

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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

ORDER

This case involves an investigation of Henry County Water District No. 2's ("Henry District") Offsetting Improvement Charge. At issue is whether the charge is a fair and reasonable method of allocating costs to the construction of new water distribution mains. Finding in the negative, we direct Henry District to cease assessing the charge 180 days from the date of this Order.

BACKGROUND

Henry District, a water district organized pursuant to KRS Chapter 74, owns and operates facilities that provide water service to 6,367 customers in Henry, Trimble, Oldham, Carroll, and Shelby counties, Kentucky.¹ It provides wholesale water service to the cities of New Castle and Eminence, Kentucky and to West Carroll Water District.² As of December 31, 2007, it had utility plant of \$25,277,525.³ For the year ending December 31, 2007, Henry District had operating revenues of \$3,191,579, operating

¹ Report of Henry County Water District No. 2 to the Kentucky Public Service Commission for the Year Ending December 31, 2007 ("2007 Annual Report") at 5 and 27.

² *Id.* at 30.

³ *Id.* at 7 and 11.

expenses of \$1,973,105, and net income of (\$57,601).⁴ Henry District's general service area and the location of its major service facilities are shown on Figure 1.

Henry District obtains its water supply from wells located in Trimble County, Kentucky, near the Ohio River. It pumps water from these wells to a water treatment facility, also located in Trimble County, where the water is filtered and treated with fluoride.⁵ This treatment facility, which was constructed in 1998 at a cost of approximately \$9.4 million,⁶ has a maximum daily capacity of 4 million gallons.⁷ Its average daily production in 2007 was approximately 2.14 million gallons.⁸ Henry District's average daily sales for the same period were 1.58 million gallons.⁹

Henry District's transmission and distribution system covers Henry County, the southern portions of Trimble County, and small segments of Oldham, Carroll, and Shelby counties. Between 2000 and 2007, the total water utility plant classified as transmission or distribution mains increased from \$6,221,216 to \$8,164,935.¹⁰ During the same period, Henry District's total utility plant increased from \$19,926,631 to

⁴ *Id.* at 11.

⁵ Transcript at 17.

⁶ See Case No. 96-378, The Application of Henry County Water District No. 2 of Henry County, Kentucky for Order Approving Construction Financing, Certificate of Public Convenience and Necessity, and Water Rates for Federally Funded Construction Projects (Ky. PSC Sep. 12, 1996).

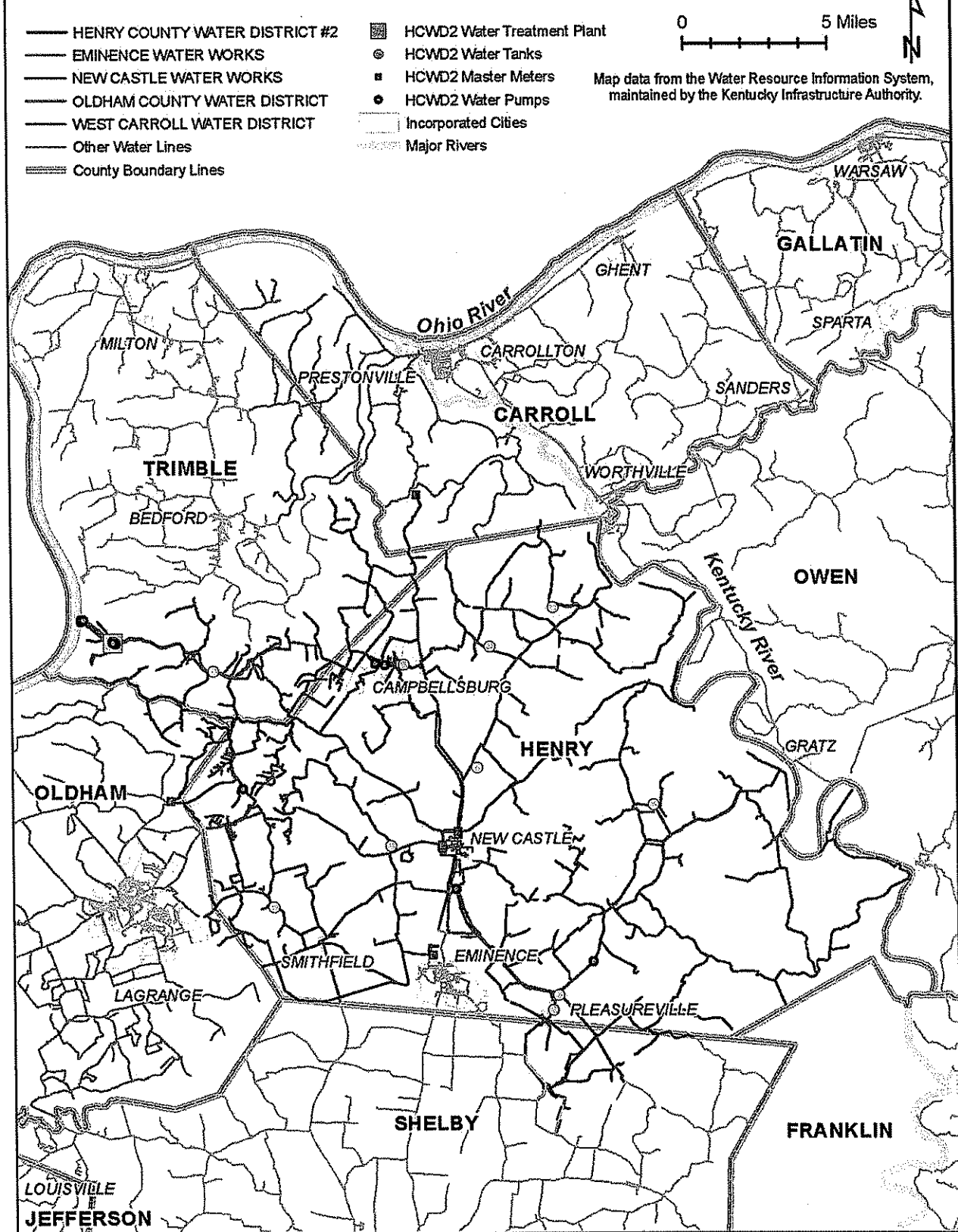
⁷ Water Resource Development Commission, *Water Resource Development: A Strategic Plan* (Oct. 1999), App. B (KIPDA Area Development District) at 14 (available at <http://kia.ky.gov/NR/rdonlyres/5316D210-CBA9-475B-B0D8-1792DCF42677/0/kipda.pdf>).

