



TETRA TECH, INC.

LETTER OF TRANSMITTAL

RECEIVED

DATE: February 15, 2007

FEB 15 2007

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

PUBLIC SERVICE
COMMISSION

RE: Case No. 2006-00191
Henry County Water District No. 2
Responses to Interrogatories and Requests for Production of Documents
Ordered December 22, 2006

WE ARE SENDING YOU THE FOLLOWING: [X] Attached [] Under separate cover via
[] Shop Drawings [] Prints [] Plans [] Specifications [] Reports [] Samples
[] Copy of Letter [] Change Order [X] Other

Table with 2 columns: Copies, Description. Row 1: 1, Original of Responses. Row 2: 8, Copies of Responses.

THESE ARE TRANSMITTED:

- [] For Approval [] Approved as submitted [] Resubmit ___ copies for approval
[] For your use [] Approved as noted [] Submit ___ copies for distribution
[X] As requested [] Returned for correction [] Return ___ corrected prints
[] For review and comment [] Rejected [] Other

COMMENTS:

As directed, we submit herewith one original and eight copies of the above referenced document in response to Order issued December 22, 2006.

Signed [Signature]
Thomas Green

Copies to: Honorable David Spenard, Office of the Attorney General
Merle Brewer, Chairman, HCWD2
Honorable D. Berry Baxter
Central Files - 03299

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

RECEIVED

FEB 15 2007

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

**RESPONSES TO INTERROGATORIES AND REQUESTS FOR
PRODUCTION OF DOCUMENTS**

As Ordered December 22, 2006

HENRY COUNTY WATER DISTRICT NO. 2

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RESPONDENT CERTIFICATIONS

PSC Interrogatories – Case 2006-00191

I certify that, on behalf of Henry County Water District No. 2, I have prepared or supervised the preparation of the responses to Items 1 through 4, 7 through 11, 13 through 20, and 23. On several questions I have consulted with Andy Woodcock, PE, MBA, also of Tetra Tech. I certify that these responses are true and accurate to the best of my knowledge, information, and belief formed after a reasonable inquiry.

Tom Green
Thomas Green
Tetra Tech, Inc.

2-14-07
date

I certify that, on behalf of Henry County Water District No. 2, I have prepared or supervised the preparation of the responses to Items 5, 6, 10, 12, 21, and 22, and that these responses are true and accurate to the best of my knowledge, information, and belief formed after a reasonable inquiry.

James Simpson
James Simpson
Chief Operating Officer
HCWD2

2-12-07
date

1. Refer to Electronic Mail Message from Tom Green to Gerald Wuetcher (Oct. 31, 2006). Mr. Green states that “the cost of our OIC [Offsetting Improvement Charge] is mostly for transmission mains.” Define “transmission main” and state the main sizes that Henry District considers as transmission mains.

From the PSC memorandum of the October 9, 2006 informal meeting:

“Mr. Wuetcher noted that the Commission’s approach did not appear to support the use of system development charges for the construction of distribution mains. He interpreted the Commission’s final order in Administrative Case No. 375 as recognizing the use of system development charges to finance system improvements such as additions to treatment plant capacity, water storage tanks, and transmission mains.”

From the final Order in Administrative Case 375, “Guidelines on the Development and Administration of System Development Charges,” regarding the use of SDC proceeds:

“Funds from the account are to be used exclusively to fund growth related capital projects such as, but not limited to, water treatment plants, storage facilities, pumps, distribution mains, transmission, storage and treatment.”

If the Public Service Commission refuses to allow system development charges to be used for water mains unless they are defined as “transmission mains,” then the only relevant definition will be the Commission’s.

As we previously attempted to make clear five years ago in our response to Interrogatory 19 of the January 28, 2002 Order in Case 2001-00393:

“We have made no distinction in terminology between water mains used for ‘transmission’ and ‘distribution,’ and have simply referred to the entire pipe network as the distribution system.”

The representatives of the Henry District who were present at the informal meeting thought that Mr. Wuetcher had said the Commission in Case 375 did not intend SDCs to be used for “water lines.” We did not recall his making a distinction between distribution and transmission mains. In our response to his meeting memorandum we addressed the issue only in order to explain that even if the PSC insisted on making a distinction which was not meaningful in the context of the Henry District’s OIC, we could nevertheless show that most of our costs could be considered to fall into the “transmission main” category.

In general engineering usage, the category of “transmission mains” would certainly include the primary lines that interconnect storage tanks. This would apply to the OIC-eligible projects along KY 153 (\$1.9 million) and to the US 421 project (\$300,000). Therefore the total of our “transmission main” cost is at least \$2.2 million, representing two-thirds of the \$3.3 million total cost of OIC-eligible projects.

