STATE OF TENNESSEE

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Reply to:
Consumer Advocate and Protection Division
Post Office Box 20207
Nashville, TN 37202

May 30, 2003

Honorable Sara Kyle
Chairman
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243

RE: In Re: Petition of Tennessee American Water Company to Change and Increase Certain Rates and Charges So As to Permit it to Earn a Fair and Adequate Rate of Return on Its Property Used and Useful in Furnishing Water Service to Its Customers
Docket No. 03-00118

Dear Chairman Kyle:

Enclosed is an original and thirteen copies of the Direct Testimony of Michael D. Chrysler of the Consumer Advocate and Protection Division of the Office of the Attorney General. Kindly file same in this docket. Copies are being sent to all parties of record. If you have any questions, kindly contact me at (615) 532-3382. Thank you.

Sincerely,

Shilina B. Chatterjee

Shilina B. Chatterjee
Assistant Attorney General

Enclosures
cc: All Parties of Record

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Before the

TENNESSEE REGULATORY AUTHORITY

IN RE: PETITION OF TENNESSEE-AMERICAN WATER COMPANY FOR APPROVAL OF CHANGE IN RATES AND CHARGES DOCKET NO. 03-00118

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DIRECT TESTIMONY OF MICHAEL D. CHRYSLER

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May 30, 2003

Q-1 Please state your name for the record.

A-1 My name is Michael D. Chrysler.

Q-2 By whom are you employed and what is your position?

A-2 I am employed as a Regulatory Analyst by the Consumer Advocate and Protection Division ("CAPD") in the Office of the Attorney General for the State of Tennessee.

Q-3 How long have you been employed in the utility industry?

A-3 Approximately 30 years. Before my employment with the Attorney General, I was employed with Terre Haute Gas Corporation for approximately 2 ½ years and Northern Indiana Public Service Company (NISOURCE) for 24 years.

Q-4 What is your educational background?

A-4 I have a Bachelors degree in Business Administration from Fort Lauderdale University (1970) with a major in accounting. Additionally, I have attended numerous "outside" training classes including NARUC Eastern Rate Case School, Arthur Andersen Rate Case School, American Gas Association Rate Case School, and a mini MBA school offered to NIPSCO Senior Management (and invited staff) provided by Purdue University Northwest.

Q-5 Describe your work experience.

A-5 Before joining the Consumer Advocate and Protection Division, I was employed by Terre Haute Gas Corporation as an Assistant Office Manager, with NIPSCO in various positions in Consumer Accounting, Rate and Contract, Strategic Planning, Consulting Services, and finally as Principal of Electric Business Planning Departments. I am employed as a Regulatory Analyst and responsible for analysis

and development of utility issues as assigned.

Q-6 What is the purpose of your testimony in this proceeding?

A-6 Since the last rate case in 1997, Tennessee-American Water Company (Tennessee-American) has made several management decisions that may adversely impact consumers. The current petition reveals several items of concern that my testimony will highlight. In particular, I will address three main topics: 1) reduction in meter reading; 2) the proposed system of automatic yearly rate increases known as DSIC (Distribution System Improvement Surcharge) or DSR (Distribution System Renewal Surcharge); and 3) the Tennessee-American lease entered into in 1997 at a time when Tennessee-American was reducing personnel.

Q-7 What have you reviewed concerning Tennessee-American's meter reading?

A-7 I have reviewed the response to CAPD's Data Request #1, Question 69; "For each month of the 12 month period ending July 31, 2002, provide for each customer class the number of estimated bills rendered and the number of bills issued." I have included a copy of their response as MDC Exhibit 1B.

Q-8 What did your review reveal about meter reading?

A-8 My analysis of Tennessee-American's response to CAPD's Question 69 indicated that there was only an increase in meters of about 3% from 1997-2002, but the percentage of estimated bills had gradually increased from 1.4% to 19.27% during the same time frame.

Q-9 Please explain what you attribute this increase in estimated bills in meter reading.

A-9 Since Tennessee-American can read meters "at its option" (as incorporated in its

rules & regulations below) estimated bills have increased from 1.4% in 1997 to 19.27% in 2002 **(MDC Exhibit 1B)**.

Q-10 Are you sponsoring any Exhibits related to meter reading?

A-10 Yes, I am sponsoring **MDC Exhibit 1 "Meter Reading"** which contains a chart **(MDC Exhibit 1A)** reflecting the increase in number of estimated to actual read bills from data supplied by the company **(MDC Exhibit 1B)** received in CAPD Data Request #1, Question 69. Also, attached is a copy of Tennessee-American Water Company's Original Sheet No. 31, Section 14.9 **(MDC Exhibit 1C)** illuminating the ability of Tennessee-American Water to estimate customer bills. Section 14.9 states:

Section 14.9, Original Sheet No. 31; *"The Company may estimate the bill of any customer for good cause, including, but not limited to: request of Customer; inclement weather; labor or union disputes; inaccessibility of a Customer's meter; other circumstances beyond the control of the Company or its agents and employees; and, a billing period with a varying meter reading schedule; or the Company may render an estimate bill when a meter is found to be not registering. In such cases, the Company shall estimate the charge for the water used by averaging the amount registered over a similar period preceding or subsequent to the period of nonregistration or for corresponding period in previous years, adjusting for any changes in the Customer's usage."*

Q-11 Did Tennessee-American provide an explanation regarding the increase in estimated meter readings?

A-11 An explanation was provided in their response to Question 15 of the Second Set of Data Requests wherein Tennessee-American states:

"The increase in estimated bills is the result of the following:

1. The Outside Commercial Department has been reduced by two employees who have been gone due to long term illnesses over a two year period. One has since resigned and the other is applying for a disability retirement. These positions have not been replaced.

2. Many employees in this department have several years of seniority and qualify for three weeks or more of vacation under the Union Contract. This results in vacancies in the meter reading department and it is difficult to temporarily transfer employees who do not have experience.
3. Prevailing weather patterns during this period of time hamper meter reading."

Q-12 What are the ramifications of this increase in estimated readings?

A-12 Tennessee-American's response indicates that its management decision of not filling vacant positions due to retirement or resignations contributed to a reduction in service quality. This indicates that service quality has eroded because of conscious management decisions.

Q-13 What material did you review concerning Tennessee-American's leases?

A-13 The 1977 lease between Tallan Properties and Tennessee-American, copy of lease extension agreement and follow-up responses of Tennessee-American submitted on May 23, 2003 in response to CAPD's letter seeking additional information dated May 21, 2003.

Q-14 What did you discover in your review of the capital lease.

A-14 In 1977, Tennessee-American requested Second Century, Inc. (Tallan Properties) to build a two-story 15,488 sq. ft. office building at 1101 Broad Street in Chattanooga, Tennessee. Upon completion, Tennessee-American entered into a 20-year capital lease which ended in 1997. Although Tennessee-American was making efforts to reduce their staff during this time and had plans to further reduce their work force, they inexplicably entered into a 15-year lease extension at approximately twice the rental cost. Additionally, "physical structure requirements" necessitated replacing two air conditioners for the building totaling

approximately $100,000 which were mentioned in the negotiations. While other Tennessee utilities are/were downsizing and moving "customer service and corporate office" headquarters to "operating" buildings, Tennessee-American continued to lease the same 15,000 sq. ft. building utilized in 1977 and paying double the rental cost instead of downsizing, moving and/or consolidating.

Q-15 Did you request any additional material concerning the 15-year lease extension?

A-15 Yes, the CAPD has asked for cost-benefit analysis work papers performed (*see* **MDC Exhibit 2D**) prior to entering the new lease with alternatives including possible modifications of other Chattanooga workplace location(s).

Q-16 Are you sponsoring any Exhibits related to capital leases of property?

A-16 Yes. MDC Exhibit - 2, "Summary of Leased and Owned Property" which supplied the various locations of property used to supply service, the number of square feet of each building, and the number of employees as of 1997 and 2002. A copy of a map **(MDC Exhibit 2A)** is also included and indicates the locations of the Office, Distribution Center, and the Meter Service Center. The location of the "Production/Water Quality" facility is not referenced since the company supplied data response was incomplete because it did not provide a service address. Attached are summaries of the original 20-year lease **(MDC Exhibit 2B)** entered into by Tennessee-American and Tallan Properties (Second Century, Inc., Stone Fort Land Company, etc.). Also included **(MDC Exhibit 2D)** is the company supplied analysis[1] and correspondence from 1997 that was utilized in

[1]Data request response in attachment to correspondence from Mr. T.G. Pappas dated May 21, 2003.

consideration of a 15-year lease extension **(MDC Exhibit 2C)**.

Q-17 Upon review of the analysis of the work papers and correspondence provided by Tennessee-American what is your opinion regarding the 15-year lease extension?

A-17 Although providing correspondence and financial considerations for the lengths of the lease, Tennessee-American failed to provide an analysis of alternatives to entering into the lease extension. Moreover, it is not clear why Tennessee-American did not consider moving its office operations to one of its other "owned" properties and make the necessary utilization modifications similar to the way other utilities have consolidated offices (such as ATMOS Energy did in Murfreesboro, TN) to "operating" buildings or review other lease/buy opportunities in Chattanooga at that time.

Q-18 What is the DSR (Distribution System Replacement Surcharge)?

A-18 The DSR is a recovery of cost mechanism in investment through a calculation process. It allows the company to earn a return on eligible improvements and recover depreciation and taxes by imposing a surcharge. Tennessee-American proposed to add a DSR mechanism to its rate structure in order to recover the costs of additional investments quarterly on an automatic basis without a formal rate proceeding. This would allow Tennessee-American to make adjustments to the rate base for residential and commercial customers through the surcharge.

Q-19 Please explain the DSR proposal by Tennessee-American and its purpose.

A-19 In Mr. James Salser's pre-filed testimony regarding the DSR proposal wherein he suggests that it is an "innovative ratemaking mechanism that encourages and

assists water utilities to make the investment necessary to replace aging infrastructure and the costs to relocate Company's facilities in public rights-of-way as required by City and State Governments." The proposal cited an attempt to mathematically translate a sum of completed projects into a simplistic charge to customers to bypass the traditional regulatory process. Since the details of the Tennessee-American proposal were incomplete compared with the other similar proposals in Pennsylvania, Illinois[2] and Indiana specific comments would be presumptive. It should be noted that state Legislatures in all these states provide the statutory framework to their Public Service Commissions prior to final implementation. Exhibit MDC - 3 details many of the deficiencies involved in a similar, "Innovative Process," and shows a process more defined than the one presented by Tennessee-American. "Piecemeal or single-issue ratemaking" are terms that have been applied in years past to proposals of the same "urgency" as the one presented by Tennessee-American. The proposal does not deal with these questions or the consideration that the DSR surcharge would eliminate an incentive to control costs between rate cases, and would also generate an incentive to increase spending, and promote an incentive to include costs not otherwise recoverable through a formal rate proceeding.[3]

Q-20 Do any other water utility companies use a DSR/DSIC (Distribution System

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[2]Although the Illinois Legislature (Qualifying Infrastructure Plan Surcharge) has authorized the process on January 1, 2000, Illinois American Water Company has not applied for approval in rates.

[3] I.U.R.C. Order , page 10, paragraph 3; "Mr. Cutshaw (Indiana American witness) stated that the DSIC was not intended to be and will not result in a final determination that the DSIC assets are in rate base for purposes of a general rate case. The Public will have the opportunity to conduct a full rate base review in its next general rate case."

Improvement Surcharge)?[4]

A-20 Indiana American Water Company, Pennsylvania American Water Company and Pennsylvania Suburban Water Company.

Q-21 Did the state public utility commission allow the DSR for water utilities?

A-21 Only after the respective state Legislature enacted legislation allowing it.

Q-22 Did any other state Legislatures enact legislation to allow a DSR?

A-22 Yes, the Illinois legislature has approved an "infrastructure plant surcharge." However, Illinois American Water has not applied for it as of this date.

Q-23 What did the other state public utility commissions opine?

A-23 It appears that the state public utility commissions followed the legislative mandates and filled-in the details concerning the DSR proposal. However, Indiana Public Utility Commission's Order sets forth the problems with a DSR.

Q-24 Are you sponsoring any Exhibits related to the DSR proposal?

A-24 Yes. (1) MDC Exhibit 3 "Petition of Indiana-American Water Company, Inc. For Approval of A Distribution System Improvement Charge ('DSIC') Pursuant To Ind. Code Chap. 8-1-31;" (2) A New Rate Schedule Reflecting The DSIC; and (3) Inclusion Of The Cost Of Eligible Distribution System Improvement In Its DSIC" - Indiana Utility Regulatory Commission Cause No. 42351 DSIC-1. The Indiana Commission's Order,[5] details some of the difficulties incurred with a more defined DSR proposal than those presented by Tennessee-American. These include interpretations of applicable accounts for recovery and the inclusion of

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[4]DSR and DSIC are synonymous. Pennsylvania and Indiana refer to it as DSIC.

[5]Indiana Utility Regulatory Commission Order in Cause No. 42351 DSIC-1 approved February 27, 2003.

certain projects in these accounts. See discussion on page 18 "F. Projects to be included as Distribution System Supports Charges." This discussion provides an example of the complexity involved even in a more detailed proposal than the one presented by Tennessee-American and the difficulty the TRA staff will have in determining proper recovery projects/amounts.

Q -25 Did you make any further analyses and prepare any additional exhibits?

A-25 Yes.

Q-26 What would you describe as the purpose of CAPD Exhibit Schedule 2?

A-26 The purpose of the exhibit is an analysis and comparison of the various components of Tennessee-American's Rate Base as presented by the company as well as two adjustments that we have proposed.

Q-27 Would you please explain the CAPD Reductions to Rate Base in CAPD Exhibit Schedule 2?

A-27 Yes, the first is, "RWIP" (line 6) Reduction of $42,984 which restates the RWIP balance from $64,899 to $21,915. The second adjustment reduction is to remove the net management audit of $164,839, "Other Deferred Debits" ($219,059 less amortization of $54,220) from working capital because it was transferred to "CCC" or "Call Center."

Q-28 Please summarize your recommendations in this case.

A-28 As summarized above, the increase in percentage of estimated bills appears to be a barometer of a decrease in service quality in meter reading as well as other operating areas throughout the Tennessee-American distribution system. I am very concerned with the service quality of Tennessee-American. The continuation

of the Capital Lease for an additional 15 years without documentation of alternatives in a period of declining work force coupled with consolidation of arguably other owned buildings is questionable. On one hand they are reducing cost, employees, and job centralization, but decide to stay in the same office location since 1977 when other "owned" office locations were available. Additionally, the DSR mechanism (as presented) is an incomplete proposal to a very complicated issue that the Tennessee Regulatory Authority should not approve because:

1. Although the company provided reasons[6] why it is needed in Tennessee, the reasons do not adequately justify the need specifically for the DSR mechanism.
2. The proposal by Tennessee-American is unspecific about the details and in comparison to other DSR proposals in other states, it lacks specificity.
3. In other states where the DSR has been allowed, the Commission only allowed/approved following legislative action. Commissions have not acted prior[7] to legislative approval.
4. Even in states with legislative approval, identification of applicable

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[6]One of the reasons stated by Tennessee-American: "Tennessee-American Water Company's customers will benefit from FIRE PROTECTION, water quality, improved pressure, service reliability, and lower rates." Comment: It appears that Tennessee-American thinks that FIRE PROTECTION will not be provided if the "DCR" is not approved. The main concern is not "if" you provide for fire protection rather, "how you pay for it?"

[7] The Pennsylvania Commission authorized a proposal, prior to Legislative action subsequently was appealed to the Commonwealth Court by the Pennsylvania Office of People's Counsel regarding the Commission's approval; however, the appeal was made moot by legislative authorization by the Pennsylvania State Legislature.

projects recoverable through the "DSR/DSIC" process may still require Commission interpretation and review.[8]

5. The proposal does not allow enough time for TRA staff to review each filing to satisfy questions of project recovery admissibility (to assure rules compliance and assurance to ratepayers that additional costs are not improperly included for recovery).

6. Other utilities may request the same recovery of similar costs on a going forward basis. This approval could lead to a significant increase in filings and review requirements by regulatory authorities and staff.

7. Such "single issue" rate adjustment mechanisms upset the current well-proven regulatory scheme that encourages improvements in efficiencies rather than constant automatic rate increases.

Q-29 Does this conclude your testimony?

A-29 Yes.

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[8] See Indiana Utility Regulatory Commission Docket No. 42351 DSIC-1 **(MDC Exhibit 3)** p. 19, paragraph 3: "All of these considerations serve to emphasize the limitations built into the DSIC statute that are not found in a traditional rate case, such as a longer review period and more public notice, all of which are very important for projects of this size and scope." Page 20, Paragraph 3: "the traditional ratemaking process contains the safeguards needed for comprehensive review, particularly of complex and expensive projects, by the Public, the Commission, and the public in general."

BEFORE THE TENNESSEE REGULATORY AUTHORITY
AT NASHVILLE, TENNESSEE

IN RE: PETITION OF TENNESSEE-AMERICAN WATER COMPANY FOR APPROVAL OF CHANGE IN RATES AND CHARGES	))))	**DOCKET NO. 03-00118**

AFFIDAVIT

STATE OF TENNESSEE)

COUNTY OF DAVIDSON)

Before me, the undersigned authority, duly commissioned and qualified in and for the State and County aforesaid, personally came and appeared, Michael D. Chrysler, being by me first duly sworn deposed and said that:

He is appearing as a witness on behalf of the Consumer Advocate and Protection Division of the Tennessee Attorney General's Office and if present before the Authority and duly sworn, his testimony is set forth in the annexed transcript consisting of 12 pages.

Michael D Chrysler
MICHAEL D. CHRYSLER

Sworn to and subscribed before me
this 30th day of May, 2003.

Emily Knight
NOTARY PUBLIC

My commission expires: Oct. 25, 2003

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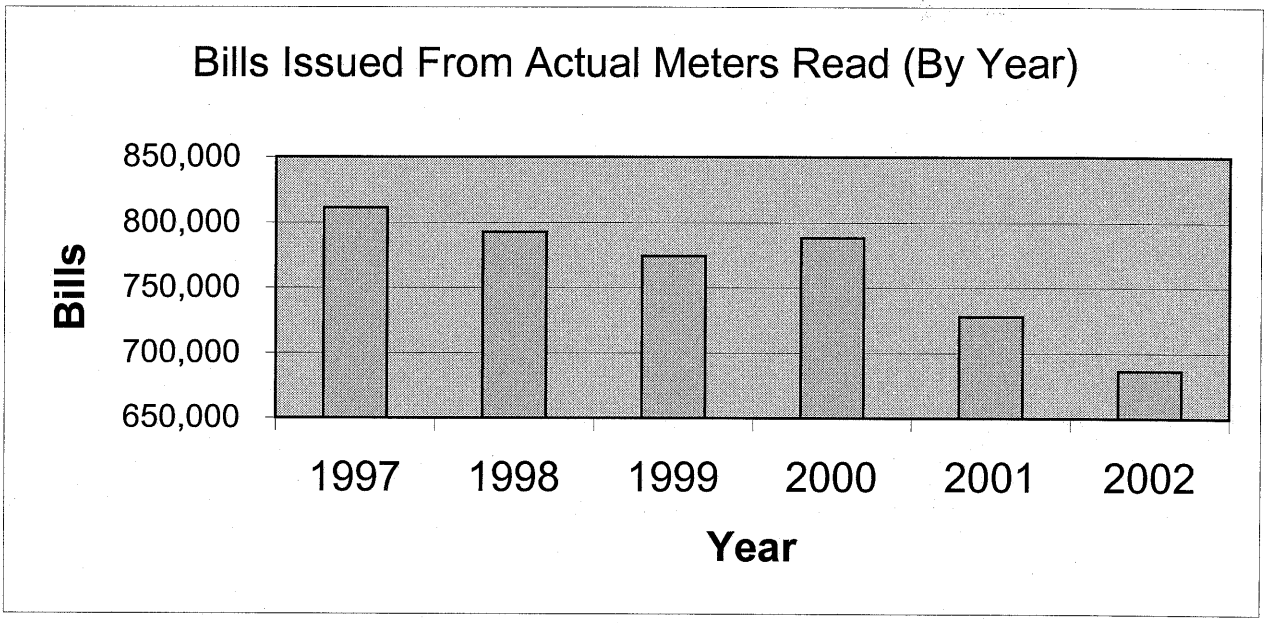
MDC EXHIBIT 1A

Tennessee American Water Company
Comparison of "Estimated" to "Actual" Bills *
Data Source: TAWC Data Response 5/21, 2003

	Bills Issued	Estimated Bills	Bills Read
1997	822,547	11,477	811,070
1998	829,022	36,609	792,413
1999	839,513	65,433	774,080
2000	844,164	55,963	788,201
2001	847,778	119,984	727,794
2002	850,164	163,809	686,355



MDC EXHIBIT 1B

Interrogatories and Requests for Production
Of Documents by the
Attorney General (First Set)
To Tennessee-American Water Company
Rate Case No. 03-00118

69. Q. FOR EACH MONTH OF THE 12 MONTH PERIOD ENDING JULY 31, 2002, PROVIDE FOR EACH CUSTOMER CLASS THE NUMBER OF ESTIMATED BILLS RENDERED AND THE NUMBER OF BILLS ISSUED.

