

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ELECTRONIC PROPOSED ADJUSTMENT OF)	
THE WHOLESALE WATER SERVICE RATES)	CASE NO.
OF THE CITY OF PIKEVILLE TO MOUNTAIN)	2019-00080
WATER DISTRICT)	

ORDER

By petition filed on January 13, 2020, the city of Pikeville (Pikeville), requests a rehearing of the Commission's final Order issued on December 19, 2019 (Final Order), pursuant to KRS 278.400. Among other things, the Final Order authorized a wholesale water rate of \$1.97 per 1,000 gallons and for Pikeville to be able to recover its allowable rate case expense of \$64,394 through a 60-month surcharge of \$537 to be charged to Mountain Water District (Mountain District) and to Southern Water and Sewer District (Southern District).

Pikeville raises multiple issues on rehearing, which are addressed below. Mountain District did not file a response to Pikeville's rehearing petition. This matter stands submitted for a decision.

DISCUSSION AND FINDINGS

Legal Standard

KRS 278.400 establishes the standard of review of applications for rehearing. KRS 278.400 provides that, upon rehearing, a party may offer additional evidence that could not with reasonable diligence have been offered at the time of the original hearing. Rehearing does not present parties with the opportunity to relitigate a matter fully

addressed in the original Order. KRS 278.400 is intended to provide closure to Commission proceedings by limiting rehearing to new evidence not readily discoverable at the time of the original hearings. Thus, final orders remain undisturbed absent extraordinary circumstances, such as a material error or omission in the order. KRS 278.400 provides an opportunity for the Commission to address any errors or omissions in an order.

Customer Allocation Factor

Citing the absence of a supporting study or analysis, the Commission found that Pikeville's fixed shared costs would not vary with the amount of water that Pikeville either produced or sold.¹ In prior proceedings the Commission found that a more equitable allocation method would be the number of customers that are served by each division (Customer Allocation Factor). The Commission finds that Pikeville's shared fixed costs should be reallocated using a five-year average Customer Allocation Factor. Using the five-year average customer allocation factor the Commission allocated 33.423 percent of the shared fixed costs to the outside-the-city system and 65.577 percent to the inside-the-city system. By reallocating the shared fixed costs between the two customer classes, the Commission decreased the operation and maintenance expense allocated to inside-the-city customers by \$106,059.

Pikeville explains that historical test-year ratemaking is premised on the "matching principle" of accounting, where the relationship of revenues and expenses is established.²

¹ Final Order at 8.

² Petition for Rehearing by City of Pikeville (Pikeville Rehearing Petition) filed January 13, 2020, at 8.

Pikeville's interpretation of the "matching principle" is that all revenues, expenses, rate base components, plant additions, and capital items are updated to the same period.³ Pikeville argues that the Commission is violating the matching principle by applying a customer allocation factor that is based on an average calculated with customer data from 2014 to 2018 to fiscal year 2017 operating expenses.⁴

Pikeville notes that the Commission cited numerous cases to support the use of a customer allocation factor to allocate to Pikeville's shared fixed costs. However, in none of the cases cited, Pikeville argues, did the Commission or its Staff use a multi-year average to determine the appropriate allocation factor of shared fixed costs.⁵ Pikeville requests that the Commission revise its Order to reflect allocating the shared fixed costs between the two systems using the 2017 fiscal year customer allocation factor.⁶

The Commission acknowledges that the Final Order failed to give a full explanation for the reason the Commission decided to use a five-year average Customer Allocation Factor to allocate the shared fixed costs between the outside-the-city and the inside-the-city systems. The Commission finds that rehearing should be granted to clarify the Final Order as discussed below.

The common definition of a fixed cost, is a cost that does not change with increases or decreases in units of production volume.⁷ For a water utility water production would

³ *Id.*

⁴ *Id.*

⁵ *Id.*

⁶ *Id.*

⁷ <https://corporatefinanceinstitute.com/resources/knowledge/accounting/fixed-and-variable-costs/>

not directly impact a fixed cost, but changes in the number of customers served (increases or decreases) over time will have some degree of impact. Even though the customer level does have some impact, a fixed cost would not vary widely from year to year, but would remain constant throughout a relevant range.⁸

In reviewing the historical customer data, the Commission notes that for every year in the five-year period there is variation between the customers served by each division which would result in differences in the annual fixed cost allocation factor. A five-year customer allocation factor is an average of the highs and lows that have occurred over a relevant range. For this reason the Commission finds that the use of five-year average customer allocation factor results in a reasonable cost allocation between the two water systems. Therefore, Pikeville's request for rehearing on this issue is denied.