But “transmission mains” along their entire length can and often do directly serve the daily demands of large numbers of customers. This renders these lines, in effect, “distribution mains” also. For the purposes of our system development charge, if a line must be paralleled with a larger line solely due to growth, it is appropriate for growth to bear that expense, regardless of the category into which the line might be arbitrarily assigned.

In discussing transmission versus distribution mains the most significant factor is function, not diameter. A larger diameter line which serves high demand in only one localized area is much more a distribution main than a smaller diameter line which carries moderate flows a long distance to reach and serve distant demand. But it is the entire, interconnected pipe network which makes possible the efficient delivery of drinking water to customers. The Kentucky Infrastructure Authority’s state clearinghouse project application form lists only four categories of water projects: source, treatment, distribution, and storage. By their terminology *all* water lines are “distribution.”

In AWWA Table 28-4, which excludes distribution mains from SDC calculations, it is assumed that “...on-site facilities such as distribution mains ...are contributed by the developer....” The AWWA has interpreted “distribution” to mean the developers’ contributed internal subdivision lines, which are clearly not legitimate components of an SDC calculation (see p. 205 of Chapter 28 *System Development Charges*, AWWA Manual M1). Henry District has not included any such on-site internal subdivision lines in our OIC, therefore according to the SDC calculation illustrated in the AWWA table, all OIC-eligible lines are “transmission.”

2. Refer to Henry District's Response to the Commission's Order of May 22, 2006, Item 3. Henry District states that "[t]he OIC is limited to the cost of installing larger diameter water lines."

a. State the sizes of water lines that will not be included in the OIC.

By "larger diameter" we simply mean lines larger than those which they parallel or replace. If in our judgment, a 2" or 3" line, rendered inadequate due to customer growth, can be paralleled with a larger 4" line which properly serves the growth demands in limited vicinity, we would do so. However, we anticipate 6" to be the minimum size of most OIC projects, as is indicated in Appendix C of our responses to the May 22, 2006 Order.

b. State the criteria that Henry District uses to determine if a waterline should be included in the OIC calculation.

Whenever any new line is installed which provides greater hydraulic capacity than the existing line, the cost and the net capacity increase of that line are included in the OIC calculation. Also, when any development is proposed, we determine the most cost-effective improvement which would offset that development, and, using past construction costs for similar projects, include that proposed improvement in the basis of the OIC calculation.

Last October at our informal meeting with Commission staff and David Spenard of the Office of the Attorney General, the concern was expressed that proceeds from our OIC could be used simply to replace worn out lines. Because we submit a list of all proposed projects and also account for all OIC expenditures, the misuse of proceeds by Henry District is not likely. However, we agree that there is a legitimate aspect of this concern.

Although smaller lines will most often remain in service, being paralleled, not replaced by the larger OIC-funded lines, nevertheless, when those smaller lines do reach the end of their serviceability, the existence of the larger line will mean that in most cases no replacement of the smaller line will then be needed. We therefore propose adjusting our OIC calculations so that the percentage of the smaller line's useful life is used to calculate the dollar amount of depreciation potentially eliminated by the OIC-funded line. In a manner acceptable to the Commission, we will deduct this amount from the larger line's cost as entered in the OIC calculation, effectively reducing the charge in acknowledgement of this benefit.

3. State whether in Henry District’s opinion that the construction of a new water storage facility is a “hydraulic improvement.” Explain.

As we have previously attempted to make clear to the Commission, for the specific purposes of the OIC, our definition of “hydraulic improvement” intentionally excludes storage tanks and other growth-necessitated infrastructure. Therefore a new tank would not be considered an *OIC-eligible* “hydraulic improvement.” We have excluded the cost of these elements of growth because we wanted to be fair to new customers. Instead of calculating and assessing them the full costs of all infrastructure necessitated solely by growth, and then also charging them rates which support elements of the system which are *not* necessary to serve them, we have given consideration to new customers by limiting our OIC to the costs of larger lines. It is obvious that each new customer would have an adverse impact on the system as a whole, including storage and treatment facilities, but again, we intentionally have omitted these facilities from our calculation.

In general usage, we would consider the term “hydraulic improvement” to include a new tank constructed in a new location, or a new replacement tank which was either of a larger capacity or at a more advantageous elevation than the old tank. However, replacing an age-deteriorated tank with new tank of identical capacity and elevation would not provide any “hydraulic improvement.”

