kentucky, 42240

WHAT IS YOUR PROFESSION? I am General Manager of the Hopkinsville Sewerage and Water Works Commission dba Hopkinsville Water Environment Authority (HWEA).

HOW LONG HAVE YOU BEEN ASSOCIATED WITH HWEA? I have been continuously employed by HWEA since September 1994.

WHAT IS YOUR EDUCATIONAL BACKGROUND? I am a graduate of Vanderbilt University with a Bachelor of Science degree, cum laude, in Environmental and Water Resources Engineering. I am currently a member of the American Water Works Association, a director of the Kentucky Water Utility Council, a member of the Water Environment Federation, a member of the Municipal Water and Wastewater Association of Kentucky.

WHAT IS YOUR PROFESSIONAL EXPERIENCE? Upon graduation I was employed by Peabody Coal Company as their Eastern Environmental Supervisor for all their mines in Alabama, Kentucky, and Indiana. I managed their environmental and water quality laboratory in Central City, Kentucky. Later I was hired as an environmental engineer by Howard K. Bell Consulting Engineers, Inc. During my twenty years with Howard K. Bell Consulting Engineers, Inc., I achieved the position of principal and assistant manager of their Hopkinsville, Kentucky office. As a consultant for Howard K. Bell, I was project manager for over 56 major water, wastewater, air pollution, and solid water projects. I worked with municipalities, counties, regional authorities, institutions, and private industry. In 1994 I was hired as the General Manager of the Hopkinsville Water Environment Authority. During this time, I have been part of several focus groups and committees working with the Kentucky Cabinet for Natural Resources and Environmental Protection in writing environmental rules and regulations.

PLEASE DESCRIBE THE HOPKINSVILLE WATER ENVIRONMENT AUTHORITY. HWEA is a municipal water and wastewater utility directly serving over 16,000 water customers and 14,000 wastewater customers in Hopkinsville, Pembroke, Crofton, and Christian County. HWEA owns and operates the 10 MGD Moss Water Treatment Plant in Hopkinsville. HWEA also owns and operates the Northside Wastewater Treatment Plant (WWTP), Hammond-Wood WWTP, and Crofton WWTP. HWEA maintains over 250 miles of water mains, eight water storage facilities, and two booster stations. HWEA also maintains 229 miles of sewers and 48 pumping stations. HWEA is one of the oldest municipal water utilities in the Commonwealth of Kentucky, being formed in 1895. HWEA consistently meets or achieves the highest standards of water quality in the Commonwealth. In 1996 the HWEA received the highest award for water treatment issued by the Kentucky/Tennessee American Water Works Association.

HWEA is one of only three water utilities in the Commonwealth of Kentucky to achieve the federal AWOP designation.

WHAT IS THE BASIS FOR THE PROPOSED WHOLESALE RATE INCREASE?

HWEA will soon bid and construct a 36" diameter raw water main from Hopkinsville to Lake Barkley. The 26 mile pipeline and 20 MGD raw water intake on Lake Barkley will ensure sufficient water supply for HWEA for the next 50 years. HWEA's current raw water supply, North Fork of the Little River, is inadequate to meet the current and future needs of our customers. Furthermore the deteriorating water quality of the North Fork necessitates that HWEA locate another raw water source. The proposed Lake Barkley Raw Water Project will ensure a more reliable and better quality raw water supply, which will benefit all HWEA customers. This includes a 2004 commitment to provide up to 2 MGD of water to the CCWD for the next 42 years as approved by the PSC on February 6, 2004, Case No. 2003-00087.

In order to fund the Lake Barkley Raw Water Project, HWEA and the City of Hopkinsville have issued a $25 million revenue bond. The proposed wholesale rate increase is needed to help HWEA meet the increased indebtedness payments and the operation and maintenance costs of the Lake Barkley project. The 2003 wholesale rate agreement with the CCWD approved by the PSC in its Orders dated December 17, 2003 and February 6, 2004 in Case No. 2003-00087 requires the wholesale rate to increase as HWEA's Hopkinsville rates increase.

HOW DOES THE LAKE BARKLEY RAW WATER PROJECT BENEFIT CCWD? In the agreement between HWEA and the CCWD, as approved by the PSC and referred to above, HWEA is required to commit up to 2 MGD or 20% of its daily current water treatment capacity to the CCWD. The CCWD's consumption has increased about 5-8% over the last five years. In order to meet the current and future water needs of the CCWD, HWEA must seek out and implement a more reliable raw water supply. The Lake Barkley project will permit HWEA to meet this need. In 2004 HWEA signed an agreement with the CCWD to supply 2 MGD and up to 49 MG per month of treated water to the CCWD. This agreement also extended HWEA's commitment to the CCWD through 2046. The Lake Barkley project will enable HWEA to better meet the commitments listed in the January 8, 2004 agreement between the parties and approved by the PSC on February 6, 2004.

IN THE CCWD OBJECTION OF WHOLESALE RATES TO THE PSC DATED APRIL 21, 2005, THEY STATE THAT THEY HAD NO KNOWLEDGE OF THE IMPENDING RATE INCREASE. IS THAT TRUE? No. As early as 2002 in the discussions of the wholesale rate increase, the CCWD admitted that they knew that HWEA's Lake Barkley project would require another wholesale rate increase. In fact, they tried to talk HWEA into postponing the July 1, 2001 rate increase until HWEA implemented the Lake Barkley project. In addition to this, the rate increase was closely reported in the *Kentucky New Era*, WKAG TV, WHOP, and WHVO. Exhibit "A" is attached, which is an April 4, 2005 article in the *Kentucky New Era* regarding the upcoming water rate increase needed to support the Lake Barkley Raw Water Project. In their letter of April 21, 2005, the CCWD admitted to reading the *Kentucky New Era* on page 2 of the letter in regards to the "REZ initiative".

The PSC's December 18, 1998 Instructions to Municipal Utilities on filing wholesale rates state that rates must be submitted to the PSC not less than 30 days before the rates become effective. A copy of which is attached as Exhibit "B". That same guidance document states that the rates should be submitted to the public utility affected by the rates at the same time. HWEA submitted the tariff sheet for the new wholesale rates to the PSC with a copy to the CCWD on April 15, 2005, with an effective date of July 1, 2005. This submittal complied with the subject PSC guidance document.

HOW WAS THE WHOLESALE RATE DETERMINED FOR THE CCWD?

HWEA hired Black and Veatch to perform a rate study and cost of service study. The rate study was needed to determine the amount of retail rate increase needed to cover the additional indebtedness and operation and maintenance cost of the Lake Barkley project. In addition HWEA requested Black and Veatch to perform a cost of service study for the wholesale rates. Please see the written testimony of Rowe McKinley for a more detailed description of how the wholesale rates were determined. In 2003, HWEA signed a wholesale rate agreement with the CCWD, which as noted previously was approved by the PSC by the Orders in Case No. 2003-00087 that defined the method for determining wholesale rates.

Although HWEA was satisfied with the wholesale rate formula contained in the 1973 agreement, which the PSC had approved, the CCWD initiated the discussions in 1996 that led to the adoption of the 1.3 multiplier method for determining wholesale rates. At that time the CCWD Board preferred the multiplier over the formula. In July 2001 HWEA offered to discontinue the multiplier method and revert back to the formula. HWEA gave the CCWD a six month extension to consider this request. The CCWD took advantage of the extension granted by the HWEA apparently for the sole purpose of delaying the imposition of any new rates. It does not appear to HWEA that the CCWD had any real intention of considering the previous formula contained in the parties' original agreement and approved by the PSC on September 9, 1994.