A. See attached.

Aug 01 - July 02

	Aug 01	Sept 01	Oct 01	Nov 01	Dec 01	Jan 02	Feb 02	Mar 02	April 02	May 02	Jun 02	Jul 02	12 Mos. Ending
Actual Number of Bills	70,813	70,493	70,493	70,415	69,956	70,794	70,022	70,186	71,350	70,430	70,418	71,825	847,195
Number of Estimated Bills	5,910	12,316	12,316	12,778	27,439	12,623	11,133	18,976	12,641	15,924	18,095	6,141	166,292

1997														
Actual Number of Bills													822,547	
Number of Estimated Bills													11,477	1.4%
1998														
Actual Number of Bills													829,022	
Number of Estimated Bills													36,609	4.42%
1999														
Actual Number of Bills													839,513	
Number of Estimated Bills													65,433	7.79%
2000														
Actual Number of Bills													844,164	
Number of Estimated Bills													55,963	6.63%
2001														
Actual Number of Bills													847,778	
Number of Estimated Bills													119,984	14.15%
2002														
Actual Number of Bills													850,164	
Number of Estimated Bills													163,809	19.27%

MDC EXHIBIT 1C

14.7 Customers are responsible for furnishing the Company with their correct addresses. Failure to receive bills will not release Customer from payment obligations.

14.8 The use of water by the same Customer at different Premises or localities will not be combined for billing.

14.9 The Company may estimate the bill of any Customer for good cause, including, but not limited to: request of Customer; inclement weather; labor or union disputes; inaccessibility of a Customer's meter; other circumstances beyond the control of the Company or its agents and employees; and, a billing period with a varying meter reading schedule; or the Company may render an estimated bill when a meter is found to be not registering. In such cases, the Company shall estimate the charge for the water used by averaging the amount registered over a similar period preceding or subsequent to the period of nonregistration or for corresponding period in previous years, adjusting for any changes in the Customer's usage.

14.10 The Company may include charges for special services with charges for Water Service on the same bill if such charges are identified.

15. DISCONTINUANCE OF WATER SERVICE

15.1 Upon Customer's Request

(a) The Customer shall notify the Company at least three (3) days in advance of the desired termination day and shall remain responsible for payment of all service until service is terminated pursuant to such request. The Company shall terminate service within three (3) working days of the requested termination date. The Customer shall not be liable for any service rendered to such address or location after the expiration of these three (3) days.

15.2 Without Customer's Request

(a) The Company may disconnect service without request by the Customer and without prior notice only:

I. If a condition dangerous or hazardous to life, physical safety or property exists; or

MDC EXHIBIT 2

Tennessee American Water Company
Summary of Owned and Leased Property

		Square Footage	% Total	1997 Employees	2002 Employees	Property Status
1.	Office	15,488	26.9%	54.5 /C	36 /C	Leased
2.	Distribution Ctr.	18,266	31.7%	42 /A	42 /A	Owned
3.	Meter Svc. Ctr.	5,530	9.6%	28 /A	28 /A	Owned
	Production/Wtr. Quality	18,272	31.7%	32 /A	25 /A	Owned
	Total	57,556		156.5	131	
	Budget /B			156.5	131	

Data Source:

/A TN American Response Letter Dated5/21/03
/B Operating Data Report Budget 1997 - 2002 (Response to CAPD Data Request #1, Question 20
/C /B - total of /A

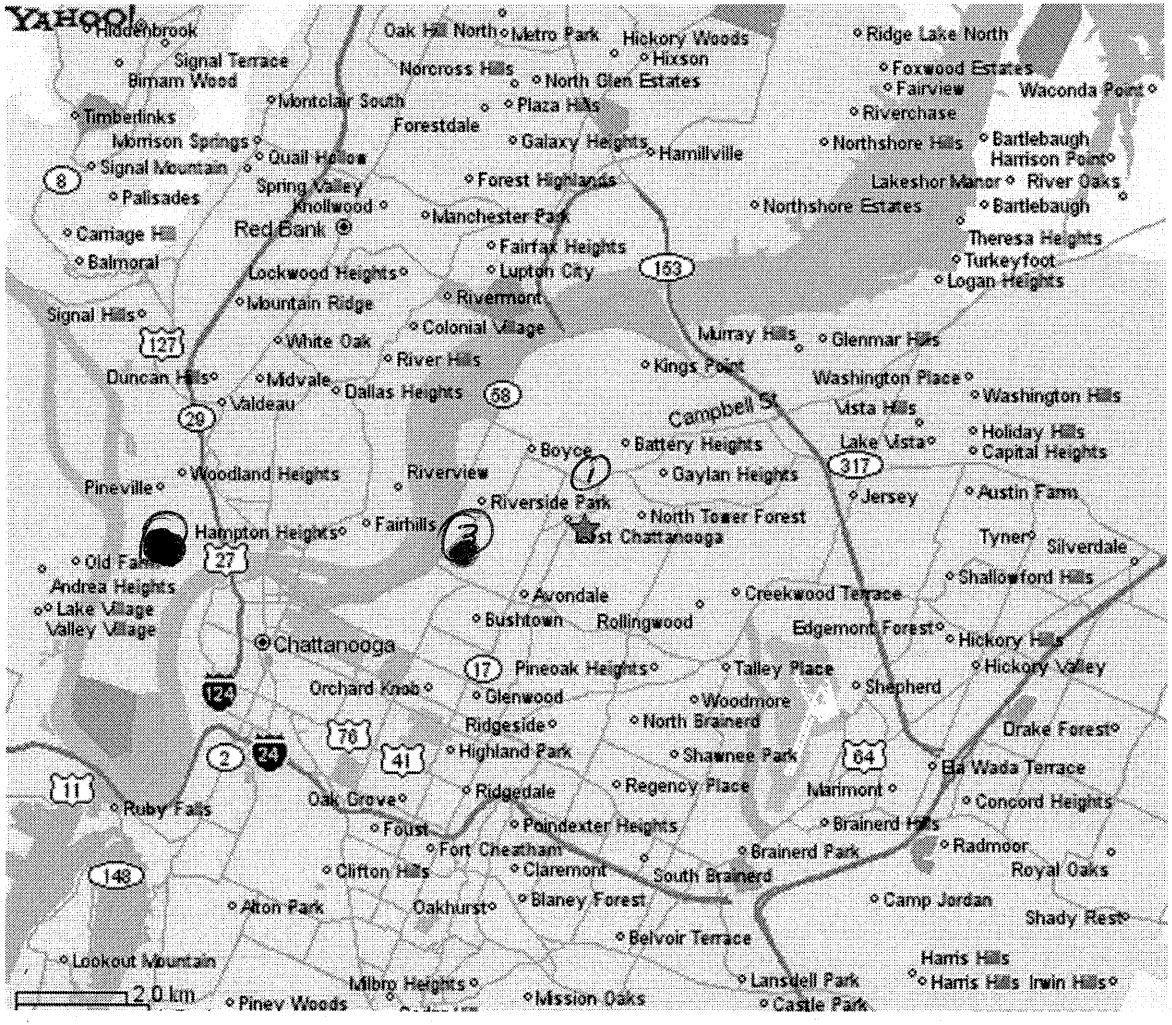
MDC EXHIBIT 2A

YAHOO! Local Maps

Yahoo! Maps

Back to Map

1101Broad Street, Chattanooga, TN 37406



MDC EXHIBIT 2B

L E A S E

THIS LEASE made this 24th day of June, 1977, by and between TALLAN PROPERTIES CO., a Tennessee Limited Partnership acting by its managing general partner, SECOND CENTURY, INC., a Tennessee corporation, hereinafter referred to as "Owner", and TENNESSEE-AMERICAN WATER COMPANY, a Tennessee corporation, hereinafter referred to as "Tenant".

WITNESSETH:

Owner hereby leases to Tenant, and Tenant hereby rents from Owner the premises described in Exhibit A attached hereto and made a part hereof on which the Owner is to construct a building as hereinafter set forth (the land and building being hereinafter sometimes referred to as the "Leased Premises" and the building being hereinafter sometimes referred to as the "Building") to be rented for an office upon the following terms, covenants and conditions and subject to the following restrictions, to all and every one of which the parties consent; and each of the parties hereby expressly covenants and agrees to keep, perform, and observe all the terms, covenants and conditions herein contained on its part to be kept, performed and observed.

1. Construction of Building. The Owner shall, at its own cost and expense, except as hereinafter set forth, construct a two-story Building containing approximately 15,488 square feet of floor space on the Leased Premises in substantial compliance with detailed plans and specifications to be prepared by Selmon T. Franklin Associates, Architects, Inc. and approved by the parties, such approval being a condition precedent to the obligations of the parties under this Agreement. The Tenant may, during the course of construction, modify the plans and specifications by written change orders approved by the Owner and Tenant. In such event, Tenant shall pay to the Owner upon completion of construction the amount of additional costs incurred by the Owner as a result of such change orders, provided, however, Tenant may at its option elect not to pay up to but not in excess of Ten Thousand Dollars ($10,000.00) of such additional costs and in lieu thereof increase its annual rental payments by an amount equal to thirteen percent (13%) of such additional costs up to but not in excess of Ten Thousand Dollars ($10,000.00). If Tenant elects to increase its annual rental payments, the parties shall enter into a written agreement in which the increase in the annual rental payments is specified for the entire initial twenty (20) year term, as well as for the purpose of determining the annual rental payments for any renewal term.

During the course of such construction, Tenant, its employees, agents and contractors may enter upon the Leased Premises at all reasonable times for the purpose of inspection and, as soon as possible after such construction is substantially completed, may enter upon the Leased Premises for the purpose

of installing improvements, fixtures, and other equipment, upon the condition that the Tenant, its employees, agents and contractors will not unreasonably interfere with the Owner's employees, agents or contractors in the pursuit of the Owner's construction. The Owner shall commence construction within three (3) months after the parties have approved the detailed plans and specifications referred to above and shall use its best efforts to tender possession of the Leased Premises to the Tenant within seven (7) months after the commencement of construction subject, however, to delays occasioned by reason of strikes, inability to obtain labor or materials, Acts of God, or other cause beyond the control of Owner, but if the Owner shall be unable to tender possession of the Leased Premises on or before seven (7) months, for any reason, the Owner shall not be subject to any liability for such inability to give possession. If the Owner shall be unable to tender possession of the Leased Premises within one (1) year after commencement of construction for any reason other than delays occasioned by reason of strikes, inability to obtain labor or materials, Acts of God or other cause beyond Owner's control, the Tenant may, at its option, terminate this lease by ten (10) days written notice to Owner.

2. Quality of Construction. Owner covenants that construction of the Building shall be undertaken, performed and completed in good and workmanlike manner in full compliance with all provisions of all Federal, state and local authorities having jurisdiction. Owner further represents that at the time of delivery of possession of the Leased Premises to Tenant the Leased Premises will be free and clear of all tenancies, occupancies, and liens other than the lien of a permanent first mortgage and Owner warrants that presently and at such time, it will own good and merchantable free simple title in and to the real property.

3. Term. The term of this lease shall be twenty (20) years commencing on the date on which the Owner tenders possession of the Leased Premises to the Tenant and the Tenant accepts them. Tender of possession of the Leased Premises by the Owner to the Tenant shall be evidenced by written notice given by the Owner to the Tenant stating that the Building has been substantially completed and the Leased Premises are ready for occupancy, accompanied by a certificate of the supervising architect to that effect. Thereupon, Tenant shall accept the Leased Premises by written notice to Owner, which acceptance shall not be unreasonably withheld. If the effective date of this lease shall be a day other than the first day of a calendar month, then the term of this lease shall be deemed extended by the number of days between the effective date of this lease and the first day of the first calendar month following the effective date of this lease, so that the term of this lease shall expire twenty years after such first day of the first calendar month following the effective date of this lease. In such case, the Tenant shall pay pro rata rent, in advance, for the period from the effective date of this lease to the first day of such following calendar month.

4. Rent. The Tenant shall pay to the Owner during the first ten (10) years of this lease annual rent of Seventy-Six Thousand Eight Hundred and no/100 Dollars ($76,800.00) in equal monthly installments of Six Thousand Four Hundred and no/100 Dollars ($6,400.00) in advance on the first business day of each month during the term of this lease. The Tenant shall pay to Owner during the 11th through 15th years of this lease annual rent of Eighty-Four Thousand Five Hundred Forty-Four and 00/100 Dollars

($84,544.00) in equal monthly installments of Seven Thousand and Forty-Five and 33/100 Dollars ($7,045.33). The Tenant shall pay to Owner during the 16th through 20th years of this lease annual rent of Ninety-Two Thousand Two Hundred Eighty-Eight and 00/100 Dollars ($92,288.00) in equal monthly installments of Seven Thousand Six Hundred Ninety and 67/100 Dollars ($7,690.67). The rent shall be payable at the office of the Owner or at such other place as the Owner may designate in writing. Owner shall not, by receiving partial payment of rent in arrears, be-deemed to have waived any right of forfeiture for non-payment of rent or any part thereof.

5. Repairs. The Owner, during the term of this lease, shall keep the structural supports, exterior walls and roof of the Building in good order and repair, and the Owner shall be responsible to repair any defects in construction of the Leased Premises, including Building, lawn, shrubbery, sidewalks and parking lots arising during the period of one (1) year after tender of possession and Owner shall be responsible for the replacement of the heating and air-conditioning equipment installed in the Building by Owner. The Tenant shall, during the term of this lease, (except as provided in the preceding sentence) be responsible for: (a) the upkeep and repair of the (i) exterior of the Building, including without limitation, lawn, shrubbery, sidewalks and parking lots; (ii) interior of the Building, including without limitation, heating and air-conditioning equipment; and, (iii) plumbing, lighting and other equipment in the Building; (b) the replacement of sidewalks and parking lots, plumbing, lighting and other equipment in the Building, as required, and including without limitation, replacement of light fixtures and bulbs and similar items requiring replacement as a result of use or normal wear and tear; and, (c) all janitorial services. Notwithstanding the foregoing, Tenant shall not have the responsibility to repair damage caused by or due to the willful acts of negligence of the Owner, its agents, servants or employees. All damage or injury to the Leased Premises or to the Building or to its fixtures and equipment caused by Tenant moving property in or out of the Building or by installation or removal of furniture, fixtures or other property, or from the erection or removal of signs on the exterior of the Building, or resulting from air-conditioning unit or system, short circuits, flow or escape of water, steam, gas, sewerage or odors or by bursting or leaking of pipes or plumbing works or gas, or from any other cause of any other kind or nature whatsoever (unless caused by or due to the willful acts or negligence of the Owner, its agents, servants or employees) shall be repaired, restored or replaced promptly by Tenant at its sole cost and expense to the satisfaction of Owner. All aforesaid repairs, restorations and replacements shall be in quality and class equal to the original work or installations. If Tenant fails to make such repairs, restorations and replacements shall be in quality and class equal to the original work or installations. If Tenant fails to make such repairs, restorations or replacements, same may be made by Owner at expense of Tenant and collectible as additional rent or otherwise and shall be paid by Tenant within thirty (30) days after rendering a bill or statement therefor.

6. Taxes. The Tenant, in addition to the fixed rent provided for herein, shall pay all taxes and assessments levied against and imposed upon the Leased Premises and Building within thirty (30) days upon presentation to the Tenant by the Owner of the bill evidencing such taxes and assessments. All taxes levied or imposed prior to but payable after the effective date of the lease term, and all taxes levied or imposed after the lease term, shall be adjusted and prorated so that Owner

shall pay its pro rata share for the period prior to and for the period subsequent to the lease term. All assessments levied or imposed during the last five (5) years of the original term or during any renewal term shall be adjusted and pro rated between the Owner and Tenant so that Tenant shall pay the portion thereof upon the basis of the ratio of the number of months then remaining prior to the expiration of the initial term or any renewal term bears to sixty (60), unless the Tenant revises the term pursuant to paragraph 25 hereof in which event-Tenant shall pay the entire amount of such assessment. In the event that any Federal, state or local law is passed during the term of this lease, or any extension or extensions thereof, requiring the payment of a tax based on the amount of rent to be paid by Tenant under this lease, or in any other manner subjecting the rent provided in this lease to any form of tax by whatever name it may be designated (as distinguished from a tax imposed upon the income of Owner of which the rent hereunder may constitute a portion thereof), such tax shall be the obligation of and shall be paid by Tenant and shall be in addition to the rent to be paid by Tenant as specified in this lease. During the lease term, Tenant may in good faith, by appropriate proceeding, at Tenant's expense, in Owner's name or Tenant's name, whenever necessary, contest any levy or assessment of taxes against or imposed upon the Leased Premises or attempt to obtain a lower assessed valuation on the Leased Premises or attempt to obtain a lower assessed valuation on the Leased Premises provided that Tenant shall pay to Owner such sum as Owner may from time to time deem necessary to cover interest or penalties accrued or to accrue on each item.

7. Utilities. Owner shall not be required to furnish water, gas, electricity or other utilities of any sort for any purpose whatsoever. The Tenant shall pay the charges for all water, gas, electricity or other utilities used on the Leased Premises during the term of this lease including water or pressure of any sprinkler system on the Leased Premises. Owner shall not be liable to the Tenant for any discontinuance of heat and/or electricity and/or gas and/or water caused by accident, breakage, strike, or any other cause whatsoever.

8. Glass. Tenant shall replace, at its own expense, any and all plate or other glass broken or damaged from any cause whatsoever in and about the Leased Premises. In the event the Tenant does not replace broken or damaged glass within seven (7) days, then Owner shall have the right to replace the glass at the Tenant's expense.

9. Floors. Tenant agrees to use care in loading the floors in the Building so as to avoid overloading, and Tenant shall be liable for any damage, or injury to the Building or persons or property in or about the Leased Premises caused by improper loading and overloading of the floors by the Tenant, its agents or employees.

10. Alterations. The Tenant may, at its own expense, make such alterations, improvements, additions, and changes to the Leased Premises as it may deem necessary or expedient in the operation of the Leased Premises, provided the Tenant, without the written consent of the Owner, shall not tear down or materially demolish any of the improvements on the Leased Premises or make any material change or alteration in the Building which, when completed, would substantially diminish the value of the Leased Premises. The Tenant shall not make any change in or alteration to the Leased Premises which would violate the terms of any mortgage then a lien upon the Leased Premises, or of any policy of insurance in force with respect to the Leased Premises. If the estimated cost of any proposed alteration, improvement, addition, or change to the Leased Premises shall

exceed the sum of $10,000, the Tenant shall first obtain the approval of the plans therefor, but such approval shall not be unreasonably withheld by the Owner. The Tenant shall make such alterations, additions, or improvements at its own expense; and Tenant shall carry such Workmen's Compensation and General Liability Insurance as Owner may reasonably require. All alterations, additions or improvements, except movable trade fixtures, made by either party shall inure to the benefit of the Owner and shall become the property of Owner when made or installed. In the event the Owner agrees to make repairs, alterations or additions to the Leased Premises during the term of this lease, and the completion of said repairs, improvements, alterations or additions is delayed by a strike or strikes, or other causes beyond the control of the Owner, Owner shall not be liable to the Tenant, or to any other party for any damages resulting from such delay.

11. Mechanics Liens. The Tenant shall, whenever and as often as any mechanic's lien is filed against the Leased Premises and Building purporting to be for labor or material furnished or to be furnished to the Tenant, discharge the same of record within ten (10) days after the date of filing, provided, however, that Tenant shall have the right, at its expense, to contest the validity of any lien or claim upon agreement with Owner to pay any final judgment rendered against it with all proper charges and cost within ten (10) days of entry of the judgment. Notice is hereby given that the Owner shall not be liable for any labor or materials furnished or to be furnished the Tenant upon credit, and that no mechanic's or other lien for any such labor or materials shall attach to or affect the reversionary or other estate or interest of the Owner in and to the Leased Premises and Building. If, notwithstanding the above, Tenant suffers any lien for materials or labor to attach to the Leased Premises, and/or Building, and the same is not satisfied or removed by Tenant within thirty (30) days after written demand by Owner, the Owner may treat such failure as a default, or Owner may elect to pay the amount of such lien, in which event, such payment, plus all costs and expenses incurred in accomplishing the removal of such lien, including attorney's fees, shall be deemed additional rent hereunder, payable on the first day of the month following such payment by Owner.

12. Insurance.

(a) Upon acceptance of the Leased Premises, Tenant, at its sole cost and expense, shall keep the Building insured for the mutual benefit of Owner and any holder of a mortgage on the Leased Premises and Tenant, during the term of this lease, against loss or damage by fire and other casualty or risks, included in the broadest form of extended coverage insurance from time to time available, in an amount equal to one hundred percent (100%) of the then "full replacement cost of the busindings and improvements", "full replacement cost" being the cost of replacing the Building and other improvements. Such full replacement cost may be determined from time to time (but not more frequently than once in any 24 calendar months) at the request of Owner by an appraiser, engineer, architect or contractor designated by Tenant and approved in writing by Owner (such approval not to be unreasonably withheld) and paid by Tenant. No ommission on the part of Owner to request any such determination shall relieve Tenant of any of its obligations under this Section 12.