⁸ 2007 Annual Report at 29.

⁹ *Id.* at 30.

¹⁰ *Id.* at 14; Report of Henry County Water District No. 2 to the Kentucky Public Service Commission for the Year Ending December 31, 2000 ("2000 Annual Report") at 14.

Figure 1 of an Order of the Kentucky Public Service Commission for Case No. 2006-00191 regarding Henry County Water District #2 (HCWD2)



\$25,277,525.¹¹ Table 1 reflects the changes in the composition of its mains during this period.

TABLE 1

| WATER MAIN IN SERVICE (IN LINEAR FEET) | | | | | | | | |
|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
| 1-inch | 36960 | 36696 | 36140 | 38500 | 38500 | 38500 | 38500 | 42500 |
| 2-inch | 162096 | 162096 | 164208 | 164800 | 164800 | 164800 | 164800 | 164800 |
| 3-inch | 1325280 | 1327340 | 1295184 | 1296200 | 1296200 | 1297700 | 1497700 | 1497700 |
| 4-inch | 220176 | 230578 | 245520 | 246900 | 246900 | 243900 | 266900 | 273900 |
| 6-inch | 406560 | 419338 | 487238 | 482200 | 482200 | 485700 | 985700 | 985700 |
| 8-inch | 89760 | 90077 | 96994 | 89200 | 89200 | 96700 | 111700 | 111700 |
| 10-inch | 109296 | 109507 | 105019 | 105000 | 105000 | 105000 | 115000 | 125000 |
| 12-inch | 146784 | 146784 | 134904 | 134900 | 134900 | 134900 | 134900 | 134900 |
| 16-inch | 0 | 0 | 9398 | 9400 | 9400 | 9400 | 19400 | 2900 |
| 18-inch | 4224 | 4382 | 4119 | 4100 | 4100 | 4100 | 4100 | 4100 |
| 24-inch | 528 | 528 | 687 | 700 | 700 | 700 | 2700 | 2700 |

Source: Henry District Annual Reports to Kentucky Public Service Commission

During the same period, Henry District experienced slow to moderate growth in its customer base.¹² Between 1997 and 2007, as shown in Table 2 below, its total number of customers increased from 4,827 to 6,256, or 29.6 percent. The average annual increase in its customer base was approximately 2.4 percent. During relatively the same period, 2000 to 2007, the population of Henry County is estimated to have increased from 15,060 to 15,711 or 4.3 percent.¹³ By comparison, Kentucky's population increased by 4.9 percent.

¹¹ 2002 Annual Report at 13; 2007 Annual Report at 13.

¹² Transcript at 155.

¹³ Kentucky State Data Center, "County Population Estimates and Change in Population: 2000-2007" (available at <http://ksdc.louisville.edu/kpr/popest/coest2007.xls>). During this period, Henry County's position among Kentucky counties remained virtually unchanged. It ranked 73rd in population among Kentucky counties in 2007. In 2000 it ranked 74th. See Kentucky State Data Center, "County Population Estimates: 2000-2007, Ranked by 2007 Population" (available at <http://ksdc.louisville.edu/kpr/popest/coest2007byrank.xls>).