Allocations of Repairs and Maintenance Plant and Insurance

Pikeville explains that when the Commission allocated the shared fixed costs between the inside- and outside-the-city customer classifications it started its adjustment based on the total inside-the-city and outside-the-city expense.⁹ According to Pikeville the Commission failed to add the outside-the-city allocated expenses of \$1,888 (Ross Valve Manufacturing, Eco Lab, and ML Johnson) before applying the Customer Allocation Factor.¹⁰ Similarly, Pikeville requests the Commission to correct the formulas for calculating the fixed shared cost adjustments to Insurance Expense and the Repairs and Maintenance Plant Expense.¹¹ In reviewing Pikeville's response to the Commission

⁸ http://economics.fundamentalfinance.com/micro_costs.php

⁹ Pikeville Rehearing Petition, at 9.

¹⁰ *Id.*

¹¹ *Id.*

Staff's First Request for Information, the Commission agrees with Pikeville that \$1,888 should be included to the repairs and maintenance expense before applying the customer allocation factor. Including this amount into the allocation adjustment results in an increase to repairs and maintenance expense of \$1,257, which is *de minimis* because it does not materially impact the calculation of Pikeville's wholesale rate. Further, the formulas used by the Commission to calculate the cost allocations between the inside-the-city and the outside-the-city systems are correct.¹²

For the above reasons, the Commission finds that the Pikeville failed to establish a material error or omission in the Final Order, or that the Final Order was unreasonable or unlawful, and therefore fails to satisfy the standard for rehearing. Pikeville's request for rehearing on this issue is denied.

Electric Expense based on Sales not Production

The only variable shared cost reported by Pikeville was electric expense.¹³ The Commission found that without the pumping stations and the storage tanks located inside the city system, Pikeville would be unable to provide water service to the outside-the-city system.¹⁴ Using the five-year average of water produced, the Commission calculated an electric cost per gallon produced of \$0.0000281. Using the average inside-the-city water

¹² Repairs and Maintenance Plant: $\$6,368$ (Net Repairs and Maintenance Plant) \times -33.253% (5-Year Outside Customer Allocation Adjustment) = $\$(2,128.38)$ (Outside-the-City Allocation) + $\$6,368$ (Net Repairs and Maintenance Plant) = $\$4,239.62$ (Inside-the-City Allocation) \div $\$6,368$ (Net Repairs and Maintenance Plant) = 66.577% .

Insurance: $\$34,896$ (Total Insurance) \times -33.253% (5-Year Outside Customer Allocation Adjustment) = $\$(11,663.29)$ (Outside-the-City-Allocation) + $\$34,896$ (Total Insurance) = $\$23,232.71$ (Inside-the-City Allocation) \div $\$34,896$ (Total Insurance) = 66.577% .

¹³ Chemical expense is also a variable cost, but it is embedded in the UMG Management Fee so an additional adjustment is unnecessary.

¹⁴ Final Order at 9.

sales the Commission calculated a decrease to electricity expense for the inside-the-city system of \$46,328.

Pikeville claims that the methodology employed by the Commission leaves a void whereby Pikeville would be unable to recover for electric expense associated with water produced but not sold.¹⁵ Pikeville further claims that the Commission is violating the matching principle by using a five-year average of data for water production and water sales.¹⁶

In the test year there is a difference of 380,001,700 gallons or 32.9 percent between water production of 1,155,123,700 gallons and water sales of 775,122,000. In its Petition for Rehearing Pikeville only identifies the void in electric expense associated with water produced but not sold without fully explain the cause of the excessive difference water sales and production or to provide evidence as to why the cost associated with this difference should be recovered from its wholesale customers. Accordingly, the Commission is denying Pikeville's request for rehearing on this issue.

Customer Related Cost Adjustments

Pikeville claims that the Commission identified certain expenses as being customer-related costs and without giving a reasonable explanation as to why some customer-related costs should be totally recovered from the retail water customers, while others are allocated using the number of meters in Pikeville's system.¹⁷ Pikeville argues that the evidence of record does not support the Commission's decision that employee

¹⁵ Pikeville Rehearing Petition at 10.