(b) Tenant, at its sole cost and expense, but for the mutual benefit of Owner and Tenant, shall maintain:

(i) Personal injury and property damage liability insurance against claims for bodily injury, death or property

damage, occurring thereon, in or on the Leased Premises, in or about the adjoining sidewalks, such insurance to afford minimum protection during the term of this lease, of not less than Two Hundred Fifty Thousand Dollars ($250,000) in respect of bodily injury or death to any one person, and of not less than Five Hundred Thousand Dollars ($500,000) in respect to any one accident, and of not less thn One Hundred Thousand Dollars ($100,000) for property damage subject to adjustment by agreement of the parties to reflect the effect of inflation upon the value of the U. S. Dollar and in the absence of agreement of the parties, the minimum coverage shall be increased at the end of each five year period of the lease term in proportion to the increase in the cost of living index for all cities as published by the United States Bureau of Labor Statistics over such cost of living index on the effective date of this lease; and

(ii) Such other insurance, and in such amounts as may from time to time be reasonably required by Owner, against other insurable hazards which at the time are commonly insured against in the case of premises similarly situated, due regard being, or to be, given to the height and type of building, its construction, use and occupancy.

(c) Tenant may effect for its own account any insurance not required under the provisions of this lease, but any insurance effected by Tenant on the Building, whether or not required under this Section 12 shall be for the mutual benefit of Owner and Tenant and shall be subject to all other provisions of Section 12 hereof.

(d) All insurance provided for in this Section 12 shall be effected under valid and enforceable policies issued by insurers of recognized responsibility which are licensed to do business in the State of Tennessee, and have been approved by Owner, such approval not to be unreasonably withheld. Upon the execution of this lease, and thereafter not less than thirty (30) days prior to the expiration dates of the expiring policies theretofore furnished pursuant to this Section 12, or any other section of this lease, originals of the policies bearing notations evidencing the payment of premiums or accompanied by other evidence satisfactory to Owner of such payment, shall be delivered by Tenant to Owner.

(e) All policies of insurance provided for in paragraphs (a) and (b) hereof shall name Owner and Tenant as the insureds as their respective interests may appear and shall include, if obtainable, a waiver by the insurer of all right of subrogation against Owner or Tenant in connection with any loss or damage thereby insured. The loss, if any, under any policies provided for in paragraph (a) above shall be adjusted with the insurance companies by Owner in the case of any particular casualty resulting in damage or destruction. The proceeds of any such insurance shall be payable to Owner for the purpose set forth in Section 14 of this lease. The loss, if any, under any policies provided for in Paragraph (b) shall be adjusted and paid jointly.

(f) All policies provided for in paragraphs (a) and (b) shall provide that the loss, if any, thereunder shall be adjusted and paid as hereinabove provided. Each such policy shall contain a provision that no act or omission of Tenant shall affect or limit the obligation of the insurance company to pay to Owner the amount of any loss sustained, and shall contain an agreement by the insurer that such policy shall not be cancelled without at least ten (10) days' prior written notice to Owner.

13. Liability and Indemnification.

(a) The Owner and Tenant and all parties claiming under them hereby mutually agree to release and discharge each other to the extent of the Tenant's insurance coverage from any liability for loss or damage caused by fire or other risks now or hereafter embraced by "Extended Coverage", so called even if such fire or other casualty shall be brought about by the fault or negligence of the Owner, its agents of employees, provided, however, that this release shall be in effect only if it does not contravene any law with respect to exculpatory agreements.

(b) Tenant does hereby agree to indemnify and save Owner harmless from any and all liability, loss, damage and expense, including without limitation court costs and attorneys' fees, sustained by, imposed upon or assessed against Owner because of suits, claims, demands or actions by Tenant, Tenant's agents, employees, invitees or licensees for personal injury, including death, and property damage caused by, resulting from or in any way contributed to by (i) any condition of the Leased Premises created or allowed to exist by Tenant, (ii) any breach, violation or nonperformance of any obligation of Tenant hereunder or (iii) any act or omission of Tenant, Tenant's agents or employees; and Tenant agrees to defend all said suits, claims, demands and actions without expense to Owner and to pay all judgments rendered thereon.

(c) Tenant covenants and agrees that Owner shall not be liable to Tenant for any injury or death to any person or persons or for damage to any property of Tenant, or any person claiming through Tenant, arising out of any accident or occurrence in the Leased Premises unless caused by or resulting from the direct and proximate negligence of the Owner or any of the Owner's agents, servants or employees in the operation or maintenance of the Building, and Tenant hereby agrees to indemnify and save Owner harmless from any such liability or loss incurred by reason thereof.

14. Damage or Destruction.

(a) In case of casualty, damage or destruction to the Leased Premises, Tenant shall promptly give written notice thereof to Owner and Owner shall thereupon secure estimates in reasonable detail as to the cost of restoring, repairing, replacing or rebuilding the Building. Owner shall adjust the loss with the insurance company and the proceeds shall be payable to Owner. The insurance proceeds, less the actual cost, fees and expenses if any incurred in adjusting the loss shall be referred to herein as "Net Insurance Proceeds". If the Net Insurance Proceeds are sufficient to restore, repair, replace or rebuild the Building, the Owner shall restore, repair, replace or rebuild the same as nearly as possible to its value, condition and character immediately prior to such damage or destruction but Owner's obligation to restore, repair, replace or rebuild shall not include fixtures, improvements or other property of the Tenant. Such restoration, repairs, replacements or rebuilding shall be commenced promptly and prosecuted with reasonable diligence, unavoidable delays excepted. If the Net Insurance Proceeds are not sufficient to cover the cost of restoration (as defined in the next sub-paragraph), Tenant will deposit with Owner the estimated deficiency. Thereafter, Owner shall restore, repair, replace or rebuild as set forth herein.

(b) All insurance money paid Owner on account of such casualty, damage or destruction and the Tenant's deposit of the estimated deficiency, if any, shall be applied by Owner to the payment of the cost of the aforesaid demolition, restoration, repairs, replacements, rebuilding or alterations, including the

cost of temporary repairs or for the protection of property pending completion of permanent restoration, repairs, replacements, rebuilding or alterations, (all of which temporary repairs, protection of property and permanent restoration, repairs, replacements, rebuilding or alterations are herein collectively referred to as the "Restoration Costs").

(c) When restoration has been completed and paid for in full so that there are no liens on the Leased Premises other than mortgages against the Leased Premises existing at the time of such casualty, damage or destruction, any balance of the Net Insurance Proceeds and/or money deposited with Owner by Tenant to cover the estimated deficiency shall be paid to Tenant by Owner. If the actual Restoration Costs exceed the Net Insurance Proceeds and the Tenant's deposit of the estimated deficiency, if any, Tenant shall promptly pay to Owner the deficiency.

(d) No destruction or damage to the Leased Premises or any part thereof by fire or any other casualty shall permit Tenant to surrender this lease and Tenant waives any rights now or hereafter conferred upon it by statute or otherwise to quit or surrender this lease or the Leased Premises or any part thereof. If such casualty, damage or destruction partially damages the Building and the Leased Premises are not rendered untenantable, the rent shall be abated pro rata according to the part of the Leased Premises which is usable by the Tenant until such damage or destruction has been repaired. If the Leased Premises are totally damaged or destroyed or the Leased Premises are rendered fully untenantable by casualty, damage or destruction, rent shall abate until the Leased Premises are restored to habitable condition.

(e) Notwithstanding the foregoing provisions of this section, any insurance monies in the hands of the Owner shall not be required to be paid out if, at the time of the request for payment, the Tenant is in default in the performance of any term of this lease as to which notice of default has been given and which has not been remedied within the time limit specified in this lease.

15. Bankruptcy. If there shall be filed by or against Tenant in any court pursuant to any statute either of the United States or of any state a petition in bankruptcy or insolvency, or for reorganization, or for the appointment of a receiver or trustee of all or a portion of Tenant's property or if Tenant makes an assignment for the benefit of creditors or petitions for or enters into an arrangement, and within thirty (30) days thereof the Tenant fails to secure a discharge thereof, this lease, at the option of Owner, may be cancelled or terminated, in which event neither Tenant nor any person claiming through or under Tenant by virtue of any statute or of any order of any court shall be entitled to possession or to remain in possession of the Leased Premises but shall quit and surrender the Leased Premises; and notwithstanding any other provisions of this lease, the Owner shall forthwith be entitled to the Owner's remedies set forth in the next paragraph or elsewhere in this lease.

16. Default. If the Tenant defaults in the payment of rent on the due date thereof and such default remains uncured for twenty (20) days thereafter, or if the Leased Premises become deserted or vacant for twenty (20) days, or if the Tenant defaults in the performance or observance of any of the provisions of this lease and such default remains uncured after thirty (30) days written notice thereof, or in case of a default which cannot be cured within such thirty (30) day period, Tenant fails to proceed within such thirty (30) day period to commence curing the same and thereafter to prosecute the curing of such default with due diligence,

the Owner may, at its option, terminate this lease, without notice, and re-enter the Leased Premises, either by force or otherwise, and dispossess the Tenant by summary proceedings or otherwise and remove the Tenant or other occupants, and their effects without liability of any kind, and without prejudice to any remedy which the Owner might have for arrears of rent or prior breach of covenant In case of any such default, re-entry, expiration and/or dispossession by summary proceedings or otherwise, the Tenant shall remain liable as hereinafter provided, or the Owner may, if it so elects, by written notice to the Tenant, hold the Leased Premises as if the lease had not been made, in which event the Tenant shall be released from all liability hereunder. If the Owner does not elect to hold the Leased Premises as if this lease had not been made, the Owner may, but only if it so elects, relet the Leased Premises or any part thereof, in the name of the Owner or as agent of the Tenant, for the whole or any part of the original term hereof, or longer, granting reasonable rent concessions, if necessary; but the Owner shall in no event be liable for failure to relet the Leased Premises; or, if the Leased Premises are relet, for failure to collect the rent due under such reletting. The Tenant shall pay to the Owner as liquidated damages for the failure of the Tenant to observe or perform the provisions of this lease, any difference between the rent reserved hereunder and any amount collected under a reletting of the Leased Premises for the balance of the original term hereof. In computing such liquidated damages, there shall be added to the amount of rent reserved hereunder any expenses the Owner may incur in connection with re-entry and reletting, including legal expenses and fees, brokerage, and the expenses of any repairs, alterations or improvements deemed reasonably necessary by the Owner for the purposes of reletting; and such liquidated damages shall be paid in monthly installments by the Tenant on the rent days specified in this lease. Suits to enforce such liability of the Tenant may be brought by the Owner at any time and from time to time.

17. Condemnation of Leased Premises.

(a) If at any time during the term of this lease the whole or any part of the Leased Premises shall be taken for any public or quasi-public purpose by any lawful power or authority by the exercise of the right of condemnation or eminent domain, or private purchase in lieu thereof by a public body vested with the power of eminent domain, the Tenant shall not be entitled to any payment based inter alia upon the value of the unexpired term of this lease, consequential damage to the land not so taken or the dimunition of the value of the land not so taken. The Tenant shall have the right to notice and to participate in the condemnation proceedings together with the Owner and nothing contained herein shall be construed to preclude the Tenant from prosecuting any claim directly against the condemning authority in such condemnation proceedings for loss of business, or depreciation to, damage to, or cost of removal of, or for the value of stock, trade fixtures, furniture, and other personal property belonging to the Tenant.

(b) If such proceedings shall result in the taking of the whole or substantially all of the Leased Premises, this Lease and the term hereof shall terminate and expire on the date of such taking, and the net rent, additional rent, and other sums or charges provided in this lease to be paid by the Tenant shall be apportioned and paid to the date of such taking.

(c) If less than the whole or less than substantially all of the Leased Premises and/or Building shall be taken in such proceedings, the Owner shall, with reasonable dispatch, repair the remaining portion of the Leased Premises and/or Building so as to restore the Leased Premises and/or Building as a complete plot and

building in itself, but the Owner shall not be obligated to expend thereon more than the sum allowed to the Owner in such condemnation proceeding for damage to the Leased Premises and/or Building, less all expenses incurred by the Owner in such proceedings, provided, however, that if the expense of such restoration would be greater than the sum allowed to the Owner, less such expenses in such condemnation proceedings, then the Owner shall have an option, for a period of sixty (60) days after such partial taking, within which to decide whether to make such restoration or to terminate this lease. If, within such sixty (60) day period, the Owner shall give written notice to the Tenant of termination, this lease and the term hereof shall terminate and expire on the last day of the calendar month following the month in which such notice shall be given and the rent, additional rent, and other sums or charges in this lease provided to be paid by the Tenant shall be apportioned and paid to the date of such terminatio ; provided, however, that if the Tenant shall agree in writing, within twenty (20) days after receiving any such notice of termination from the Owner, to pay the difference by which the cost of such restoration exceeds the sum allowed to the Owner in such condemnation proceeding, less such expenses, then the Owner's notice of termination and right to terminate hereunder shall cease and Owner shall make such restoration as hereinabove required. If the Owner does not exercise its option to terminate this lease, the rent shall abate during such restoration pro rata according to the part of Leased Premises which are usable by Tenant. Upon completion of the restoration, the rent shall be reduced by an amount which bears the same proportion to the net rent immediately prior to the condemnation as the rental value of the Leased Premises so taken shall bear to the rental value of the whole Leased Premises. Notwithstanding the foregoing, the rent, additional rent, or other sums or charges in this lease provided to be paid by Tenant shall not be reduced if such condemnation does not result in the taking of any portion of the Building.

(d) For the purposes of this paragraph, substantially all of the Leased Premises shall be deemed to have been taken if the portion of the Leased Premises not so taken does not constitute, or cannot be repaired or reconstructed so as to constitute, a complete plot and structure usable by the Tenant as an entity for the proper conduct of its business.

(e) The Tenant shall be entitled to receive out of any award the sum, if any, specifically allowed to the Tenant for moving expenses and the Tenant's trade fixtures.

18. Assignment or Sublease. Except for the assignment of its properties including this lease, to the purchasers and/or holders of bonds issued by Tenant, the Tenant shall not assign, mortgage or encumber this lease nor sublet or permit the Leased Premises or any part thereof to be used by another, without the prior written consent of the Owner in each instance. If this lease is assigned, or if the Leased Premises or any part thereof is sublet, or occupied by anybody other than the Tenant, the Owner may, after default by the Tenant, collect rent from the assignee, subtenant or occupant and apply the net rent collected to the rent herein reserved. No such assignment, subletting, occupancy or collection shall be deemed a waiver of this covenant or the acceptance of the assignee, subtenant or occupant as Tenant, or a release of the covenants of this lease. The consent by the Owner to an assignment or subletting shall not be construed to relieve the Tenant from obtaining the consent in writing of the Owner to any further assignment or subletting.

19. Fixtures. The Tenant, provided it is not in default hereunder, shall have the right on or before the termination of this lease to remove any movable trade fixtures that were purchased or installed by it and which are susceptible of being moved without damage to the Building and title to such property shall remain in the Tenant. This shall not include the right to remove any plumbing or wiring or linoleum or carpeting glued or attached to the floor, or structural alterations, additions or improvements to the Building and shall, as a matter of course, not include any fixtures that were furnished or paid for by the Owner.

20. Performance of Tenant's Obligations. If the Tenant shall default in the performance of any covenant or condition in this lease required to be performed by the Tenant, the Owner may, after twenty (20) days' written notice to the Tenant or without notice if the Owner's opinion an emergency exists, perform such covenant or condition for the account of and at the expense of the Tenant. If the Owner shall incur any expense, including reasonable attorneys' fees, in instituting, prosecuting or defending any action or proceeding instituted by reason of any default of the Tenant, the Tenant shall reimburse the Owner for the amount of such expense. If the Tenant, pursuant to this lease, becomes obligated to reimburse or otherwise pay the Owner the Owner, be added to any subsequent installment of the specific any sum of money in addition to the specific rent, the amount thereof shall be deemed additional rent and may, at the option of the Owner, be added to any subsequent installment of the specific rent due and payable under this lease, in which event the Owner shall have the remedies for default in the payment thereof provided by this lease. The provisions of this paragraph shall survive the termination of this lease.

21. Inspection. The Owner or the Owner's agents or servants shall have the right to enter the Leased Premises at all reasonable times to examine and inspect them and to show the Leased Premises to prospective purchasers or tenants. During the period commencing ninety (90) days prior to the expiration of the term of this lease, Owner may place upon the demised premises the usual "For Sale" and/or "For Rent" notices, which notices Tenant shall permit to remain thereon without molestation.

22. Use of Premises. The Leased Premises and Building shall, during the term of this lease, be used only and exclusively as an office building, and no part of the Leased Premises or Building shall be used in any manner whatsoever or occupied for any purpose in violation of the municipal, county, state, or Federal rules, regulations, and laws. Tenant agrees to observe and comply with all rules, regulations, and laws now in effect, or which may be enacted prior to the expiration of this lease by any municipal, county, state or Federal authorities having jurisdiction over the Leased Premises and Building, and to make at its own cost and expense all repairs, additions or alterations to the Leased Premises ordered or required by such authorities in order to meet the special need of Tenant, or by reason of the type of occupancy of Tenant.

23. Quiet Enjoyment. If and so long as the Tenant pays the rent reserved by this lease, and performs and observes all the covenants and provisions hereof, the Tenant shall quietly and peaceably enjoy the Leased Premises, subject however, to the terms and conditions of this lease.

24. Surrender. Upon the expiration or termination of the term of this lease, Tenant shall quit and surrender to Owner the Leased Premises in as good order and repair as delivered to it excepting ordinary wear and tear and damage by fire, the elements and casualty.

25. Options to Extend. Tenant shall have the option, to be exercised as hereinafter provided, to extend the term of this Lease for two separate and successive periods of five (5) years each following the initial term hereof (each of such periods being hereinafter referred to as the "Extended Terms"), upon condition that at exercise there is no default in the performance of any term or condition of this Lease as to which notice of default has been given to Tenant; provided, however, that in the case of any such default which cannot with due diligence be cured prior to the last date on which Tenant is entitled to exercise such option, if the Tenant shall have proceeded promptly after the service of notice of default with due diligence to cure such default, Tenant may, nevertheless exercise such option and shall be entitled to any such Extended Term. The Tenant shall exercise the option for an Extended Term by notifying the Owner in writing at least twelve (12) months prior to the expiration of the initial term or Extended Term, as the case may be, of its desire to extend the term of this Lease. Upon such exercise, the Owner and Tenant shall commence good faith negotiations of the annual rental to be paid during the Extended Term which annual rental shall not be less than the annual rental in effect for the last year of the initial lease term. Upon Owner and Landlord reaching agreement as to the annual rental for the Extended Term, this lease shall be deemed to be extended upon the same terms and conditions but at the agreed upon annual rental without execution of any further lease by parties but the parties shall enter into a written agreement in which the amount of annual rental for the Extended Term is specified.

26. Right of First Refusal. In the event Owner, during the lease term or any renewal term, elects to sell the Leased Premises, whether separately or as a part of a larger tract of which the Leased Premises are a part, the Tenant shall have the right of first refusal to meet such bona fide offer and to purchase the Leased Premises separately on the same terms and conditions of such offer after Owner has given to Tenant written notice thereof. If such offer is for a larger tract, the purchase for the Leased Premises shall be determined upon the basis of ratio of the value of the Leased Premises to the value of the entire larger tract. If Tenant fails to meet such bona fide offer to purchase within fifteen (15) days after notice thereof from Owner, the Owner shall have the absolute right to sell the Leased Premises to such third person in accordance with the terms and conditions of such offer free and clear of this right of first refusal which shall thereupon be extinguished. Any variation for the terms and conditions of such bona fide offer shall require submission of the offer to the Tenant. The Tenant's failure to meet such bona fide offer with respect to any proposed transaction shall not constitute a waiver or cancel the Tenants right of first refusal created herein with respect to any subsequent transaction unless the Owner shall sell the Leased Premises to a third party in accordance with the terms and conditions of such bona fide offer.

27. Waiver. No failure of Owner to exercise any power given Owner hereunder or to insist upon strict compliance by Tenant with its obligations hereunder and no customary practice of the parties at variance with the terms hereof shall constitute a waiver of Owner's right to demand exact compliance with the terms of this lease.

28. Mortgage Subordination. Upon request by Owner, Tenant shall execute and deliver an agreement subordinating this lease to any first mortgage upon the Leased Premises; provided, however, such subordination shall be upon the express condition that the validity of this lease shall be recognized by the mortgagee,

and that, notwithstanding any default by the mortgagor with respect to said mortgage or any foreclosure thereof, Tenant's possession and right of use under this lease in and to the Leased Premises shall not be disturbed by such mortgagee unless and until Tenant shall breach any of the provisions hereof and this lease or Tenant's right to possession hereunder shall have been terminated in accordance with the provisions of this lease.

29. Short Form of Lease; Recording. Tenant shall not record this lease without obtaining the prior written consent of Owner. However, the parties hereby agree to execute a memorandum or so-called "short form" of this lease for the purpose of recordation. Said memorandum or short form of this lease shall describe the parties, the Leased Premises, term of this lease and shall incorporate this lease by reference. Owner agrees to cause such "short form" of this lease to be recorded and pay the cost thereof.

30. Partial Invalidity. If any provision of this lease or application thereof to any person or circumstance shall to any extent be invalid, the remainder of this lease or the application of such provision to persons or circumstances other than those as to which it is held invalid shall not be affected thereby and each provision of this lease shall otherwise be valid and enforced to the fullest extent permitted by law.

31. Rights of Successors and Assigns. The terms, covenants and conditions contained in this lease shall apply to and inure to the benefit of and be binding upon the parties hereto and upon their respective successors in interest, heirs, legal representatives and assigns.

32. Notice. Any notice by either party to the other shall be in writing and shall be deemed to be duly given only if delivered personally or mailed by Registered or Certified Mail in a postpaid envelope addressed to the Tenant at the Building on the Leased Premises and to the owner at 118 East Eighth Street, Chattanooga, Tennessee.