In the last 20 years, Henry District has adjusted its general service rates only once. The water district applied to significantly increase its rates for water service in 1996.¹⁴ In its application, which was made pursuant to KRS 278.023 and therefore was subject to limited Commission review,¹⁵ Henry District sought and received rates that increased the cost of a monthly bill for 5,000 gallons by approximately 89.5 percent.

TABLE 2

| HENRY COUNTY WATER DISTRICT NO. 2 CUSTOMER GROWTH | | | | | | | | | | | |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Year | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
| Residential | 4,706 | 4,835 | 5,017 | 5,165 | 5,293 | 5,380 | 5,770 | 5,859 | 5,929 | 6,013 | 6,086 |
| Commercial | 94 | 103 | 106 | 103 | 107 | 107 | 126 | 122 | 149 | 146 | 142 |
| Industrial | 4 | 5 | 4 | 4 | 3 | 3 | 3 | 3 | 3 | 3 | 3 |
| Public Authority | 23 | 26 | 25 | 27 | 28 | 29 | 35 | 34 | 34 | 34 | 25 |
| Total | 4,827 | 4,969 | 5,152 | 5,299 | 5,431 | 5,519 | 5,934 | 6,018 | 6,115 | 6,196 | 6,256 |
| Percent Increase | | 2.94% | 3.68% | 2.85% | 2.49% | 1.62% | 7.52% | 1.42% | 1.61% | 1.32% | 0.9% |

In 2000 Henry District began assessing an Offsetting Improvement Charge as a condition for service to new customers. It viewed the charge as a means to more fairly and equitably assess new customers the costs associated with upsizing water distribution mains.¹⁶ The charge represented the cost of facility improvements necessary to restore minimum daily water pressures in the general vicinity of a potential customer's location that were detrimentally affected as a result of serving the potential customer.

¹⁴ Case No. 96-378, The Application of Henry County Water District No. 2 of Henry County, Kentucky For Order Approving The Construction, Financing, Certificate of Public Convenience and Necessity, and Water Rates for Federally Funded Construction Projects (Ky.PSC Sept. 12, 1996). Prior to this case, Henry District last applied for a rate adjustment in 1987. See Case No. 9920, The Application of Henry County Water District No. 2 of Henry, Trimble, Carroll, Oldham and Shelby Counties, Kentucky, For Approval of Construction, Financing, and Increased Water Rates (Ky.PSC Sept. 30, 1987).

¹⁵ KRS 278.023 requires the Commission to accept agreements between water districts and the United States Department of Agriculture for the financing of construction projects and to issue certificates of public convenience and necessity and any other orders necessary to implement the terms of such agreements.

¹⁶ Prefiled Testimony of Thomas Green at 3-4.

Initially, Henry District imposed the Offsetting Improvement Charge through special contracts.¹⁷ It required all applicants who requested water service to execute contracts that required the payment of the Offsetting Improvement Charge even in those instances where the water district's existing facilities were adequate to support the applicant's expected demand.

In November 2001, Henry District proposed revisions to its rate schedules to permit the assessment of an Offsetting Improvement Charge to any applicant for water service who connected to its distribution system or to any real estate developer who requested water service for a real estate development. For all residential and agricultural tracts, the water district assumed that each tract or connection to Henry District's distribution system would result in the loss of one gallon per minute of peak water flow. For commercial, industrial, and other non-commercial usages, the water district required a hydraulic analysis to be performed to determine the applicant's effect on peak water flow. Henry District proposed to assess the charge regardless of the ability of its existing facilities to serve the applicant.

Under Henry District's proposal, a real estate developer would pay an Offsetting Improvement Charge for each lot in a proposed real estate development prior to the water district's certification to the local planning and zoning commission of the availability of water service to the proposed real estate development. Non-industrial and commercial customers who were not real estate developers, residential customers, or agricultural customers would pay the charge prior to making a service connection.

¹⁷ See, e.g., Case No. 2001-00352, A Special Contract Between Henry County Water District No. 2 and Pearce Brothers Ready Mix Concrete and Supply Company, Inc. (Ky.PSC Aug. 1, 2002).

Henry District proposed to calculate the level of the Offsetting Improvement Charge using the water district's improvement projects over a 4-year period. It would total the cost of these projects and the increase in peak water flow that results from each improvement. It would then divide total cost by total peak flow to obtain a cost per gallon per minute (gpm). This amount is then multiplied by the expected reduction in peak flow to obtain the total Offsetting Improvement Charge.¹⁸ The charge is recalculated biennially.

