

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE TARIFF FILING OF SOUTH ANDERSON	)	
WATER DISTRICT SETTING POLICY FOR	)	CASE NO. 2006-00118
WATER MAIN EXTENSIONS TO SERVICE REAL	)	
ESTATE DEVELOPMENTS	)	

ORDER

South Anderson Water District (“SAWD”) proposes revisions to its existing policy on water main extensions to real estate subdivision developments. At issue is whether SAWD should be permitted to deviate from Administrative Regulation 807 KAR 5:066, Section 11(3), to limit the total amount that must be refunded annually for water main extensions to a real estate subdivision development. Finding in the affirmative, we approve the proposed revisions.

SAWD, a water district organized pursuant to KRS Chapter 74, owns and operates facilities that distribute water for compensation to approximately 2,523 customers in the southern portion of Anderson County, Kentucky. It is a utility subject to Commission jurisdiction.<sup>1</sup>

On October 17, 2006, SAWD submitted proposed revisions to its existing tariff sheets to clarify and delineate its rules and responsibilities for water main extensions to subdivision real estate developments.<sup>2</sup> SAWD’s current tariff is silent on this issue. The

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<sup>1</sup> KRS 278.010(3)(d); KRS 278.015; KRS 278.040.

<sup>2</sup> On March 14, 2006, SAWD petitioned for relief from all refunding requirements set forth in Administrative Regulation 807 KAR 5:066, Section 11(3). On October 17, 2006, it amended its Petition to seek more limited relief and requested approval for its proposed tariff revisions. No person has intervened in this proceeding. Pursuant to the Commission’s Order of November 8, 2006, SAWD published notice of its proposed tariff revisions in a newspaper of general circulation. No comments regarding the proposed tariff have been submitted.

proposed revisions, with one major exception are virtually identical to those which the Commission approved for North Mercer Water District.<sup>3</sup> This exception involves the utility's treatment of refunds to real estate subdivision developers.

Administrative Regulation 807 KAR 5:066, Section 11(3), prescribes the following refund policy for water main extensions to a real estate subdivision:

An applicant desiring an extension to a proposed real estate subdivision may be required to pay the entire cost of the extension. Each year, for a refund period of not less than ten (10) years, the utility shall refund to the applicant who paid for the extension a sum equal to the cost of fifty (50) feet of the extension installed for each new customer connected during the year whose service line is directly connected to the extension installed by the developer, and not to extensions or laterals therefrom. Total amount refunded shall not exceed the amount paid to the utility. No refund shall be made after the refund period ends.

SAWD proposes to limit the amount of refunds in a calendar year to real estate subdivision developers for connections made to a water main extension to a real estate subdivision. Under its proposed tariff revision, SAWD would be required to refund to a subdivision developer an amount equal to the cost of 50 feet of the water main extension for each customer connecting to the main extension for the first 10 years following the utility's acceptance of the water main. Refunds in a calendar year, however, would not exceed the "Maximum Cumulative Refund Amount" ("MCRA"). As defined in the proposed tariff, the MCRA equals the "total cost of water distribution mains" multiplied by the "number of years elapsed since preliminary acceptance of water distribution mains" multiplied by 10. If the refund owed to a developer would result in the MCRA being exceeded, then the utility would defer the refund payment until

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<sup>3</sup> Case No. 2000-00376, The Tariff Filing of North Mercer Water District to Add a Subdivision Water Main Extension Agreement (Ky. PSC Nov. 1, 2001).

the following year. The practical effect of this proposal is to limit the average annual refund payments to no more than 10 percent of the total cost of the water main extension.<sup>4</sup>

While it does not change SAWD's total refund liability for water main extensions to real estate developers or the time period in which a real estate developer is eligible for refunds, the proposed revision potentially lengthens the time period that a developer must wait before receiving his or her refunds.<sup>5</sup> This extension differs from the refunding arrangements set forth in Administrative Regulation 807 KAR 5:066, Section 11(3), and requires a deviation.<sup>6</sup>

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<sup>4</sup> Under the proposed revision, SAWD may refund up to 10 percent of the total cost of the water main extension. If total connections to the water main extension in an annual period required refunds to the developer exceeding 10 percent of the cost of the water main extension, SAWD would refund to the developer 10 percent of the total cost for that period and refund any remaining obligation in the following year.

For example, assume a 100,000 foot water main extension with a total construction cost of \$1,000,000. The average cost per foot of extension would be \$10. For each connection to the extension, SAWD is required to refund \$500. In Year 1, assume there are 200 connections to that water main extension. SAWD would be required to refund \$100,000 to the developer. The required refund would be exactly 10 percent of total construction cost.