33. Effect of Instrument. It is expressly understood and agreed that this instrument contains the entire contract between the parties hereto and that all covenants, agreements and conditions herein shall be binding and may be legally enforced by the said parties, their heirs, personal representatives, successors in interest and assigns, respectively.

34. Controlling Law. This agreement shall be governed by the laws of the State of Tennessee.

IN WITNESS WHEREOF, the parties have executed this Agreement on the day and year first above written.

TALLAN PROPERTIES CO.,
a Tennessee Limited Partnership

BY: SECOND CENTURY, INC.,
Managing General Partner

BY: _____
W. A. Lupton, Jr., President

TENNESSEE-AMERICAN WATER COMPANY

By _____
Title: Vice President

STATE OF TENNESSEE)

COUNTY OF HAMILTON)

Before me Mary Patricia Baker of the state and county aforesaid, personally appeared T. A. LUPTON, JR., with whom I am personally acquainted, and who, upon oath, acknowledged himself to be President of SECOND CENTURY, INC., the within named bargainor, a Tennessee corporation, and that he as such President, being authorized so to do, executed the foregoing instrument for the purpose therein contained, by signing the name of the corporation by himself as President, in behalf of TALLAN PROPERTIES CO., a Tennessee Limited Partnership, as General Partner.

WITNESS my hand and seal, at office in Chattanooga Tennessee this 24 day of June, 1977.

Mary Patricia Baker
Notary Public

My Commission Expires: 10/8/79

STATE OF TENNESSEE)

COUNTY OF HAMILTON)

Before me Mary Patricia Baker of the state and county aforesaid, personally appeared Edward W. Tonkel, with whom I am personally acquainted, and who, upon oath, acknowledged himself to be Vice President of TENNESSEE-AMERICAN WATER COMPANY, the within named bargainor, a corporation, and that he as such Vice President, being authorized so to do, executed the foregoing instrument for the purpose therein contained, by signing the name of the corporation by himself as Vice President.

WITNESS my hand and seal, at office in Chattanooga Tennessee this 24 day of June, 1977.

Mary Patricia Baker
Notary Public

My Commission Expires: 10/8/79

LEASE AMENDMENT

THIS LEASE AMENDMENT made this 26 day of April, 1975, by and between TALLAN PROPERTIES CO., a Tennessee Limited Partnership acting by its managing general partner, SECOND CENTURY, INC., a Tennessee corporation (hereinafter referred to as "Owner") and TENNESSEE-AMERICAN WATER COMPANY, a Tennessee corporation, hereinafter referred to as "Tenant."

W I T N E S S E T H:

WHEREAS, the parties entered into a Lease Agreement dated June 24, 1977, (hereinafter called the "Lease") under which Owner rented to Tenant the land and building (the land and building hereinafter being referred to as the "Leased Premises" and the building hereinafter being referred to as the "Building,") the Leased Premises being located at the corner of Broad and Eleventh Streets, Chattanooga, Tennessee, and the Building to be constructed by Owner and contain approximately 15,488 square feet of floor space, all as more particularly described in the Lease; and

WHEREAS, under the provisions of paragraph 1 of the Lease, Tenant is granted the right to modify the plans and specifications subject to paying Owner the additional cost in the form of a lump sum payment or additional rental payments; and

WHEREAS, Tenant has made modifications in the plans and specifications and desires to pay a portion of the additional costs through an increase in rental payments with the balance of such additional costs to be paid in the form of a lump sum payment;

NOW, THEREFORE, in consideration of the premises, the parties do hereby amend the Lease in the following particulars:

1. The annual rent set forth in paragraph 4 of this Lease shall be increased to the following amounts:

Term	Annual Rental	Monthly Rental
First 10 years	$77,400.00	$6,450.00
11 through 15 years	85,144.00	7,095.33
16 through 20 years	92,888.00	7,740.67

2. The minimum annual rental referred to in paragraph 25 to be paid during the extended terms shall not be less than the annual rental in effect on the last day of the initial lease term as adjusted in paragraph 1 of this Amendment.

3. Except as specifically herein amended, the Lease shall continue in full force and effect and is herewith ratified and confirmed.

IN WITNESS WHEREOF, the parties have executed this Lease Amendment on the day and year first above written.

TALLAN PROPERTIES CO., a
Tennessee Limited Partnership

By: SECOND CENTURY, INC.,
Managing General Partner

By: _____
T. A. Lupton, Jr., President

TENNESSEE-AMERICAN WATER COMPANY

By: _____
Title: VICE PRESIDENT

MDC EXHIBIT 2C

TALLAN PROPERTIES COMPANY

SUITE 1201 TALLAN BUILDING

TWO UNION SQUARE

THOMAS A. LUPTON, JR. CHATTANOOGA, TENNESSEE 37402 423/756-0418

September 8, 1997

FD # 3 - 17

Mr. R. T. Sullivan
Vice President and Manager
Tennessee-American Water Company
P. O. Box 6338
Chattanooga, TN 37401

Dear Dick:

Enclosed are two fully executed copies of the Lease Amendment between Tallan Properties Company and Tennessee-American Water Company. I want to take this opportunity to thank you and my friends at the water company for the manner in which you have handled not only this lease negotiation, but all of our relationships. You have been very fair and a pleasure to work with, for which I am deeply grateful.

Yours truly,

T. A. Lupton, Jr.

TALjr/yeo

LEASE AMENDMENT NO. 2

THIS LEASE AMENDMENT made this 4th day of September, 1997, by and between TALLAN PROPERTIES COMPANY, a Tennessee Corporation, formerly SECOND CENTURY, INC., ("Owner") and TENNESSEE-AMERICAN WATER COMPANY, a Tennessee corporation, ("Tenant").

WITNESSETH:

WHEREAS, the parties entered into a Lease Agreement dated June 24, 1977, ("Lease") in which Owner leased to Tenant the land and building located at the corner of Broad and Eleventh Streets, Chattanooga, Tennessee, ("Leased Premises"); and

WHEREAS, on April 26, 1978, the parties executed a Lease Amendment ("Lease Amendment No. 1"), which increased the Annual Rent to reflect Tenant's modifications in the plans and specifications for construction of the Leased Premises; and

WHEREAS, the parties wish to extend the term of the Lease.

NOW THEREFORE, in consideration of the premises, the parties do hereby amend the Lease as follows:

1. The Term set forth in Section 3 of the Lease shall be extended for fifteen (15) years beginning on June 1, 1998 and ending on May 31, 2013 ("First Extension Term").

2. The annual rent set forth in Section 4 of the Lease shall be increased to the following:

Year	Annual Rent	Monthly Rental
21	$154,880	$12,906.67
22	$170,368	$14,197.33
23	$181,984	$15,165.33
24	$193,600	$16,133.33
25	$205,216	$17,101.33
26	$209,088	$17,424.00
27	$209,088	$17,424.00
28	$216,832	$18,069.33
29	$216,832	$18,069.33
30	$216,832	$18,069.33
31	$224,576	$18,714.67
32	$224,576	$18,714.67
33	$232,320	$19,360.00
34	$232,320	$19,360.00
35	$232,320	$19,360.00

1,560,000 3120,832 3900,000

3. Section 22 of the Lease entitled "Use of Premises" is hereby amended accordingly adding thereto the following provisions:

(a) Tenant shall not (either with or without negligence) cause or permit through the actions of Tenant, its employees or contractors the escape, disposal or release of any hazardous substances or materials in the Leased Premises. Except for normal office supplies for office use and petroleum products and vehicles parked in parking facilities, Tenant shall not allow the storage or use of such hazardous substances or material in the Leased Premises in any manner not sanctioned by law and then only in accordance with the standards prevailing in the industry for the storage and

use of such substance or materials, nor shall Tenant allow to be brought into the Leased Premises any such permitted materials or substances for use in the ordinary course of Tenant's business. Without limitation, hazardous substances and materials shall include those described in the Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended, 42 U.S.C. Section 9601, et seq., the Resource Conservation and Recovery Act, as amended, 42 U.S.C. Section 6901, et seq., any applicable state or local laws and the regulations adopted under these acts. If any lender or governmental agency shall during the term of the Lease or extension hereof, require testing of the Leased Premises to ascertain whether or not there has been any release of hazardous material on the Leased Premises by Tenant, then the reasonable costs thereof shall be reimbursed by Tenant to Landlord upon demand as additional charges if such requirement applies to the Leased Premises and if any hazardous substances or concentrations above applicable standards are present in the Leased Premises as a result of the action of Tenant or its employees. In addition, Tenant shall execute affidavits, representations and the like from time to time at Owner's request concerning Tenant's best knowledge and belief regarding the presence of hazardous substances or materials on the Leased Premises. Tenant shall indemnify, defend and hold harmless Owner from and against all claims, liabilities, losses, damages, costs and expenses, foreseen and unforeseen, including without limitation, counsel, engineering and other professional or expert fees which Owner may incur by

reason of Tenant's failure or omission to comply with its obligations under this Section from any release of hazardous materials on the Leased Premises caused by Tenant while Tenant is in possession.

4. Section 25 of the Lease shall be revised to read as follows:

25. Options to Extend. Tenant shall have the option, to be exercised as hereinafter provided, to extend the term of this Lease for two separate and successive periods of five (5) years each following the First Extension Term hereof, upon condition that at exercise there is no default in the performance of any term or condition of this Lease as to which notice of default has been given to Tenant; provided, however, that in the case of any such default which cannot with due diligence be cured prior to the last date on which Tenant is entitled to exercise such option, if the Tenant shall have proceeded promptly after the service of notice of default with due diligence to cure such default, Tenant may, nevertheless exercise such option and shall be entitled to any such extended term. The Tenant shall exercise the option for an extended term by notifying the Owner in writing at least twelve (12) months prior to the expiration of the First Extension Term or subsequent extended term, as the case may be, of its desire to extend the term of this Lease. Upon such exercise, the Owner and Tenant shall commence good faith negotiations of the annual rental to be paid during the extended term which annual rental shall not be less than

the annual rental in effect for the last year of the First Extension Term. Upon Owner and Landlord reaching agreement as to the annual rental for the extended term, this lease shall be deemed to be extended upon the same terms and conditions but at the agreed upon annual rental without execution of any further lease by parties but the parties shall enter into a written agreement in which the amount of annual rental for the extended term is specified.

5. Except as specifically herein amended, the Lease shall continue in full force and effect and is herewith ratified and confirmed.

IN WITNESS WHEREOF, the parties have executed this Lease Amendment on the day and year first above written.

TALLAN PROPERTIES COMPANY

By: _____
T. A. Lupton, Jr., President

TENNESSEE-AMERICAN WATER COMPANY

By: _____
R. T. Sullivan, Vice-President

MDC EXHIBIT 2D

American Water Works Service Company, Inc.
1325 Virginia Street, East • Box 593 • Charleston, West Virginia 25322 • (304) 340-0700

Dillard L. Edgemon
Regional Vice President

MEMORANDUM

TO: R. T. Sullivan

FROM: D. L. Edgemon

DATE: October 29, 1990

SUBJECT: Possible Purchase of Office Building

I have again discussed with the Board of Directors Tommy Lupton's interest in selling the building in which our office is now located. Prior to this discussion, I had asked Chris Jarrett to do a quick financial analysis to determine the impact on the revenue requirement for the next 20 years. Of course, the increase in the revenue requirement for the next 8 years would be greater; however, with the purchase, the requirement for the following 12 years would be much less than it will probably be if we either negotiate an extension to the lease in 1998 or construct a building at another location. It appears that there is absolutely no financial advantage with the purchase of the building for a cost of $1 Million. Also, if the building was purchased, our options would be very limited during the next 20-year period.

It was the Board's consensus that no further consideration be given to the purchase of the building unless the total costs were reduced to somewhere around $700,000 to $750,000. There was no interest on the part of Occoquan Land Corporation to purchase the building.

DLE:vs

D. L. Edgemon

TALLAN PROPERTIES COMPANY

SUITE 1201 TALLAN BUILDING

TWO UNION SQUARE

CHATTANOOGA, TENNESSEE 37402

THOMAS A. LUPTON, JR.

423/756-0418

June 27, 1996

Mr. Richard Sullivan
Tennessee American Water Company
1101 Broad Street
Chattanooga, TN 37402

Dear Dick:

I know that you have been patiently waiting and are somewhat anxious to get a new lease proposal for your long-term planning relative to the office building that Tennessee American Water Company leases from Tallan Properties Company. I am certainly willing to take care of your requirements in this regard. I am, however, having a difficult time trying to figure out a rental rate that would take place about two years from now. To accommodate the request of the Water Company, I have elected to disregard the difficulties of making this proposal and proceed in good faith toward a suggested new lease or an extension that I trust you can live with.

I have diligently tried to maintain your current rental rate for the next two years, which is $6.00 per square foot. However, with the failure of the air conditioning equipment, which is going to cost Tallan Properties about $48,000.00 immediately and, within a year, probably another $48,000.00 for an air conditioner that sits right next to the one that has failed, holding the rate at $6.00 would be extremely burdensome.

Both machines will probably cost about $100,000.00. Because of these air conditioning failures and the expense of them, I would like not to hold the current rental rate but make adjustments over a period of time that reflects discounts in latter years to offset increases in earlier years.

What I am proposing is a 17 year lease at the following rentals:

Lease Years	Rate Per Square Foot
1 & 2	$ 9.00
3 & 4	10.00
5 through 7	12.00
8 through 12	13.50
13 through 17	14.50

All other conditions in the current lease would remain the same.

Because time is on the Water Company's side and this proposal is given placing me in somewhat of a disadvantageous situation, I would like for you to respond to this proposal within 60 days. The lease itself could be done by simple amendment to the existing lease, which I would be happy to have Miller & Martin prepare.

I have always been proud of the fact that I could be of service to the Water Company in providing you with space over the last number of years. I think your building has served you well and trust that it can continue to do so for the foreseeable future. You are a great group of people to work with and for it I am deeply grateful. Please let me hear from you as to any questions you might have regarding this proposal. Thank you for allowing me to make it.

Yours truly,

T. A. Lupton, Jr.

TALjr/yeo

Tennessee-American Water Company

P.O. Box 6338 • 1101 South Broad Street • Chattanooga, TN 37401

(615) 755-7620
Fax (615) 755-7634

Richard T. Sullivan
Vice President and Manager

August 23, 1996

T. A. Lupton, Jr., President
Stone Fort Land Company
1201 Tallan Building
Two Union Square
Chattanooga, TN 37402

Dear Tommy:

This is in response to your letter of proposal regarding a new 17-year lease for the office building at 1101 Broad Street, to replace the current lease which expires in May of 1998.

In reviewing the proposed terms, I assume that the proposal of $9.00 per square foot for Lease Years 1 and 2 would replace the current rate of $6.00 per square foot for the years 1996-97 and 1997-98. This would equate to an increase of approximately $46,432 per year, or $92,864 over the two-year period that would be incurred by the Company. This would cause us a real problem since this would not be recognized as an allowable expense by the Tennessee Regulatory Authority for ratemaking purposes. Their reasoning would be simply, that we already had an agreement on a rate through May 1998, and that if we were to agree to a higher rate, then we would have to "eat" the difference. I seriously doubt that my Board of Directors would be willing to consider the additional cost being absorbed by Tennessee-American.

It was unfortunate about the air conditioner, and the expense you had to incur to correct the problem. But, I really appreciate your prompt attention to the matter. You certainly have been an ideal landlord, and friend. I sincerely hope that we can work something out that will satisfy both our needs to continue our relationship well into the future.

Why don't you give me a call, and maybe we can continue discussions over lunch one of these days. Thanks, Tommy.

Sincerely,

R T Sullivan

Richard T. Sullivan
Vice-President and Manager

RTS/lvbs
Enclosures

MAIL TO .....

HAND TO ..... BG .....

Message

Please issue RTS

to proceed with removing

the lease

Date ..... 7/3 ..... From ..... BtG .....

FORM 304

From The Desk Of:
Bruce E. Tillotson

Bob:

I agree with Dick on his 15 year analysis - - -

The purchase price requires an initial year revenue requirement of $287,300

Kathy has the argument

BT

American Water Works Service Company, Inc.
200 East Park Drive, Suite 600
Mt. Laurel, NJ 08054
609-778-0400
Fax: 609-439-8400

TALLAN PROPERTIES COMPANY

SUITE 1201 TALLAN BUILDING

TWO UNION SQUARE

CHATTANOOGA, TENNESSEE 37402

THOMAS A. LUPTON, JR.

423/756-0418

June 11, 1997

JUN 12 1997

Mr. Richard T. Sullivan
Vice President and Manager
Tennessee-American Water Company
1101 Broad Street
Chattanooga, TN 37402

Dear Dick:

At the outset, I would like to thank all of the people of the Tennessee-American Water Company for the relationships that have existed between my company and the Water Company over the past 15 or 20 years, and for that matter - all of my adult life. Our association, I think, has been good and I would be hopeful that it can continue for many years to come. It is a privilege for me to be of service to you in this endeavor.

You have asked that I give you a lease renewal proposal and a suggested purchase price for your consideration in determining which route you would like to take, as far as leasing versus ownership is concerned. I have thought long and hard about this particular situation, recognizing that at the expiration of a 20 year term, rental rates are naturally going up substantially from rates that were established 20 years ago. I know that the Water Company, being a regulated utility, understands these things.

I am familiar with some rental rates in our particular area. The rentals that I am going to quote are below rentals, for instance, charged on Gunbarrel Road in the Hamilton Place general area, in many cases substantially lower. They will be comparable to rentals charged by other downtown locations with the same qualities and location that you currently have. I have tried to take all of these things into consideration, as well as my long association with you and the fact that I would like for you to remain in this building.

If you elect to buy this building, the price would be $1,700,000. Capital gains taxes influence the level of this sales price. As explained to you earlier, my letter of June 14, 1990 indicates a willingness to sell at a price of $1,200,000. This was seven years ago almost to the day, and at that time Tallan Properties was having somewhat of a financial problem. You elected

not to purchase the premises, which I can certainly understand, and Tallan survived its problem.

As far as a rental rate is concerned, I am suggesting a graduated rental with adjustments every few years, all the way through the lease. I am proposing a 12 year term with the rentals being allocated by year and amount as outlined in the table below:

Year	Rate Per Square Foot	Annual Rental
1	$10.50	$162,624
2	11.25	174,240
3	12.00	185,856
4	12.75	197,472
5	13.50	209,088
6	13.50	209,088
7	13.50	209,088
8	14.25	220,704
9	14.25	220,704
10	14.25	220,704
11	15.00	232,320
12	15.00	232,320

In the event you elect to renew your lease, I would suggest that it be done by amendment with a beginning date at the expiration of your existing lease, which would allow you the benefit of the lower rate for the next 11 month period, and expire 12 years from that date. All other conditions would remain basically the same as in the original lease, unless you want changes made thereto.

I trust that the above proposal is satisfactory to you and will allow you to continue, in one form or another, as an occupant of this building. I am sure you will have questions, so please feel free to call me. I trust that I can be of a continuing service to you and thank you for the opportunity to do so.

Yours truly,

T. A. Lipton, Jr.

TALjr/yeo

JUN 12 '97 09:09

TALLAN PROPERTIES COMPANY

SUITE 1201 TALLAN BUILDING
TWO UNION SQUARE
CHATTANOOGA, TENNESSEE 37402

THOMAS A. LUPTON, JR.

423/756-0418

June 13, 1997

MEMORANDUM

TO: Richard T. Sullivan
Vice President & Manager
Tennessee-American Water Company

FROM: T. A. Lupton, Jr.
President
Tallan Properties Company

RE: TAWC Lease Renewal

Dick,

Do these figures look any better? Please give me your comments whenever you can. Thanks.

Year	Rate Per Square Foot	Annual Rental
1	$10.00	$154,880
2	11.00	170,368
3	11.75	181,984
4	12.50	193,600
5	13.25	205,216
6	13.50	209,088
7	13.50	209,088
8	14.00	216,832
9	14.00	216,832
10	14.00	216,832
11	14.50	224,576
12	14.50	224,576
13	15.00	232,320
14	15.00	232,320
15	15.00	232,320

TALjr/yeo

Tennessee-American Water Company

P.O. Box 6338 • 1101 South Broad Street • Chattanooga, TN 37401

(423) 755-7620
Fax (423) 755-7634
http://www.tawc.com

Richard T. Sullivan
Vice President and Manager

TO: R. J. Gallo

FROM: R. T. Sullivan

DATE: June 13, 1997

RE: **Office Building Lease**

At your suggestion, I contacted Tommy Lupton concerning increasing the length of the lease renewal from 12 to 15 years, and do a little revision of the annual rates. Mr. Lupton was very willing to rework the figures for a 15-year lease renewal, and I am enclosing a copy of the proposed annual lease figures. Also enclosed is a copy of the letter he originally sent, with the proposal to either sell the building, or renew the lease for 12 years. In comparing the two sets of figures, the annual rental figures for the first 12 years of the 15-year lease proposal is $50,336 less than the 12-year lease proposal. All in all, I feel that he is being very fair with us, and I would recommend that we accept the 15-year lease proposal.

Mr. Lupton, in his letter of June 11th, suggested that if we were interested in continuing to lease the building, it be done by amendment with a beginning date at the expiration of the existing lease (May 31, 1998). Therefore, I am enclosing a copy of the original lease for you and Kathy Pape to review in order to make that decision to simply amend, or change language in the lease. Again, I would recommend that we simply amend the existing lease.

I will await your comments and guidance in this matter.