Under Henry District's proposal, all collected charges are placed in an escrow account and their use restricted to water line projects that improve hydraulic conditions in the distribution system. The water district was required to provide the Commission with periodic accountings of all expenditures from the escrow account. "Hydraulic need" and "cost-effectiveness" were the criteria for selecting projects to be financed with Offsetting Improvement Charge proceeds.

On July 25, 2002, the Commission approved the proposed charge of \$980 per gallon per minute peak flow with some modifications. The Commission, however, expressed concerns about the charge:

¹⁸ The following example illustrates how the Offsetting Improvement Charge is calculated:

During a 4-year period, Henry District constructs one water main improvement or extension project. The project costs \$30,000 and increases peak water flow rates by 30 gallons per minute. Using this project, the Offsetting System Charge would be \$1,000. [Total cost of the improvement projects (\$30,000) ÷ Total improvement in water flow (30 gpm) = \$1,000 per gpm]. If a real estate developer requests certification for a 20-lot subdivision, the water district would assess a charge of \$20,000. [Offsetting Improvement Charge x Number of Lots x Loss of water flow = \$1,000 per gpm x 20 lots x 1 gpm loss per lot = \$20,000. The development is assumed to reduce peak flow by 1 gpm per lot.] If a commercial customer requests a connection that would reduce peak water flow by 30 gallons per minute, it would be assessed a charge of \$30,000. [Offsetting Improvement Charge x Loss of water flow = \$1,000 per gpm x 30 gpm loss = \$30,000.]

The proposed tariff provides no means of distinguishing how the construction of system line improvements may benefit existing customers; nor does it contain a provision addressing the need to measure the effects of those improvements, or the proposed charge, upon existing customers. The proposed tariff filing also lacks controls regarding the use of proceeds of the proposed charge. Henry District has no long-term plan for the construction of water mains. It has no criteria for locating or upsizing water mains. Moreover, under the proposed plan, the district has complete discretion as to the location of new facilities. Thus, the potential for arbitrary decision-making is very high.¹⁹

Observing that the proposed charge presented “a case of first impression,” the Commission authorized Henry District’s assessment of the charge for three years only and directed that a full review of the charge’s operation be conducted at the end of this period to determine if the charge should be renewed.

On July 25, 2003, Henry District filed revisions to its Offsetting Improvement Charge to comply with the Commission’s Order of one year earlier. These revisions required the water district to provide the Commission with a long-range construction plan for the use of Offsetting Improvement Charge proceeds, including a prioritized listing of proposed distribution system improvements. They further provided that the only criteria to be used to identify and prioritize such improvements were “[g]rowth, low pressure, and cost-effectiveness.” They also prohibited projects that repaired water mains, constructed pumps or tanks, or extended water service. While the revisions further required the water district to consider whether improvements financed through

¹⁹ Case No. 2001-00393, Tariff Filing of Henry County Water District No. 2 to Add Tariff Language for An Offsetting Improvement Charge (Ky.PSC July 25, 2002) at 6.

Offsetting Improvement Charge proceeds would create benefits for existing customers, they assumed no benefit from such improvements.²⁰

On August 11, 2005, Henry District advised the Commission of its intent to continue with the assessment of the Offsetting Improvement Charge pending completion of any Commission examination on the operation of this charge and filed revised tariff sheets with the Commission that provided for the continued assessment of the charge. It further advised the Commission that, based upon its recalculation of the charge as required in the Commission's Order of July 25, 2002, the charge should be reduced to \$950 per gallon per minute peak flow.

As of August 31, 2007, Henry District had collected approximately \$420,000 in proceeds through the Offsetting Improvement Charge.²¹ Of this amount, approximately \$270,000 remained deposited in an escrow account.²²

PROCEDURE

On May 22, 2006, the Commission initiated this proceeding to review the operation of the Offsetting Improvement Charge and determine whether the charge should be permitted to continue. We further authorized Henry District to continue

²⁰ The possibility of the OIC tariff providing benefits to existing customers shall also be reviewed as part of the District's biennial submittal to the PSC. Since this charge is calculated strictly on the basis of development restoring its specific hydraulic impact, existing customers system-wide should receive no net benefit beyond the maintaining of the status quo. Those existing customers who may experience better pressures on roads with both development and OIC-financed improvements should be counterbalanced by those existing customers who experience lower pressures on roads with development, but where no OIC projects have been constructed.

Offsetting Improvement Charge Tariff Sheet 3.

²¹ Transcript at 51.

²² *Id.* at 52.

collection of the charge during the pendency of this case. The Commission, on its own motion, further directed that the Attorney General ("AG"), who was a party in Case No. 2001-00393, be made a party to this proceeding.

After several rounds of discovery, the Commission advised the parties in January 2007 that the matter would stand submitted after the submission of written briefs unless a request for hearing was received. Henry District subsequently requested a hearing.