Assume that in Year 2, 400 connections are made. SAWD would have an obligation to refund an additional \$200,000 (400 connections x \$500), but must only refund \$100,000 of this obligation in Year 2. The cumulative refund amount of \$300,000 (\$100,000 + \$200,000) would exceed the MCRA. The MCRA for Year 2 would be \$200,000 (\$1,000,000 x .10/YR x 2 years). The refund of the remaining \$100,000 would be deferred to the next year.

Assume that in Year 3, 100 connections are made. SAWD would have an obligation to refund \$50,000 for these connections. It also would have a deferred obligation of \$100,000 from Year 2. Its cumulative refund obligation since construction of the water main would be \$350,000 (\$100,000 + \$200,000 + \$50,000). The MCRA for Year 3 would be only \$300,000 (\$1,000,000 x .10/YR x 3 years). SAWD would refund \$100,000 to the developer in Year 3 and would continue to defer refund of \$50,000.

Assume that in Year 4, 100 connections are made. SAWD would have an obligation to refund \$50,000 for these connections. It also would have a deferred obligation of \$50,000 from prior years. Its cumulative refund obligation since construction of the water main would be \$400,000 (\$100,000 + \$200,000 + \$50,000 + \$50,000). The MCRA for Year 4 would be \$400,000 (\$1,000,000 x .10/YR x 4 years). SAWD would refund \$100,000 to the developer in Year 4.

<sup>5</sup> The example provided in Footnote 4 illustrates this delay. Under the refund plan set forth in Administrative Regulation 807 KAR 5:066, Section 11(3), SAWD would pay the full amount of the refund in the year in which the connections were made. No deferments of refunds would be permitted.

<sup>6</sup> Administrative Regulation 807 KAR 5:066, Section 11(5) and Section 18.

A water utility in Kentucky generally has a duty to make reasonable extensions of service.<sup>7</sup> KRS 278.030(2) requires all utilities to render “adequate, efficient and reasonable service.” KRS 278.280(3) permits the Commission to order reasonable extension of service.<sup>8</sup> Based upon these statutory authorities, Kentucky courts have recognized this duty to make service extensions.<sup>9</sup> The Attorney General has recognized that a similar duty exists for water districts to make extensions throughout their territory.<sup>10</sup>

Since its creation the Commission has sought to define “reasonable extension of service.” In 1935 we promulgated rules requiring extensions of a water distribution main of 50 feet and less to be made at no cost to an applicant for service. In 1960 we revised these regulations to provide for refunds for extensions made in excess of 50 feet and to make specific provision for extensions made to real estate subdivision developments. These regulations have remained virtually unchanged for the past 47 years.

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<sup>7</sup> 64 Am. Jur. 2d Public Utilities § 36 (2006) (a public utility has “a public duty to render service commensurate with its offer of providing a service system that will be reasonably adequate to meet the wants of the community or territory, not only at the time of the commencement of the service but likewise to keep pace with the growth of the community or territory served and gradually to extend its system as the reasonable wants of the community or territory may require.”).

<sup>8</sup> KRS 278.280(3) provides:

Any person or group of persons may come before the commission and by petition ask that any utility subject to its jurisdiction be compelled to make any reasonable extension. The commission shall hear and determine the reasonableness of the extension, and sustain or deny the petition in whole or in part.

<sup>9</sup> See, e.g., City of Bardstown v. Louisville Gas & Electric Co., 383 S.W.2d 918, 920 (Ky.1964) (“We conceive that the duty of a public utility under the general public utility statutes is to render adequate, efficient and reasonable service . . . within the scope or area of service provided for in its certificate of convenience and necessity. . . . It can be compelled to make any reasonable extension of its service facilities within its certificated scope or area of service.”) (citations omitted).

<sup>10</sup> OAG 75-719 (a water district is “under an obligation to serve all inhabitants . . . within its geographical area of service as fixed under KRS 74.010 and defined by the certificate of convenience and necessity.”).

The Commission's regulation on extensions to real estate subdivision developments allocates the financial risk of such extensions. It requires the developer to finance the cost of such extensions. By limiting a water utility's obligation to make refunds to the 10-year period following construction, it allocates to the developer all risk associated with the development's success. If a developer is unable to attract residential home buyers to his development within the 10-year period, he loses the ability to recover the cost of the water main extension from the water utility.

Conversely, a water utility's risk and investment are limited. The water utility is not required to make any investment in water distribution mains during the construction phase. It bears no risk regarding the success of the development. If residential home buyers are not attracted to the development, the water utility experiences no capital investment loss.<sup>11</sup> The water utility makes no refund to the developer, and hence assumes no portion of the cost of the extension, unless a connection is made to the extension.