HWEA AND THE CCWD INTENDED FOR THE 1.3 MULTIPLIER CONTAINED IN THE 2003 AGREEMENT APPROVED BY THE PSC TO BE USED FOR SUBSEQUENT RATE INCREASE? In 1996 at the urging of the CCWD Chairman and Board, HWEA considered their request to supplant the wholesale rate formula used consistently since 1973, with a municipal rate based multiplier. The CCWD was insistent that they wanted a wholesale rate based upon Hopkinsville municipal rates. Minutes, memos, and letters from the period leading up the 1996 Agreement and through the settlement approved by the PSC, Case No. 2003-00087 support this position, see Exhibit "C". Exhibit "C" includes: October 25, 1995 Letter from HWEA (Lynch) to CCWD (Burkhead), May 30, 2001 Letter from HWEA (Hale) to CCWD (Owen), June 25, 2001 Letter from HWEA(Hale) to CCWD(Owen), and January 29, 2002 Letter to the PSC from Andrew Self (regarding history of wholesale rate agreements with the CCWD). The 1996 Agreement specifically identified that the rate increase would occur on July 1, 2001 using the 1.3 multiplier. Although this Agreement was not submitted to the PSC, this multiplier was subsequently approved by the PSC in its December 17, 2003 Order, Case No. 2003-00087.

DID THE CCWD COMPLY WITH THE AGREEMENT SIGNED IN 1996? No. HWEA notified the CCWD in January 2001 that a rate increase would occur on July 1, 2001. That notification was repeated twice before July 1, 2001. Shortly before the rate increase was to take effect as outlined in the 1996 Agreement, the CCWD objected to the rate increase and appealed it to the PSC. In a joint meeting in July 2001, the CCWD agreed to pay the 1.3 multiplier wholesale rate if HWEA would delay the rate increase until January 1, 2002. HWEA agreed to this request. However in January 2002, the CCWD refused to pay the wholesale rate determined by the 1.3 multiplier.

HOW DID HWEA RESOLVE THE DISPUTE WITH THE CCWD IN 2003? In an effort to expedite the negotiations and the implementation of new wholesale rates, HWEA agreed to add a fourth tier for the 2003 Agreement. HWEA took the old fourth tier rate in effect in 1996 and adjusted it by the average rate increase implemented by the Hopkinsville City Council in November 2000. The CCWD agreed to this compromise, which resulted in the September 9, 2003 Settlement Agreement approved by the PSC, in its December 17, 2003 Order, Case No. 2003-00087.

WAS IT HWEA'S INTEPRETATION THAT THE 1.3 MULTIPLIER METHOD AGREED TO BY THE CCWD IN 2003 WOULD BE USED FOR DETERMINING WHOLESALE WATER RATES IN THE FUTURE? Yes. In all of the meetings and conversations in 2003 between HWEA and the CCWD, it was agreed that the 1.3 multiplier would be the method for determining wholesale water rates in the future, see Exhibit "D" (an interoffice HWEA memo summarizing a meeting with the CCWD in which they requested that the wholesale formula be replaced with a multiplier). The 2003 Settlement Agreement states: "The rates will only change as the City rates change." The wholesale rates under objection by the CCWD were developed in accordance with this language. The Hopkinsville City Council raised "city rates" in April 2005. As a result the wholesale rates were changed as well.

WHAT DID HWEA UNDERSTAND TO BE THE IMPACT OF THE PSC'S DECEMBER 17, 2003 ORDER IN CASE NO. 2003-00087? HWEA understood that the PSC did not approve the terms and conditions of the 1996 Agreement between HWEA and the CCWD, but understood that the PSC had approved the rates set forth in the parties' September 9, 2003 Settlement Agreement which were based on the 1.3 multiplier for future rates between the parties.

THE PROPOSED WHOLESALE RATES OF APRIL 2005 ALSO CONTAIN A FOURTH TIER. WHY? HWEA anticipated that the CCWD would use the same argument used in 2002 to object to the new wholesale rates. HWEA asked Black and Veatch in conducting the Cost of Service Study to develop a fourth tier consistent with the cost of service, which explained in more detail with the written testimony of Rowe McKinley.

DOES THIS CONCLUDE YOUR TESTIMONY? Yes it does.

Len Hale, General Manager
Hopkinsville Water Environment Authority

Commonwealth of Kentucky\
County of Christian\

Before me a Notary Public in and for Kentucky this date appeared Len Hale, General Manager, Hopkinsville Water Environment Authority, and acknowledged this Prefiled Testimony to be his voluntary act and deed and to be true and accurate to the best of his knowledge, information, and belief formed after a reasonable inquiry.

Witnessed my hand and Notary Seal this 25th day of August, 2005.

My Commission expires: 5/6/07

Kristine Baumgarner
Notary Public

04-08-05 EXHIBIT "A" CASE NO. 2005-00174

Utility prices to rise

Rate hike to finance Lake Barkley project

BY JENNIFER P. BROWN
NEW ERA SENIOR STAFF WRITER

The average water and sewer bill in Hopkinsville will increase about $42 a year as part of a rate hike proposed by the Hopkinsville Water Environment Authority (HWEA).

The utility is seeking the increase to finance two major upgrades — a $25 million bond issue for the Lake Barkley raw water project and approximately $8 million in low-interest loans for various sewer improvements.

The Lake Barkley project "will meet the raw water needs for the next 50 years," Len Hale, HWEA manager, told Hopkinsville City Council members at their budget meeting Thursday night.

An ordinance authorizing the separate rate increases for water and sewer service will be presented to the council at its next regular meeting on April 19. It will require two readings to be approved. HWEA wants the increase to begin on July 1.

HWEA is building a water line from Hopkinsville to Lake Barkley to supply all of the raw water needs for the utility,

SEE UTILITIES, PAGE A6

UTILITIES: Rate hike will finance Lake Barkley pipeline

FROM PAGE 1

which serves Hopkinsville, Pembroke and Crofton. When the project is completed in about two years, it will replace HWEA's raw water supply from Little River and the North and South quarries.

Four watershed lakes supplement the flow in the North Fork but those have lost about 40 percent of their capacity over the years because of sedimentation. The lakes range in age from 41 to 98 years.

HWEA draws about 7.4 million gallons of water a day from the North Fork. The withdraw rate has increased by 42 percent, or 2.2 million gallons a day, since 1995.

The Lake Barkley line — 36 inches in diameter and 24 miles long — will be able to deliver 20 gallons of water a day.

Hale said HWEA wants to deed three of the watershed lakes — Tandy, Boxley and Morris — back to the city when the Barkley project is complete. The city still owns Lake Blythe.

Council member Richard Covington noted that the lakes could be drained and serve as a mechanism for flood control. One of the lakes may be maintained as a fishing site.

The rate increases proposed for Hopkinsville customers include: $2.14 per month on the average water bill, from $11.82 to $13.96; and $1.39 per month on the average sewer bill, from $17.43 to $18.82. Combined, the water and sewer bill for the average customer will increase $3.53 a month, or $42.36 a year.

