



U.S. Department of Agriculture

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Office of Inspector General  
Northeast Region

# Audit Report

## Rural Development Water Grants to the City of Frostburg, Maryland

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Report No. 09099-03-Hy  
June 2005



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Mid-Atlantic Region

Suite 2-2230

5601 Sunnyside Avenue, Stop 5300

Beltsville, Maryland 20705-5300



June 14, 2005

REPLY TO

ATTN OF: 09099-03-Hy

TO: Marlene Elliott  
State Director  
Rural Development

ATTN: Kathy Biesner  
Management Control Officer

FROM: Rebecca Anne Batts /S/  
Regional Inspector General  
for Audit

SUBJECT: Water Grants to the City of Frostburg, Maryland

This report presents the results of the subject audit. Your response to the official draft, dated May 18, 2005, is included as exhibit B. Excerpts of your response and the Office of Inspector General's (OIG) position are incorporated into the Findings and Recommendations section of the report. Based on your response, we were not able to reach management decision on the report's two recommendations. Management decision can be reached once you have provided the additional information outlined in the report section OIG Position.

In accordance with Departmental Regulations 1720-1, please furnish a reply within 60 days describing the timeframes for implementing the planned corrective actions. Please note that the regulation requires management decision to be reached on all recommendations within 6 months of report issuance.

Attachment

cc: w/Attachment

John Purcell, Audit Liaison, Director, Financial Management Division, Operations  
and Management

# ***Executive Summary***

## **Rural Development, Water Grants to the City of Frostburg, Maryland (Audit Report No. 09099-03-Hy)**

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### **Results in Brief**

In response to a request from the Rural Development (RD) State Director for Maryland, we agreed to review whether the City of Frostburg, Maryland (City) calculated its water rate in accordance with the terms and conditions of its RD grants. Since 1985, RD provided in excess of \$12.6 million in loan and grant funding for the regional water system. The loans have been refinanced; however, according to RD officials, the grant conditions remain in effect indefinitely unless the money is repaid to RD.

State RD officials concluded that the rates implemented in July 2003 by the City were not fair and equitable to all users of the regional water system. We found, however, that the grant documents did not define these terms and did not specify how to evaluate whether rates established by the City were fair and equitable. Nothing came to our attention to indicate that the City did not calculate its water rate in accordance with the grant terms. However, we did conclude there was a breakdown in communication between the City and RD caused, in part, by the lack of specificity in the various grant documents.

RD's Water and Waste Program provides funding for the development of water and waste systems for rural areas in America. Loan and grant funding is provided to small towns and cities to develop utility systems.

RD, the Maryland Department of the Environment, and the County of Allegany, Maryland provided funding for a regional water system to serve the citizens of Frostburg, Maryland and its surrounding communities. We reviewed 12 agreements involved with this project between RD and the City. The agreements included four grant agreements, one memorandum of agreement, and seven water purchase agreements (see Exhibit A). The grant agreements and associated documentation (e.g., grant applications and Letters of Conditions<sup>1</sup>) specify the terms and conditions for the development of a water system for the City and its surrounding communities. The grant agreements require that RD approve the City's initial water rate schedule. Thereafter, the City may make modifications to the rate as long as RD agrees that the rate remains reasonable.

We concluded that the large number of agreements led to confusion and a breakdown of communication in three areas between RD and the City. The first area deals with the authority to set rates. The City believes it has sole

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<sup>1</sup> RD uses a Letter of Conditions to document matters that must be understood and agreed to by an applicant for grant funds before further consideration and approval may be given.

authority to set water rates for its customers based on the 1993 Memorandum of Agreement.

RD agrees that the City does set the rates as long as they remain fair and equitable to all users of the system. However, RD must agree that the rates set by the City are fair and equitable.

The second area is concerned with whether water rates need to be agreed to by all parties. While RD contends that all parties must agree to water rates, the City asserts its own authority to set rates, independent of RD concurrence. The final area deals with the types of changes that need RD approval. RD contends that they must approve any rate changes before the change is valid. In contrast, the City does not agree that RD approval of rate changes is required. We noted that the terms of the various agreements were not specific with regard to these issues. Thus, we were not able to substantiate RD's assertions that the City was in noncompliance with the terms of the agreements.

To reduce the confusion over the specific conditions associated with retaining Federal funding, a new master agreement should be negotiated which brings together all grant terms and establishes a methodology for determining water rates. This agreement should also include the actions to be taken when parties are in disagreement and the methodology to be used when changes to the agreement are needed. After compiling the new master agreement, an independent rate study should be conducted to isolate specific costs and determine the appropriate water rates for in-town and out-of-town users.