On September 13, 2007, the Commission conducted a hearing in this matter. The following persons presented testimony: James Simpson, Henry District's Chief Operating Officer; Thomas Green, Senior Engineering Technician, Tetra Tech, Inc.; and Andrew Woodcock, Professional Engineer, Tetra Tech, Inc. Gary Larrimore, Executive Director, Kentucky Rural Water Association, presented a statement in support of Henry District's position. Following the hearing, Henry District and the AG submitted written briefs.

DISCUSSION

Scope of Review

We begin by clarifying the scope of this proceeding. Henry District has asserted that the scope of this proceeding should be limited to a review of its administration of the Offsetting Improvement Charge and not include a review of reasonableness and appropriateness of that charge. Its witnesses contend that the Commission had addressed and determined the reasonableness of the charge in the earlier proceeding and the further examination of this issue is unnecessary and unproductive.²³

²³ Prefiled Testimony of Thomas Green at 9-10.

The Commission finds no basis for limiting the scope of this proceeding. In our Order of July 25, 2002, the Commission stated that the Offsetting Improvement Charge was established "for an initial 3-year period only" and that, at the end of this initial period, we would "conduct a full review of the operation of the program and determine whether it should be renewed."²⁴ We placed no restrictions on the scope of this review. In similar cases when the Commission has authorized the assessment of a rate or charge on an experimental or pilot basis, we have held that the Commission has full discretion to review the reasonableness and appropriateness of the rate at any time.²⁵

KRS 278.260(1) permits the Commission to investigate the reasonableness of any existing utility rate at any time. Given the unique nature of the charge, the water utility community's great interest in this charge,²⁶ and the possible implications of permanent approval of this charge, further examination of the Offsetting Improvement Charge is not only appropriate but should have been anticipated. The reasonableness of the charge is critical to any decision to permit its continued assessment.²⁷

Moreover, given the limited review conducted in the prior case, we find that *further examination of the reasonableness of the Offsetting Improvement Charge is appropriate.* In our review of the record of Case No. 2001-00393, we found no inquiry

²⁴ Case No. 2001-00393, Order of July 25, 2002 at 6.

²⁵ See, e.g., Case No. 1995-00161, The Tariff Filing of North Shelby Water Company to Revise Its Extension Policy to Include a Line Upsize Charge (Ky.PSC Sept. 25, 1995).

²⁶ See, e.g., Transcript at 10-14.

²⁷ KRS 278.030(1) permits utilities to collect only "fair, just and reasonable rates."

regarding Henry District's customer growth rates and their effect on utility revenues, Henry District's depreciation practices, its history of general rate adjustments, or the general need for the Offsetting Improvement Charge. These issues, however, are relevant to any determination of the charge's reasonableness and should be considered before the charge is re-authorized.

Nature of the Charge: System Development Charge or Nonrecurring Charge?

The parties to this case differ as to the nature of the Offsetting Improvement Charge. Henry District contends that the charge is a system development charge that "identifies a cost which is clearly and specifically associated with growth."²⁸ The AG rejects this characterization and instead contends that the charge is merely a "non-recurring charge with regard to conditions for receiving service."²⁹

The characterization of the Offsetting Improvement Charge is important because it significantly affects the standards that are used to gauge the reasonableness of that charge. Administrative Regulation 807 KAR 5:090 governs system development charges and prescribes certain requirements for their assessment.³⁰ If the charge is not a system development charge, then the Commission will review the charge to determine if it is "fair, just, and reasonable."³¹

²⁸ Henry District's Response to The Commission's Order of May 22, 2006, Item 3 at 1.

²⁹ AG Brief at 7. The AG has retreated from his earlier position in which he characterized the Offsetting Improvement Charge as a system development charge. See Case No. 2001-00393, AG's Brief at 4.

³⁰ In addition, the Commission established guidelines for the development and administration of system development charges in Administrative Case No. 375. See Administrative Case No. 375, An Investigation Into the Design and Use of System Development Charges (Ky.PSC May 15, 2001).

³¹ KRS 278.030(1).

“System development charge” is defined as a

one (1) time charge assessed by a water utility on a real estate developer, on a new customer, or on an existing customer who significantly increases its demand for water service to finance construction of a system improvement necessary to serve that customer or a proposed real estate development.³²

The AG asserts that, because the Offsetting Improvement Charge is limited to improvements in water distribution facilities and does not address “costs associated with facilities or projects such as source of supply development, treatment, and storage,” it is not a system development charge.³³ The Offsetting Improvement Charge, he argues, is designed to address a problem that “stems from inequity resulting from differences in ‘local’ hydraulic conditions and relate[s] primarily to distribution system consideration rather than transmission considerations.”³⁴

Henry District has taken exception to such arguments. It notes that the regulatory definition of “system development charge” makes no distinction between distribution facilities and transmission facilities.³⁵ Moreover, given the nature of its water distribution system, it argues, such a distinction is meaningless.³⁶ It asserts that its water mains perform both distribution and transmission functions. The charge, it asserts, is not local in nature but system-wide.

