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July 11, 2003

VIA HAND DELIVERY

Ms. Deborah Taylor Tate, Chairman
TENNESSEE REGULATORY AUTHORITY
460 James Robertson Parkway
Nashville, Tennessee 37243

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 Tate:

Enclosed for filing in the above-styled matter are the original and thirteen copies of Petitioner Tennessee American Water Company's Post-Hearing Brief. Should you have any questions with respect to this filing, please do not hesitate to contact me at the number shown above.

Thanking you in advance for your assistance with this matter, I am

Very truly yours,

R. Dale Grimes

RDG/sdt
Enclosures

BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

IN RE:)	
)	
PETITION OF TENNESSEE AMERICAN)	**Docket No. 03-00118**
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)	

PETITIONER TENNESSEE AMERICAN WATER COMPANY'S POST-HEARING BRIEF

Petitioner Tennessee American Water Company ("TAWC") respectfully submits this Post-Hearing Brief pursuant to the schedule established by Director Ron Jones at the Hearing on July 1, 2003, before the Tennessee Regulatory Authority ("TRA").

BACKGROUND

This case was filed by TAWC on February 7, 2003, pursuant to T.C.A. § 65-5-201, in which TAWC sought to put into effect tariffs that would produce additional annual revenues of $3,866,813, at a proposed rate of return of 8.559%. TAWC filed tariffs that would produce annual revenues in that amount by increasing charges to all classes of customers. Accompanying its Petition, TAWC pre-filed the testimony of numerous witnesses supporting its position in this case.

Three parties were permitted to intervene in the case: the Consumer Advocate and Protection Division of the Office of the Attorney General (the "AG"); the Chattanooga

Manufacturers Association (the "CMA"); and the City of Chattanooga (the "City"). Pursuant to the schedule established by Director Jones as Pre-Hearing Officer, these parties pre-filed testimony in support of their positions, and all parties had the opportunity to pre-file rebuttal testimony.

Pursuant to notice, the TRA heard the merits of this case on June 30 and July 1, 2003. Upon motion made by Director Pat Miller and unanimously adopted by the panel, all pre-filed direct and rebuttal testimony was made part of the evidentiary record. Transcript of Proceedings ("TR"), Vol. I, at 56 –57.[1]

The rate base for the projected period for which the rates were to be made include all of TAWC's depreciated investment on all of its properties used in providing services to its customers. In a rate case filed pursuant to T.C.A. § 65-5-203, the TRA considers the following:

(a) The investment or rate base upon which the utility should be permitted a fair rate of return;

(b) The proper level of revenues for the utility;

(c) The proper level of expenses for the utility; and

(d) The rate of return the utility should earn.

Prior to the hearing, TAWC and the AG reached a settlement of most issues in the case, which was filed with the TRA on June 27, 2003, and made part of the evidentiary record at the Hearing. TR, Vol. I, Exhibit 2. Pursuant to the Settlement Agreement and the attached "Settlement Schedules" 1 and 2, TAWC and the AG agreed, among other things, on the capital structure of TAWC, a 7.73% return on investment with a 9.9% return on equity, the rate base of $87,062,756, and a revenue deficiency of $2,745,411. TAWC and the AG also agreed that "in

[1] Pursuant to the Pre-Hearing Officer's Order of June 27, 2003, the testimony of Dr. Christopher Klein was excluded.

the event the Tennessee Regulatory Authority continues to impute the reduction of the fire hydrant annual charges as ordered by the TRA in its response to the Company's petition to voluntarily reduce its annual price for public fire service from $301.20 to $50.00 per public fire hydrant, in TRA Docket No. 99-00891," the revenue deficiency would be $1,617,447. At the Hearing, both the City and the CMA supported the Settlement Agreement. TR, Vol. I, at 11.

Accordingly, Director Jones moved to accept the proposed Settlement Agreement, TR, Vol. I, at 31-32, which was unanimously adopted by the TRA, TR, Vol. I, at 44. In his Motion, Director Jones stated that approval of the Settlement Agreement would "remove from the table for the purposes of further litigation the rate base, cost of capital, overall return on investment, return on equity, the revenues, and expenses." TR, Vol. I, at 31-32. In addition to approval of the Motion by the other Directors, all parties agreed with Director Jones' analysis of the effect of the TRA's approval of the Settlement Agreement. TR, Vol. I, at 37-38. Director Jones then announced that "all issues have been resolved in this matter other than the fire hydrant issue and rate design." TR, Vol. I, at 44.