**Recommendations  
In Brief**

RD officials should negotiate a new master agreement that specifies: (a) the conditions associated with retaining Federal funding, (b) the methodology for determining water rates, (c) the terms of water purchase agreements, (d) the actions to be taken when parties do not agree, and (e) the methodology to be used when changes to the agreement are needed. Subsequent to negotiating the new master agreement, RD should require the City to conduct an independent rate study based on the new agreement.

**Agency  
Responses**

RD did not agree with the report's recommendations. We have incorporated excerpts from RD's response in the Findings and Recommendations section of this report, along with the Office of Inspector General (OIG) position. RD's response is included in its entirety as Exhibit B.

**OIG  
Position**

Based on RD's response, we were not able to reach management decision on the report's two recommendations. The Findings and Recommendations

section of this report provides the details of the additional information needed to reach management decision.

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## Abbreviations

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City	City of Frostburg, Maryland
CPA	Certified Public Accountant
FY	Fiscal Year
OIG	Office of Inspector General
PSC	Public Service Commission
RD	Rural Development
USDA	U.S. Department of Agriculture

# ***Background and Objectives***

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## **Background**

The Water and Waste Program was created to support the development of water and waste systems in rural America. Public bodies and non-profit organizations receive direct loans and grants from the Rural Utilities Service to develop and maintain their water and septic systems. The program enables small towns and cities to develop badly needed utility services in rural areas. Rural Development (RD) State offices implement the program.

Since 1985, RD has provided over \$12.6 million to fund a regional water system for the City of Frostburg, Maryland (City) and its surrounding communities. The funding was in the form of loans and grants to rehabilitate the Piney Dam, the main water source for the region, and to upgrade the water treatment facility. In March 2003, the loans totaling more than \$9.2 million were refinanced with a commercial lender. The RD funding also included over \$3.4 million in grant funds to the City. Funding for the regional water system has also been provided by the Maryland Department of the Environment and the County of Allegany, Maryland.

Disagreements arose regarding the City's water rates when the initial rates expired in 1991. Since that time, at least three water rate studies have been completed, but there has not been agreement on what the new water rates should be. In 1992, the City paid the Maryland Rural Water Association to perform a rate study. The second rate study was completed by the Environmental Finance Center of the University of Maryland in 2002; this study was funded by RD.

The third rate study, initiated in January 2003, was performed by a task force comprised of elected officials from Frostburg and the Allegany County Commissioners and staff members from both Frostburg and Allegany County. The task force's objective was to review and help recommend a rate structure to be utilized for the billing of both in-town and out-of-town customers for the City's water system.

In January 2003, State RD officials sent the City a letter that outlined their expectations of how the rate should be established. In the letter, RD explained that the rates to be established should be fair, reasonable, and equitable to all users on the system. At a minimum, all users should be paying the minimum cost of producing water based on the operation of the Piney Dam and the water treatment facility. RD was not opposed to a reasonable escalator for those users outside of town, as long as all users are paying the minimum cost of water production. In the letter, RD also stated that users outside the City's system should not be responsible for maintenance or cost of the distribution system or any cost not directly related to the water source or treatment.

According to City officials, the task force met several times in the spring of 2003. According to the task force’s final report, dated May 2003, the task force could not agree on a rate structure to be utilized. Officials from the City explained they implemented rates they felt were in accordance with the grant terms that allowed the City to set water rates. The grant terms require, in part, that water be provided at a reasonable charge. However, the grant terms do not define how to determine whether the water rate is reasonable. RD approved the initial water rates. Thereafter, the City could make modifications to the water rates as long as RD agrees that the rates remain reasonable.

In July 2003, City officials implemented the following rate structure:

<u>Water Usage</u>	<u>Water Rate</u>
<u>In-Town Users</u>	
0 to 3,000 gallons	\$2.25 per 1,000 gallons
3,001 to 30,000 gallons	\$2.29 per 1,000 gallons
30,001 to 300,000 gallons	\$3.35 per 1,000 gallons
Over 300,000 gallons	\$4.52 per 1,000 gallons
<u>Out-of-Town Users</u>	\$4.52 per 1,000 gallons

After reviewing the task force’s final report, State RD officials concluded the rates implemented in July 2003 by the City were unfair and inequitable to all users on the regional water system. Consequently, the RD State Director notified the City that it was not complying with the terms and conditions of its grant agreements.