R. T. Sullivan

RTS/lvbs

c: Kathy Pape

Year	Rate Per Sq Ft	Total Sq. Ft.	Annual Rental	Cumulative	Savings 15 yr - 12 yr
1	$10.00	15,488	$154,880	$154,880	$7,744
2	$11.00	15,488	$170,368	$325,248	$11,616
3	$11.75	15,488	$181,984	$507,232	$15,488
4	$12.50	15,488	$193,600	$700,832	$19,360
5	$13.25	15,488	$205,216	$906,048	$23,232
6	$13.50	15,488	$209,088	$1,115,136	$23,232
7	$13.50	15,488	$209,088	$1,324,224	$23,232
8	$14.00	15,488	$216,832	$1,541,056	$27,104
9	$14.00	15,488	$216,832	$1,757,888	$30,976
10	$14.00	15,488	$216,832	$1,974,720	$34,848
11	$14.50	15,488	$224,576	$2,199,296	$42,592
12	$14.50	15,488	$224,576	$2,423,872	$50,336
13	$15.00	15,488	$232,320	$2,656,192	
14	$15.00	15,488	$232,320	$2,888,512	
15	$15.00	15,488	$232,320	$3,120,832	

Year	Rate Per Sq Ft	Total Sq. Ft.	Annual Rental	Cumulative
1	$10.50	15,488	$162,624	$162,624
2	$11.25	15,488	$174,240	$336,864
3	$12.00	15,488	$185,856	$522,720
4	$12.75	15,488	$197,472	$720,192
5	$13.50	15,488	$209,088	$929,280
6	$13.50	15,488	$209,088	$1,138,368
7	$13.50	15,488	$209,088	$1,347,456
8	$14.25	15,488	$220,704	$1,568,160
9	$14.25	15,488	$220,704	$1,788,864
10	$14.25	15,488	$220,704	$2,009,568
11	$15.00	15,488	$232,320	$2,241,888
12	$15.00	15,488	$232,320	$2,474,208

Interrogatories and Requests for Production
Of Documents by the
Attorney General (Second Set)
To Tennessee-American Water Company
Rate Case No. 03-00118

14. Q. Provide the location of all additional locations providing services to TAWC or affiliates in the Chattanooga area. Provide the functions (similar to (f) and (g) above in Request No. 3) performed from the location, number of square foot utilized, the number of personnel at 12/31/1997 vs. today, if the property is owned vs rented/leased.

Response:

See attached. (Additional Information Attached on May 20, 2003)

DISTRIBUTION CENTER

#1 1500 RIVERSIDE DR. 8,262 SQ. FT
1490 RIVERSIDE DR. 10,004 SQ. FT.

#2 1997= 44 Employees
2003= 42 Employees

#3 Daily efficient, reliable operation of all maintenance in the distribution system.

#4

(7) Heavy Equipment Operators	Operate Backhoe's and big equipment
(3) Utility Worker	Perform maintenance and Install new services
(3) Clerks	Do all clerical duties required in the department purchases/receipts etc.
(22) Truck/Driver Utility Worker	Perform maintenance, install new services and drive Dump Trucks
(6) Operations Supervisors	Plan, Organize and control all maintenance and installations in the system.
(1) Operations Superintendent	Oversee all department maintenance, budget and all of the above duties.

We own these facilities.

METER SERVICE CENTER
7 WIEHL STREET
CHATTANOOGA, TN 37403

Square Footage of building approximately 5530 sq ft.

No. Employees 1997 28
No. Employees 2003 28

The Outside Commercial Department is responsible for meter reading, meter repair and testing, servicing customers premises, including turning water on & off, setting and removing meters, maintenance of meter boxes, etc.

POSITION DESCRIPTION

OPERATIONS SUPERINTENDENT (1)
Directs the management, development and operation of the Outside Commercial Dept.

OPERATIONS SUPERVISOR (2)
Directs the day to day operation and management of the personnel of the Outside Commercial Department

ON & OFF (5)
Turns water on & off. Removes and sets Meters. Makes minor repairs to meter settings. Investigates customer inquiries regarding high bills, leaks, etc.

METER READER (8)
They are responsible for the accurate reading and recording of over 70,000 meters each month. Reports exceptions from the field.

METER REPAIR (2)
Maintains Meter Inventory. Test and repair meters as directed. They do field testing of all meters 3" and larger and repair as needed. Set and change meters as needed.

FIELD SERVICES (2)
First response to field emergencies including main breaks, burst meters, customer leaks, etc. Provide service until midnight, 7 days a week.

OUTSIDE COMMERCIAL CLERK (2)
Provide field support including dispatching to field personnel. Maintains meter information. Prepares statistical data as needed.

FIELD REPRESENTATIVE (6)
Trained in all of the above classifications. Works any assignment as needed.

Meter Service Center is located on property adjacent to production facilities. Constructed in 1987 and is a Company owned facility.

Production/Water Quality

1. Lab and chemical building-8,272'

Citico pump station- approximately 10,000'

2. 1997 Production Employees with total 21:

Production Superintendent (1)
Production Supervisors (2)
Master Maintenance (2)
Maintenance (6)
Citico Operators (4)
Laborers/Laborer Relief (5)
Senior Clerk II (1)

1997 WQ Employees with total 11:

Water Quality Superintendent (1)
Water Quality Supervisor (1)
Chemists (4)
Lab Worker (1)
Filter Plant Operators (4)

2003 Production Employees with total 16:

Operations Superintendent (1)
Operations Supervisor (2)
Master Maintenance (3)
Maintenance (4)
Laborer/PT in Training (1)
Laborer/Laborer Relief (4) {3 positions filled; one currently open}
Senior Clerk (1)

2003 WQ Employees with total 9:

Water Quality Superintendent (1)
Lab Analyst (3)
Lab Worker (1)
Process Technicians (4)

3. Production- This department is responsible for the pumping and treatment of all water; maintenance of plant; booster stations and tanks; Grounds keeping/housekeeping of plant and boosters.

Reports; Budgets; Capital improvements; Security; Waste Residuals; Treatment Chemicals; Purchasing/Receiving.

Water Quality- Responsible for water treatment and testing; Regulatory monitoring; Reports; Budgets; Customer Inquiries; Waste Residuals; Treatment Chemicals; Purchasing/Receiving.

4. Operations Superintendent (1): Oversees continuous, efficient operation of the treatment plant and remote facilities; Budgeting; Security; Required Reporting.

Operations Supervisor (2): Responsible for the direct work supervision, scheduling, and payroll of the union staff.

Master Maintenance (3): All plant and remote facility maintenance as assigned with emphasis on electronic and computer repair.

Maintenance (4): All plant and remote facility maintenance as assigned.

Laborer/PT in Training (1): General laborer tasks with apprenticeship towards operations certification.

Laborer/Laborer Relief (4) {3 positions filled; one currently open}: General laborer tasks with the relief filling in as needed as process technician.

Senior Clerk (1): Accounting tasks; payroll; vehicle maintenance logs; assists with required operational reports.

2003 WQ Positions with total 9:

Water Quality Superintendent (1): Responsible for the operation of the laboratory and water quality monitoring; Reports; Budgeting; Purchase Approval; Customer Inquiries; Treatment Chemical Inventory; Residuals Management.

Lab Analyst (3): Collection and analysis of water and waste residuals; Customer Inquiries; Purchasing/Receiving; Equipment Calibration; Reporting; Treatment Chemical Testing; Media and Reagent Preparation; Laboratory Housekeeping

Lab Worker (1): Collection and analysis of bacteriological samples; Reporting; Laboratory Housekeeping.

Process Technicians (4): Water treatment; Pump Station Operations; Remote Booster/Tank Operations; Process Water Collection and Testing; Monitor Security Systems; Respond to calls from Call Center.

5. All facilities are owned.

MDC EXHIBIT 3

ORIGINAL

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF INDIANA-AMERICAN WATER COMPANY, INC. FOR APPROVAL OF (A) A DISTRIBUTION SYSTEM IMPROVEMENT CHARGE ("DSIC") PURSUANT TO IND. CODE CHAP. 8-1-31; (B) A NEW RATE SCHEDULE REFLECTING THE DSIC; AND (C) INCLUSION OF THE COST OF ELIGIBLE DISTRIBUTION SYSTEM IMPROVEMENTS IN ITS DSIC	)	CAUSE NO. 42351 DSIC-1
	)	APPROVED: FEB 2 7 2003

BY THE COMMISSION:
Judith G. Ripley, Commissioner
William G. Divine, Administrative Law Judge

On December 19, 2002, pursuant to Indiana Code 8-1-31, Indiana-American Water Company, Inc. ("Petitioner" or "Indiana-American") filed its Petition seeking approval of a Distribution System Improvement Charge ("DSIC") for various improvement projects that were placed in service between August 1, 2001 and November 30, 2002. Given the statutory deadline requiring the Commission to issue an Order not later than sixty (60) days after a petition is filed under Indiana Code 8-1-31, the Presiding Officers, in lieu of convening a Prehearing Conference, issued a Docket Entry on December 27, 2002 establishing a procedural schedule for this Cause and scheduling an Evidentiary Hearing date of January 29, 2003. Petitioner prefiled its direct case-in-chief on December 19, 2002. The Indiana Office of Utility Consumer Counselor ("Public") prefiled its case-in-chief on January 21, 2003. The Petitioner prefiled rebuttal testimony on January 24, 2003.

Accompanying its Petition, on December 19, 2002, Petitioner filed a *Verified Motion for Establishment of Procedures to Protect Against Disclosure of Confidential Information* ("Motion to Protect Confidential Information"). The Motion to Protect Confidential Information sought confidential treatment of evidence to be introduced at the Evidentiary Hearing concerning Petitioner's security improvements made in response to the terrorist attacks of September 11, 2001. In addition to the claim of trade secrets, Petitioner claimed that detailed disclosure of its security improvements could jeopardize the effectiveness of its security system. In a December 30, 2002 Docket Entry, the Presiding Officers established a procedure that, following the public portion of the evidentiary hearing, an *in camera* session would be conducted for the purpose of eliciting detailed information about Petitioner's security improvements for which it was requesting approval of a DSIC. Attendance at the *in camera* session was limited to the Presiding

Officers, other Commissioners, and authorized Commission and Public employees. Based on a preliminary finding that the security improvements constituted trade secrets, the disclosure of which might also jeopardize a security system that is within the state's and national interest to protect, this Docket Entry provided that the record comprising the *in camera* session of the Evidentiary Hearing would be handled and maintained as confidential information, in accordance with Indiana Code 5-14-3.

Thereafter, and pursuant to notice published as required by law, an Evidentiary Hearing was convened on January 29, 2003 at 10:30 a.m. EST, in Room E-306 of the Indiana Government Center South, Indianapolis, Indiana. Petitioner and the Public attended and participated in the Evidentiary Hearing by presenting evidence into the record of this Cause. On January 29, 2003, at the conclusion of both the public and *in camera* sessions of the Evidentiary Hearing, this Cause was adjourned. On January 31, 2003, each party filed a Proposed Order that aligned with its testimonial position taken at the January 29, 2003 Evidentiary Hearing.

On January 30, 2003, Petitioner and the Public advised the Presiding Officers via telephone that they had reached a settlement agreement. The Presiding Officers agreed to consider a late-filed settlement agreement. On February 3, 2003, the parties filed their *Stipulation and Settlement Agreement* and a joint Proposed Order. Also filed on February 3, 2003, was *Petitioner's Notice with Respect to 60-Day Deadline*, which stated Petitioner recognized that the Commission's receipt and consideration of a settlement agreement at this point in the proceedings would require time beyond that allowed by Indiana Code 8-1-31-9(c) for the Commission to issue its Order and Petitioner would have no objection to an Order being issued beyond the 60-day deadline so long as an Order was issued by March 5, 2003. In order to receive the *Stipulation and Settlement Agreement* into the record of this proceeding, this Cause was public noticed according to law for an Evidentiary Hearing to be conducted on February 14, 2003. With Petitioner and the Public in attendance, this Cause was reopened on February 14, 2003, at 1:30 p.m. EST, in Room E306 of the Indiana Government Center South, Indianapolis, Indiana. The *Stipulation and Settlement Agreement* was admitted into the record at the Evidentiary Hearing and, with no members of the general public appearing or having expressed a desire to be heard, this Cause was adjourned.

1. **Notice and Jurisdiction.** The Commission published notice of the public Evidentiary Hearings held in this Cause as required by law. Petitioner is a "public utility" within the meaning of Indiana Code 8-1-2-1 and is subject to the jurisdiction of the Commission in the manner and to the extent provided by the laws of the State of Indiana. This Commission has jurisdiction over Petitioner and the subject matter of this proceeding.

2. **Petitioner's Characteristics.** Petitioner is an Indiana corporation engaged in the business of providing water utility service to approximately 268,000 customers in twenty-one (21) counties in the State of Indiana. Petitioner's corporate office is located in the City of Greenwood, Indiana. Petitioner provides water utility service by means of water utility plant, property, equipment and related facilities owned,

leased, operated, managed and controlled by it, which are used and useful for the convenience of the public in the production, treatment, transmission, distribution and sale of water for residential, commercial, industrial, sale for resale, public authority and public and private fire protection purposes. In addition, Petitioner provides sewer utility service in the City of Somerset, Wabash County, Indiana and in or near the City of Muncie, Delaware County, Indiana.

3. **Indiana Code 8-1-31.** Effective July 1, 2000, the Indiana Legislature enacted Indiana Code 8-1-31 which provides for the Commission to approve distribution system improvement charges in order to allow water utilities to automatically adjust their basic rates and charges to recover a pre-tax return and depreciation expense on Eligible Distribution System Improvements. Eligible Distribution System Improvements are defined as new, used and useful water utility plant projects that:

(a) do not increase revenues by connecting the distribution system to new customers;
(b) are in service; and
(c) were not included in the public utility's rate base in its most recent general rate case. Indiana Code 8-1-31-5.

A petition under Indiana Code 8-1-31 may not be filed more than once every twelve (12) months or in the same calendar year in which the public utility has petitioned the Commission for a general increase in its basic rates and charges. Indiana Code 8-1-31-10. The rate of return allowed on Eligible Distribution System Improvements is equal to the public utility's weighted cost of capital. Unless the Commission finds that such determination is no longer representative of current conditions, the cost of common equity to be used in determining the weighted cost of capital shall be the most recent determination by the Commission in a general rate proceeding of the public utility. Indiana Code 8-1-31-12. The Commission may not approve a DSIC to the extent the proposed DSIC would produce total DSIC revenues exceeding 5% of the public utility's base revenue level approved by the Commission in the most recent general rate proceeding. Indiana Code 8-1-31-13. The DSIC is to be calculated based upon a reasonable estimate of sales in the period in which the charge will be in effect. At the end of each 12 month period with the charges in effect, the difference between the revenues produced through the DSIC ("DSIC revenues") and the depreciation expense and pre-tax return associated with the Eligible Distribution System Improvements ("DSIC costs") shall be reconciled and the difference refunded or recovered as the case may be through adjustment of the DSIC. Indiana Code 8-1-31-14. When a petition to establish a DSIC is filed, the Public may, within thirty (30) days of the petition being filed, confirm that the system improvements are eligible and that the charges were properly calculated, and submit a report to the Commission. The Commission is required to hold a hearing and issue its order not later than 60 days after the petition is filed. Indiana Code 8-1-31-9.

4. **Relief Requested.** Petitioner seeks approval of a DSIC pursuant to Indiana Code 8-1-31, a new rate schedule reflecting the DSIC, and inclusion of the cost

of the Eligible Distribution System Improvements in Petitioner's DSIC. Briefly stated, Petitioner seeks to recover its DSIC costs for Eligible Distribution System Improvements placed in service between August 1, 2001 and November 30, 2002 amounting to $11,959,762. (The total cost of the projects for which Indiana-American claims the ability to recover through a DSIC is $13,270,267, with $11,959,762 representing the investor supplied additions and being the figure used to determine the requested DSIC revenue requirement due to reimbursement from the Indiana Department of Transportation ("INDOT") in the amount $1,310,504.) The depreciation expense of such improvements is $297,503 (calculated by using Petitioner's current Commission-approved depreciation accrual rates), with a return on the improvements using a weighted after-tax cost of capital of 7.83% (10.81% on a pre-tax basis). The rate of return was calculated based on Petitioner's current capital structure and debt cost rate and the cost of common equity determined by the Commission in Petitioner's last rate order. Petitioner's proposed DSIC would produce additional annual revenues of approximately $1,590,353, which would equate to an increase of approximately 1.29% above the rates currently in effect.

5. **Petitioner's Direct Evidence.** Petitioner's direct evidence was presented and supported by two (2) of its officers: Assistant Treasurer and Assistant Secretary James L. Cutshaw, who is a Senior Financial Analyst for Petitioner, and Alan J. DeBoy, Vice President of Engineering.

Mr. Cutshaw provided some general background information about DSICs, testifying that the purpose served by a DSIC is to provide an innovative ratemaking mechanism necessary to replace aging infrastructure, which is an issue of national concern. Mr. Cutshaw testified that DSIC revenues to be derived from approval of the Petition would amount to $1,590,353, which is 1.29% of its current base revenue level of $123,449,194. Mr. Cutshaw provided evidence concerning the calculation of the proposed DSIC and sponsored, as *Petitioner's Exhibit JLC-1*, Petitioner's proposed rate schedules reflecting the DSIC. He explained that the rate of return used in the DSIC revenue requirement calculation is Petitioner's weighted average cost of capital derived from Petitioner's capital structure as of November 30, 2002. The long-term debt cost rate used in the calculation is the average embedded long-term debt cost rate as of that date. A common equity cost rate of 10.5% was used because that rate was determined by the Commission in Petitioner's most recent general rate case in Cause No. 42029. The result is a weighted average cost of capital of 7.83% on an after-tax basis. This rate was converted to a pre-tax rate of 10.81% to include revenues for state and federal income taxes.

Depreciation expense was calculated by applying the applicable Commission-approved depreciation accrual rates to the Eligible Distribution System Improvements, net of related retirements. The proposed DSIC volumetric rate was calculated by dividing the DSIC revenue requirement by Petitioner's projected 2003 water sales. Mr. Cutshaw testified that the DSIC revenues that would be produced by the proposed DSIC will be less than 5% of Petitioner's base revenue level as approved in Petitioner's last base rate order.

Petitioner's witness Alan J. DeBoy sponsored *Petitioner's Exhibit AJD-1* that gave a brief description of each improvement project, the cost of each project, the date each project was placed in service, the account number assigned to each project based on accounting standards found in the Uniform System of Accounts, and Petitioner's operation area where each project exists. Mr. DeBoy generally described the projects as being replacement infrastructure, reinforcement infrastructure, or security improvements. Mr. DeBoy defined replacement infrastructure as consisting of mains, valves, hydrants, customer services, a water storage tank, process unit components like filter media, coating systems, and sludge collector drive units. Mr. DeBoy stated that a significant portion of main replacements are associated with right-of-way improvement projects where the location of Petitioner's mains conflicts with municipal improvement projects. Reinforcement projects, according to Mr. DeBoy, are projects that improve service to large areas of the existing distribution system by increasing flow capacity, and consist of new mains, a water storage tank in Hobart, Indiana, and a pump station located in Petitioner's Northwest operation referred to as the Taft Street Pump Station. Mr. DeBoy stated that security improvements provide enhancements that deter, delay and detect unauthorized entry to water utility property.

Mr. DeBoy also provided testimony that each improvement listed on *Petitioner's Exhibit AJD-1* was an "Eligible Distribution System Improvement" as defined in Indiana Code 8-1-31-5. As to the eligibility requirement that a project not increase revenues by connecting the distribution system to new customers, Mr. DeBoy testified that he had an understanding and familiarity with all of the projects listed on *Petitioner's Exhibit AJD-1*, and none on them increased revenues by connecting the distribution system to new customers. Regarding the second statutory eligibility requirement that all projects are in service, Mr. DeBoy stated that he has personal knowledge of the projects listed on *Petitioner's Exhibit AJD-1*. Mr. DeBoy further testified as to his understanding that before an in service date can be designated on Petitioner's accounting system the person responsible for oversight of the project must conduct a physical inspection to confirm that the project is in service. Mr. DeBoy also reiterated Mr. Cutshaw's testimony that none of the improvements were included in Petitioner's rate base in its most recent general rate case. Mr. DeBoy testified that the rate base cutoff date used in Petitioner's last general rate case was July 31, 2001, and that all projects listed on *Petitioner's Exhibit AJD-1* reflect in service dates subsequent to July 31, 2001.

6. **Public's Case-In-Chief.** The Public's case-in-chief was presented through three (3) of its employees: Edward R. Kaufman, Lead Financial Analyst in the Rates/Water/Sewer Division; Judith I. Gemmecke, Utility Analyst; and Scott A. Bell, Assistant Director of the Sewer/Water Division.

Mr. Kaufman asserted that Petitioner should not be allowed to recover through a DSIC proceeding those improvements to components of its utility that comprise source of supply, water treatment plant, general plant or security. After removing improvements to those utility components that should be disallowed, Mr. Kaufman proposed that completed plant amounting to $7,723,795 could be included in Petitioner's DSIC.