Hale provided rate comparisons for surrounding communities and the state. The state average for a residential water bill is $24.82 a month, compared to $13.96, the proposed rate in Hopkinsville after the increase. The state average for a sewer bill is $24.52, compared to $18.82, the proposed rate in Hopkinsville after the rate increase.

JENNIFER P. BROWN can be reached by telephone at 887-3236 or by e-mail at jpbrown@kentuckynewera.com

April 8, 2005

EXHIBIT "B" CASE NO. 2005-00174

98-0343Z

COMMONWEALTH OF KENTUCKY
PUBLIC SERVICE COMMISSION
730 SCHENKEL LANE
POST OFFICE BOX 615
FRANKFORT, KENTUCKY 40602
www.psc.state.ky.us
(502) 564-3940

December 18, 1998

TO ALL MUNICIPAL UTILITIES PROVIDING WHOLESALE UTILITY SERVICE TO JURISDICTIONAL PUBLIC UTILITIES

In Simpson County Water District v. City of Franklin, Kentucky, Ky., 872 S.W.2d 460 (1994), the Kentucky Supreme Court held that the Public Service Commission has jurisdiction over contracts between municipal utilities and public utilities. For the last four years, the Commission has attempted to execute the Supreme Court's directive. The purpose of this letter is to provide guidance on the procedures that a municipal utility must follow when changing its rates for utility service to public utilities and to alert municipal utilities to a recent change in notice requirements.

A municipal utility has two methods for changing its rates for utility service to a public utility:

- Filing A New Rate Schedule. This method, which is governed by KRS 278.180 and Public Service Commission Regulation 807 KAR 5:001, is the easier and faster method for adjusting a rate. A municipal utility files a rate schedule which contains the new rate. (If the new rate is part of a new contract with a public utility, then the contract is filed.) The rate schedule must be filed with the Public Service Commission not less than 30 days before the proposed rate is scheduled to take effect. A copy of the form on which the proposed rate schedule should be filed is enclosed. **Any filing which does not use this form will be rejected.** When filing its rate schedule, a municipal utility must notify its public utility customers of the proposed rate change. This notice should be in writing and should generally conform with the requirements of Commission Regulation 807 KAR 5:001, Section 10(3). Proof of notice to the public utility should be submitted when the rate schedule is filed.

- Formal Application For Public Service Commission Approval. Public Service Commission Regulation 807 KAR 5:001 governs this filing. Under this method, the municipal utility makes a formal application to the Public Service Commission for approval of its proposed rates. The application must be filed with the Public Service Commission not less than 30 days before the proposed rates are to become effective. The application must include information about the municipal utility's past operations. Commission Regulation 807 KAR 5:001, Section 10, a copy of which is enclosed, identifies all required information. When it files its application for rate adjustment, a municipal utility shall notify its public utility customers of the proposed rate changes in the same manner as municipal utilities that file new rate schedules.

Please note that the Public Service Commission no longer requires a municipal utility **to provide notice of a change in its wholesale rates to the customers of the affected public utility.** Notice to the affected public utility is sufficient for filing purposes.

Please also note that a municipal utility must comply with one of these procedures even when its wholesale customers have agreed to the proposed rate adjustment. Failure to follow these procedures will prevent the proposed rates from becoming effective.

The Public Service Commission has 30 days from the filing of a rate schedule or an application for rate adjustment to suspend the rate for further review. Where a municipal utility files a new rate schedule and the Public Service Commission suspends the proposed rate for further review, the municipal utility must provide the information which Commission Regulation 807 KAR 5:001, Section 10, requires.

If the proposed rate is suspended, it may not be placed into effect for five months. If the Public Service Commission has not approved the proposed rate within this five-month period, then the municipal utility may place the proposed rate into effect subject to refund. The Public Service Commission must rule on the proposed rate within ten months of the filing of the rate schedule or application.

For your reference, copies of KRS 278.180 and 278.190, Administrative Regulation 807 KAR 5:001 and a sample notice are enclosed.

Recognizing that most municipal utilities are unfamiliar with its rules and procedures, the Public Service Commission has instructed its Staff to assist municipal utilities whenever possible. Municipal utilities are encouraged to contact the Commission's Staff for information about filing procedures and related matters. Your questions should be directed to Gerald Wuetcher at (502) 564-3940, Extension 259, or Carryn Lee at (502) 564-3940, Extension 248.

Sincerely,

Helen C. Helton
Helen C. Helton
Executive Director

Enclosures
1. Rate Schedule Form
2. KRS 278.180
3. KRS 278.190
4. 807 KAR 5:001
5. Sample Notice

cc: All Public Water Utilities

C:\My Files\PSC General\Municipal Utilities\General\121898_Letter_Procedures for Rate Adjustment.DOC

EXHIBIT "C" CASE NO. 2005-00174

Hopkinsville Water Environment Authority
101 North Main Street • P.O. Box 628 • Hopkinsville, Kentucky 42241-0628

HWEA

Phone (502) 887-4240
Fax (502) 887-4244

LEN F. HALE
GENERAL MANAGER

October 25, 1995

Mr. C.D. Burkhead
Chairman
Christian County Water District
P. O. Box 7
Hopkinsville, KY. 42241

Subject: Response to CCWD Rate and Territory Proposal

Dear C.D.:

While I do not have authority to bind the other Commissioners of HWEA, Len Hale and I will recommend approval of the enclosed agreement which is in response to the proposal you made regarding a rate freeze and service territory modification. You will note that there are two alternatives we are proposing with regard to rate. You may choose either a rate freeze for five more years or a permanent rate index of one hundred and twenty percent of the average rate paid by city rate payers. (This index is based on the current ratio of CCWD rate to the average city rate.)

We appreciate your consideration and look forward to your response.

Sincerely,

Wendell Lynch
Chairman

Hopkinsville Water Environment Authority
401 East Ninth Street • P O Box 628 • Hopkinsville, Kentucky 42241-0628

HWEA

Phone (502) 887-4240
Fax (502) 887-4244

LEN F. HALE
GENERAL MANAGER

May 30, 2001

Mr. James Owen, Manager
Christian County Water District
P.O. Box 7
Hopkinsville, KY. 42241-0007

Subject: Change in Wholesale Water Rates

Dear James:

In case you had forgotten, we wanted to make you aware that the water rates charged by HWEA for water consumed by the Christian County Water District (CCWD) will change on June 30, 2001. In the Contract Modification Agreement signed on June 19, 1996, the method for determining the wholesale water rates was changed to 1.3 times the HWEA user rates. This was the rate change requested by the CCWD at that time. The HWEA in the agreement kept the wholesale rate constant for over five years. However as the contract agreement stipulated, the wholesale rate was to change to a multiplier rate of 1.3 times the HWEA rate on June 30, 2001. The wholesale rate prior to 1996 was established in the original water purchase agreement of June 28, 1973 in the form of a formula for determining the cost of water. The formula was used to evaluate the rate every three years.

In an effort to help you gauge the impact of this rate change, we have used the last monthly bill for the water consumed at your Princeton Road water meter for comparison. Last month the CCWD consumed 274,540 cubic feet. The bill for this meter last month was $2965.03. Using the new rate of 1.3 times the HWEA rate results in a bill of $4039.42 for the same consumption. This is approximately 36.2% higher than the previous monthly bill. The current HWEA water rates approved by the Hopkinsville City Council in November 2000 are: $1.77/100 CF for the first 3000 CF, $1.55/100 CF for the next 3000 CF, and $1.12/100 CF for all over 6000 CF.