In response to RD’s assertion, the City requested in November and December 2003 that RD provide specific citations regarding the City’s violations of the grant agreements. RD’s responses from December 2003 through February 2004 maintained that the City had agreed to establish fair and equitable water rates for all users when it received Federal funding to improve the water system. These responses stated RD’s conclusions that the established water rates were not fair and equitable, but the responses did not provide specific citations regarding the City’s alleged violations of the grant agreements.

In February 2004, RD urged the City to take the following steps: (1) initiate a new rate study, (2) voluntarily suspend the rates implemented in July 2003, (3) voluntarily place the funds generated from the increased water rates into an escrow account until the dispute is resolved, and (4) set up a meeting with all involved parties to resolve this issue in a fair and equitable manner.



In January 2004, the U.S. Department of Agriculture's (USDA) Office of the General Counsel suggested to RD that an independent audit be conducted to determine the reasonableness of water rates charged to out-of-town residents by the City before RD took further action. In March 2004, the Maryland State Director for RD requested that the USDA Office of Inspector General review the water and waste disposal grants made to the City. The State Director was concerned that the water rates implemented by the City in July 2003 were not in accordance with the terms of the grants.

## **Objectives**

Our objective was to determine whether the City calculated its water rate in accordance with the terms of the RD Water and Waste Disposal Grants.

To accomplish our objective, we became familiar with the requirements associated with water and waste disposal grants and evaluated how the grants to the City were administered. We gained an understanding of concerns with the water rate through discussions with officials from RD, the City, the Maryland Department of Environment, and County of Allegany, Maryland. We also examined the documentation maintained by RD and the City. Our audit fieldwork was conducted from March 2004 through February 2005 (See Scope and Methodology for details).

# **Findings and Recommendations**

## **Section 1. Breakdown in Communications Between the City of Frostburg and Rural Development**

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### **Finding 1**

The City and RD officials did not have a common understanding of how water rates would be set. This occurred because the grant terms lack specificity as to the methodology to be used to calculate the water rate. The grant terms require, in part, that water be provided at a reasonable charge. However, the grant terms do not define how to determine whether the water rate is reasonable. As a result, there was a breakdown in communication and the City and RD officials experienced difficulties in working together to ensure the provision of water at reasonable rates to RD constituents.

Since 1985, there have been four grant agreements between the City and RD. The grant agreements and associated documentation (e.g., grant applications and Letters of Conditions) specify the terms and conditions for the development of a water system for the City and its surrounding communities. The grant agreements require that the City's initial water rate schedule to be approved by RD. Thereafter, the City may make modifications to the rate as long as RD agrees that the rate remains reasonable.

Our analysis of the grant terms noted a number of items that were not clear. The lack of clarity and the inability to resolve the grant terms led to a breakdown in communication between the City and RD. This breakdown threatened the ability of the regional water system, developed with over \$12.6 million in Federal loan and grant funds to provide water at reasonable rates to those for whom the grants were intended to provide benefit. The breakdown in communication revolved around three major areas: (1) the authority to set water rates, (2) whether water rates needed to be agreed to by all parties, and (3) the types of changes that needed RD approval.

#### **1. Authority to Set Water Rates**

The preamble of the Memorandum of Agreement,<sup>2</sup> dated October 1993, states "the City shall own, operate, and maintain the water system and retain authority over the establishment of rates from its water customers."

According to City officials, this provision gives the City the sole authority to set rates.

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<sup>2</sup> The parties associated with the Memorandum of Agreement include the City, RD, the Allegany County Commissioners, and the Maryland Department of the Environment.

In a letter dated September 3, 2004, the City's attorney supported this position stating the Memorandum of Agreement is plainly worded and is unambiguous.

RD officials agreed that the City retained the authority to set water rates as long as the rates are fair and equitable to all users. However, RD must agree that the rates set by the City are fair and equitable. According to RD officials, the water rates implemented in July 2003 were not fair and equitable. RD officials claimed that the water rates were not based on the cost to treat and deliver water, as determined by the annual audit, as is required by the January 1997 version of the water purchase agreement.

Our review disclosed that the grant agreements did not specify how to determine the cost to treat and deliver water, the type of review that should be performed, or who should perform this review. Further, neither the 1993 Memorandum of Agreement nor the grant agreements defined how to evaluate whether water rates were fair and equitable to all users.