4. State whether in Henry District's opinion the construction of new capacity at a water treatment facility is a hydraulic improvement.

Increasing treatment capacity does not affect pressures in the system and could only be considered a hydraulic improvement if treatment capacity were interpreted to include the filling of a new ground storage tank which provides the initial hydraulic gradient for the distribution system, or if treatment capacity were interpreted to include the installation of larger high service pumps.

Treatment capacity is clearly another growth-related cost, but one which we have intentionally excluded from our OIC calculation in order to be fair to new customers.

5. State when Henry District currently expects to add additional water treatment capacity.

The HCWD2 treatment plant is currently rated at 4 MGD, and was designed for expansion to 6 MGD without major modifications. Our usage is currently averaging about 2 MGD. Therefore, depending on growth, our treatment capacity should remain adequate for a number of years. However, in addition to residential growth rate, a strong potential for industrial development exists at several locations in our system, and the high daily demands of industry are a significant, if unpredictable, factor in the future expansions of our plant.

This discussion of our treatment capacity again demonstrates the need for water districts to be permitted the flexibility to formulate SDCs which best fit the specific circumstances of their systems. In the Henry District, our most pressing growth-related infrastructure cost is larger mains, not the treatment and storage elements more typically included in the 10 year capital improvement plans of standard incremental SDC methodology. But \$3 million of line upsizing cost necessitated solely by growth is no less reasonable a justification for an impact fee than \$3 million in plant expansion or new storage tanks. And \$3 million of line upsizing cost necessitated solely by growth is no more reasonable a burden for existing customers to bear.

6. State when Henry District currently expects to add additional water storage capacity.

We hope to replace a 100,000 gallon tank in the southeast portion of the system with a 300,000 gallon tank in the next two years depending on funding. Within the next five years, a 200,000 gallon tank on US 42 will be probably be replaced, most likely with at least a 500,000 gallon tank.

7. State why it is reasonable to ignore the effect of customer growth on water treatment capacity and water storage capacity and focus solely on the capacity of water mains in assessing the “hydraulic impact of growth.”

As we have previously attempted to make clear to the Commission in several responses, for the specific purposes of our OIC, we intentionally exclude water treatment and storage tanks. We are not *ignoring* the effect of growth on these facilities, nor have we ever said it would be reasonable to do so. We are consciously and purposefully exempting these costs from the OIC calculation to reduce the charge in consideration of the general rates which new customers pay, and the general systemwide benefit inherent in those rates.

8. a. State whether, in the course of considering and implementing its OIC, Henry District calculated a system development charge for new customers based upon the “equity methodology” that the American Water Works Association recognizes.

As we previously attempted to make clear to the Commission in our response to Item 3 in the May 22, 2006 Order:

“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.”

It is noteworthy that, according to both the AWWA and the PSC Case 375 guidelines, the proceeds of incremental SDCs may be used to repay the utility for previously constructed growth-related projects:

“This method is used most commonly where SDCs are used to finance capital expansion as well as to recoup investments creating excess capacity for new demand.”

“Reimbursement or repayment of advancements or withdrawals from other funding accounts to pay for such growth-related capital projects is an appropriate use of SDC funds.”

An equity element therefore functions *within* the incremental SDC methodology- new customers are “buying in” by reimbursing the system for a share of existing capacity (“equity”) already in place. This realization may be useful in helping break down the rigid and very official-sounding distinctions between standard SDC methodologies. In fact, the AWWA suggests that various combinations of equity and incremental methodologies may be appropriate. They do not endorse rigid approaches; instead they state that the design and implementation of an SDC should “evaluate the underlying criteria important to a specific water system...” The fact that Henry District has formulated its own reasonable, cost-based approach to system development charges is therefore not so much a deviant affront to the two immutable SDC categories, as it is a fair-minded solution to the specific needs of our district, based on our actual experience.

The AWWA proposes an equity approach to SDCs in systems where current facilities adequately serve existing and future customers and where no new significant investment is anticipated, which indicates that the essential prerequisite for an SDC *cannot* be a growth rate which outpaces the utility's ability to fund and construct infrastructure improvements. It must be concluded that the *fairness* of growth paying for itself is the paramount consideration of the system development charge, not the specific *rate* of growth.

b. If yes, provide the results.

N/A

c. If no, explain why Henry District did not make such calculations.

Please see our response to 8 (a) above.

9. State whether, in Henry District's opinion, the construction of new water storage facilities is a means of remedying the effects of growth on a water distribution system. Explain.