In his testimony, Public's witness Mr. Kaufman discussed the theory behind DSICs. Mr. Kaufman asserted that the DSIC was created as a special tool to provide utilities with additional resources to accelerate the replacement of aged distribution assets. Mr. Kaufman supported his analysis by quoting several sources including a January 18, 2000 memo from Eric W. Thornburg, former Vice President of Indiana-American, to the Members of the Indiana Senate Committee on Commerce and Consumer Affairs. This memo was included as *Attachment No. 1 to Public's Exhibit No. 1*. In that memo Mr. Thornburg stated as follows:

> This new technique will allow for the replacement of aged infrastructure, primarily pipelines, without the necessity of filing for a rate increase with the added cost to customers and delay of such undertakings. It does not include new main extensions that would produce additional revenues for the utility.

Mr. Kaufman then discussed the factors that differentiated distribution mains and other distribution assets from other investments made by utilities between rate cases. In *Public's Exhibit No. 1, pgs. 7 & 8*, Mr. Kaufman asserted as follows:

> There are several factors which in combination give weight to the need for a DSIC to specifically promote the replacement of old distribution system assets:
>
> 1) The scope of replacing these assets is very large.
>
> 2) The replacement of distribution system assets is ongoing or continuous in nature.
>
> 3) The replacement of distribution assets is a series of many small projects. Thus, a utility is unable to time a rate case around their replacement as it could for a single large project.

Mr. Kaufman added that if one accepts the supposition that the factors described above are so severe that traditional ratemaking is unlikely to adequately facilitate necessary infrastructure improvements on a large scale, then the same rationale needs to be used to determine what plant should be approved in a DSIC case. Mr. Kaufman contended that the purpose of a DSIC is to accelerate the repair and replacement of aging infrastructure that has not or would not occur under traditional ratemaking. He added that the DSIC was created as a special tool to promote the adequate replacement of old and/or dilapidated distribution assets. The DSIC should not be applied to typical investments made by water utilities on a regular basis and investments that can be handled through traditional ratemaking should be handled in that manner.

Mr. Kaufman also noted that Petitioner's proposed DSIC seeks to earn a return on and return of assets that did not rehabilitate its distribution system and that Petitioner was

using the DSIC as a catch-all for virtually all of its rate base additions (other than those that increase revenues by hooking up new customers to the distribution system). Mr. Kaufman then referred to several of Petitioner's responses to data request questions that highlighted Petitioner's assertion that the DSIC was designed to include treatment plant, general plant and source of supply assets as well as distribution assets. Mr. Kaufman added that Indiana-American's response to data request question 36 indicated that Indiana-American has not accelerated the replacement of its mains as a result of the opportunity to collect DSIC revenues.

Mr. Kaufman also asserted that the limited time frame of a DSIC procedure limited the Public's ability to conduct meaningful fact finding and that a DSIC procedure should not include additions that are controversial and/or require a lengthy review. Additionally, Mr. Kaufman stated that the DSICs used in Pennsylvania and Illinois had significant differences than the DSIC proposed by Petitioner. The key differences were that both Illinois' and Pennsylvania's DSICs limited recovery to very specific account categories, included an earnings test and required consumer notification. Finally, Mr. Kaufman proposed that any future DSIC should include a 10-year projection of plans to repair and rehabilitate its distribution. Mr. Kaufman argued that since the rationale of the DSIC is to promote the replacement of aging infrastructure it seems logical that utilities should have a plan on how and when they intends to replace aging infrastructure. Such a plan will help to address the concerns expressed by the parties that led to creation of the DSIC.

Also testifying on behalf of the Public was accountant, Judith I. Gemmecke. Ms. Gemmecke echoed Mr. Kaufman's beliefs about what should be included in a DSIC and discussed specific calculations of the DSIC given certain parameters shown below. In considering Ms. Gemmecke's testimony it is important to note that Petitioner presented its calculation for the DSIC which included a return of 10.81% (before tax) on additions made which Petitioner asserts are subject to the surcharge, less the amounts contributed by INDOT. To that result, Petitioner added depreciation, which it calculated by subtracting retirements from the total additions of assets. Ms. Gemmecke noted that by making no adjustment for those contributed funds, this calculation allows depreciation on Contributions in Aid of Construction ("CIAC").

Ms. Gemmecke, presented her calculation of the DSIC, which also included the 10.81% before tax return, but only on the additions the Public recommends should be allowed in the DSIC as discussed earlier. Her calculation decreases the allowable additions by the amount of related retirements at original cost. To that result, Ms. Gemmecke also added depreciation expense, which she calculated by subtracting retirements from the total additions of allowable assets. By making no adjustment for funds contributed by INDOT, this calculation also allows for depreciation to be collected on CIAC. Ms. Gemmecke points out in her testimony that Indiana is one of a handful of states that allows water utilities to collect depreciation on CIAC. Allowing depreciation on contributed plant accomplishes many of the same goals the DSIC was intended to accomplish -- namely, providing additional funds to replace aging distribution systems.

On *page 6 of Public's Exhibit No. 2*, Ms. Gemmecke included the following accounts in her calculation of the DSIC:

Account	Description
331001 –	TD (Transmission/Distribution) Mains Not Classified by Size (formerly Mains Conversions)
333000 -	Services
334200 –	Meter Installations
335000 –	Hydrants

The Public encouraged the Commission to use these same accounts in determining eligibility for a DSIC, especially in light of the time limitations for conducting discovery, conducting an evidentiary hearing, and issuing a final order.

The Public's engineering witness, Mr. Scott A. Bell, Assistant Director of the Public's Rates/Water/Sewer Division, testified that Petitioner's investments in Source of Supply, Water Treatment Plant and General Plant should not be included in the calculation of the DSIC. He also stated that there are some items Petitioner listed as Transmission and Distribution Plant that should also not be included in the calculation of the DSIC. Mr. Bell pointed out that Petitioner made investments in "Tank Security Improvements" in a number of its operational areas that total approximately $1,977,417. He stated that Petitioner has categorized those investments as "Transmission and Distribution Plant" and assigned to Account No. 330000. While having no independent knowledge of the exact nature of the security improvements other than what was represented by Petitioner in its pre-filed testimony, Mr. Bell testified that these "Tank Security Improvements" should not be considered eligible for inclusion in the calculation of the DSIC because these improvements are not repairs or replacements of aging transmission and distribution infrastructure, but rather are investments in the new security systems as a result of the increased security risks after September 11, 2001. He concluded that while it is important that a utility make prudent investments in security, such improvements should not be considered eligible for inclusion in the calculation of the DSIC. Mr. Bell recommended that Petitioner should recover its security related investments in a more appropriate proceeding.

Mr. Bell also testified about Petitioner's inclusion of the 1.5 MG water storage tank in Hobart, Indiana, which represents an investment of approximately $1,644,841. He testified that the water storage tank and associated facilities should not be eligible for inclusion in the calculation of the DSIC because the investment Petitioner made in the Hobart water storage tank was not only to replace an aging water storage facility, but also to provide additional storage capacity to adequately serve increasing water demands or to meet fire-flow requirements. He stated that, in effect, the Hobart water storage tank would increase Indiana-American's revenue by making it possible to connect the distribution system to new users. He concluded that the investment in the 1.5 MG storage facility should not be considered DSIC eligible.

7. **Petitioner's Rebuttal.** Mr. Cutshaw responded to the Public's testimony to exclude improvements that have been recorded as Source of Supply, Water Treatment Plant, General Plant, Distribution Reservoirs and security improvements. Mr. Cutshaw testified that Indiana-American reviewed the language of the statute, as written, to determine what improvements are and are not eligible. Mr. Cutshaw suggests that the Public is attempting to add factors not provided in the statute and is relying on variations of the DSIC implemented in the States of Pennsylvania and Illinois to support its position. Mr. Cutshaw testified that these additional factors are not found in Indiana Code 8-1-31 and stated that Indiana-American's proposed DSIC is calculated pursuant to the definition the Legislature used.

Mr. Cutshaw stated that it is significant that some of the improvements Indiana-American included as "Eligible Distribution System Improvements" could not be included in a similar rate adjustment in either Illinois or Pennsylvania because it reveals the differences in the Indiana legislation as compared to Pennsylvania and Illinois. He explained that the Pennsylvania variety of the DSIC was first employed before there was a statute specifically authorizing it. The Pennsylvania Public Utility Commission established its DSIC in the order that is included with Mr. Kaufman's testimony as *Attachment No. 4*. The only statutory authority for the request was the generic authority to approve automatic tracker mechanisms. The Pennsylvania Commission approved of the concept of a DSIC, and in the process, established all of the procedures and requirements for a DSIC without any guidance from the legislature. In doing so, the Commission defined what is and is not eligible. After the Pennsylvania DSIC was first approved in this fashion, the Pennsylvania legislature confirmed what the Commission had done, and left all decisions regarding the eligibility and implementation to the Pennsylvania Commission. 66 Pa. Cons. Stat. § 1307(g).

Mr. Cutshaw further testified that the Illinois variety of the DSIC is likewise very general. The Illinois legislature left the decision whether to approve a DSIC entirely up to the Commission, indicating that the Commission "may authorize" the mechanism. 220 Ill. Code § 5/9-220.2. Mr. Cutshaw states these differences are significant for purposes of Indiana's DSIC legislation because this alternative approach was available to the General Assembly when Indiana Code 8-1-31 was enacted. The Legislature could have left to the Commission the decisions whether a DSIC should be approved, what would be eligible and what procedures would govern, as has been done in both Illinois and Pennsylvania. He speculated that the Legislature chose not to do so and instead specifically chose to define what is authorized as a DSIC.

Mr. Cutshaw responds to Mr. Kaufman's concerns that Indiana-American has not increased its investment in the replacement of mains by noting that Indiana-American makes its investment decisions based upon what will be needed, when it will be needed, and whether and to what extent there is capital available. Indiana-American believes the DSIC should help with its ability to access capital by mitigating some of the effects of regulatory lag. The DSIC should therefore help Petitioner in its ability to make all types of rehabilitations, replacements, and improvements throughout its utility systems. Mr. Cutshaw did not consider it appropriate to eliminate the Hobart storage tank from the

DSIC asserting it was not included in rate base in Cause No. 42029, and that it does not increase revenues by connecting new customers. He also stated that, while not a requirement under Indiana Code 8-1-31, the Hobart storage tank is a replacement of existing tanks as explained by Mr. DeBoy.

In defending the inclusion of security costs, Mr. Cutshaw testified that the security improvements are improvements to existing infrastructure. Mr. Cutshaw suggests that if a 100-foot section of a main is replaced, the overall main will have been improved. In the same manner, if an investment is made to secure one of its facilities against a terrorist attack, the facility will have been improved. He does not believe an improvement to existing infrastructure should be treated any differently from the replacement of existing infrastructure. Mr. Cutshaw further testified that he believed adequate access to information had been provided to the Public related to the security improvements and he finds it significant that a Non-Disclosure Agreement was executed with the Utility Consumer Counselor and the Public's Water and Sewer/Rates Director. Mr. Cutshaw also disagreed that Indiana-American has provided no more information on the security-related improvements than it provided on security expense in Cause No. 42029. He stated that at issue in Cause No. 42029 were security-related Operation and Maintenance expenses as opposed to the capital items at issue here. He explained that Indiana-American has provided in this proceeding every security task order number, the total amount for each, and the operation for each in *Petitioner's Exhibit AJD-1*. Indiana-American also provided information on security capital expenditures through the presentation of its case-in-chief during the in camera portion of the hearing. Finally, Indiana-American's witnesses have been available to respond to any questions about the security program or task orders that are included in *Petitioner's Exhibit AJD-1*.

As to Mr. Kaufman's concern that the type of review that would be done in a rate case cannot be completed during the abbreviated process for a DSIC, Mr. Cutshaw stated that the DSIC was not intended to be and will not result in a final determination that the DSIC assets are in rate base for purposes of a general rate case. The Public will have the opportunity to conduct a full rate base review in its next general rate case.

Mr. Cutshaw stated that he did not believe limitations on accounts that are eligible for DSIC and an earnings test would be consistent with Indiana Code 8-1-31. However, Mr. Cutshaw believed a requirement for customer notice and a requirement that a utility file a forecast that could be updated in future DSIC proceedings could be consistent with the DSIC statute and could be adopted if the Commission finds appropriate. Mr. Cutshaw stated Indiana-American would be willing to comply with these requirements in future DSIC proceedings if the Commission requests, but suggested a five-year forecast instead of ten years.

Mr. Cutshaw does not agree with the Public's assertion that retirements should be deducted from additions subject to DSIC in determining the net investor supplied DSIC additions to which the pre-tax return is applied. Mr. Cutshaw explained that under mass asset accounting rules, retirements are treated as fully depreciated with the original cost

being deducted from both utility plant and accumulated depreciation. Such a retirement results in no change to the net book value of the Company's assets.

Mr. Cutshaw also disagreed with the depreciation rates used by the Pubic because different depreciation rates apply to Petitioner's Northwest, Mooresville, Warsaw, West Lafayette, and Winchester operations. Mr. Cutshaw provided a table that was later corrected at the hearing which reflects the appropriate depreciation rates. Next, Mr. Cutshaw disagreed with the Public's conversion from MGAL to CCF. Indiana-American determined the conversion to CCF (hundred cubic feet) by dividing the MGAL (thousand gallons) by 0.75. He explained that this is the same relationship that has existed in the Company's tariff sheets for many years.

Finally, Mr. Cutshaw disagreed with the Public's suggestion to separate Water Groups 1,2,3 into Water Group 1, Water Group 2, and Water Group 3. Mr. Cutshaw explained that this is inappropriate because the company's rate design has moved toward Single Tariff Pricing ("STP"). Rate base and operating income findings have been proposed and approved for the combined Groups, not for each separate Group mainly because there are different groupings for General Water Service, Sales for Resale, Private Fire Protection, and Public Fire Protection. The Groups shown on Schedule *No. 1 of Public's Exhibit No. 2* are the Sales for Resale groupings. For General Water Service there are only two Groups, with Johnson County and Southern Indiana in Group 2. Mr. Cutshaw stated it is consistent with the movement towards STP to continue to make one finding for Water Groups 1,2,3 as a whole as proposed on *Petitioner's Exhibit JLC-2.*

During Indiana-American's rebuttal case, Mr. DeBoy testified that he did not agree with Mr. Bell's opinion that the Hobart water storage tank should not be included in this case. He asserted that the Hobart tank satisfied the conditions for eligible distribution system improvements put forth in Mr. Cutshaw's testimony. Mr. DeBoy testified that he believed that Mr. Bell proposed to exclude the tank because it is new as opposed to replacement infrastructure. Mr. DeBoy noted that there is nothing in the statute that states only replacement infrastructure is eligible. He went on to explain that, in fact, the Hobart water storage tank actually replaced three elevated water storage tanks that were beyond economical repair.

8. **Commission Findings and Analysis.** We note, first, that the Petitioner and Public have filed a *Stipulation and Settlement Agreement.* The Commission has a clear standard for its review and consideration of settlement agreements. Settlements presented to the Commission are not ordinary contracts between private parties. *United States Gypsum, Inc. v. Indiana Gas Co.,* 735 N.E.2d 790, 803 (Ind. 2000). When the Commission approves a settlement, that settlement "loses its status as a strictly private contract and takes on a public interest gloss." *Id.* (quoting *Citizens Action Coalition v. IPL Energy,* 664 N.E.2d 401, 406 (Ind. Ct. App. 1996)). Thus, the Commission "may not accept a settlement merely because the private parties are satisfied; rather [the Commission] must consider whether the public interest will be served by accepting the settlement." *Citizens Action Coalition,* 664 N.E.2d at 406.

As will be explained more fully below, we find that the public interest will not be served by approving the parties' settlement.

A determination of whether the Petition filed herein complies with Indiana Code 8-1-31 hinges on the phrase "distribution system." This phrase is not defined in Indiana Code 8-1-31 or elsewhere in Title 8 of the Indiana Code. In addition, the testimony of the Parties agrees neither on the meaning nor significance of this phrase. Petitioner contends that any improvement to a water utility qualifies for a DSIC so long as the improvement meets the eligibility criteria of (1) not increasing revenues by connecting the distribution system to new customers, (2) being in service, and (3) not being included in the public utility's rate base in the most recent general rate case. Indiana Code 8-1-31-5. Petitioner encourages the Commission to look to the plain language of the statute and find that any improvement to any component of a water utility qualifies for a DSIC, limited only by the above three (3) eligibility criteria. The Public, on the other hand, supports a more limited meaning of "distribution system," relying on legislative intent, DSIC legislation in other states, as well as an interpretation of the language of Indiana's DSIC statute that may tend to argue against the broad view advocated by Petitioner.

A. Meaning of "Distribution System." Use of the phrase "distribution system" as applied to different types of utilities, and of the phrase "water distribution system" as applied specifically to water utilities, is not foreign or uncommon to the Commission or to those whom it regulates. This Commission has used the phrases "distribution system" or "water distribution system" to identify one component of a water utility that is distinguishable from other water utility components. By way of example, on September 18, 2002, in Cause No. 42226, the Commission issued an Order in a proceeding brought by the same Petitioner in this proceeding, Indiana-American Water Company, Inc., seeking approval to acquire the water distribution system properties of the Town of Dune Acres. The Commission's Order in that acquisition proceeding restated Indiana-American's testimony as to the relief it was seeking: "He (Indiana-American witness, Randal D. Edgemon) testified that Indiana-American proposes to acquire only the distribution system assets consisting of the distribution mains, valves, hydrants and other appurtenances necessary to provide water service. This also includes the service lines, meters, and meter installation. Mr. Edgemon testified that Indiana-American is not purchasing the source of supply, storage or booster pumps related to source and treatment from Dune Acres. The remaining facilities not purchased will not be needed to provide service after the system is interconnected to Indiana-American's Northwest Operation." Cause No. 42226, September 18, 2002, pg.3.

Other Commission Orders have also distinguished the distribution system from other functional components of a water utility. See, for example, Cause No. 41684, August 4, 2000, pgs. 3 & 4: "The directors of North Dearborn Water Corporation authorized Robert E. Curry & Associates to perform an engineering study of the utility's source of water supplies, water treatment, water distribution system and elevated water storage for the purpose of determining the adequacy of the existing water works facilities to accommodate present and future water demands to the utility." In Cause No. 41879, July 3, 2001, pg. 2, it states: "Petitioner's facilities consist of a water distribution system serving the customers and a water treatment plant rated at 350,000 gal/day that was built

in 1952. Petitioner's facilities also include 2 wells with a pumping capacity of 350 GPM each and a water tower with a capacity of 150,000 gallons." From these examples, the commonly recognized components of a water utility are its source of supply (underground wells or surface water), treatment (water treatment plants), storage (elevated water storage tanks), and distribution (mains/pipes, valves, hydrants and meters needed to deliver water to customers). In short, this Commission and regulated water utilities commonly differentiate among their various utility components, including the segregation of activity into the "distribution system."

This differentiation was established in this proceeding in a response to a discovery request from the Public asking Petitioner to identify the categories of all relevant capital improvements. The discovery response, submitted by the Public into evidence (*Public's Exhibit No. 1, Attachment No. 3, pg. 20*), is a table containing information that Petitioner prepared using the same accounting format as other water utilities when submitting their Annual Reports to the Commission. More specifically, this table is an account matrix that corresponds to accounting practices originally promulgated by the National Association of Regulatory Utility Commissioners ("NARUC") and then adopted by most state public utility commissions, including Indiana's Commission. Indiana's adoption, by reference, of NARUC's rules governing the classification of accounts for water utilities is found at 170 IAC 6-2-2. A summary of Petitioner's account matrix, categorizing all of its proposed DSIC eligible projects, is illustrated below. The "Subsidiary Accounts" and their corresponding numbers shown on the vertical axis are further segregated by the matrix into classifications by function as shown on the horizontal axis (EG: "Source of Supply," "Water Treatment," and "Transmission and Distribution").

Subsidiary Account	Description	Amount	Source of Supply/ Pumping Plant Plant (SS)(PU)	Water Treatment Plant (WT)	Transmission & Distribution Plant (TD)	General Plant
303200	Land SS	143,998.81	143,998.81			
304100	Structures SS	74,673.16	74,673.16			
304200	Structures PU	545,787.04	545,787.04			
304300	Structures WT	111,572.31		111,572.31		
304302	Tank Ptg WT	49,498.00		49,498.00		
304800	Structures Misc	51,299.61				51,299.61
307000	Wells & Springs	31,632.50	31,632.50			
311200	Pump Eq Elec	320,973.09	320,973.09			
311300	Pump Eq Diesel	62,477.00	62,477.00			
320100	WT Equip	340,250.55		340,250.55		
320190	Wt Equip Clear	60,529.00		60,529.00		
320191	WT Equip Plant	27,903.00		27,903.00		
330000	Dist Reserv	3,622,258.29			3,622,258.29	
331001	Mains	5,020,306.63			5,020,306.63	
333000	Services	1,279,349.58			1,279,349.58	
334200	Mtr Installs	1,074,128.33			1,074,128.33	
335000	Hydrants	350,010.33			350,010.33	
343000	Tools/Shop	4,339.00				4,339.00
346100	Comm Equip	30,085.00				30,085.00
346190	Remote Instrum	10,608.00				10,608.00
347000	Misc Equip	58,588.08				58,588.08
Grand Total		13,270,267.31	1,179,541.60	589,752.86	11,346,053.16	154,919.69

The Public's evidence supports, for DSIC purposes, those project amounts identified in Subsidiary Account Nos. 331001 (Mains), 333000 (Services), 334200 (Meter Installations), and 335000 (Hydrants), totaling $7,723,795, all of which are further categorized functionally on the matrix within "Transmission & Distribution Plant." The only other Subsidiary Account Petitioner lists within "Transmission and Distribution Plant," and for which the Public's evidence supports exclusion from DSIC, is No. 330000 (Distribution Reservoir), amounting to $3,622,258.29, which the evidence shows accounts for all "Tank Security Improvements," and the installation of a 1.5 million gallon water storage tank in Hobart, Indiana.