The Commission's regulation has been criticized as unfairly favoring real estate subdivision developers. Opponents have argued that the regulation permits a real estate subdivision developer to recover the cost of the water distribution main facilities twice. Developers, they argue, recover these costs first through the sale of the residential lots and then again through water utility refunds. The effect of these refunds, opponents argue, is to increase general utility rates and place the burden of capital expenditures to serve new customers on existing customers.

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<sup>11</sup> While the water utility is not exposed to any capital investment loss, it may be exposed to some risk for greater maintenance and operation expenses. In those cases where a real estate subdivision development fails to attract residential buyers, and hence, water utility customers, water flows may be less and chlorination problems may be more likely to occur. Such conditions require more frequent line flushings and water releases to eliminate "stale water" from the distribution main.

We find little merit in these contentions. The Commission has yet to be provided with supporting empirical data. No such evidence was presented at the Commission's recently concluded proceeding on water main extension practices.<sup>12</sup> The "double-recovery" argument, moreover, fails to consider that market forces, which involve many variables, determine the price of a real estate lot.<sup>13</sup>

Opponents also fail to consider the favorable revenue effects that additional customers connecting to the water main extension produce. Each added customer produces additional revenues and allows the water utility's fixed costs to be spread over a larger customer base. The result is lower average fixed costs per customer and generally more stable rates.

In some cases, however, the extension practices that our regulation mandates will have a disruptive and adverse effect on a water utility's finances. The regulation requires a water utility to refund the full cost of a water main distribution over a 10-year period. If customer connections occur at a rapid pace, the time period for required refund may be significantly shorter. The construction of a water distribution main, however, is ordinarily a capital expenditure. Its cost is generally recovered through depreciation expense in general service rates over the service life of the water distribution main. This service life may range from 20 to 40 years.<sup>14</sup> Potentially, the Commission's regulation requires a payment of the cost of the main extension in a

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<sup>12</sup> Administrative Case No. 386, An Examination of Existing Water Distribution Main Policies (Ky. PSC Aug. 15, 2002).

<sup>13</sup> The advocates of the "double-recovery" argument also fail to consider whether a knowledgeable purchaser and real estate developer, when negotiating the purchase price of a real estate lot, take into consideration the required refund and adjust their asking and selling price accordingly. Double-recovery advocates assume that the refund is never considered.

<sup>14</sup> See, e.g., National Association of Regulatory Utility Commissioners, Depreciation Practices for Small Water Utilities (Aug. 15, 1979).

period as short as 2 years while full recovery of those costs through general rates may not occur for 40 years.

To overcome this timing difference, the water utility may be forced to issue long term debt instruments to make the required refunds. This practice is especially likely for small water utilities with limited financial resources, modest planning tools, and limited means to access financial markets. These utilities are less able to quickly respond and adjust to rapid growth occurrence. SAWD falls within this category of water utility.

The proposed revision, while not altering the total amount that SAWD will refund to any real estate subdivision developer, will allow SAWD to plan better for such refunds and to ensure some predictability in the refunding process. It will also provide SAWD with the opportunity to fund the refunds through existing funds in lieu of issuing additional debt instruments and incurring additional interest expense.

Given the unique circumstances presented in this proceeding,<sup>15</sup> the Commission finds that:

1. The proposed revisions are reasonable and appropriate.
2. Good cause exists to permit SAWD to deviate from the refunding provisions of Administrative Regulation 807 KAR 5:066, Section 11(3), in the manner requested.

IT IS THEREFORE ORDERED that:

1. SAWD is permitted to deviate from the refunding provisions of Administrative Regulation 807 KAR 5:066, Section 11(3), in the manner requested.

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<sup>15</sup> For a discussion of the challenges that Administrative Regulation 807 KAR 5:066, Section 11(3), presents to SAWD, see Memorandum from Gerald Wuetcher, Commission Counsel, to Case File No. 2005-00221 (Feb. 2, 2006) (found in Case No. 2005-00221, The Tariff Filing of South Anderson Water District Setting Policy For Water Main Extensions to Serve Real Estate Developments (Ky.PSC)).

2. The proposed tariff revisions are approved.
3. Within 20 days of the date of this Order, SAWD shall file revised tariff sheets in accordance with Administrative Regulation 807 KAR 5:011, Section 3, setting forth the revisions that are approved in this Order.
4. Subject to the filing of a timely petition for rehearing pursuant to KRS 278.400, these proceedings are closed. The Executive Director shall place any future filings in the appropriate utility's general correspondence file or shall docket the filing as a new proceeding.

Done at Frankfort, Kentucky, this 16<sup>th</sup> day of August, 2007.

By the Commission

ATTEST:



Executive Director