Please see our response to Item 3 of this Order. Additionally, we would point out that storage facilities will not alleviate the primary problem facing our district. Water in a storage facility does us no good if it cannot reach new customers at the minimum required pressure. Unless our mains are of adequate capacity to carry increased flow at acceptable pressures, the growth of the system and the community will be impaired because by regulation, we cannot allow additional customers to tap on to the system.

10. a. State the total cost that Henry District has incurred to develop its OIC.

Developing the OIC began in the summer of 1999 with our requests to the PSC for direction in designing our charge, and included several visits to Frankfort to do research in the PSC tariff library. Our work continued through the formulation of our engineering and cost-based methodology, including the hydraulic analyses and the compilation of our overall project database, and, after several encouraging conversations with PSC staff, the drafting of the tariff language. When the final order in Case 375 was issued, we were told that time was right to submit our tariff; we were *not* told that it should be rewritten in any way. We submitted our OIC tariff November 6, 2001, three weeks after the PSC had filed its proposed SDC regulation with the Legislative Research Commission on October 18, 2001. Interrogatories in our case were issued on January 28, 2002.

Our OIC costs continued through the preparation of interrogatory responses, attending an informal meeting, and the nine month review in Case 2001-00193 which resulted in the OIC's approval in July 2002. Our costs continued through the 2003 clarification of "previous applicant," and other issues, and finally through the submittal and August 2003 approval of a second tariff containing revised and additional language as directed by the PSC. From August 1999 to August 2003 the total four-year engineering, legal, and accounting costs were approximately \$50,000. Beyond these professional consultant costs there were a great many hours of work done by HCWD2 personnel.

In 2003 we considered these costs to be high, but worthwhile in that the growth in our system would be required to shoulder its fair share of costs of the infrastructure it necessitated, instead of those costs being paid by existing customers. We also understood that we were the first district to apply for an SDC following Administrative Case 375, and that our expenses were to some extent on behalf of the many other districts who had expressed the need for appropriate new funding and rate mechanisms to address growth.

In its July 25, 2002 Order the PSC stated that it was in "general agreement with the rationale supporting the charge" with the exception of several specific concerns which we addressed to the Commission's satisfaction in our second tariff submittal, approved August 24, 2003.

In our response to Item 6 of the August 11, 2006 Order we stated:

“During the three-year trial period of the OIC, we have complied with the terms of the tariff by submitting our annual and biennial accountings, and we have maintained our records in order to be well-prepared for the required “full review of the operation of the program...”

In Case 2001-00393, the July, 25, 2002 Order approving our tariff stated:

“We conclude that the Offsetting Improvement Charge appears to be in the public interest in that it will benefit both Henry District and its customers. However, because the proposed charge presents a case of first impression for the Commission, we believe that it should be established for an initial 3-year period only, after which we will conduct a full review of the operation of the program and determine whether it should be renewed.” (emphasis added)

Case 2006-00191, however, begins by inaccurately paraphrasing Case 2001-00393. Referring to the initial case, the 2006 Order incorrectly states:

“Noting that the proposed charge presented a case of first impression, the Commission directed that the operation and reasonableness of the charge be reexamined after three years to determine if it should continue.” (emphasis added)

This modification of the intent of the 2002 Order has had the effect of requiring HCWD2, after taking on the considerable initial expense of developing and obtaining PSC approval of a sensible and equitable impact fee, to defend all over again the rationale which earned PSC approval in 2002, and by which the Commission has permitted HCWD2 to charge prospective customers over \$270,000.”

From the August 2003 approval of the revised tariff until now, our additional OIC-related costs of approximately \$30,000 have included several minor issues such as “agricultural use,” but have otherwise entirely resulted from the current Case 2006-00191, which not only revisits issues which we thought had been resolved, but which also raises numerous entirely new issues. In our view, if such issues are significant considerations vital to establishing the reasonableness of the OIC, they would have been addressed prior to PSC approval of our charge in 2002, and prior the levying of hundreds of thousands of dollars in charges since.

Our regulatory costs continue to rise and will soon include either the preparation of an extensive final brief or a hearing in Frankfort. Case 2006-00191 has given us the impression that the Commission has been searching diligently for a reason to disallow the same charge which it found reasonable and in the public interest in 2002. Because the OIC and the pertinent guidelines and regulations have not changed, the only variable we can identify is the PSC itself.

Having actively sought the Commission's guidance and direction from the outset, we have thus far spent seven and a half years and approximately \$80,000 attempting to get the HCWD2 Offsetting Improvement Charge approved. We would not be surprised if our total costs reach \$100,000.