³² 807 KAR 5:090, Section 9(3).

³³ AG’s Brief at 2.

³⁴ *Id.* at 2, n.6.

³⁵ Henry District’s Response to Commission Staff’s Second Set of Interrogatories and Requests for Production of Documents, Item 1.

³⁶ E-Mail from Tom Green, Tetra Tech, to Gerald Wuetcher, Counsel for Commission Staff (Oct. 31, 2006, 10:56 AM); Henry District’s Response to Commission Staff’s Third Set of Interrogatories and Requests for Production of Documents, Item 1.

When the Commission first considered the Offsetting System Improvement Charge, Administrative Regulation 807 KAR 5:090 had yet to be promulgated. Though the regulation became effective prior to the issuance of our final Order in Case No. 2001-00393, we did not classify the Offsetting Improvement Charge as a system development charge, nor did we use that regulation to reach our decision. That the Commission authorized the Offsetting Improvement Charge on a temporary basis only, despite the existence of a regulation that specifically authorized system development charges, is clear evidence that the Commission did not regard the proposed charge as a system development charge.

Moreover, the Offsetting Improvement Charge does not fall within the parameters of 807 KAR 5:090 or system development charges generally. It is limited to a specific type of system improvement – the installation of water distribution mains to replace or supplement existing water distribution mains that are deemed inadequate. Generally, system development charges are intended to recover all costs related to system development or expansion.³⁷

The improvements on which the Offsetting Improvement Charge focuses are primarily water mains that serve a limited or localized area.³⁸ System development charge-related capital improvements are “restricted to common-use facilities; generally, they do not include site-specific or local facilities. Examples of common-use facilities

³⁷ Transcript at 158.

³⁸ See, e.g. Henry District’s Response to Commission Staff’s First Set of Interrogatories and Requests for Production of Documents, Item 1.

are supply sources, source water intakes, source water transmission, water treatment facilities, and major water transmission mains.”³⁹

The Offsetting Improvement Charge is not supported by a capital improvement plan. Administrative Regulation 807 KAR 5:090 requires a capital improvement plan that, among other things, projects the amount of and characteristics of anticipated growth and the demand that such growth will place on the system; states the cost of system upgrades and improvements needed to provide the desired level of service; states when and where the proposed system upgrades and improvements would be needed; provides a deficiency analysis of the applicant's current system; and identifies the system improvements necessary to provide adequate service at existing and future demand levels.⁴⁰ The record fails to reflect that Henry District either prepared or provided such a plan.

The Offsetting Improvement Charge is not based upon a recognized system development charge methodology. It does not follow either of the two basic methods for calculating a system development charge—the equity method or the incremental cost method. Henry District describes the charge as “an alternative methodology.”⁴¹ Its expert witness describes the methodology as unique.⁴²

³⁹ American Water Works Association, *Principles of Water Rates, Fees, and Charges* (5th ed. 2000) at 204.

⁴⁰ 807 KAR 5:090, Section 3(6).

⁴¹ Henry District's Response to the Commission's Order of May 22, 2006, Item 1.

⁴² Transcript at 155.

Based upon the above, the Commission finds that the Offsetting Improvement Charge should not be characterized as a system development charge and that Administrative Regulation 807 KAR 5:090 is not applicable to our review of the charge. The Commission will instead review the charge as a nonrecurring charge and use the criteria that are set forth 807 KAR 5:011, Section 10, to determine the reasonableness and fairness of the charge.

Reasonableness of the Offsetting Improvement Charge

Henry District's stated purpose for developing and implementing the Offsetting Improvement Charge is to allocate "to development the reasonably determined cost of improvements necessitated by growth."⁴³ The Charge is a reflection of the water district's policy "that development . . . pay to offset its hydraulic impact on the water distribution system, rather than such costs being paid by the District's customers."⁴⁴ It also reflects the water district's strongly held belief that "it is unreasonable for the District *not* to relieve its existing customers of a portion of the burden of growth necessitated costs."⁴⁵

The Offsetting Improvement Charge is premised upon two assumptions. First, Henry District's existing rates for general water service fail to adequately recover water distribution main upgrade and improvement costs associated with the addition of new customers and, therefore, a new source of revenue is necessary to finance such costs. Second, recovery of water distribution main upgrade and improvement costs associated with the addition of new customers through general service rates effectively requires

⁴³ Henry District's Response to the Commission's Order of May 22, 2006, at 1.