¹⁶ *Id.* at 11.

¹⁷ *Id.* at 13.

related expenses (salaries and wages, workers compensation, employee benefit insurance, pension, payroll tax, and unemployment tax) should be recovered exclusively from the retail customers. Pikeville claims that its employees perform the following duties that are directly related to providing wholesale water service to Mountain District (take calls from Mountain District, prepare work orders for maintenance of facilities benefiting Mountain District, send bills to Mountain District, and receive payments from Mountain District).¹⁸

According to Pikeville, the Commission erroneously calculated the allocation factor for customer-related costs based on Mountain District receiving wholesale service through 9 wholesale water meters when actually there are 11 master meters providing wholesale service to Mountain District.¹⁹ This correction would increase the allocation factor for customer-related costs from 0.181 percent to 0.221 percent.²⁰

Pikeville claims that the Commission eliminated recovery of certain UMG Management Fee expenses twice. First the Commission determined that the overall UMG Management Fee expense that could be recovered from the inside-the-city system should be reduced from \$1,162,040 by \$49,416 to a total of \$1,112,624. Next the Commission eliminated \$58,102 of customer-related administrative costs from the UMG Management Fee. Samuel "Buddy" Petty calculated this administration component by multiplying UMG Management fee of \$1,162,040 by 5 percent. Pikeville argues the

¹⁸ *Id.*

¹⁹ *Id.* at 13–14.

²⁰ *Id.* at 14.

5 percent factor should be multiplied by the reduced fee of \$1,112,642 for a revised customer-related administrative cost of \$55,632.

The Commission agrees with Pikeville in that the Commission used the wrong number of wholesale meters when it calculated the allocation factor for customer-related costs. Using 11 wholesale master meters increases the allocation factor from 0.181 percent to 0.221 percent. Increasing the allocation factor to 0.221 percent would increase the revenue requirement by \$118, which is *de minimis* because it does not materially impact the calculation of Pikeville's wholesale rate. Further, the Commission in its Order noted the numerous deficiencies in the allocation factors used by Mr. Petty in his proposed rate analysis. Although the administration component of the UMG Management is based on an unsupported factor, the Commission recognizes that some portion of the UMG management fee relates to administrative costs that would not be recovered through the wholesale rate. For this reason the amount identified by Mr. Petty in his study was viewed as a fixed cost that would not vary with changes in the allocation of the UMG Management fee between the various city departments.

For the above reasons, the Commission finds that the Pikeville failed to establish a material error or omission in the Final Order, or that the Final Order was unreasonable or unlawful, and therefore fails to satisfy the standard for rehearing. Pikeville's request for rehearing on this issue is denied.

Nonrecurring Expenditures

The Commission reduced repairs and maintenance expense by \$99,506 (the telemetry repairs at Toller and the rehabilitation of the Bob Amos tank) finding these items

are nonrecurring that should have been amortized rather than expensed.²¹ It also reduced maintenance/repairs plant expense by \$24,264 finding that the repair of a high service pump is a nonrecurring expenditure. The Commission amortized the nonrecurring expenditures over a 15-year life.

Pikeville claims that over the past 15 years, it has consistently reported similar types of expenditures as operating expenses, rather than as nonrecurring costs that would be amortized.²² Because Pikeville expensed (rather than amortized) these expenditures that have occurred within the past 14 years, the fiscal year 2017 operations and maintenance expense is understated.²³ Accordingly, Pikeville argues that if the Commission determines that similar expenses within the test year must be amortized over a 15-year period, effectively reducing the revenue requirement for the inside-the-city system by \$118,206, the Commission should increase amortization expense by \$16,653 to reflect amortizing past nonrecurring expenditures that Pikeville originally expensed.²⁴

The rule against retroactive ratemaking is a generally accepted principle of public utility law which recognizes the prospective nature of utility ratemaking. It prohibits regulatory commissions from setting future rates to allow a utility to recoup past losses or to recover expenses incurred in prior years. Including the past nonrecurring expenditures in the current revenue requirement of Pikeville is a violation of retroactive ratemaking. Accordingly, the Commission is denying Pikeville rehearing request for this issue.