Recently the superintendent of the City of LaGrange water system, which borders our district on the southwest, requested that the LaGrange City Council approve a \$1000 per lot impact fee to help pay for larger lines. The fee was authorized the next month.

b. List each component (e.g., engineering services, legal) of the total cost and its cost.

It is an impressive irony that our 6,000 customer rural water district, having been required to bear the costs of the Commission's prolonged investigation of a straightforward and commonsense system development charge, would now additionally be asked to conduct an accounting breakdown of those expenses over the past seven years. Concern as to the costs our district has incurred would more effectively express itself in a streamlining of the review process. Note the number of responses to this and earlier Orders which contain the phrase "as we stated in our previous response." Or consider the following three questions from the current Order:

"14. Describe the analyses that Henry District undertook to determine the effect of customer growth on its revenues and expenses. Provide all analyses and studies that Henry District or its representatives conducted and all associated workpapers used in the preparation of these analyses and studies."

"17. Provide all studies and analyses that Henry District has conducted or commissioned regarding the effect of customer growth on its revenues and its expenses for any period from 1999 to 2020."

"18. State whether Henry District has commissioned any studies or conducted any analyses and studies regarding any increase in operating revenues and expenses due to customer growth and the use of any net operating revenues, if any, to offset the cost of system improvements needed to serve these new customers."

These studies are nowhere mentioned in state regulations or in PSC guidelines, and yet now, after seven and a half years, they are being requested for the first (and second, and third) time.

11. In its Response to the Commission’s Order of May 22, 2006, Item 3, Henry District states that “our methodology calculates and charges what growth *does* cost, instead of what we estimate growth may cost.” Explain why, to the extent that Henry District does not immediately construct facilities to offset the hydraulic impact of growth, Henry District’s methodology is not also an estimate of the cost of future facilities.

As we have previously attempted to make clear to the Commission, we have included the actual costs of projects constructed in the past four years, and the historically-based costs of similar proposed developments. This second group does not involve future, inflation-adjusted *increased* cost projections as would a ten year CIP; rather it incorporates only the actual past cost of similar projects. Because construction costs are far more likely to rise than fall, our calculation of this second group is not at all an estimate of future costs, it is a conservative cost summary of the recent past.

Although we do not charge an inflation-adjusted estimate of future costs, we are unable to understand why doing so would alarm the Commission. Standard incremental SDC methodology suggested by the AWWA and endorsed by the PSC is *entirely* an estimate of future costs. Developers must pay an impact fee derived from a future cost estimate, derived from a future facilities estimate, derived from a future growth estimate. This “estimate cubed” is the standard against which the reasonableness of the Henry District’s cost-based OIC is being evaluated.

12. Refer to Henry District's Response to the Commission's Order of May 22, 2006, Item 3, Sheet 3 of 4.

a. Describe Henry District's present position on the provision of fire protection service to customers served through water mains that are capable of providing fire flows.

Our present position is clearly stated in our tariff approved by the PSC May 21, 1986:

"The District does not guarantee pressure at a residence for the purpose of fire protection."

"Water hydrants on the District are solely for the purpose of flushing of lines and not for personal use or fire protection."

b. State whether any local planning and zoning commission within Henry District's territory has considered the availability of fire protection service in determining the zoning classification for proposed subdivision developments.

We have contacted the Henry, Oldham, and Shelby planning commissions. All three stated that their zoning classifications were based entirely on land use considerations, not the availability of fire protection.

c. State whether a local planning and zoning commission or the Commission's requirement that fire hydrants be located in real estate developments would affect Henry District's position that an increase in water pressure provides no benefit to existing customers. Explain.

As we stated in our response to Item 19 of the August 11, 2006 Order:

"PSC Administrative Case 385 observed:

'Kentucky law does not expressly confer an obligation upon any water utility to provide fire protection service... By this Order, the Commission does not expand or extend any water utility's obligation to provide fire protection services.'

Our primary and overriding obligation is to adhere to the orders and directives of the Public Service Commission. We understand that developers must comply with planning and zoning

requirements, but we seriously question whether a county planning commission's authority includes the dictating of policies and procedures to a PSC-regulated utility. If planning commissions had such authority, they would in effect control the district's budget by mandating improvements which would prioritize our infrastructure expenditures, and consequently, our rates. In our view the local planning commission could not mandate that Henry District provide fire protection; this could be done only by the PSC itself.