We traced the numbers used in the May 2003 Taskforce Rate Study, the document used by the City to support its rates, to the City's fiscal year (FY) 2003 annual financial statements. A licensed Certified Public Accountant (CPA) audited these statements and issued an unqualified opinion on the fairness of statement presentation. However, we noted that the CPA firm did not opine on the cost to treat and deliver water. Further, the CPA firm had not been engaged or requested to do this.

In an additional attempt to identify inconsistencies between established rates and the City's accounting records, we traced the support for the rates implemented in July 2003 to amounts recorded in the City's audited accounting records for the water fund for FY 2003. Nothing came to our attention to cause us to believe that there were material discrepancies between the support for the water rates and the audited water fund records for FY 2003.

## 2. Water Rates Agreed to by All Parties

Section 1 of the Memorandum of Agreement, dated October 1993, states "a financial evaluation and rate study will be performed of the City's water system using such consultants as agreed upon by all parties. The scope of the evaluation and study will be as agreed upon by all parties."

According to City officials, agreement by all parties is only needed regarding the scope of the study and the consultants to be used. City officials also contended that the Memorandum of Agreement required only one rate study.

In a letter dated September 3, 2004, the City's attorney supported this position citing the plain language of the Memorandum of Agreement.

RD officials stated that compliance with this section requires the City to implement water rates that are agreed to by all parties. According to RD officials, the City is not complying with this section, because it implemented rates in July 2003 that were not agreed to by all parties.

While we agree that it is desirable for all parties to agree to the water rates implemented, we concluded that Section 1 of the Memorandum of Agreement does not clearly establish this requirement.

### 3. Changes Needing RD Approval

RD uses a Letter of Conditions to document matters that must be understood and agreed to by an applicant for grant funds before further consideration and approval may be given. The Letter of Conditions, dated June 1995, states "any changes in the project cost, source of funds, scope of services, or any other significant changes in the project or application must be reported to and approved by Rural Economic and Community Development<sup>3</sup> by written amendment to this letter." We found that this was a standard condition included in the Letter of Conditions for each of the four grant agreements.

City officials explained that this provision applies to the project for which grant funds were awarded and does not extend to the establishment of water rates.

According to RD officials, the establishment of water rates is a significant change requiring their approval. This is because the amount of grant funds awarded to the City was based on the rates shown in the City's grant application.

We verified that RD uses the water rate schedule provided in the application to determine the amount of grant funds to be awarded. Accordingly, changes in the water rates would represent changes in the application, which require RD approval. However, the Letter of Conditions did not specify the time period for which RD had approval authority over water rates. Additionally, it did not specify whether the requirement for RD approval remained in effect after completion of the projects for which the grants were made.

To reduce the confusion on the specific conditions associated with retaining Federal funding, a new master agreement should be negotiated which brings

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<sup>3</sup> In 1994, Rural Economic and Community Development became RD.

together all grant terms and establishes the methodology for determining water rates. The entities that should be a part of this agreement include RD, the City, the County of Allegany, Maryland, and the Maryland Department of Environment. This agreement should include a condition that specifies the action to be taken when all parties cannot agree. This agreement should also include the methodology to be used when changes to the agreement are needed.

After compiling the new master agreement, an independent rate study should be conducted to isolate specific costs and determine the appropriate water rates for in-town and out-of-town users.

### **Recommendation No. 1**

Negotiate a new master agreement that specifies: (a) the conditions associated with retaining Federal funding, (b) the methodology for determining water rates, (c) the terms of water purchase agreements, (d) the actions to be taken when all parties do not agree, and (e) the methodology to be used when changes to the agreement are needed.

#### **Agency Response.**

As stated in the draft background and summary of this report, the City has been unwilling to accept the requirements of the USDA RD grant agreements and instructions that require the Agency to review and concur in the water rate structure to determine that it is fair and equitable to all users. Since the beginning of this discussion, USDA RD has repeatedly requested the City to come to the table and negotiate a resolution to this impasse. The City has continually declined to do so stating their belief that USDA has no rights to monitor or concur in the rates. Based on the current situation with other government agencies and the 20 year history of providing financing to the City, it is unlikely that the City would be receptive to negotiating a new master water agreement. Any additional delay in this matter only prolongs the unfair situation to the residents of the County of Allegany, Maryland and the taxpayers served by USDA RD.

#### **OIG Position.**

We do not accept the response for management decision. As noted in the finding, our analysis of the grant terms noted a number of items that were not clear, which, in part, led to a breakdown in communication between the City and RD. To reach management decision, RD should specify a timeframe for negotiating a new master agreement or propose an equivalent alternative action with a timeframe for completing it.