This breakdown of a water utility into its various functional components is also used by the American Water Works Association ("AWWA"). In response to a bench question as to his definition of "distribution system," the Public's engineering witness, Scott A. Bell, answered by referring to the AWWA's Manual: *Principles of Water Rates, Fees, and Charges.* Mr. Bell specifically referred to Table 7-1 in the section of the manual regarding "Allocating Costs of Service to Cost Components," and described how that table separates a water utility's components into Intangible Plant, Source of Supply Plant, Water Treatment Plant, Transmission and Distribution Plant and General Plant.

We believe that the AWWA manual and NARUC's accounting system are consistent with the general understanding in the industry of what can and cannot properly be described as distribution system improvements in the context of water utility plant projects. Items that fall within the other functional categories (EG: Source of Supply/Pumping Plant, Water Treatment Plant, and General Plant) should not be considered distribution system for purposes of a DSIC.

B. DSIC Laws in Other States. We also note, as referenced in the Public's testimony, the comparison of Indiana's DSIC statute with the DSIC statutes enacted in other states, specifically Pennsylvania and Illinois. The DSIC statutes in these states contain many obvious similarities to Indiana's statute. In its *Exhibit No. 1, Attachment No. 4*, the Public produced in evidence an Order from the Pennsylvania Public Utility Commission ("PPUC") that discusses that state's DSIC statute. One issue before the PPUC in that proceeding, and an issue presented by the Public in this proceeding, was a concern that the DSIC statute would be in conflict with the traditional ratemaking process. In *Public's Exhibit No. 1, Attachment No. 4, pgs. 11 & 12* the PPUC states: "Recovery of this narrow set of (DSIC) costs is clearly permitted under Section 1307 (a)...and Pennsylvania case law; and, in the Commission's judgment, this proposal ("to file and implement an automatic adjustment clause to recover its distribution system improvement costs") is in no way a mechanism to "disassemble" the traditional ratemaking process for several reasons: first, the DSIC is designed to identify and recover the distribution system improvements costs incurred between rate cases; second, the costs to be recovered represent a narrow subset of the company's total cost of service; and third, the DSIC will be capped at a relatively low level to prevent any long-term evasion of a base rate review of these plant costs."

In this same Pennsylvania proceeding, the PPUC spoke generally about the purpose of a DSIC: "We agree with the company that the establishment of a DSIC would enable the company to address, in an orderly and comprehensive manner, the problems presented by its aging water distribution system, and would have a direct and positive effect upon water quality, water pressure and service reliability." *Public's Exhibit No. 1, Attachment 4, pg. 8.* This Commission agrees with and endorses such a purpose for a DSIC.

The evidence shows that in Illinois the only projects eligible for DSIC consideration are those that fall within the account numbers noted above: 331 (Transmission and Distribution Mains), 333 (services), 334 (Meters and Meter Installations) and 335 (Hydrants). *Public's Exhibit No. 1, Attachment 5, page 4.* These are the same accounts to which the Public proposes to limit DISC eligibility and, as shown in the above matrix, accounts to which Petitioner has assigned some of the projects for which it seeks approval of a DSIC. While not using the exact same account numbers, it appears from the evidence that Pennsylvania likewise generally limits DSIC-eligible property to services, meters, hydrants and mains. *Public's Exhibit No. 1, Attachment 4, page 18.*

C. A DSIC Proceeding is an Expedited Proceeding. In contrast to traditional rate case proceedings, Indiana Code 8-1-31 obviously intends for a

determination on a DSIC automatic rate adjustment to be made in an abbreviated and accelerated fashion. First, public notice that a DSIC petition has been filed is not required. Indiana Code 8-1-31-8(c). In addition, the Public is under a statutory deadline to issue a report to the Commission, if it chooses to do so, no later than thirty (30) days after the petition is filed. And the Commission is required to conduct a public evidentiary hearing and issue an order within sixty (60) days of the DSIC petition being filed. Indiana Code 8-1-31-9. These short time frames are not indicative of a proceeding that would require any extensive discovery on the part of the Public or review on the part of the Commission of complex projects that are often, and appropriately, the subject of traditional rate case proceedings.

These short time frames are, however, consistent with purposes set forth in Eric W. Thornburg's memo to the Indiana Senate, urging passage of the DSIC legislation. As noted above, Eric Thornburg was Vice President of Indiana-American. Mr. Thornburg stated as follows:

> Regardless of their size and complexity, a common challenge is the age of underground infrastructure, the water mains that convey the product to the customer's tap. The principal focus of regulatory and financial resources has been on improving the quality of our drinking water primarily through promulgating water treatment standards. However, once the water leaves our plants, it travels through piping systems that can be 125 years old.
>
> With so much of the capital available going towards improving water treatment systems, little has been available for replacing pipelines. Compounding the situation is the cost differential. New water lines vary in cost depending on their size, but typical installations average $20 – 100 per foot. We are often retiring pipe that cost less than $1 per foot when it was installed and rate shock can result.
>
> This new technique will allow for the replacement of aged infrastructure, primarily pipelines, without the necessity of filing for increases with the added cost to customers and delay of such undertakings. It does not include new main extensions that would produce additional revenue for the utility.
> *Petitioner's Exhibit No. 1, Attachment No. 1.*
> (Emphasis added.)

If Indiana-American's request in this proceeding were consistent with its former Vice President's description of the DSIC legislation, it would not have included improvements to utility components such as water treatment or source of supply, or security improvements, but would have concentrated primarily on the replacement of pipelines, meters and hydrants within the distribution system. In this proceeding, however, Petitioner contends that the lack of qualifying language in Indiana Code 8-1-31-5 to specifically limit "water utility plant projects" to projects within the "distribution system" results in DSIC eligibility for any utility plant project that is in service, was not included in the utility's last rate case, and was not a project to hook-up new customers.

D. Legislative Intent. To the extent Petitioner's reading of this statute has merit we rely on what the courts have said regarding the discernment of legislative intent. "The intention of the legislature, as ascertained from a consideration of the act as a whole, will prevail over the literal meaning of any of the terms used therein." *Brown v. Grzeskowiak*, 230 Ind. 110, 101 N.E. 2d 639 (1951). In *City of Indianapolis v. Evans*, 216 Ind. 555, 24 N.E.2d 776, (1940), the court said: "The legislative intent, however, is to be ascertained by an examination of the whole, as well as the separate parts of the act, and when so ascertained, the intention will control the strict letter of the statute or the literal import of particular terms of phrases, where to adhere to the strict letter or literal import of terms would lead to injustice, absurdity, or contradict the evident intention of the legislature." And in *Rexing v. Princeton Window Glass Co.*, 51 Ind. App. 124, 94 N.E. 1031 (1912), we look to the language: "The purpose and scope of an act of the legislature must be determined from its title," and then to the title of Indiana Code 8-1-31, which is: "Distribution System Improvement Charges." When read as a whole, particularly with the intended and repeated reference to "distribution system," we find the most reasonable intent of Indiana Code 8-1-31 is to limit water utility plant projects to projects that are within the utility's distribution system.

E. The Language of Indiana Code 8-1-31. In addition, we also find the actual language of Indiana Code 8-1-31 to be consistent with our finding as to legislative intent. We, therefore, do not accept Petitioner's assertion that a plain language examination of Indiana Code 8-1-31 necessarily results in the conclusion that eligible improvements under this statute include any utility improvements that do not increase revenue by connecting the distribution system to new customers; are in service; and were not included in the utility's last general rate case. Indiana Code 8-1-31-5 states:

> As used in this chapter, "eligible distribution system improvements" means new used and useful water utility plant projects that:
>
> (1) do not increase revenues by connecting the distribution system to new customers;
> (2) are in service; and
> (3) were not included in the public utility's rate base in its most recent general rate case.

This statute specifically disallows DSIC eligibility for "water utility plant projects" that would increase revenues by connecting the "distribution system" to new customers. This is one place in the statute where the phrase "water utility plant projects" is juxtaposed against the phrase "distribution system," thereby imparting a meaning to "distribution system" that is narrower than that of "water utility plant projects." If the broad meaning of "water utility plant projects" was intended to carry through all of Section 5, why qualify Section 5(1) with the phrase "distribution system?" We find it a reasonable interpretation that the statute as written is stating what was obviously intended, which is that the type of water utility plant projects contemplated are necessarily within the water utility's distribution system.

In addition, this juxtaposition of the phrase "water utility plant projects" with the phrase "distribution system" results only in a limitation that excludes from DSIC eligibility a particular category of utility plant project within the distribution system (connecting to new customers). Connecting to new customers describes a classic type of distribution system activity within the common meaning of "distribution system" as discussed above. We do not find it logical that this "Distribution System Improvement Charge" statute, with this single, exclusionary reference to a specific type of "distribution system" project, intended thereby to open the door of DSIC eligibility to any other "water utility plant project." Rather, we find that this one exclusion of a type of project within the distribution system is meant to thereby imply the inclusion, or DSIC eligibility, of all other types of distribution system improvements. We find the language and intent of this statute to include the requirement that a water utility plant project, in order to be eligible for DSIC consideration, must be a project within the "distribution system," limited, as to type of project, only by the ineligibility of projects that connect to new customers.

Accordingly we find, as applied to water utilities, that a common and consistent meaning of the phrase "distribution system" is found: in our previous Orders, in other states' DSIC laws, and in the water utility industry in general. We find that meaning identifies one component of a water utility that is distinguishable in plant and function from other components such as source of supply, water treatment and, in some instances, water storage. We also find that the evident legislative intent of Indiana Code 8-1-31, as well as the express language of that statute, conveys that same meaning. We cannot conclude that the Indiana General Assembly chose to adopt and repeatedly refer to "distribution system" in Indiana Code 8-1-31 as a way to generally identify, as Petitioner contends, the whole of a water utility. As to what water utility projects fall within the distribution system for DSIC eligibility, we find it within the purpose and meaning of Indiana Code 8-1-31 to look to the categories or accounts that the water utility industry uses, and specifically NARUC's system of accounts, to identify projects that are within a utility's distribution system.

F. Projects and Amounts to Be Included and Excluded as Distribution System Improvement Charges. Of the $13,270,267 Petitioner has requested for DSIC eligibility, the Public sought to allow $7,723,795. All of this $7,723,795 is categorized on Petitioner's matrix within the following Subsidiary Accounts: " Mains (331001), Services (333000), Meter Installations (334200), and Hydrants (335000). And all of these Subsidiary Accounts are contained within the functional category: "Transmission and Distribution." Based on our discussion above, since these improvements are categorized as being within Petitioner's distribution systems, we find that they should be approved for DSIC recovery.

The Public sought to disallow $5,546,472, which includes $2,402,473 for security improvements and $3,143,999 for non-security improvements that the Public claims are either not distribution system improvements or are otherwise not eligible. Of the total amount the Public seeks to disallow, $1,499,158 relates to costs for non-security projects, and $425,057 is for security-related projects, that Petitioner has categorized on its matrix within the functional categories of "Source of Supply/Pumping," "Water Treatment," and

"General Plant." Petitioner has categorized the remaining $3,622,258 within the matrix category of "Transmission and Distribution." Of that Transmission and Distribution amount, $1,644,841 accounts for the cost of a project to erect a tank in Hobart, Indiana, and $1,977,417 relates to various projects to improve tank security.

Based on our analysis above of the DSIC statute, we find that all non-security projects that fall outside of improvements to the utility's distribution system; that consist of improvements to Source of Supply/Pumping, Water Treatment and General Plant, should be excluded from recovery of a DSIC charge. In this proceeding, therefore, $1,499,158 should be excluded.

We turn our attention next to the $1,644,841 attributed to placing a new water tower in service in Hobart, Indiana. We agree that the Hobart Water Tower was properly categorized by Petitioner on the account matrix discussed above as being functionally within "Transmission and Distribution Plant", in Subsidiary Account No. 330000 ("Distribution Reservoir"). Based on our discussion above, that fact argues for inclusion of the water tower as a DSIC. However, we also note that both Pennsylvania and Illinois do not include "Distribution Reservoir" in their definition of DSIC eligible, distribution system projects. That fact suggests, as we believe, that water storage may go beyond the distribution system improvements contemplated by this statute. We are not convinced that the replacement of three (3) water towers with one tower that is three (3) times the capacity of the three (3) replaced towers combined, at a cost of $1.5M dollars, could be adequately reviewed by the Public and determined by this Commission within the time prescribed for the issuance of a DSIC Order.

The construction of new or replacement water storage tanks is accomplished at a considerable expense for water utilities. That expense is ultimately borne by water utility customers, who are the ratepayers. In this proceeding, the Hobart Water Tower is the most expensive single project that Petitioner has presented to this Commission for DSIC approval. As already noted, the DSIC statute does not require public notice that a DSIC petition has been filed. It is difficult to reconcile the inclusion of projects of this magnitude with the procedural constraints imposed by the DSIC statute. Consideration of the water tank in this proceeding is complicated even more by the fact that this tank project has resulted in an infrastructure very different from the infrastructure it has replaced. All of these considerations serve to emphasize the limitations built into the DSIC statute that are not found in a traditional rate case, such as a longer review period and more public notice, all of which are very important for projects of this size and scope. Referring to a Pennsylvania court decision, the PPUC stated: "...the purpose of (Pennsylvania's automatic rate adjustment law) is to permit reflection in customer charges of changes in one component of a utility's cost of providing public service without the necessity of the broad, costly and time-consuming inquiry required in a...base rate case." *Public's Exhibit No. 1, Attachment 4, pg. 10.*

It is also arguable that the costs of the Hobart Water Tower project are subject to allocation, with some costs being DSIC eligible and some not being DSIC eligible. But there is not sufficient evidence in this proceeding to support a cost allocation. Even if

such evidence did exist, timely review would be hindered by the complexity of allocation techniques and by the statutory deadlines inherent to DSIC proceedings that have already been discussed.

Mr. DeBoy testified that the Hobart Water Tower project was in the planning stage prior to Petitioner's acquisition of the Northwest Indiana Water Company, though not placed in service until after its last rate case was filed on June 29, 2001 in Cause No. 42029. This Commission approved Indiana American's acquisition of the Northwest Indiana Water Company on December 15, 1999. We note, however, our rate Order in Cause No. 42029 gave consideration to certain of Petitioner's projects (Tunnel Project, Newburgh Project, and Wabash Valley Project) that included estimated costs and estimated in-service dates for completion. Thus, the Commission has allowed for projects that are not yet in service and outside the test year to be included in rates during traditional rate case proceedings. Petitioner could have effectively included the Hobart Water Tower in this most recent traditional rate case, which allowed for a two-step increase to be phased in upon completion of the Tunnel Project.

We also note that the Hobart Water Tower was constructed, at least in part, with additional customer revenue in mind. Mr. DeBoy testified that it would have been shortsighted for Petitioner not to consider future needs in determining the capacity of the Hobart Water Tower and that additional customers were, in fact, a consideration in determining the size tank to build. Notwithstanding, therefore, the argument that the Hobart Water Tower can be described as a distribution system improvement, there is also evidence that a substantial portion of the much larger water tower will increase revenues by permitting connection of the distribution system to new customers, thereby making it ineligible for DSIC recovery. Of course we realize, first, that no water utility customer is directly connected to a water storage tank and, second, that some aging distribution system infrastructure, such as mains, could, for example, be replaced with larger diameter mains in response to or anticipation of new customers, yet still be DSIC eligible. A new or replacement water tower, however, can play a significant role in connecting new customers. It is clearly the intent of the DSIC statute to exclude distribution system projects that connect to new customers, and we find this water tower, with its ability to generate new revenue, fits within the purpose of that exclusion.

This Cause is the first DSIC proceeding brought before this Commission, and our findings and conclusions will impact future DSIC petitions. It is a primary charge of this Commission to ensure just and reasonable utility rates. The traditional ratemaking process contains the safeguards needed for comprehensive review, particularly of complex and expensive projects, by the Public, the Commission, and the public in general. We find the DSIC statute is similar in purpose to other "tracker" statutes that allow utilities expedited adjustment to rates in matters that fall outside the need for the comprehensive review allowed in a traditional rate case.

We are, however, not prepared to find in this proceeding, as has been determined in Pennsylvania and Illinois, that any project categorized within "Distribution Reservoir" is not DSIC eligible. Distribution Reservoir projects presented to the Commission for

DSIC recovery will be considered on a case-by-case basis. We find only, for all of the above reasons specific to this particular project, that the Hobart Water Tower project is not DSIC eligible.

Finally, we address the $2,402,473 in security costs that Petitioner has proposed for DSIC recovery. An amount of $425,057 for security improvements is DSIC excludable for the same reason as the non-security improvements above that did not take place within the distribution system. And even though Petitioner has categorized a portion ($1,977,417) of its security costs as being projects within the distribution system, we find that those security costs should also be excluded from DSIC recovery. We agree with the Public's testimony that the purpose of a DSIC proceeding is to encourage, through an expedited and automatic rate increase, repair or replacement of a distribution system's aging and failing infrastructure. Security improvements, while providing overall improvement to a utility, are not the type of infrastructure improvements contemplated by DSIC statutes.

In addition, given the highly sensitive nature of all security system information, more time than the DSIC statute allows is needed to permit the Public as well as the Commission to fulfill its statutory duties. Indiana Code 8-1-31-9(b) states that the Public may issue a report on a DSIC request within thirty (30) days of the petition being filed. The Public testified, through Mr. Kaufman, that any discovery about improvements that are claimed to be sensitive is difficult and arguments about the recovery of those improvements are awkward, thereby suggesting a lengthier process to ensure adequate review. Given the time needed for the Public and Petitioner to enter into a standard confidentiality agreement, plus the time needed for possible discovery on these sensitive issues, would almost certainly require more than thirty (30) days for the Public to conduct a meaningful review. In addition, given the sixty (60) day time limit for the Commission to issue an order, the meaningfulness of our review is hampered by additional procedures that must be considered and invoked in order to ensure proper confidential handling of sensitive information. Again, the point simply being that the additional complexities of considering security improvements are better suited for a traditional rate case proceeding.

In response to Mr. Kaufman's concern that the review performed in a traditional rate case cannot be completed during the abbreviated process for a DSIC, Mr. Cutshaw stated that the DSIC process was not intended to and will not result in a final determination that the DSIC assets are in rate base for purposes of a general rate case and that the Public will have the opportunity to conduct a full rate base review in the utility's next general rate case. We note, however, that Petitioner's assertion that an imprudent investment can be subsequently removed from rate base does not justify its inclusion in a DSIC. If an investment is, in fact, subsequently excluded from rate base in a future rate case, then ratepayers will have paid both a return on and of an asset that was determined to be ineligible. It is unfair for ratepayers to have incurred such a cost. Moreover, if an asset does not belong in rate base then ratepayers should not have to pay a return on and of that asset. Given the limited time frame, DSIC eligible assets should only include assets that require a minimal review and whose inclusion in rate base is assumed to be reasonable.

For the foregoing reasons and without need to refer to specific categories or describe even in general terms Petitioner's security improvements and without need to make any determination as to the relative prudence of those improvements, we deny recovery of the security improvements in this DSIC proceeding. We find that, without regard to what component of a system they are designed to make secure, security improvements do not properly fall within the descriptor "distribution system improvement" and were not intended to be recovered in a DSIC proceeding regardless of their desirability. In so concluding, we also agree with the Public's testimony that a utility's undertaking of prudent security measures should not be dissuaded. With a heightened concern about terrorist attacks, we encourage utilities to take prudent measures to ensure that their facilities and employees are protected, and to ensure that a safe product can be delivered to consumers. Given, however, the need expressed by Petitioner to be sensitive to the need to maintain secrecy where appropriate, a DSIC case simply does not allow sufficient time to afford due process to the parties and adequate time for the Commission to balance the need for secrecy with the expedited review required by statute. Petitioner may seek to recover these expenditures in a subsequent general rate case.

In addition to the foregoing reasons to exclude security improvements as well as the other excluded items we believe our position here is reasonable given our practice of allowing utilities to recover depreciation of contributed property. In Cause No. 39595, the Commission stated on page 23, "The Commission's current policy of allowing the recovery of depreciation on the contributed property provides to the Company additional internally generated funds to cover at least part of the replacement cost." Indeed, Petitioner's last rate case, Cause No. 42029, had $60 million in CIAC on which depreciation was calculated and included in rates.

Also, We agree with the Public's recommendation that future DSIC proceedings should include a projection of plans to repair and rehabilitate the distribution system, but find Petitioner's suggestion that such a projection be limited to a 5-year forecast, as opposed to 10 years, to be more reasonable.

G. Calculation of Distribution System Improvement Charges. As to calculation of a DSIC, both Petitioner and the Public agree the before tax rate of return should be 10.81% on certain additions less the amounts contributed by INDOT. The Public further reduces the amount on which the return applies by the original cost of those assets that are now no longer in service as they have been replaced by the assets eligible for the DSIC. Petitioner has acknowledged Indiana allows a return on the Fair Value of assets. Petitioner also acknowledges that if such asset values were not eliminated in the DSIC calculation, Petitioner would earn a return on assets no longer in service as well as earning a return on the replacement of those assets. On cross-examination by the Public, Petitioner's witness Mr. Cutshaw indicated, under Petitioner's method of calculation, it will be earning a return on the fair value of the assets which have been retired as well as earning a return on these new assets, some of which were replacements for those assets retired. In its proposed order, the Public notes that Mr.