Any new PSC-mandated fire protection policy would need to take into account a host of issues. It would need to address the obligation versus the option of adding hydrants wherever possible, or adding them wherever possible and *requested*, or adding hydrants wherever they could be *made* possible through the reasonably shared expenditures of the District and groups of willing customers. It would need to take into account the impact of such decisions on property values (positive and negative), impacts which would result from the establishing of "protected" and "unprotected" zones. It would have to determine how rates should be fairly adjusted to reflect these inequitable levels of water service, and it would have to answer the fundamental and very difficult question of why all long-term existing customers desiring fire protection should not reasonably expect to receive hydrants (and the hydraulic capacity to support them) *before* customers in new subdivisions should be provided such service.

d. Describe the revisions, if any, that would be required to the current methodology used to calculate the OIC if fire protection service were provided.

We would certainly have to adjust the OIC calculation to account for those situations where upsizing to 6" lines would provide a newly available benefit of fire protection to existing customers. However, the additional state minimum fire flow demand of 250 gpm for two hours with adequate residual system pressures would increase very significantly the cost of the offsetting improvements necessary to serve a proposed new subdivision. Our current calculation indicates the average systemwide cost of adding one gpm peak flow capacity to be \$950. Therefore it would require \$237,500 in hydraulic capacity to serve a hydrant at 250 gpm. Conversely, subtracting this fire flow commitment from our existing capacity would mean that our lines could be certified to provide basic water service to far fewer new customers.

Given these issues and those listed in our preceding response to Item 12 (c), it is impossible to predict what OIC adjustments would need to be made in response to a PSC requirement of fire protection.

Such a mandate would dramatically impact us and all other small districts throughout the state. While we agree that fire protection is a worthwhile goal, the cost to serve our entire district would be astronomical as indicated above, and we are not sure why this has become an issue at this point in the SDC proceeding. Our primary function is to provide safe drinking water to rural customers at a reasonable price. This mission would be severely impaired if we had to upsize hundreds of miles of lines at enormous cost to provide fire protection.

13. State whether in Henry District's opinion increased customer growth will increase the water district's revenues.

Our gross revenues would increase, but the extent to which *net income* would increase is dependent on the concurrent expense increases which accompany producing water for, and otherwise servicing, a larger number of customers.

14. Describe the analyses that Henry District undertook to determine the effect of customer growth on its revenues and expenses. Provide all analyses and studies that Henry District or its representatives conducted and all associated workpapers used in the preparation of these analyses and studies.

In our informal meeting with PSC staff on October 9, 2006, we acknowledged that, although we had reduced the OIC by excluding from its calculation several significant cost components of growth in order to give consideration to the overall systemwide benefit of new customers, we had not subjected this benefit to a specific study. Nevertheless, we are asked now in Item 14, and will be asked again in Items 17 and 18 of this Order, to provide studies and analyses which we have made very clear to Commission staff have not been commissioned or conducted.

In the fairly recent past the Commission exhibited an impressive clarity regarding the system development charge. Section 5 of 807KAR5:090, promulgated by the PSC, indicated 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.”

This regulation does not require a study of the hypothetical benefit of the “growth revenue effect.” The Order approving our OIC in 2002 did not require or even mention such a study. Benefits to existing customers were addressed by the Commission in our OIC approval only as “the benefits existing customers receive *from any system improvements...*” (emphasis added).

We are given opportunities to discuss this issue further in Items 17 and 18 of this Order.

15. Refer to Electronic Mail Message from Tom Green to Gerald Wuetcher (Oct. 31, 2006). At the informal conference of October 9, 2006, Mr. Green stated, that he had not analyzed the benefits from additional customers because the OIC counterbalanced these considerations by excluding the costs of treatment and storage.

a. Explain how the OIC counterbalances any benefits from additional customers by excluding the costs of treatment and storage.

As we previously attempted to make clear to the Commission in our response to Item 3 of the May 11, 2006 Order:

“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. “

Administrative Case 375 stated that alternative SDC methodologies would be approved if they were shown to achieve a more reasonable result than the standard approaches outlined in PSC guidelines. Those guidelines contained no provision for a study or analysis of the possibility of benefits of growth revenue. They contained no provision for addressing the “double jeopardy effect” as discussed in our above response. Therefore, regardless of whether the good faith effort of the Henry District to give fair and reasonable consideration of these issues to the new customer by significantly reducing the scope of the OIC calculation achieves a *precisely correct* result, it nevertheless most certainly achieves a *more reasonable* result than an SDC which disregards these issues.

b. Provide all studies and analyses that Henry District has conducted or commissioned to assess a charge on new customers related to their effect on treatment and storage costs.