## **Recommendation No. 2**

Require the City to conduct an independent rate study based on the new master agreement.

### **Agency Response.**

Allegany County did have an independent study completed by a recognized rate tariff specialist. The study was based on industry standards, and it established an industry norm rate of approximately \$2.38 per thousand gallons of water purchased based on the information provided in the City's 2003 audit as well as information provided by City staff and utilized in the Task force meeting. The study was provided to the City for consideration of relief of the unfair rate structure. The City chose not to accept the results of the independent study. The County is now in the process of petitioning the Public Service Commission (PSC) for a rate review.

We do not concur with the conclusion and recommendations by the OIG in the draft Executive Summary. The task, as requested by the RD State Director, was to determine whether or not Frostburg had calculated its water rates in accordance with the terms and conditions of the RD grant agreements. It continues to be RD's position that the City is not in compliance with the intention of the grant agreements. Further, this audit has demonstrated that this noncompliance results from differing views on the equitable cost of water.

In good faith to all of the taxpayers, RD will enter into full support of the County and State's position to bring the matter to the PSC for mediation and resolution within the terms of RD's existing grant agreements.

### **OIG Position.**

We do not accept the response for management decision. According to RD's Director of Community and Business Programs and the Office of the General Counsel's Regional Attorney, the PSC does not have jurisdiction over the rates established by the City and the PSC's findings and recommendations would not be binding on the City. To reach management decision, RD should specify a timeframe for requiring the City to conduct an independent rate study based on the new master agreement or propose an equivalent alternative action with a timeframe for completing it.

## ***Scope and Methodology***

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We performed fieldwork at the RD State office to gain an understanding of the funding provided to the City. The State office in Camden, Delaware is responsible for RD programs in Delaware and Maryland. At the State office, we reviewed the grant agreements and their supporting documentation (e.g., project summaries, grant agreements, letters of conditions, and water purchase agreements).

We performed fieldwork at the City's office to gain an understanding of their interpretation of the terms and conditions of their grant agreements. We also evaluated the documentation the City maintained to substantiate its compliance with the grant agreements.

We met with representatives of the Maryland Department of Environment and County of Allegany, Maryland to gain an understanding of their concerns about the water rates established by the City.

Fieldwork was performed from March 2004 to February 2005. Our audit was conducted in accordance with Generally Accepted Government Auditing Standards.

# Exhibit A — Agreements Reviewed

<b>Grant Agreements</b>	<b>Amount</b>	<b>Terms Regarding Water Rates</b>
1. Piney Dam Grant Agreement	\$1,200,000	Services provided at reasonable charges. The initial rate schedule must be approved by RD. Thereafter, the City may make such modifications to the rate system as long as the rate schedule remains reasonable and nondiscriminatory.
2. Water Treatment Center	\$1,575,000	
3. Emergency Water Grant	\$25,000	
4. Appalachian Regional Commission	\$610,000	
<b>Total</b>	<b>\$3,410,000</b>	
<b>Agreement</b>	<b>Date</b>	<b>Terms Regarding Water Rates</b>
5. Memorandum of Agreement	October 1993	The City shall own, operate, and maintain the water system and retain authority over the establishment of rates from its water customers.
<b>Water Purchase Agreements</b>	<b>Date</b>	<b>Terms Regarding Water Rates</b>
6. Eckhart Water Purchase Agreement	November 1983	The provisions of this contract pertaining to the schedule of rates to be paid by the purchaser for water delivered are subject to modification at the end of every 2-year period. Any increase or decrease in rates shall be based on a demonstrable increase or decrease in the costs of performance.
7. Borden/Zihlman Water Purchase Agreement	June 1995	The City shall own, operate, and maintain the water system and retain authority over the establishment of rates from its water customers.  The rate will be determined annually based upon the cost to treat and deliver water as determined by the annual audit. Rates for both in-town and out, shall be raised or lowered by the same percentage. This percentage shall not exceed 50 percent greater than the inside rate for the first 10,000 gallon rate class. The second and third rate category class shall be 75 percent and 95 percent respectively of the inside rate for that class.