This new rate will be charged on all bills issued by HWEA to the CCWD after June 30, 2001. The water rates will not change after June 30, 2001 until the City Council changes HWEA rates for the Hopkinsville Utility Division.

If you have any questions or wish to discuss this matter, please contact us. If you need copies of the documents referenced herein, please call us.

Sincerely,

L.F. Hale
General Manager

enclosures

cc: HWEA Board of Commissioners
Hon. Steve Tribble, Judge Executive

Hopkinsville Water Environment Authority
401 East Ninth Street • P.O. Box 628 • Hopkinsville Kentucky 42241-0628

Phone (502) 887-4240
Fax (502) 887-4244

HWEA

LEN F. HALE
GENERAL MANAGER

June 25, 2001

Mr. James Owen, Manager
Christian County Water District
P.O. Box 7
Hopkinsville, KY. 42241

Subject: Wholesale Water Rates

Dear James:

Thank you for meeting with us on June 14, 2001 to discuss the new wholesale water rates which will go into effect on July 1, 2001. In summary, we will revert back to the formula contained in the original 1974 contract. Using the June 2000 audit, as required by the formula, the new wholesale rate will be $1.6654 per 1000 gallons.

As we discussed in the meeting, beginning in July 1, 2001 the wholesale rate will be calculated every three years using the contract formula. If the rate does not change by 5%, the wholesale rate will not change. The line items in the formula, for example administrative costs, are assigned proportionately to the amount of water used by the Christian County Water District. The formula uses 40% of HWEA water administrative costs for the calculation. From the June 2000 audit the total cost of water administration was $894,508, so 40% would be $357,803.20. Since the CCWD only uses about 10% of HWEA water capacity, CCWD would only be responsible for 10% of $357,803.20. The formula is used to determine the cost of generating and transporting water for the CCWD. Such operating costs as 60% of administrative, setting meters, repairing service, repairing hydrants, transportation costs (vehicles), etc. are not included in the formula. This formula was approved by the PSC in 1994.

As you know the HWEA is also interested in negotiating an agreement with the CCWD to transport HWEA water to Crofton. On May 14, we presented a proposal to you to cover this arrangement. HWEA would pay CCWD $0.35/1000 gallons to transport our water to Crofton. In addition HWEA would amend the water purchase contract with the CCWD to include five more master meter connections. The rate would be tied to energy costs and as justifiable energy costs increase, the transportation rate could also be increased accordingly. However we have not received any response from the CCWD to this proposal, except for the verbal proposal from Mr. Lile on June 14, 2001. We have investigated Mr. Lile's proposal and determined that we cannot accept it.

In an effort to resolve both issues and continue our working relationship with the CCWD, we're prepared to make the following offer. HWEA is prepared to delay the implementation of the new wholesale water rate for CCWD for six months. In return the CCWD will accept our proposal for transporting water to Crofton. The new wholesale rate determined by the 1974 proposal would be delayed until January 1, 2002. That would give CCWD enough time to adjust rates to your customers if necessary. We would appreciate a response from the CCWD by July 10th.

If you have any questions or need more information, please contact us. Thank you.

Sincerely,

L.F. Hale
General Manager

cc: HWEA Board of Commissioners
Andrew Self, Attorney

JAN 2 9 2002

DEATHERAGE, MYERS, SELF & LACKEY
ATTORNEYS AT LAW
701 SOUTH MAIN STREET
POST OFFICE BOX 1065
HOPKINSVILLE, KENTUCKY 42241-1065

ANDREW C. SELF

TELEPHONE 270-886-6800
TELECOPIER 270-885-7127
EMAIL aself@dmsllaw.com

January 29, 2002

Mr. Thomas M. Dorman, Exec. Director
Public Service Commission
211 Sower Blvd.
P. O. Box 615
Frankfort, KY 40602-0615

RE: Our Client: Hopkinsville Water Environment Authority

Dear Mr. Dorman:

Please be advised that our firm serves as legal counsel for the Hopkinsville Water Environment Authority ("HWEA").

This is in response to your letter dated January 17, 2002 to Mr. Len F. Hale, General Manager of HWEA, in which you indicated that the Public Service Commission ("PSC") had been advised by the Christian County Water District ("CCWD") that HWEA had "increased its rate for wholesale water service." Upon receipt of your letter, I contacted the Hon. Gerald Wuetcher, Assistant General Counsel for the PSC, and requested an opportunity for HWEA to explain its position regarding this matter. The following is HWEA's response:

I. BACKGROUND

In 1973, the CCWD and HWEA (using its legal name of the Hopkinsville Sewerage And Water Works Commission) entered into an agreement which among other things provided for HWEA to provide wholesale water service to the CCWD. The contract entered into by and between the parties dated June 28, 1973, specifically provided a formula for the purpose of determining the rate to be paid by the CCWD for the purchase of wholesale water from HWEA.

Although there have been several transfers of territory and several other minor revisions of the original contract, including a mutual extension of the term of the contract, the rate formula has remained unchanged. Following the Kentucky Supreme Court's ruling in ***Simpson Co. Water Dist. v. City of Franklin***, Ky., 872 S.W.2d 460 (1994), HWEA, out of an abundance of caution, submitted the 1973 agreement and the subsequent amendments and addendums to that agreement to the PSC for its consideration. By copy of a letter dated September 19, 1994 from Jordan Neel, Public Utility Rate Analyst, Rates And Research Division, PSC, HWEA was notified that the subject contract had "been received and reviewed by appropriate members of the Commission's staff without objection." A copy of Mr. Neel's letter and a stamped copy of the subject contract, including the 1973 agreement which provides the formula for determining the rate to be paid by the CCWD, are attached hereto as Exhibit A.

In June of 1996, at the request of the CCWD, HWEA entered into a Contract Modification Agreement which provided for a new method for calculating the wholesale water rate to be charged to the CCWD by the HWEA. A copy of that Contract Modification Agreement dated June 19, 1996, is attached hereto as Exhibit B. Again, the Contract Modification Agreement dated June 19, 1996 was entered into at the request of the CCWD.

There are several aspects of the 1996 agreement that are worth mentioning. First, because of a territory transfer, HWEA agreed to give the CCWD a ten-cent per thousand gallons ($.10/1000 gal.) reduction in the rate provided for by the 1973 formula. Secondly, the parties agreed to a five (5)-year moratorium on any rate adjustments from July 1, 1996 until June 30, 2001. Finally, at the insistence of the CCWD, at the end of the moratorium period, the CCWD would be charged a rate based upon an index of 1.3 times the applicable rates charged to other HWEA customers which are prescribed by the Hopkinsville Code of Ordinances.

In the spring of 2001, in anticipation of the expiration of the moratorium period provided for by the 1996 agreement, representatives of HWEA and the CCWD met to determine how best to proceed. At that time, it became apparent to all involved that calculating the rate based on the 1996 agreement would impose a substantially higher rate to be paid by the CCWD for wholesale water. In an effort to accommodate our friends and neighbors at the CCWD, HWEA agreed to revert to the 1973 formula, which had been previously approved by the PSC, for the purpose of determining the rate.