On average, our residential customers use 170 gallons per day (gpd). Based on our past experience, we have determined that new storage tanks cost at least \$1 per gallon, and because state regulations require us to maintain one day's storage, each new customer therefore creates at least \$170 in storage costs. Our 1998 treatment plant project increased potential capacity by 4MGD at a cost of \$9 million, or \$2.25 per gpd. Therefore the 170 gallons per day for each new customer equates to costs of about \$380 in water treatment infrastructure.

The total of these two OIC-excluded costs is about \$550, and if we added this amount to the current HCWD2 charge of \$950, it would come to \$1500. 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.

16. State whether Henry District agrees with the following statement: “If customer growth produces sufficient revenues to recover the costs associated with such growth, no need exists for a system development charge or other separate charge assessed upon new customers.” Explain.

Growth produces greater revenues *and* greater expenses. The first question is how growth could possibly produce increases in revenues which so greatly exceed the associated increases in expenses that the net income *surplus* could adequately fund growth-necessitated infrastructure improvements.

If growth could produce such high levels of excess net income, then 113 water districts in Kentucky would not have responded as they did in PSC Administrative Case 375:

“These responses indicated a need on the part of 113 respondents for additional funding and rate mechanisms to address increased development and customer growth within their systems.”

And if water rates were *intended* by the Commission to generate, in growth situations, so much revenue in excess of the simultaneously increasing system expenses that new growth-related infrastructure could be funded, then the PSC-approved rates of the overwhelming majority of water utilities in Case 375 would not have failed to do so.

If it were possible for excess net income generated by growth to finance the infrastructure improvements necessitated by growth, then surely this issue would have been raised much earlier in our OIC review process than the current Item 16, which is actually the ninety-fifth interrogatory we have addressed since 2002. Surely our charge could not have been approved with no examination of the issue. If such levels of excess net income were possible, it would be reasonable to expect that 807 KAR 5:090 would list among the requirements and information which must accompany an SDC application that the district provide a study or analysis “conducted or commissioned regarding the effect of customer growth on its revenues and its expenses.” It does not.

But even under the tenuous assumption that such levels of excess net income are possible, Item 16 muddies the water by addressing separate rate and growth issues as if they were one.

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.

17. Provide all studies and analyses that Henry District has conducted or commissioned regarding the effect of customer growth on its revenues and its expenses for any period from 1999 to 2020.

We have carefully reviewed 807 KAR 5:090, as well as Chapter 28, "System Development Charges," in the AWWA Rates Manual, as well as the PSC Case 375 "Guidelines on the Development and Administration of System Development Charges," which references portions of AWWA documents. Nowhere in any of these documents is mentioned the conducting of a study or analysis of the effect of customer growth on revenue and expenses.

However, an informative (if informal) analysis of the net effect of customer growth on revenues and expenses is included in our response to Item 14 of the August 11, 2006 Order. Based on our annual reports to the PSC, Henry District has had seven year cumulative net income before contributions of negative \$289,971, for an average loss of \$41,410 per year:

Net Income Before Contributions

1999	\$145,415
2000	(\$100,278)
2001	\$ 38,422
2002	\$ 7,855
2003	(\$165,849)
2004	(\$ 94,466)
2005	(\$120,970)

The "contributions" which are added to the above figures to determine Net Income in the years 1999 through 2002 are basically the value of dedicated subdivision lines and extensions, not actual income. However, in the three year period 2003-2005, when our cumulative Net Income Before Contributions was a loss of \$381,000, our subsequent "contributions" not only contained dedicated lines, but *also* included about \$288,000 in cash proceeds from the OIC.

18. State whether Henry District has commissioned any studies or conducted any analyses and studies regarding any increase in operating revenues and expenses due to customer growth and the use of any net operating revenues, if any, to offset the cost of system improvements needed to serve these new customers.

Our response to Item 16 herein addresses both the likelihood that such levels of surplus net income could result from growth, and also the appropriate use of such income.

In its Order approving our tariff in July 2002, the PSC instructed that within twelve months we would include in our OIC "...a method to determine the benefits existing customers receive *from any system improvements...*" (emphasis added). We were not directed to commission studies on possible benefits which an increase in gross revenues might produce. The amended tariff we submitted in 2003 stated that no net benefit would accrue to existing customers *from new lines* because we calculate the OIC based on specific offsetting improvements. In its 2002 Order the Commission made no mention of revenue benefits, nor did our subsequent 2003 tariff submittal, approved by the Commission August 24, 2003.

The current Case 2006-00191 was intended in 2002 to "review the operation" of a program which had already been found to be acceptable in its rationale, and in the best interest of the district and its customers. It is the only water district impact fee in the Commonwealth of Kentucky, where 87% of water districts have gone on record as needing such mechanisms.