Water Purchase Agreements	Date	Terms Regarding Water Rates
8. Borden/Zihlman Water Purchase Agreement	January 1997	The rate will be determined annually based upon the cost to treat and deliver water as determined by the annual audit. Rates for Borden/Zihlman customers shall be raised by the same percentage of increases assessed "inside" city customers.
9. Grahamtown/Wrights Crossing Water Purchase Agreement	March 2001	The City will engage at their expense a consulting firm to conduct a water rate study for the purpose of establishing a uniform rate structure for sale of water to existing and future system owned by Allegany County. Within 1 year of signing the agreement, the City shall deliver a final study to Allegany County. Allegany County reserves the right to engage, at their expense, a consulting and/or CPA firm to review the study including but not limited to the methodologies, assumptions, and underlying support used by the consulting firm engaged by the City. The City agrees to fully cooperate in making its information and its consultant available to Allegany County and its consulting or CPA firm.  The rate analysis shall be provided to RD and the Maryland Department of the Environment for their review and comment prior to being implemented. After consultation with Allegany County, the City shall establish uniform bulk water rates consistent with the rate analysis.
10. Consol Water Purchase Agreement	May 2001	
11. Borden/Zihlman/Morantown Water Purchase Agreement	May 2001	
12. Carlos/Shaft/Klondike Water Purchase Agreement	November 2002	



**United States Department of Agriculture  
Rural Development  
State Office**

May 18, 2005

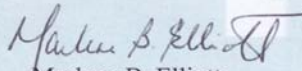
**SUBJECT:** Water Grants to the City of Frostburg, Maryland

**TO:** Rebecca Anne Batts  
Regional Inspector General for Audit  
Beltsville, MD

**ATTN:** 09099-03-Hy

Thank you for the extension in responding to the official draft report concerning water grants to the City of Frostburg, Maryland. We have reviewed the report in its entirety and after careful consideration to each of the recommendations outlined in the report, and dialogue with the Office of General Counsel, please find attached our response.

If you have any questions, please do not hesitate to contact me at (302) 857-3580 or Kathy Beisner, Management Control Officer at (302) 857-3582.

  
Marlene B. Elliott  
State Director

Attachment

Cc: John Purcell, Audit Liaison, Director, Financial Management Division, Operations and Management

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To file a complaint of discrimination write USDA, Director, Office of Civil Rights, Room 326-W, Whitten Building, 14<sup>th</sup> and Independence Avenue, SW, Washington, DC 20250-9410 or call (202) 720-5964 (voice or TDD).

Response to USDA/OIG-Audit No. 09099-03-Hy

Recommendation No. 1

Negotiate a new master agreement that specifies (a) the conditions associated with retaining Federal funding, (b) the methodology for determining water rates, (c) the terms of water purchase agreements, (d) the actions to be taken when all parties do not agree, and (e) the methodology to be used when changes to the agreement are needed.

Agency Response

As stated in the draft background and summary of this report, the City of Frostburg has been unwilling to accept the requirements of the USDA Rural Development grant agreements and instructions that require the Agency to review and concur in the water rate structure to determine that it is fair and equitable to all users. Since the beginning of this discussion, USDA Rural Development has repeatedly requested the City to come to the table and negotiate a resolution to this impasse. The City has continually declined to do so stating their belief that USDA has no rights to monitor or concur in the rates. Based on the current situation with other government agencies and the twenty year history of providing financing to the City of Frostburg, it is unlikely that the City would be receptive to negotiating a new master water agreement. Any additional delay in this matter only prolongs the unfair situation to the residents of the County and the taxpayers served by USDA Rural Development.

Recommendation No. 2

Require the City to conduct an independent rate study based on the new master agreement.

Agency Response

Allegany County did have an independent study completed by a recognized rate tariff specialist. The study was based on industry standards, and it established an industry norm rate of approximately \$2.38 per thousand gallons of water purchased based on the information provided in the City's 2003 audit as well as information provided by City staff and utilized in the Task force meeting. The study was provided to the City for consideration of relief of the unfair rate structure. The City chose not to accept the results of the independent study. The County is now in the process of petitioning the Public Service Commission (PSC) for a rate review.

We do not concur with the conclusion and recommendations by the Office of Inspector General in the draft Executive Summary. The task, as requested by the Rural Development State Director, was to determine whether or not Frostburg had calculated its water rates in accordance with the terms and conditions of the Rural Development grant agreements. It continues to be Rural Development's position that the City of Frostburg is not in compliance with the intention of the grant agreements. Further, this audit has demonstrated that this noncompliance results from differing views on the equitable cost of water.

Response to USDA/OIG-Audit No. 09099-03-Hy (continued)

In good faith to all of the taxpayers, Rural Development will enter into full support of the County and State's position to bring the matter to the PSC for mediation and resolution within the terms of Rural Development's existing grant agreements.

Thank you for your review of this matter.