At that time, HWEA also learned that the 1996 agreement had never been approved by, nor even submitted to, the PSC by either party. Therefore, in reliance upon the previous approval of the formula set forth in the 1973 contract by the PSC, HWEA felt it would certainly be acceptable to everyone involved to revert to that rate formula.

In subsequent meetings with CCWD officials, it became apparent that the CCWD was contesting the right of HWEA to charge any rate higher than the $1.44/1000 gal. rate which had been in effect continuously since the 1996 agreement. Furthermore, the CCWD insisted that the HWEA could not charge a higher rate without first going through a long, complicated, and expensive process and obtaining rate adjustment approval by the PSC. We respectfully disagree.

II. HWEA'S POSITION

HWEA is certainly cognizant of and familiar with the ***Simpson Co.*** decision and Administrative Case No. 351. As we understand it, because HWEA is relying upon and seeking to enforce the formula provided for in the 1973 contract, which was subsequently approved by the PSC, there is no requested change or revision that would implicate either the mandates of the ***Simpson Co.*** decision nor the directives of the PSC in Administrative Case No. 351.

There is certainly no attempt to gouge or otherwise impose an unfair rate for wholesale water service by the HWEA. Instead, there is the desire to simply apply the formula set forth in a contract which has been in effect between the parties for over 25 years. The formula, approved by the PSC when the PSC approved the entire contract, remains unchanged. Clearly, both parties contemplated that consistent enforcement and application of the contract formula could potentially result in a higher (or lower) rate based on a fluctuation of the components of the formula. However, because the formula remains unchanged, it is our opinion that there is no "revised contract" that would necessitate any action by the PSC.

Furthermore, there are some interesting nuances created by the 1996 agreement which should also be addressed. Although as an attorney it seems to me that two (2) parties who voluntarily and consensually enter into a conscionable agreement should be obligated to comply with that agreement, we realize that there are other considerations in this instance. Recognizing that relevant statutes, administrative regulations and case law require "revised contracts" such as the 1996 agreement to be submitted to the PSC for its approval, HWEA is seeking neither approval of the 1996 agreement nor review of that agreement by the PSC. However, pursuant to KRS 278.160, it appears that HWEA may have certain legal rights and obligations against the CCWD.

Specifically, since the 1996 agreement was never approved by the PSC, the CCWD, by law, should have continually been charged the rate provided for in the formula set forth in the 1973 contract. Because the rate provided for by the formula was greater than the rate provided for in the 1996 agreement, retroactive application of the approved formula rate for the period of July 1, 1996 through June 30, 2001 would indicate that the CCWD owes the HWEA approximately $224,000.00.

This is based on the provisions of KRS 278.160(2) which provides that "no utility shall charge, demand, collect, or receive. . . a greater or less compensation for any service rendered . . . than that prescribed in (schedules filed with the PSC). " Since the 1996 agreement was never filed with the PSC, it seems that the 1973 formula, by law, should have been imposed even during the five (5)-year moratorium agreed upon by and between the parties.

Finally, attached hereto as Exhibit D is the calculation of the rate to be charged based on the 1973 formula, taking into consideration the relevant numbers provided by HWEA's audit for the 2000-01 fiscal year. Based on that information, the appropriate rate to be charged the CCWD is 1.733/1000 gal. Please note that although the formula provides for the CCWD to pay a percentage of the cost factors based on its consumption, it is required to pay a percentage of only 40% of administrative and general expenses incurred by HWEA. Again, the rate formula, agreed upon by both parties and which we believe to be fair, remains unchanged.

III. <u>CONCLUSION</u>

Based on the foregoing, HWEA respectfully submits that the rate of \$1.733/1000 gal. to be charged to the CCWD does not represent a "rate increase," but rather a current application of a previously approved rate formula. Consequently, HWEA respectfully requests that it not be required to formally file any "proposed revisions" and furthermore that it not be required to obtain any additional approval from the PSC with regard to this matter.

Thank you for your consideration of these concerns. If you have any questions or if you need any additional information, please let us know. We look forward to hearing from you at your earliest convenience.

Sincerely,

Andrew C. Self

ACS/rmb

c: Len Hale
Hon. John P. Kirkham
Hon. J. Michael Foster
Mr. Gerald Wuetcher

REPORT TO FILES

NEGOTIATIONS WITH CCWD ON TERRITORY AND RATES

May 13, 1996

On May 9, 1996, Wendell Lynch and I met with Billy Poole and William Lyle of the CCWD at their offices to discuss the pending agreement on the transfer of territory and rate adjustments. Based on previous discussions between Wendell and then chairman, CD Burkhead, Wendell had us prepare a proposal offering a 10 cents per 1000 gallons rate reduction and five year freeze on rate increases. Under the terms of the CCWD contract, HWEA can raise rates every three years in June. HKB had calculated that the rates this year could be raised from $1.54 to $1.65 per 1000 gal. A copy of the proposal is attached.

In the meeting Wendell reminded them that the rates are due to increase. He would like to complete negotiations of the matters brought up by Burkhead in Oct., 1995, before the HWEA Board votes on a rate increase. Wendell gave them time to read the proposal and then presented the proposal, item by item to them. The points of contention were:

- they requested that we identify all potential industrial sites that we wanted transferred. We told them there was no way to identify all industrial sites that would be needed in the future. We finally agreed to have the Hopkinsville Industrial Foundation prepare a map of potential sites.

- they wanted to make sure that the territory transferred for industrial and commercial use would not include residential customers (the basis for their revenue).

- regarding the transfer of any territory annexed by the City into their limits, they disagreed with this, even if the HWEA compensates them for annexed infrastructure and customers.

- they wanted to know what the basis for setting rates would be after the five year moratorium. We told them there would no way we could project the rates after the five year period. Finally we agreed to investigate alternate rate formulas and present options at the next meeting. They liked the idea of a indexed rate rather than a formula.

All agreed to look at modifying the agreement to resolve differences and meet again on Monday, May 13, 1996. It was decided that if Lyle and Poole are satisfied with an agreement, they will recommend it to their board. There was some of the old rhetoric, but they seemed to agree that a something needed to be done to respond to their rate questions and to our need for territorial adjustments for non-residential and US 41A.

On Monday, May 13, 1996 we met again to review the modified proposal of May 9, 1996. The changes included: a 1.3 index of city rates for the future after the five year moratorium, withdrawal of the concession for annexed territory, and for territory transferred for non-residential use - all existing CCWD residential customers will not be affected. Both Lyle and Poole seemed satisfied with the changes. Lyle agreed to meet privately with his board members to go over the proposal. If OK, the proposal will be presented to the attorneys for preparation into a legal document. Then it will be presented to both boards for execution. Wendell agreed, that he would withhold the presentation of a motion to raise rates until June, hoping that an agreement can be worked out by then. HWEA will await word from Lyle that the agreement has met with the approval of his board. A copy of the revised proposal is attached.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

PROPOSED ADJUSTMENT OF THE WHOLESALE WATER SERVICE RATES OF HOPKINSVILLE WATER ENVIRONMENT AUTHORITY	CASE NO. 2005-00174

PREFILED

DIRECT TESTIMONY

OF

JENNINGS ROWE MCKINLEY II

BLACK & VEATCH CORPORATION

FOR

HOPKINSVILLE WATER ENVIRONMENT AUTHORITY

DIRECT TESTIMONY OF
JENNINGS. ROWE MCKINLEY II
BLACK & VEATCH CORPORATION

Q. Please state your name and business address.

A. My name is Jennings Rowe McKinley II, 11401 Lamar, Overland Park, Kansas 66211.

Q. What is your occupation?

A. I am a Director in the firm of Black & Veatch Corporation in the Enterprise Management Solutions Division.

Q. How long have you been associated with the firm of Black & Veatch?

A. I have been with Black & Veatch continuously since 1970.

Q. What is your educational background?

A. I am a graduate of the University of Kansas with a Bachelor of Science Degree in Civil Engineering and a Bachelor of Science Degree in Business and Industrial Administration. I was elected to membership in the engineering honorary societies of Tau Beta Pi and Chi Epsilon and the business honorary society of Beta Gamma Sigma. I am currently a member of the American Society of Civil Engineers, the Water Environment Federation, and the American Water Works Association, and have just completed a three-year term as the Chairman of the latter organization's Rates and Charges Committee.