²¹ Final Order at 20.

²² Pikeville Rehearing Petition at 16.

²³ *Id.* at 17.

²⁴ *Id.*

Depreciation Expense Allocation to the Outside-the-City System

The Commission decreased depreciation expense by \$136,842 to allocate a part of the inside-the-city system that would be used for outside-the-city customers. The Commission's reduction was based on the application of the Customer Allocation Factor to the total pro forma depreciation expense of \$409,425. The total revenue requirement for inside-the-city customers was reduced by other operating revenue of \$60,384 which included reported special revenues of \$47,927. Pikeville now claims that special revenues represents the amount credited to inside-the-city depreciation that it assigned to its outside-the-city depreciation expense.²⁵ According to Pikeville, because depreciation expense by \$136,842, it would be inappropriate also to include an adjustment for the \$47,927 in other operating revenue that is credited to inside-the-city revenue from outside-the-city depreciation.²⁶

Pikeville was specifically requested to identify all shared revenues and expenses that were allocated between the inside-the-city and the outside-the-city systems.²⁷ In responding to the request Pikeville failed to identify depreciation as being a shared expense that was allocated.²⁸ Further, Pikeville was requested to identify individual revenue subaccounts in the fiscal year ending June 30, 2017 Trial Balance that combine to arrive at the total inside revenue - 2017 of \$2,256,339.²⁹ Pikeville provided a list of the

²⁵ *Id.* at 18.

²⁶ *Id.*

²⁷ Pikeville's responses to Commission Staff's First Request for Information, Item 8.a.

²⁸ *Id.*

²⁹ Pikeville's responses to Commission Staff's Second Request for Information, Item 16.e

revenues, but did not explain that the special revenues of \$47,927 was actually the allocation of depreciation to the outside-the-city system.³⁰

KRS 278.400 provides closure to Commission proceedings by limiting rehearing to new evidence not readily discoverable at the time of the original hearings. For this reason the Commission is denying Pikeville's request for rehearing on the depreciation allocation issue.

Debt Service 2016A Bonds

Pikeville used the proceeds from its United States Department of Agriculture (USDA) Series 2016A Bonds to construct water and sewer services to the Kentucky Enterprise Industrial Park.³¹ The total cost of the Marion's Branch Water Sewer Project (Marion Branch Project) was \$4,743,496, of which \$3,813,633, or 80 percent, was for the water department and the remaining \$929,863, or 20 percent, was sewer-related.³² Using Pikeville's engineering report and Mountain District's provided Resolution 15-05-007, the Commission determined that only 16.833 percent of the Series 2016A Bonds debt service should be included in the revenue requirement calculation.³³

Pikeville notes that the Commission's calculation is based on the Marion Branch Project cost for the storage tank and pump station, but does not include cost of the water line, valves, and fittings.³⁴ Pikeville argues that with its decision, the Commission is

³⁰ *Id.*

³¹ Final Order at 25.

³² *Id.*

³³ *Id.* at 26.

³⁴ Pikeville Rehearing Petition, page 18.

implicitly saying that Mountain District does not benefit from the costs for the water line, valves, and fittings, but the evidence of record demonstrates that Mountain District would be unable to receive service from Marion Branch Project tanks and pump station without the water line, valves, and fittings.³⁵ Pikeville argues that by including the 16.833 percent debt service for the Marion Branch Project that Mountain District should be responsible for in its revenue requirement calculation, the Commission's is reducing Mountain District's responsibility for the Marion Branch Project from 16.883 percent to 11.599 percent.³⁶ Pikeville requests the Commission to clarify that MWD is responsible for one-third of the total cost of the Marion Branch Project, and to calculate the impact of that debt service allocation to Pikeville's wholesale rate after other inside-the-city expenses are allocated to Mountain District.³⁷

The Commission acknowledges that the Final Order did not fully explain why the Commission included the 16.833 percent of the Series 2016A Bonds in the revenue requirement calculation and shared between Pikeville and Mountain District. The Commission finds that rehearing should be granted to clarify the Final Order as discussed below:

The Marion Branch Project facilities have been in service for approximately four years and the only documented time that Mountain District used the Marion Branch Project facilities was for the week of August 7, 2018, through August 15, 2018. Mountain District purchased approximately 1,687,900 gallons of water to assist in providing water

³⁵ *Id.* at 19.

