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August 4, 2009

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**PUBLIC SERVICE  
COMMISSION**

Mr. Jeff Derouen  
Public Service Commission  
PO Box 615  
Frankfort, KY 40011

Re: Case # 2006-00191

Dear Mr. Derouen,

Please find the enclosed report requested by the Public Service Commission in the June 16, 2009 Order.

If you have any questions regarding this report please contact me at 502-532-6279.

Sincerely,

James T. Simpson  
Chief Operating Officer  
Henry County Water District # 2

HENRY COUNTY WATER DISTRICT No. 2

REPORT TO THE PUBLIC SERVICE COMMISSION

As Requested in June 16, 2009 Order  
Case 2006-00191

Efforts to Develop an Alternative to the Offsetting Improvement Charge

The Henry District requested the reauthorization of the Offsetting Improvement Charge in July 2005. In December 2008 the Commission rejected the OIC in Case 2006-00191. At meetings of the Henry District Board on January 13, 2009, and on February 10, 2009, the District's board members, officers, and professional consultants discussed at length their analysis of the specifics of the twenty-four page PSC order. We examined the reasons cited for the rejection of the charge and discussed the likelihood of successfully appealing the decision.

We concluded at our February meeting that, although we disagreed with some of the Commission's reasoning, an appeal would probably not be successful. But before deciding to again commit resources to developing another type of impact fee, we wrote the PSC on February 5 to request clarifications regarding their suggestion that an SDC based on the equity methodology would be appropriate for the Henry District. The Commission responded to our request on April 2, 2009 in a letter generally supportive of an equity SDC submittal.

On April 8, 2009, the District continued its efforts by writing Assistant Attorney General David Spenard to ask whether his office considered the equity methodology to be lawful in Kentucky, an issue the AG had previously raised in Administrative SDC Case 375. In his May 8, 2009 response, Mr. Spenard advised us that the use of the equity methodology in Kentucky remains problematic to the Office of the Attorney General.

The initial six-month extension of the OIC was consumed first by the Board's deliberations regarding grounds for appeal at meetings in January and February, followed by a two-month response time by the PSC in addressing the February 5 letter from the District requesting clarification. There was a one-month response time to our April 8 letter to Assistant Attorney General Spenard. Ten days after learning that there were still legal questions to be resolved the Henry District on May 18 requested a second six-month extension to the OIC "in order to provide the District with time to make the necessary well-informed judgments regarding the structure of our SDC submittal, and in order to maintain a consistent policy toward our new customers..."

On June 16 the PSC approved an extension until September 4, 2009, and required the written report we provide herein as the prerequisite to any further extensions of time. Upon receipt of the June 16 extension we prepared a comprehensive list of our specific questions and concerns regarding equity methodology and its submittal/approval

requirements. In the view of the District, some of the reasons given by the PSC for rejecting the OIC would logically require their rejection of a Henry District equity SDC submittal as well. And several significant issues relevant to the methodology itself and to its approval were not addressed at all in 807 KAR 5:090. On June 25 we sent our questions to the PSC along with a request to meet with Commission Staff. That meeting was held from 10 am to 12:30 pm on July 21, and Commission Staff was very candid and helpful, as was Assistant AG David Spenard.

Using the \$3,000,000 rough estimate of Henry District's original cost equity which was provided by Commission Staff at the July 21 meeting, and dividing by a second estimate of 10,000 customers as system capacity, would produce an equity SDC of about \$300. This amount is less than a third of the \$950 OIC, which itself was found by the PSC to be incomplete because it excluded the costs of intake, treatment, and storage.

Because incremental SDC methodology (which we understand to be acceptable both to the PSC and to the AG's office) employs a future cost basis to determine the fee paid by the new customer, it seems reasonable that the present day replacement cost equity basis could be used under Henry District's circumstances, where growth will require the replacement of small diameter lines in many areas. Using replacement cost as the equity basis would result in a higher SDC than using original cost, but it would still not produce a charge as high as the OIC, which achieved only partial growth cost recovery. We are presently seeking AWWA guidance on the use of replacement cost as an appropriate equity basis in systems which will require capacity expansion.

As the above summary makes clear, our efforts to develop an alternative to the Offsetting Improvement Charge have involved a very thorough and time-consuming effort to gauge the realistic likelihood of regulatory approval, to understand the relevant issues and requirements for what may become the first equity methodology SDC to be approved in Kentucky, and to comply with the PSC's direction that we "develop and file with the Commission an alternative mechanism that comprehensively addresses the allocation of costs associated with customer growth."

#### Plan to Implement an Alternative SDC

1. Perform evaluations of system capacity, beginning with the maximum output of the treatment plant and adjusting by the historical average of annual peak customer consumption days to establish maximum system capacity in terms of residential customers. Scheduled completion: September 1.
2. Prepare a general rate study (analysis by Carryn Lee of Lee Utility Consulting). The PSC strongly suggested in the OIC proceedings that we examine our general rates to provide context for the review of the charge. We have now assembled and provided to Ms. Lee all data necessary to conduct her analysis. We are anticipating the completion of this work by October 1.

3. To determine which materials, prepared testimony, etc. will be required in our equity SDC application: prepare, submit and receive response from the Commission to a preliminary request for waivers from those specific sections of 807 KAR 5:090 as suggested in April 2, 2009, letter from PSC Executive Director Derouen. Scheduled completion: October 1.
4. Resolve central issue of whether to calculate and file SDC with original cost or with replacement cost equity basis. Determine which, in the District's view, is more fair and reasonable, and also weigh the higher revenue benefit of a replacement cost charge against the likelihood of added expense and greater difficulty in the regulatory approval process. Identify and document all sources of equity, assign value to all assets, make adjustments by depreciation where appropriate, compile all non-local contributions such as federal/state grants and developer-financed facilities since the Districts inception. Scheduled completion: October 15.
5. Prepare draft tariff language which incorporates the rationale and purpose of the charge, the time of its assessment, the limitations on its use (if any), the method of its periodic reevaluation as part of a general rate case, the circumstances for refunds, and all other stipulations as required by 807 KAR 5:090 and not waived by the Commission. Scheduled completion: October 30.
6. Obtain feedback from Commission Staff and from Office of the AG on draft of proposed equity SDC tariff, revise per suggestions. Simultaneously submit both rate case and equity SDC tariff. Include in submittal letter explanation that equity SDC charge is appropriate because Henry District is not an investor-owned utility. Scheduled completion: November 15.

In order to continue with a consistent policy toward our new customers, and in order to permit Henry District sufficient time to complete the work of developing and filing an approvable equity system development charge to replace the Offsetting Improvement Charge, we request an extension of the Commission's authorization of the OIC until December 31, 2009.