Q. Are you registered as a Professional Engineer?

A. Yes, I am a registered Professional Engineer in the states of Illinois, Kansas, Massachusetts, Michigan, Ohio, and Pennsylvania.

Q. What is your professional experience?

A. I have been associated with the Enterprise Management Solutions Division of the firm of Black & Veatch since graduation from the University of Kansas in 1970. During this period I have been involved in various studies related to water and wastewater utility financial feasibility and rates and the issuance of municipal revenue bonds, serving in increasing levels of responsibility from staff engineer, to project engineer, to project manager, and to director. Among the clients for which I have been involved in studies regarding water and wastewater rates and related matters, in addition to the Hopkinsville Water Environment Authority (HWEA), are the cities of Philadelphia, Pennsylvania; Lawrence and Water District No. 1 of Johnson County, Kansas; Norfolk, Virginia; New Orleans, Louisiana; Orange Water and Sewer, North Carolina; Denver, Colorado; Lee's Summit, Missouri; Washington, D.C.; Austin, Dallas, Ft. Worth, and San Antonio, Texas; the Massachusetts Water Resources Authority located in Boston, Massachusetts; Fayetteville and Little Rock, Arkansas; and Charleston Commissioners of Public Works and Greenville, South Carolina.

Q. Mr. McKinley, did any of the studies referenced above involve providing testimony before a public service commission or appearing before a decision making body such as a city council or utility board?

A. Yes, the vast majority of the utility clients with which I have worked are municipally-owned utilities. Approval of rates for these utilities typically requires a presentation of our cost of service study and proposed rates to the appropriate rate making body such as city councils and utility boards or commissions.

Recently with regards a rate study conducted for the Philadelphia Water Department, I participated in a utility rate proceeding before a Hearing Officer appointed by the City. This proceeding, which essentially follows the rules and procedures of a public service commission hearing, involved extensive discovery, preparation of direct testimony, cross examination by the consumer advocate and commercial/industrial customer interveners, as well as the Hearing Officer, rebuttal testimony, and filings of findings of fact. I participated in similar hearing procedures in each of the past three rate increases for the Water Department.

Q. Please describe the Enterprise Management Solutions Division of Black & Veatch.

A. Black & Veatch has specialized in providing financial and management consulting services to public and investor-owned utilities, government agencies and private industry, both domestic and international, since the firm was founded. These services are provided through the Enterprise Management Solutions Division, which employs a full-time staff of about 120, including personnel with undergraduate and advanced degrees in finance, accounting, engineering, economics, business administration, and computer science. Division services include utility cost of service and rate design studies, property inventory and valuation for rate base or other purposes, depreciation expense studies, organization and management studies, financial advisory services, and many other related areas of study. Clients served include water, wastewater, stormwater, electric, natural gas, telephone, and solid waste management utilities; private industry; and governmental agencies. The Division has broad experience in the area of utility rates, including water rates with which we are concerned in this hearing, and in all aspects of utility financial management services. These engagements often encompass studies of total utility revenue requirements, cost of service allocations, water rate design and, in many instances, include appearances before regulatory commissions or other governing bodies.

Q. Will you please state briefly the nature of your firm's engagement in this matter for HWEA?

A. HWEA asked our firm to conduct a study of the water utility's cost of water service and rate structure. We were retained to study the utility's costs of providing water service and recommend appropriate cost-based rates. The results of that study are included in our *Report on Revenue Requirements, Costs of Service and Rates for Water Service* dated June 2005 ("the Report" or "our Report"). It is our understanding that our Report has been submitted to the Kentucky Public Service Commission (the Commission) in conjunction with this proceeding.

Q. Does your firm specialize in water utility cost of service studies?

A. Yes, as stated above, the Enterprise Management Services Division of our firm specializes in, among other things, water utility cost of service studies, and I have specifically been involved in such studies during my 35 year career with Black & Veatch.

Q. Please describe the purpose of a cost of service study.

A. The purpose of a cost of service study is the development of an equitable water rate structure that recovers the cost of providing water service from various customer classes served by the utility in proportion to the service received.

Q. In performing your study in this case, have you become familiar with HWEA's water utility system and its costs?

A. Yes.

Q. Please describe how you went about your cost of service study in this case.

A. We approached the rate study as we would any traditional cost of service study, starting with the development of the revenue requirements for HWEA, selection of a test year, allocation of cost of service for that test year to the various customer groups served by HWEA, and then the design of rate schedules to recover the allocated cost of service for each customer group.

Q. Would you describe the revenue requirement projection phase of your study?

A. Yes. We reviewed five years of historical data, including number of customers, metered consumption, revenues under existing rates by customer group, miscellaneous operating revenue and non-operating income, operation and maintenance expenses, and other historical expense and operating data. In addition we reviewed the then current year operating budget for the fiscal year ending June 30, 2005 (FY 2005). This information was used to make a projection of revenues under existing rates and operation and maintenance expenses for the five year period of FY 2005 through FY 2009. Tables 1 through 6 of our Report summarize this historical and projected information.

We also reviewed the proposed capital improvement program for HWEA for the period of FY 2005 – FY 2009, and in conjunction with HWEA staff and their financial advisors, we developed a plan of financing the capital program, including the issuance of parity revenue bonds, state revolving loans, and system revenues as sources of funding. This information is presented in Tables 7 and 8 of the Report. The annual debt service on the projected new bonds and new loans, and the existing bonds and loans, is summarized in Table 9 of the Report. Table 10 of the Report provides a summary of projected revenues under existing rates and revenue projections for the period of FY 2005 – FY 2009. As indicated on Lines 3 through 7 of Table 10, an overall revenue increase of 32 percent was indicated to be required in mid-May of 2005. Additional overall revenue increases of 13 percent in FY 2007 and FY 2008 were also indicated.

Q. Please explain the reasons for the 32 percent increase indicated to be required in FY 2005.

A. A revenue bond issue in the magnitude of $25.75 million was projected to be issued towards the end of FY 2005 to finance the construction of a raw water intake structure and the installation of a 24 mile, 36-inch raw water main from Lake Barkley to the water treatment plant in Hopkinsville. The actual final amount of the bond issue was $25.635 million in revenue bonds for the project, plus an additional $1.545 million in revenue refunding bonds.