³⁶ *Id.* at 20.

³⁷ *Id.*

service in the Indian Hill area when a river crossing went out of service.³⁸ Given the lack of documentation of Mountains District's use of the Marion Branch Project facilities, it would be unreasonable to recover the full 16.833 percent of the Series 2016A Bonds from Mountain District. For the reasons discussed above, the Commission is denying Pikeville's request for rehearing on this issue.

Rate Case Surcharge

Pikeville proposed to assess a rate case surcharge over 36 months to recover any rate case expenses incurred in this current case. The Commission explained that surcharge amortization life is generally based on the frequency of the utility's historic rate filings.³⁹ A review of Pikeville's filed tariff showed that Mountain District's wholesale rate was last changed in 2009, making the frequency of wholesale rate increases ten years. The Commission noted that the evidence suggests that a ten-year amortization period may be appropriate; however, in the Commission's opinion the rates approved in this proceeding would become obsolete after five years due to changes that will likely occur to Pikeville's cost of providing wholesale water service.⁴⁰ Absent a more reasonable amortization period, the Commission allowed Pikeville to recover its allowable rate case expense of \$64,394 over 60-months for a monthly surcharge of \$537 to be recovered from Mountain District and Southern District.⁴¹

³⁸ Pikeville's Response to the Commission Staff's Third Request for Information, Item 5.d.

³⁹ Final Order at 34.

⁴⁰ *Id.*

⁴¹ *Id.*

Pikeville notes the Commission's acknowledgement that the wholesale rates approved in this current case will be obsolete after five years due to changes that will likely occur to Pikeville's cost of providing wholesale water service.⁴² Pikeville reasons that it is illogical to maintain that an appropriate amortization period is based on the anticipated life of the approved utility rates, only to set an amortization period ending after those rates have become obsolete.⁴³ Pikeville argues that a 36-month amortization period supports the Commission's recent emphasis that utilities should evaluate the need for more frequent rate cases.⁴⁴ By amortizing Pikeville's rate case expense over a five-year period, the Commission is signaling that rate cases need not be filed more frequently than every five years, which appears to be inconsistent with the Commission's encouragement that "[e]ach water utility should evaluate the need for more frequent rate cases."⁴⁵

According to Pikeville by using a surcharge mechanism there is no ability for Pikeville to "over-recover" as if the rate case amortization is built into the volumetric rate.⁴⁶ Pikeville argues that if the rate case amortization is recovered through the volumetric there is an incentive to use an amortization period that is consistent with the anticipated rate case cycle because if a utility is permitted to amortize the expense over a shorter period than when it next files a rate case, the utility would (in theory) over-recover on that

⁴² Pikeville Rehearing Petition at 22.

⁴³ *Id.*

⁴⁴ *Id.* at 23–24.

⁴⁵ *Id.* at 24.

⁴⁶ *Id.*

single expense.⁴⁷ Pikeville will not be able to “over-recover” because the term of the surcharge will expire when the full-amount of the rate case expense is recovered.⁴⁸

The historical evidence supports an amortization period that is longer than three years. Pikeville’s last fully litigated wholesale rate case occurred in 2002.⁴⁹ In the 17 years since Case No. 2002-00022 was litigated, Pikeville has increased its wholesale rate twice, once in 2009 and again in 2019, which results in an average of 8.5 years between wholesale rate increases. Pikeville has failed to document why a three-year amortization period is warranted other than its anticipation of the life of the new wholesale rate. The Commission finds that basing an amortization period on anticipation fails to meet the ratemaking criteria of being known and measurable. Furthermore, using an amortization period shorter than the period supported by the historical record is consistent with the Commission’s signal that rate cases need to be filed more frequently.

For the above reasons the Commission is denying Pikeville’s request for rehearing on the rate case amortization period.

Rates Charged to Southern District

Pikeville objects to the Commission’s adjustment to the wholesale rate that Pikeville charges to Southern District. Pikeville argues that the Commission violated statutory and constitutional law when it ordered Pikeville to charge Southern District the same wholesale rate that the Commission calculated for Pikeville to charge Mountain

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ See Case No. 2002-00022, *Proposed Adjustment of Wholesale Water Service Rates of the City of Pikeville, Kentucky* (Ky. PSC Oct. 16, 2002).