19. In its Response to the Commission’s Order of May 22, 2006, Item 16(b), Henry District states: “For many years our district has permitted growth without requiring offsetting improvements, and consequently our distribution system has needed a lot of hydraulic strengthening.”

a. Define “hydraulic strengthening”.

Over the years many lines have begun to approach their maximum capacity due to growth. Hydraulic strengthening addresses these areas proactively, especially in areas where growth is most likely to continue. These are not existing system deficiencies; rather they are areas where intelligent planning can anticipate and prevent possible future problems.

b. Assume that no further growth occurs in Henry District’s territory. State whether under such assumption Henry District would need to make any hydraulic improvements (other than replacements for water mains that have completed their service life). Explain.

Daily minimum pressures throughout our system are currently above the required 30 psi. Therefore, if no new services were requested, we would need to make no infrastructure improvements in order to continue to remain in compliance with state hydraulic requirements. However, as we stated in our response to Item 8 of the August 11, 2006 Order:

“...even a system with no net growth could be faced with upsizing expenses if population shifted from older areas in the core of the system to new subdivisions on its periphery.”

20. In its Response to the Commission's Order of May 22, 2006, Item 16(b), Henry District states: "Hydraulic improvements funded through general rates provide excess capacity, the cost of which can later be recouped through the OIC. In this sense the general rates are funding hydraulic projects as loans to the system which can eventually be repaid by future development."

a. Explain how subsequent collections of OIC repay the earlier loan to general ratepayers.

Please see our previous response to Item 30 (a) of the August 11, 2006 Order which requests that we:

"Explain how the cost of hydraulic improvements funded through general rates can later be recouped through the Offsetting Improvement Charge"

b. Explain why, to the extent that a person who pays an OIC and then general rates for water service, that person is not paying twice for hydraulic improvements whose costs is being recovered through both general rates and the OIC.

807 KAR 5:090, Section 11, states that the utility may use SDC funds for:

"(b) Reimbursement or repayment to other accounts from which funds have been taken to pay for growth-related capital projects..."

Administrative Case 375 "Guidelines on the Development and Administration of System Development Charges" states:

"Many major projects related to system expansion require substantial funds for design and construction before sufficient funds are available from SDC receipts. Therefore, usually some funding from user rates is needed to pay for the facilities, generally in the form of paying for debt service on bonds to finance facilities. This may result in double cost recovery if user rate funding of debt service on SDC-related facilities is not taken into account in establishing the level of an SDC. For example, debt service payments included in the user rate analysis are partially offset by the projected receipts from the SDC."

The Henry District's calculation of the costs of offsetting improvement projects includes no debt service or other financing costs. Therefore there is no "double cost recovery."

When the district's existing customers spend dollars from their general fund for larger lines which are needed *only* in order to increase the hydraulic capacity of the system, the growth which then consumes that capacity should repay those costs.

21. Refer to Henry District's Response to Commission Staff's First Set of Interrogatories, Item 10. Henry District states that in the previous 5 years it "has not had a circumstance in which a developer built a new line extension in order to reach his subdivision." State whether Henry District issues refunds to real estate subdivision developers for customer connections to water mains that are located within the real estate subdivision development and that the developer has constructed and donated to Henry District.

The pertinent KAR states that these refunds are due for "an extension to a proposed real estate subdivision..." It does not mention lines *within* that subdivision. HCWD2 has therefore understood the KAR to refer only to those lines necessary to reach the development, lines to which other future customers (not those who purchase lots *within* the subdivision) could potentially connect. In such cases a refund would be made to the developer for those other future customers who connect to a line built *to* the subdivision.

Lines *within* the subdivision are part of the total product (home+setting+services) which the new homeowner pays for, and these total costs are included in his purchase price, enabling the developer to recover the entire cost of water lines installed. HCWD2 has therefore not made refunds to developers for homes which connect within new subdivisions. It was also our understanding that in Administrative Case 386, the PSC itself seriously questioned such refunds to developers.

Developers (or subsequent homeowners) who argue that they have paid double by dedicating subdivision lines *and* by paying impact fees are ignoring the rational nexus concept of the system development charge. If no growth occurs, then neither the new lines within the subdivision, nor the upsizing of supply mains necessary to accommodate the subdivision, would need to be installed. But *both* costs are directly and exclusively attributable to growth, therefore, by the rational nexus principle, both costs should rightly be paid for by growth, not by existing customers.

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.

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.