⁴⁴ Henry County Water District No. 2, Offsetting Improvement Charge Tariff Sheet 1.

⁴⁵ Prefiled Testimony of Thomas Green at 3.

existing customers to subsidize the costs related to new customers and thus is unfair and unreasonable.

The record of this proceeding does not support these assumptions. Henry District's rates for general water service have remained unchanged since 1996. During that period, Henry District increased in total number of customers from 4,827 to 6,256, an increase of 29.6 percent. That the number of total customers increased while rates remained constant and the utility continued to add distribution mains suggests that the additional revenues generated from customer growth adequately covered any additional expenses related to growth and that growth has not placed excessive pressure on the water district's finances.

Henry District disputes that the additional revenues generated through customer growth have adequately addressed expenses associated with such growth. It notes that net operating revenue per customer has decreased by 75.7 percent from \$132.64 in 1998 to \$32.35 in 2006 and asserts that rising expenses are rapidly outpacing revenue growth.⁴⁶

Henry District further argues that the present level of its general service rates is irrelevant to the reasonableness of the Offsetting Improvement Charge.⁴⁷ The key issue, it asserts, is whether the costs to be recovered through the Offsetting Charge are related to new customer growth and the construction or expansion of water distribution mains to serve that growth. It notes that no statute or regulation requires a general rate

⁴⁶ Prefiled Testimony of Andrew Woodcock at 9. This analysis failed to distinguish between variable costs and fixed costs of production and distribution. As a result, the Commission is unable to determine whether the reduction in operating revenue is due to the addition of facilities to serve new customers or to other factors such as inflation. Based upon the methodology used to calculate the Offsetting Improvement Charge, the charge is intended to address fixed costs of distribution.

⁴⁷ Henry District Brief at 1-2.

proceeding as a prerequisite to the imposition of a charge such as the Offsetting Improvement Charge.

These arguments ignore a critical point. To determine the reasonableness of the Offsetting Improvement Charge, the Commission must first determine whether a reasonable basis to assess the charge exists. That determination requires us to review the rates for general water service and to determine the reasonableness of those rates and whether inclusion of costs related to the construction or expansion of water distribution mains to serve new growth would render that rate unreasonable.⁴⁸ Since Henry District's rates have not been reviewed in more than 20 years and have not been rebalanced within the last 11 years to reflect the current cost of providing water service, this Commission cannot conclude that the Offsetting Improvement Charge is required to meet the cost of new water distribution mains or that the inclusion of such costs in general rates is unreasonable or unfair.

When we consider the total level of Offsetting Improvement Charge proceeds collected, the Commission is unable to conclude that the Charge is an effective means of financing the construction or expansion of water distribution mains to serve new growth. From June 2002 until September 2007, Henry District collected approximately \$420,000, or an average of \$84,000 annually. The average annual proceeds represent less than 2.7 percent of Henry District's total annual operating revenues for Calendar Year 2007. Its relatively small size in relation to total operating revenues suggests that

⁴⁸ 807 KAR 5:011, Section 10, requires that the Commission consider why a proposed nonrecurring charge could not be deferred until the utility's next general rate proceeding; requires the utility to perform an absorption test under certain circumstances; and further requires the proposed nonrecurring charge to be reviewed under general rate adjustment application procedures when the utility has made more than two applications for nonrecurring charges since its last general rate adjustment proceeding.

inclusion of the costs in general rates may be more appropriate and reasonable than continuation as a separate charge.

Likewise, the record fails to reflect a significantly large number of new customers that would suggest the need for major additions to the water district's infrastructure. Between 1997 and 2007, Henry District's customer level increased an average of 2.4 percent annually. During the same approximate period, 2000 to 2007, Henry County's population increased at a rate of 4.3 percent, which was lower than the overall statewide population increase of 4.9 percent.⁴⁹

Henry District argues that any focus upon customer growth levels is inappropriate. It argues that the actual costs of growth are not a direct function of growth rate. A water utility experiencing low overall growth rates may incur significant costs related to growth because growth is concentrated in areas where water utility infrastructure is limited or non-existent.⁵⁰ While this position has merit, the record does not suggest that that this situation occurred in Henry District's case.

Henry District further argues that the Offsetting Improvement Charge is a necessary tool to prepare for potential growth.⁵¹ Should the water district experience sudden and sustained growth, it would have in place a rate mechanism that would allocate the costs of growth directly to those customers who were responsible for such costs.

While the Commission agrees that establishment of a rate mechanism that effectively and fairly allocates the costs of growth is prudent and is not preconditioned

⁴⁹ See *supra* note 13 and accompanying text.

⁵⁰ Prefiled Testimony of Thomas Green at 14.

⁵¹ *Id.* at 14-15.

upon a water utility presently experiencing significant growth, the mechanism should capture all aspects and costs of growth and not focus merely on one potential cost component as the Offsetting Improvement Charge does.