Cutshaw asserted in his rebuttal testimony that retirements should not be deducted from rate base additions in a DSIC because, under mass accounting rules, when a utility retires an asset it has no impact on the utilities net book value. We observe that such a rationale may be technically correct, but it is also irrelevant since such a factor would only apply in original cost ratemaking. Petitioner's rate base is based on the fair value of its assets. When any asset with a positive fair value is retired that will reduce the utility's fair value rate base. Thus, if retirements are ignored and a utility is allowed to earn a return on new plant through a DSIC, they will collect a return on both the new plant through its DSIC and on the retired asset through its return on the fair value rate base determination from the utility's last rate case. (We asked Mr. DeBoy if it could be determined when individual assets that have been retired were purchased. He indicated that it would be possible by pulling fixed asset records. We note that this information appears to be found in the response to data request question 33 included in *Attachment No. 3* to Mr. Kaufman's testimony.)

Petitioner did not provide the fair value determination from their last rate case for the items retired. We agree with the Public as to the net amount eligible to receive a return on. We therefore find Petitioner may receive a 10.81% before tax return on $5,859,778 of net additional plant.

In Cause No. 42029, the Commission determined that the fair value of Indiana American's rate base was $562,680,669. The Commission also determined that Indiana American's original cost rate base was $403,085,800. Mass accounting rules do not apply to the Commission's determination of a utility's fair value and any retirement of plant will impact the fair value rate base. In Cause No. 42029, Mr. Deboy used a replacement cost new less depreciation study to estimate Indiana American's fair value. His methodologies for the study are described on page 26 of our final order in that Cause. While aged plant that is retired may have a negligible original cost, the fair value of such retired assets may not be negligible and not so easily determined.

Both Petitioner and Public agree on the method of calculating depreciation. Each took what they considered DSIC eligible assets, deducted retirements, and applied the appropriate depreciation rates. The disagreement is in what constitutes DSIC eligible assets. Applying our previous decision as to what assets are DSIC eligible, we therefore find Petitioner may earn depreciation in the amount of $163,849.

As to Petitioner's objection to Ms. Gemmecke's unbundling of the Water Groups, the Commission notes that Ms. Gemmecke provided not only each water group on its own, but also as a total of all water groups. The Commission does not have a blanket stance on single-tariff pricing, but considers each case on it own merits. Ms. Gemmecke's schedules were helpful in determining if we should take the same stance in this case as we took in Cause 42029 regarding the movement toward single-tariff pricing for Indiana-American. This abbreviated proceeding does not allow us to re-visit that issue; therefore we have determined to apply the increase to the Groups as an average. We therefore find the calculations of eligible DSIC assets should be calculated and applied according to the schedule below:

DSIC Calculation and Rate Schedule

	Total	Total Water Groups 1, 2, 3	Wabash	Northwest	Mooresville	Warsaw	West Lafayette	Winchester
Additions subject to DSIC	$7,723,795	$5,942,722	$169,439	$969,547	$78,349	$73,118	$144,716	$345,905
Less Reimbursement by INDOT	1,310,504	1,310,504	0	0	0	0	0	0
Less Retirements	553,513	406,378	23,638	83,146	6,974	3,566	16,027	13,784
Net Investor supplied DSIC Additions	5,859,778	4,225,840	145,801	886,401	71,375	69,552	128,689	332,121
Pre-tax Rate of Return	10.81%	10.81%	10.81%	10.81%	10.81%	10.81%	10.81%	10.81%
Pre-Tax Return on Net DSIC Additions	633,442	456,813	15,761	95,820	7,716	7,519	13,911	35,902
Depreciation on DSIC Additions	163,849	132,872	3,660	14,073	2,354	1,520	3,859	5,511
Total DSIC Revenues	797,291	589,685	19,421	109,893	10,070	9,039	17,770	41,413
DSIC Rate per MGAL	**$0.0219**	**$0.0267**	**$0.0256**	**$0.0101**	**$0.0288**	**$0.0110**	**$0.0142**	**$0.2027**
DSIC Rate per CCF	**$0.0164**	**$0.0200**	**$0.0192**	**$0.0076**	**$0.0216**	**$0.0083**	**$0.0107**	**$0.1521**

H. Confidential Information. The December 30, 2002 Docket Entry issued in this Cause made a preliminary determination that security-related evidence received during the *in camera* portion of the Evidentiary Hearing would be handled and maintained as confidential pursuant to Indiana Code 5-14-3. This preliminary determination was based on the trade secret exception to disclosure found in Indiana Code 5-14-3-4, as well as the need to protect security-related information that, if disclosed to the public, would jeopardize a security system that is within the state's and national interest to protect. The Commission hereby makes a permanent determination that the record of the *in camera* portion of the Evidentiary Hearing conducted in this Cause on January 29, 2003, shall be handled and maintained as confidential in accordance with Indiana Code 5-14-3.

I. *Settlement Agreement.* The parties' *Stipulation and Settlement Agreement* filed in this proceeding proposes several significant findings that differ from the findings we have made herein. First, the *Stipulation and Settlement Agreement* proposes a finding that the Hobart Water Tower is an eligible DSIC project. Second, the Settlement Agreement proposes to include as DSIC eligible a pump station project ("Taft Street Pump Station") that is excluded from eligibility herein because it was not categorized by Petitioner as being within the distribution system, except for an individual pump station project that was categorized on Petitioner's matrix as being a "Main" project within "Transmission and Distribution." The remainder of the Taft Street Pump

Station projects were categorized as being within "Source of Supply/Pumping," and, therefore, excluded. Mr. DeBoy testified that the Taft Street Pump Station improves service to the distribution system. The Public, in its testimonial Proposed Order, states that the Taft Street Pump Station should be considered as being within the distribution system, though still DSIC ineligible because of testimony that it would increase the ability to connect to new customers. We are not convinced, however, that the best evidence shows anything other than a majority of the Taft Street Pump Station projects were correctly categorized as being outside of the distribution system. The third difference between the *Stipulation and Settlement Agreement* and our findings herein is the proposal that all security improvements, including tank security improvements, be excluded from DSIC recovery, but that the portion attributable to "tank security improvements" ($1,977,417) be allowed to accrue "post-in-service" allowance for funds used during construction ("AFUDC") and deferred depreciation.

AFUDC is a recognized accounting mechanism that allows a utility to accrue the cost of debt related to major construction projects during the construction period. Once an in-service project is approved in a general rate proceeding for inclusion in rate base, the utility can begin earning a return on the value of the project. However, economic erosion to the utility can occur if there is a significant lag between the time the project is placed in service and the time of the utility's next general rate proceeding. This is because once the project is placed in service, but before it is approved for inclusion in rate base as an asset of the utility, not only does AFUDC cease as an available accounting tool, but also depreciation commences which is ultimately subtracted from the net original cost of the project to determine its value in rate base. In order to avoid the economic erosion that would otherwise result to the utility, the Commission can authorize, during this lag period, the continued, or "post in-service," accrual of AFUDC as well as deferring depreciation.

Most cases brought before this Commission seeking post in-service AFUDC and deferred depreciation ("AFUDC Remedy") contemplate that remedy from the outset. The AFUDC Remedy in this proceeding, however, was apparently not contemplated, and obviously not sought, until the submission of the late-filed settlement agreement. In determining the appropriateness of the AFUDC Remedy, we have previously said: "The precedents are clear that the requested treatment (the AFUDC Remedy) is appropriate in the case of major projects being placed in service and when the denial of the requested relief would have severe financial ramifications." Cause No. 39150, June 19, 1991. Evidence of these criteria was not produced in this proceeding. While evidence of the value of the security improvements was produced, we do not have evidence to support whether or not these security improvements are "major" in the context of the AFUDC Remedy, or whether our denial of the AFUDC Remedy would have severe financial ramifications on Petitioner. The AFUDC Remedy is a different form of relief from the DSIC remedy sought in this proceeding.

The Parties' joint settlement agreement asserts that Petitioner's recovery under the settlement agreement will be less than what it sought under the DSIC remedy and, therefore, falls within Petitioner's original request as lesser included relief. As stated

above, and regardless of the amount to be recovered by Petitioner under either remedy, we consider the AFUDC Remedy to be distinct from the DSIC remedy, each requiring proof of different elements. Therefore, given our finding that the evidence does not support approval of either a DSIC or AFUDC for security improvements, we conclude that neither remedy is appropriate in this proceeding.

We do not find it in the public interest that an automatic rate increase be imposed on ratepayers for improvements that we do not find, based on the evidence, to be within the utility's distribution system, or that Petitioner be allowed to continue to accrue AFUDC and defer depreciation when eligibility for those remedies has been neither sought nor proven. Accordingly, we reject the *Stipulation and Settlement Agreement.*

IT IS THEREFORE ORDERED BY THE INDIANA UTILITY REGULATORY COMMISSION, that:

1. Indiana-American Water Company, Inc. is approved a Distribution System Improvement Charge that generates $797,291 in additional annual revenue.

2. We find that for purposes of determining the DSIC revenue, a before tax return of 10.81% should be applied to the net investor supplied DSIC eligible assets of $5,859,778. Such a figure includes distribution assets added since Petitioner's last rate case less reimbursements by Indiana Department of Transportation for line relocations, less the distribution assets retired and replaced since the last rate case.

3. Recovery of DSIC revenues through an adjustment of rates shall be in accordance with the DSIC Calculation and Rate Schedule found herein in Finding Paragraph No. 8G. Petitioner shall file with the Gas/Water/Sewer Division of the Commission, prior to placing into effect the DSIC rates herein approved, separate amendments to its rate schedule with reasonable reference therein reflecting that such charges are applicable to the rate schedules reflected on the amendment.

4. In accordance with Indiana Code 8-1-31-15, Petitioner shall file a revised rate schedule resetting the DSIC when the Commission issues an Order authorizing a general increase in rates and charges that includes the eligible distribution system in the utility's rate base.

5. In its next DSIC case, Indiana-American should file a five-year forecast of its distribution system replacement program.

6. This Order shall become effective upon and after the date of its approval.

MCCARTY, LANDIS, RIPLEY AND ZIEGNER CONCUR; HADLEY ABSENT:
APPROVED:

FEB 2 7 2003

I hereby certify that the above is a true
and correct copy of the Order as approved.

Nancy E. Manley
Secretary to the Commission

CAPD EXHIBIT
Schedules 1-8

Tennessee-American Water
Index to Schedules
For the 12 Months Ending March 31, 2004

Tennessee-American Water
Results of Operations
For the 12 Months Ending March 31, 2004

Line No.		CAPD		Company	F/	Difference
1	Rate Base	87,062,756	A/	87,270,579		(207,823)
2	Operating Income at Present Rates	5,098,465	B/	5,193,431		(94,966)
3	Earned Rate of Return (Line 2/Line 1)	5.86%		5.95%		-0.09%
4	Cost of Capital	7.46%	C/	8.559%		-1.10%
5	Required Operating Income (Line 1*Line 4)	6,494,882		7,469,489		(974,607)
6	Operating Income Deficiency (Line 5-Line 2)	1,396,417		2,276,058		(879,641)
7	Gross Revenue Conversion Factor	1.682767	D/	1.698908		(0.016141)
8	Normal Revenue Deficiency (Line 6*Line 7)	2,349,844		3,866,812		(1,516,968)
9	Fire Protection Rate Discount	(1,127,964)	E/	-		(1,127,964)
10	Rate Increase Needed (Line 8-Line 9)	1,221,880		3,866,812		(2,644,932)

A/ Schedule 2
B/ Schedule 3
C/ Exhibit SB__, Schedule 16
D/ Schedule 8
E/ TRA Order on 9/26/00 in Docket 99 - 00891
F/ Company SAV Exhibit 1, Schedule 1

Tennessee-American Water
Comparative Rate Base
For the 12 Months Ending March 31, 2004

Line No.		CAPD	A/	Company	B/	Difference
1	Utility Plant in Service	146,234,775		146,234,775		-
2	Construction Work in Progress	801,659		801,659		-
3	Utility Plant Capital Lease	1,590,500		1,590,500		-
4	Limited-Term Utility Plant - Net	(20,953)		(20,953)		-
5	Working Capital	1,403,079		1,567,918		(164,839)
6	RWIP / Def. Maint.	34,191		77,175		(42,984)
7	Total Additions	150,043,251		150,251,074		(207,823)
8	Accumulated Depreciation	44,221,915		44,221,915		-
9	Accumulated Amort. of Utility Capital Lease	565,511		565,511		-
10	Accumulated Deferred Income Taxes	11,070,493		11,070,493		-
11	Customer Advances for Construction	2,007,438		2,007,438		-
12	Contributions In Aid of Construction	5,064,245		5,064,245		-
13	Unamortized Investment Tax Credit	50,893		50,893		-
14	Plant Acquisition Adjustment	-		-		-
15	Total Deductions	62,980,495		62,980,495		-
16	Rate Base	87,062,756		87,270,579		(207,823)

A/ Modified From: Company SAV Exhibit 1, Sch. 2 (Chrysler Testimony)
B/ Company SAV Exhibit 1, Sch. 2

Tennessee-American Water
Income Statement at Current Rates
For the 12 Months Ending March 31, 2004

Line No.		CAPD		Company		Difference
1	Operating Revenues	30,040,618	A/	30,409,356	E/	(368,738)
2	Operations and Maintenance Expense	16,145,398	B/	16,164,046	B/	(18,648)
3	Depreciation and Amortization Expense	4,121,753	F/	4,121,753	F/	-
4	Taxes Other Than Income	3,430,304	C/	3,657,636	C/	(227,332)
5	State Excise Tax	126,131	D/	125,650	G/	481
6	Federal Income Tax	1,170,306	D/	1,198,579	G/	(28,273)
7	Total Operating Expense	24,993,892		25,267,664		(273,772)
8	AFUDC	51,739	H/	51,739	H/	-
9	Net Operating Income for Return	5,098,465		5,193,431		(94,966)

A/ $30,409,356 per Co. less $368,738 - eliminate bankrupt industrial customers from forecast.
B/ Schedule 5
C/ Schedule 6
D/ Schedule 7
E/ Company SAV Exhibit 2, Sch. 2
F/ Company SAV Exhibit 2, Sch. 1
G/ Company SAV Exhibit 2, Sch. 6
H/ Company SAV Exhibit 2, Sch. 3

Tennessee-American Water
Income Statement at Proposed Rates
For the 12 Months Ending March 31, 2004

Line No.		Current Rates		Adjustments		Proposed Rates
1	Operating Revenues	29,758,457	A/ B/	2,349,844	C/	32,108,301
2	Forfeited Discount Revenues	282,161	B/	22,559		304,720
3	Total Revenues	30,040,618		2,372,402		32,413,020
4	Operations and Maintenance Expense	16,145,398		21,589		16,166,987
5	Depreciation and Amortization Expense	4,121,753				4,121,753
6	Taxes Other Than Income	3,430,304		65,353		3,495,657
7	State Excise Tax	126,131		137,128		263,259
8	Federal Income Tax	1,170,306		751,917		1,922,222
9	Total Operating Expense	24,993,892				25,969,878
10	AFUDC	51,739				51,739
11	Net Operating Income for Return	5,098,465				6,494,882

A/ Schedule 3
B/ Company SAV Exhibit 2, Sch. 2 (less $368,738 industrial operating revenues)
C/ Schedule 1, Line 8 x appropriate factor from Schedule 8

Tennessee-American Water
Operation and Maintenance Expenses
For the 12 Months Ending March 31, 2004

Line No.		CAPD		Company	A/	Difference
1	Salaries and Wages	5,066,666		5,066,666		-
2	Purchased Water	17,561		17,561		-
3	Fuel and Power	1,551,622		1,551,622		-
4	Chemicals	740,531		740,531		-
5	Waste Disposal	130,151		130,151		-
6	Service Company Charges	2,507,276		2,507,276		-
7	Group Insurance	1,463,924		1,463,924		-
8	Pensions	387,895		387,895		-
9	Regulatory Expense	83,000		83,000		-
10	Insurance Other Than Group	709,686		709,686		-
11	Customer Accounting	435,427		435,427		-
12	Uncollectible Expense	245,456		245,456		-
13	Rents	42,729		42,729		-
14	General Office Expense	260,878		260,878		-
15	Miscellaneous Expense	1,802,276	B/	1,820,924		(18,648)
16	Other Maintenance Expense	700,320		700,320		-
17	Total O&M Expense	16,145,398		16,164,046		(18,648)

A/ Company SAV Exhibit 2, Sch. 3
B/ Inflation factor adjusted from 3.275% to 2.5% reduces miscellaneous expenses by $18,648

Tennessee-American Water
Taxes Other Than Income Taxes
For the 12 Months Ending March 31, 2004

Line No.		CAPD 150		Company 150	B/	Difference
1	Other General Taxes					-
2	Gross Receipts Tax	297,288		307,539		(10,251) C/
3	TRA Inspection Fee	56,538		56,538		-
4	Property Taxes	2,443,576	A/	2,660,657		(217,081)
5	Franchise Tax	251,317		251,317		-
6	FICA Taxes	375,600		375,600		-
7	Unemployment Taxes	5,835		5,835		-
8	Total Taxes Other Than Income Taxes	3,430,304		3,657,636		(227,332)

A/ Test year normalized expense $2,462,565 / Test year normalized rate base $88,207,027= 2.8%.
Property tax ratio was 2.6% in 1996. TAWC calculated 3.0% effective rate.
B/ Company SAV Exhibit 2, Sch. 5 and Working Papers Book 2, General Taxes
C/ Revenue adjustment ($368,738 Schedule 3) times gross receipts tax rate (2.78% Schedule 8).

Tennessee-American Water
Excise and Income Taxes
For the 12 Months Ending March 31, 2004

Line No.		Attrition Amount A/	
1	Operating Revenues	30,040,618	B/
2	Salaries and Wages	5,066,666	
3	Purchased Water	17,561	
4	Fuel and Power	1,551,622	
5	Chemicals	740,531	
6	Waste Disposal	130,151	
7	Service Company Charges	2,507,276	
8	Group Insurance	1,463,924	
9	Pensions	387,895	
10	Regulatory Expense	83,000	
11	Insurance Other Than Group	709,686	
12	Customer Accounting	435,427	
13	Uncollectible Expense	245,456	
14	Rents	42,729	
15	General Office Expense	260,878	
16	Miscellaneous Expense	1,802,276	
17	Other Maintenance Expense	700,320	
18	Depreciation and Amortization Expense	4,121,753	
19	Taxes Other Than Income	3,430,304	
20	NOI Before Excise and Income Taxes	6,343,163	
21	AFUDC	51,739	
22	Interest Expense	(3,216,934)	C/
23	Pre-tax Book Income	3,177,968	
24	Schedule M Adjustments	(2,547,602)	D/
25	Excise Taxable Income	630,366	
26	Excise Tax Rate	6.00%	
27	Excise Tax Payable	37,822	
28	Excise Tax Deferred	88,309	
29	Excise Tax Expense	126,131	
30	Pre-tax Book Income	3,177,968	
31	Preferred Dividend Credit	(28,824)	
32	Excise Tax	(126,131)	
33	Schedule M Adjustments	(2,547,602)	D/
34	FIT Taxable Income	475,411	
35	FIT Rate	35.00%	
36	Federal Income Tax Payable	166,394	
37	ITC Amortization	(79,314)	
38	Federal Income Tax Deferred	1,083,226	
39	Federal Income Tax Expense	1,170,306	

A/ Schedule 5.
B/ Schedule 4
C/ Schedule 1, line 1 * Weighted Cost of Debt per Exhibit SB__, Schedule 16
D/ This is the net difference of the Permanent Differences of $14,123 and the Temporary Differences of $2,561,725 shown on Ms. Valentine's Exhibit No. 2, Schedule 6, Page 2 of 2.

Tennessee-American Water
Revenue Conversion Factor
For the 12 Months Ending March 31, 2004

Line No.		Amount		Balance
1	Operating Revenues			1.000000
2	Add: Forfeited Discounts	0.0096	A/	0.009600
3	Balance			1.009600
4	Uncollectible Ratio	0.0091	B/	0.009187
5	Balance			1.000413
6	Gross Receipts Taxes	0.0278	C/	0.027811
7	Balance			0.972601
8	State Excise Tax	0.0600	D/	0.058356
9	Balance			0.914245
10	Federal Income Tax	0.3500	D/	0.319986
11	Balance			0.594259
12	Revenue Conversion Factor (Line 1 / Line 11)			1.682767

A/ Company SAV Exhibit 2, Sch. 2
B/ Company Working Papers, Book 2, Uncollectible tab, P. 1
C/ Company Working Papers, Book 2, General Taxes tab, P. 6
D/ Statutory Rate

Tennessee-American Water
Cost of Capital
For the 12 Months Ending March 31, 2004

Line No.	Parent:	Ratio	Cost	Weighted Cost
1	Common Equity	56.00%	9.21%	5.16%
2	Debt	44.00%	6.00%	2.64%
3	Total	100.00%		7.80%

	Tennessee American:	Ratio	Cost	Weighted Cost
4	Short Term Debt	6.2%	3.50%	0.22%
5	Long Term Debt	20.8%	7.62%	1.59%
6	Preferred Equity	1.6%	5.01%	0.08%
7	Common Equity	71.4%	7.80%	5.57%
8	Total	100.00%		7.46%