In order for these bonds to be issued on parity with the other outstanding senior lien revenue bonds of HWEA, a parity debt service coverage test has to be met. In addition, HWEA has an annual debt service coverage test that must also be met. Both of these coverage tests are combined tests, which include the net operating income and debt service for the water utility and the sewer utility of HWEA. However, HWEA maintains a policy that both the water utility and the sewer utility should be self-supporting in their financial operations and debt service coverage compliance requirements to the extent possible.

The parity bond test requires that HWEA must have debt service coverage of at least 130 percent on the maximum annual debt service for existing bonds and the proposed bonds in 12 consecutive months of the 18 months immediately preceding the issuance of the proposed bonds. HWEA actually has a "target" coverage level of 135 percent for this parity bond test. The parity bond covenant allows that net operating revenues in this prior 12 month period may include a proforma adjustment to recognize any rate increases which are being imposed at the time of the issuance of the proposed bonds.

Accordingly, the overall 32 percent increase in revenues of the water utility was necessary to meet both the parity bond covenant, discussed above, as well as the companion covenant which is to maintain annual debt service coverage on maximum debt service of at least 115 percent on a combined water and sewer utility basis. HWEA has a "targeted" level of 125 percent for this annual debt service coverage requirement. The demonstration of compliance with these debt service coverage requirements with the 32 percent revenue increase in water revenues are shown in Table 11 of the Report.

Q. Given the analyses presented in Tables 10 and 11 of the Report, what is the test year cost of service utilized in the cost of service and rate design portions of the study?

A. FY 2006 was chosen as the test year for purpose of cost of service allocations and rate design. This year would recognize the full impact of the 32 percent increase adopted in May of 2005 and would include virtually the full impact of the debt service on the major bond issue for the water supply project. Table 12 of the Report develops the elements comprising the test year cost of service, with each of the various line items in the table being derived directly from Table 10 for FY 2006. The total test year FY 2006 cost of service to be recovered from rates for water service, after recognizing the credits for miscellaneous operating revenues and non-operating income, amounts to $4,896,000. This is separated into operation and maintenance expenses of $2,584,800 and capital related costs of $2,311,200.

Q. Please explain the general procedures that you used to develop cost of service water rates.

A. We followed the cost of service allocation procedures recommended by the American Water Works Association (AWWA) in its Manual M1, *Principles of Water Rates, Fees, and Charges.* We first allocated the utility's costs of service to the applicable functional cost components and then distributed the functionalized costs for each component to the various customers groups. We thereafter developed rates designed to recover these costs from each of the various customer groups.

Q. Please explain the basis for allocating the test year costs of service to the various functional cost components.

A. Generally, costs are allocated to that function for which the cost is incurred, or, in the case of plant investment, to the component for which the investment was made.

Q. What are the functional cost components you have used in your study?

A. We used the Base - Extra Capacity cost allocation methodology in this water rate study. In this method costs are allocated to the functional cost components of base costs, maximum day extra capacity costs, maximum hour extra capacity costs, meters and service costs, meter reading, billing and collection costs, and direct fire protection costs.

Q. Will you please explain the basis of your allocation to these functional cost components?

A. Yes, the HWEA water system is comprised of various facilities, each designed and operated to fulfill a given function. In order to provide adequate service to its customers at all times, the system must be capable of providing not only the average annual amount of water used, but also of supplying water at maximum rates of demand. However because all customers do not exert maximum demands at the same time, capacities of the various system components are established to meet the maximum coincidental demand of all classes of customers.

The capacities of some facilities, such as the raw water supply facilities, water treatment, and pumping, are generally designed to meet maximum day demands. Other facilities, such as filtered water storage and transmission and distribution mains, are designed to meet maximum hourly rates of water use. These requirements result in different ratios of maximum to average annual demands to be met by the various parts of the system. The demand ratios, in turn, are the basis for allocating costs of respective facilities to the base (or annual average use) and extra capacity cost components.

Q. Did the allocations recognize any differences between retail and wholesale service?

A. Yes. HWEA provides service to the Christian County Water District (CCWD) on a wholesale, contractual basis. The contract agreement was entered into by the parties in 1973 and has subsequently been approved by the Commission. Since wholesale service to CCWD is provided through connections on 6–inch and larger mains, the costs associated with mains less than 6-inches in size were allocated to only retail customers. Furthermore, the original 1973 agreement with CCWD, as approved by the Commission, precludes the inclusion of certain costs in the development of the rates applicable to CCWD. Specifically excluded are costs associated with meters, services, and hydrants. Accordingly, such costs have not been included in the allocations to CCWD.

Q. Is there a specific contractual capacity available to CCWD which was recognized in the cost of service allocations to CCWD?

A. Yes. A Memorandum Agreement, dated January 8, 2004, related to the 1973 Water Purchase Contract between CCWD and HWEA, specifies that HWEA will provide CCWD with a maximum day capacity of two million gallons per day (mgd). This Memorandum Agreement was accepted by the Commission in its Order dated February 6, 2004. Accordingly, the allocation of plant investment and associated annual capital related costs recognize this 2.0 mgd contractual commitment to CCWD as related to the overall treatment plant capacity of the HWEA water system of 10.0 mgd. This contractual commitment of 2.0 mgd, which has been approved by the Commission, is a primary consideration in determining the cost of service and related rates for service to CCWD.

Q. How did you proceed in the development of allocations?

A. The total cost of service was allocated in two parts – the allocation of capital related costs of service to be met from rate revenue and the allocation of operation and maintenance expenses to be met from rate revenue. From Table 12, the annual capital related costs of service include debt service payments and capital improvements financed directly from annual revenues, less credits for applicable miscellaneous operating revenues, interest income, and available fund balances. Capital related costs to be met from rates amounts to $2,311,200.

As shown in Table 13 of the Report, the test year capital related costs (shown on Line 11) were allocated to cost components based upon an allocation of estimated test year plant investment (Line 10). The total test year plant investment of $22,732,800 reflects the original cost of plant investment as of June 30, 2004, plus construction work in progress and proposed capital improvements which are expected to be in service by the end of the test year, less accumulated depreciation expense and contributed plant investment.

Q. Please explain your allocation of capital costs between retail and wholesale customers in Table 13.

A. Plant investment and capital costs associated with small distribution mains, meters and services, fire protection, and the annual capital costs directly allocable to the Crofton retail division of HWEA were not allocable to wholesale customers (CCWD). All other investment and the associated annual capital costs were allocated 20 percent to wholesale, (2 mgd contract capacity/10 mgd total treatment plant capacity), with the balance assignable to retail customers.

The allocation of net plant investment to functional cost components uses allocation factors developed from an analysis of historical HWEA system demands and experience with similar systems. For facilities designed to meet maximum day demands, the allocation factor between base and maximum day extra capacity is 76.9 percent base and 23.1 percent to maximum day extra capacity. For facilities designed to meet maximum hour demands, the allocation factors are 50.0 percent base, 15.0 percent maximum day extra capacity, and 35.0 percent maximum hour extra capacity.

Q. Please explain your allocation of operation and maintenance expense.

A. The allocation of test year operation and maintenance expense to be recovered from water rates of $2,584,800 to functional cost components is shown in Table 14 of our Report. The allocation of operation and maintenance expense to functional cost components uses the allocation factors for base, maximum day extra capacity, and maximum hour extra capacity as discussed above for the plant investment allocations. In addition, the allocation between retail and wholesale customers also recognizes the projected units of service developed in Table 15 of the Report.