Water. Pikeville also objects to the Commission ordering Pikeville to refund to Southern District the difference from September 5, 2019, until the effective date of the rate in the Final Order, between the rate established in the Final Order (\$1.97 per 1,000 gallons) and the rate in Pikeville's tariff (\$2.25 per 1,000 gallons.)

Pikeville first argues that the issue before the Commission was solely Pikeville's wholesale water rate to Mountain Water and not the wholesale rate charges to Southern District. Pikeville asserts that at no time during this proceeding, until the December 19, 2019 Final Order, did the Commission notify Pikeville that there could be changes to Southern District's wholesale rate. Pikeville argues that the Commission's change to Southern District's wholesale rate violates KRS 278.200 (requiring a hearing before a change to water rates charged by a city), KRS 278.180 (requiring notice to a utility that it will change a rate), and KRS 278.270 (requiring a hearing and a finding that a rate is unreasonable, etc. and proscribing a rate to be followed in the future.)

Pikeville argues that the Commission failed to adhere to any of these requirements because: (1) it did not hold a hearing on the wholesale rate to be charged to Southern District; (2) it did not provide notice that it would be changing the wholesale rate to be charged to Southern District; (3) it did not find that the wholesale rate charged to Southern District was unjust, unreasonable, insufficient, unjustly discriminatory or otherwise in violation of KRS Chapter 278; and (4) it ordered Pikeville to apply the rate retroactively.

The Commission agrees with Pikeville in one regard: there should be no refund to Southern District for the difference between the rate that was on file with the Commission and the rate that the Commission ordered in the Final Order. The rate Pikeville charged to Southern District was the filed rate and could only be changed prospectively. Pikeville

should only charge Southern District the new wholesale rate for service rendered on and after December 19, 2019.

The Commission, however, disagrees that it cannot make changes to the wholesale rate that Pikeville charges to Southern District. The Commission did hold a hearing regarding Pikeville's wholesale water rate. During the hearing, Pikeville presented evidence regarding the costs incurred to provide wholesale water service, thus satisfying the hearing requirement in KRS 278.200. Pikeville may not have been on specific notice that the wholesale rate to Southern District was at issue, but the evidence presented at hearing and during the proceeding refers almost exclusively of the cost of providing wholesale water service, and not specifically to Mountain Water. Thus, it is difficult for the Commission to believe that even if Pikeville had been on notice that Southern District's wholesale rate had been at issue, the resulting wholesale rate would have been any different than that for providing the same service to Mountain Water. Furthermore, Pikeville has not provided any indication in its request for a rehearing that it could have presented evidence that Southern District's wholesale rate should be different than Mountain Water's. Pikeville's original proposed wholesale rate to charge Mountain Water was actually \$.05 more per 1,000 gallons than what it had been charging Southern District, indicating that Pikeville believed the cost of providing wholesale service to Southern District might be less than to Mountain Water. Therefore, any additional evidence taken regarding Southern District's wholesale rate, or a subsequent

investigation into Southern District's wholesale water rate, could possibly yield a lower rate than that set in the Final Order.⁵⁰

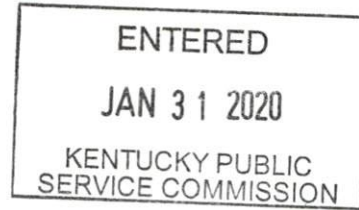
For the above reasons, the Commission finds that rehearing should be granted on the issue of refunding to Southern District any money collected before the date of the Final Order. The Commission, however, will deny rehearing on the issue of the changing of Southern District's wholesale rate.

Based on the foregoing, IT IS THEREFORE ORDERED that:

1. Pikeville's request for a hearing is granted in part and denied in part.
2. Pikeville's request to not refund any money to Southern District, as discussed herein, is granted.
3. All other Pikeville's requests for rehearing are denied.
4. This case is closed and removed from the Commission's docket.

⁵⁰ The Commission has, in the past, adjusted wholesale water rates for two utilities even though the negotiated rate was silent as to one of the utilities. See, Case No. 2005-00297 *Proposed Adjustment of Wholesale Water Service Rates of the City of Williamstown*, (Ky. PSC Nov. 30, 2005).

By the Commission



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