Moreover, we questioned the reasonableness of the Charge's underlying assumption that the addition of any customer will facilitate the need for construction of new water distribution mains. In areas where facilities are presently adequate, the exhaustion of existing distribution main capacity by growth is not possible or likely, and the addition of customers will not affect quality of service, the Offsetting Improvement Charge does not ensure that a new customer is paying the costs that his or her addition imposes on the system, nor does it place the new customer on parity with an existing customer; it merely extracts an amount to be used to finance facilities to serve others.

Based upon the above, the Commission finds that the Offsetting Improvement Charge should not be reauthorized. To prevent any disparate treatment of customers that might result from the sudden termination of the Offsetting Improvement Charge, however, the Commission will permit Henry District to continue to assess the charge for 180 days from the date of this Order. This grace period will permit Henry District sufficient time to develop and to file with the Commission an alternative mechanism that comprehensively addresses the allocation of costs associated with customer growth.⁵²

We remind Henry District that the Commission has previously recognized the equity method as an acceptable means of allocating such costs.⁵³ It is based upon the

⁵² To the extent that Henry District may require additional time to develop an alternative and obtain Commission approval of that alternative, it may apply for an extension of the 180-day period.

⁵³ Administrative Case No. 375, An Investigation Into the Design and Use of System Development Charges (Ky.PSC May 15, 2001), Appendix A at 10.

“principle of achieving capital equity between new and existing customers.”⁵⁴ This approach attempts to assess new customers a fee to approximate the equity or debt-free investment position of current customers. Its goal is to “achieve a level of equity from new customers by collecting a . . . charge representative of the average equity attributable to existing customers.”⁵⁵ Given the concerns that Henry District has previously expressed about forecasting its capital needs⁵⁶ and its slow to moderate growth rate, this methodology would more effectively achieve Henry District’s objective of parity between current and new customers without the problems presented by the Offsetting Improvement Charge.

The Commission further finds that Henry District should be permitted to retain all proceeds from the Offsetting Improvement Charge assessed during the period in which the Commission authorized the charge. The restrictions regarding the use of these proceeds and the reporting requirements that were imposed by our Order of July 25, 2002 in Case No. 2001-00393 should continue in effect until Henry District has expended all collected proceeds and made a final report of their disposition to the Commission.

Failure to Comply with Administrative Regulation 807 KAR 5:066, Section 11(3)

During the proceeding, Henry District acknowledged⁵⁷ its failure to comply with Administrative Regulation 807 KAR 5:066, Section 11(3), which provides:

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

⁵⁴ *Principles of Water Rates, Fees, and Charges* at 199.

⁵⁵ *Id.*

⁵⁶ Henry District’s Response to the Commission’s Order of May 22, 2006, Item 3.

⁵⁷ Transcript at 125 -128.

(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.

Henry District has stated that it had not made any refunds for water main extensions constructed within real estate subdivisions under the belief that the regulation required refunds only for water main extensions to a real estate subdivision and was not applicable to extensions within the subdivision development.⁵⁸

Henry District's action conflicts with the Commission's long-held interpretation of the regulation's requirements. As Henry District was party to at least one Commission proceeding in which the Commission extensively reviewed this interpretation,⁵⁹ its position on this issue is subject to question and requires further investigation. The Commission will shortly initiate a new proceeding to investigate Henry District's practices in this area and to determine whether Henry District failed to make required refunds to real estate subdivision developers.

IT IS THEREFORE ORDERED that:

1. Henry District shall cease assessing the Offsetting Improvement Charge 180 days from the date of this Order.
2. Henry District may retain all proceeds of the Offsetting Improvement Charge assessed prior to the termination date set forth in this Order. Henry District shall continue to place such proceeds in an escrow account. Its use of such proceeds

⁵⁸ *Id.*; Henry District's Response to Commission Staff's Second Set of Interrogatories and Requests for Production of Documents, Item 21.

⁵⁹ Administrative Case No. 386, An Examination of Existing Water Distribution Main Policies (Ky.PSC Aug. 15, 2002).

is limited to water main projects that improve hydraulic conditions of Henry District's distribution system.

3. Henry District shall continue to submit to the Commission an accounting of all expenditures from the escrow account for hydraulic improvement projects as required by the Commission's Order of July 25, 2002 in Case No. 2001-00393 until all proceeds from the Offsetting Improvement Charge have been expended.

4. Within 60 days after ceasing assessment of the Offsetting Improvement Charge, Henry District shall file with the Commission a list of all Offsetting Improvement Charges assessed and collected.

5. Subject to the filing of 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 8th day of December, 2008.

By the Commission

ATTEST:

Executive Director

Case No. 2006-00191

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