For example, Lines 1, 4, and 6 of Table 14 are allocated to the appropriate cost functions using the allocation factors, then separated between retail and wholesale customers based on the applicable test year units of service from Table 15. Line 2 of Table 14, Chemicals, is allocated 100 percent to base cost, and is separated between wholesale and retail based on the annual base units of service in

Table 15. Power costs shown on Line 3 of Table 14 are allocated 80 percent to base cost and 20 percent to maximum day extra capacity cost, then proportioned between wholesale and retail customers based upon the units of service for these two functional cost components from Table 15.

Q. Since the units of service from Table 15 are an important part of the overall cost allocation process, please briefly explain the determination of the test year units of service, particularly focusing on the base and extra capacity units of service.

A. The annual units of service, or "base" units, were based upon projected water sales as previously developed in Table 2 of the Report. The estimated maximum day and maximum hour capacity factors, or the noncoincidental demands, for the retail customers in the Hopkinsville, Crofton, and Pembroke districts and for wholesale service (CCWD) reflect discussions with HWEA staff as to the types of customers in each of these four customer groupings and recognition of the overall system coincidental demand characteristics.

It is our understanding from our discussions with HWEA that the two smaller retail districts of Crofton and Pembroke, as well as CCWD, are comprised almost exclusively of single family residential customers plus commercial customers and development which support the residential population. The Hopkinsville district, on the other hand, includes a significant mix of residential accounts, small and large commercial customers, and industrial development. Accordingly, the maximum day and maximum hour capacity factors, or noncoincidental demands, used for Hopkinsville in the study were lower than for the other three entities.

As a check of the reasonableness of the assumed demand factors, the ratio of noncoincidental demands to system coincidental demand (the diversity factor) for the system amounts to 1.26 for maximum day and 1.20 for maximum hour. These ratios fall within the typical range of diversity ratios for utilities recognized in the industry of between 1.10 to 1.40. Demand factors for fire protection were based upon assumed fire demands typical of a water system the size of HWEA.

Q. After performing the allocations just described, how did you apportion the allocated costs to customer classes?

A. In terms of the allocation of costs of service between wholesale (CCWD) and retail service customers, the manner in which Tables 13, 14, and 15 of the Report were developed essentially already provides such an allocation. Tables 16 and 17 follow the traditional approach of dividing (the allocated costs of service by cost function) by (the total system units of service by cost function) to obtain unit costs of service. This step is shown in Table 16 of the Report. Subsequently, the unit costs of service are applied to the units of service by customer group to obtain the distribution of costs of service to the group. This process is shown in Table 17 of the Report. The results of Table 17 further show the breakdown of the costs of service allocable to the various retail customer groups to each group, consisting of the Hopkinsville, Crofton, and Pembroke districts and public and private fire protection.

Q. How does the allocated cost of service compare to the revenues that are in effect during the test year?

A. The comparison of test year revenues under existing rates to the allocated cost of service for each customer class is shown in Table 18 of the Report. As shown in

Table 18 there are wide ranging increases in the existing rate schedules required to match revenues with allocated costs of service. The cost of service study indicates that the retail customer groups, exclusive of public fire protection, should be increased by less than the overall 32 percent increase for the system. Wholesale service to CCWD is indicated to require an increase of 61.3 percent, or almost twice the average increase, while public fire projection is shown to require an increase of over 550 percent.

Q. Have you designed water rates that will recover the cost of service?

A. Yes, the proposed water rates to recover allocated costs of service are shown in Table 19 of our Report.

Q. From a rate design perspective, do these rates differ from the existing rates?

A. No, the basic structure of all of the proposed rates is the same as the existing rates.

Q. What did you take into consideration in designing the schedule of rates applicable to CCWD?

A. The contract between HWEA and CCWD has been amended several times. Most recently, the Commission in its December 17, 2003 Order in Case No. 2003-00087 approved a schedule of rates to be used for the water HWEA provides to CCWD. As noted in the September 9, 2003 Settlement Agreement between HWEA and CCWD, attached to the Commission's December 17, 2003 Order, the approved rate schedule was derived by using "a 1.3 multiplier times the applicable (Hopkinsville) city rates." More importantly, the Commission's February 6, 2004 Order in Case No. 2003-00087 approved a Memorandum Agreement between HWEA and CCWD which required HWEA to provide

CCWD with 2.0 mgd of water (not to exceed 49 million gallons per month). In consideration of the previously existing rate schedule for CCWD, which had been approved by the Commission, the proposed rates for the first three block rates applicable to CCWD continue to be based on a multiplier of 1.3 times the Hopkinsville rates for the same usage blocks. However, there is a fourth block in the previously existing rate schedule for CCWD that is not commensurate with the Hopkinsville retail block rate structure.

Q. How did you establish the unit cost for the fourth block rate applicable to CCWD?

A. In our study, the fourth block rate for CCWD was set at a level which would recover the total allocated costs of service to CCWD that was not recovered through the first three rate blocks of the proposed rates. In order to recover the total cost of service allocated to CCWD, including the consideration of its contract capacity of 2.0 mgd, the resulting unit rate for this fourth rate block of over 90 hundred cubic feet per month (>90 Ccf/month) must amount to $1.93/Ccf. Approximately 97 percent of the annual usage of CCWD is charged at this last rate block, which, appropriately, is very close to the overall average cost of service per Ccf allocable to CCWD. The total allocated cost of service of $854,300, divided by projected metered consumption of 432,000 Ccf, amounts to an average cost of $1.98/Ccf.

Q. Do the proposed rates for water service adequately recover the cost of service from other customers in addition to CCWD?

A. Yes, as shown in Table 20 of the Report, the proposed rates recover between 99.8 percent and 100.7 percent of the cost of service allocable to each of the individual customer groups.

Q. For the FY 2006 test year, is it your opinion that the proposed level of revenues shown in your Report is reasonable and necessary to meet the projected revenue requirements of the utility, and that the proposed rates recover the revenue requirements from customer groups with a reasonable level of equity?

A. Yes.

Q. Do you have any additional comments as to the rate established by HWEA for wholesale service to CCWD?

A. Yes, I do. Based on my experience, as outlined previously in my direct testimony, the rate established for wholesale service to CCWD is the result of the application of a generally accepted cost of service allocation methodology for the water utility industry. The rates proposed by HWEA for service to CCWD are fair, just, and reasonable considering all of the circumstances between the parties, which include the need for HWEA to expand its raw water source of supply facilities and the contractual commitments for water supply required by CCWD.

Q. Does this conclude your prepared direct testimony in this matter?

A. Yes, it does.

Jennings Rowe McKinley II

Jennings Rowe McKinley II
Director, Black & Veatch Corporation

State of Kansas\
County of Johnson \

Before me a Notary Public in and for the State of Kansas this date appeared Jennings Rowe McKinley II, Director, Black & Veatch Corporation, and acknowledged this Prepared Direct Testimony to be his voluntary act and deed and to be true and accurate to the best of his knowledge, information and belief formed after a reasonable inquiry.

Witnessed my hand and Notary Seal this 25th day of August, 2005

My Commission expires: 2-6-08

Shelly Hoffman
Notary Public

SHELLY HOFFMAN NOTARY PUBLIC STATE OF KANSAS

NOTARY PUBLIC STATE OF KANSAS	SHELLY HOFFMAN
	My Appt. Exp. 2-6-08