At the request of the Directors, the parties negotiated and presented rate design proposals, one applicable to a rate increase of $1,617,447 (TR, Vol. I, Exhibit 3), and the other applicable to a rate increase in the full amount of the revenue deficiency of $2,745,411 (TR, Vol. I, Exhibit 4). All parties agreed to the rate design applicable to the $1.6 million scenario; all parties except the AG agreed to the rate design for the $2.7 million scenario. TR, Vol. I, at 20-21. The AG expressed the view that the bulk of the rate increase necessary to make up the difference between $1.6 million and $2.7 million should be allocated to the City under the $2.7 million rate increase scenario. TR, Vol. I, at 43. The other parties agreed that the rate increase should be spread in a

manner that moves towards cost base rates as proposed by the Company in its cost of service study.

The hearing proceeded with the presentation of live testimony from witnesses relevant to the fire hydrant issue and rate design. The TRA having already decided most of the issues in this case by approving the Settlement Agreement, the case is now ripe for decision by the TRA on the remaining fire hydrant and rate design issues.

ISSUES TO BE DECIDED

1. With respect to the fire hydrant issue, TAWC respectfully submits that the issue is whether or not TAWC should be permitted to earn a fair rate of return on all of its investment used and useful in providing service to the customers it serves. The Company's position is that it is entitled to recover on all of its investment used and useful in furnishing water service to its customers in the Chattanooga area. The TRA would violate well-established constitutional principles by awarding TAWC a rate increase that is $1.1 million below the agreed upon and approved revenue deficiency of $2,745,411.

2. With respect to rate design, the Company has agreed to the proposed rate designs submitted by the parties at the hearing set forth in Exhibits 3 and 4. The Company originally proposed a rate design that moves all classes of customers closer to the cost of serving those customers. In addition, it proposed a treatment of the fire protection service that would allocate 25% of the cost to the municipality, with 75% of the cost being shared by the ratepayers who actually receive the benefits of fire protection service. This is modeled after a methodology used in other states. However, TAWC is willing to accept any reasonable rate design.

THE FIRE PROTECTION SERVICE ISSUE

TAWC submits that it should be able to recover the full cost of providing fire protection service to its customers in its Chattanooga service area. These costs are part of its revenue requirement, and parts of its assets are used and useful in providing this service. The Company is entitled to recover these costs. How the costs are allocated among its customer classes is a separate issue of rate design.

The TRA has already determined in this case the rate base, return on investments, expenses, and revenue requirement. To reduce TAWC's established revenue requirement by $1.1 million would be improper, unconstitutional, and bad policy. In spite of these flaws in their argument, the City and the CMA insist that the TRA's prior order in Docket No. 99-00891 requires such a result. Yet there is nothing pertinent to that docket - - not the Order of September 26, 2000; the transcript of the parties' representations to the TRA at the hearing on January 11, 2000; the settlement agreement of October 25, 1999, between the City and TAWC; nor the Public Fire Service tariff effective January 11, 2000 - - that can serve to justify that conclusion.

For the reasons more fully discussed herein, the TRA should reject what appears to be an opportunistic exploitation of the previous settlement of litigation to extract a windfall to the detriment of the Company and ultimately of the customers it serves.

A. Disallowance of $1.1 million of the established $2.7 million revenue requirement would unconstitutionally prevent TAWC from earning its approved rate of return on its approved reasonable rate base.

Pursuant to the TRA's approval of the Settlement Agreement in this case, it is established for purposes of this case that TAWC's rate base is $87,062,756, which is the value of the property used and useful for providing water service to its customers. Likewise, it is established that "Tennessee-American is entitled to earn a 7.73% return on investments with a 9.9% return

on equity." TR, Vol. I, Exhibit 2 ("Proposed Settlement Agreement" at ¶ 1). Finally, it is established that based on the agreed upon revenues of the Company, this rate of return on its investment produces a revenue deficiency of $2,745,411. TAWC respectfully submits that this is the revenue requirement that the TRA should award in this case.

The other parties have raised the issue of a prior order of the TRA in Docket No. 99-00891, in which the TRA approved a tariff reducing the Company's fire hydrant rate to the City. The AG takes no position on the effect of this prior order, but states that it is up to the Directors to decide. The City and CMA, however, take the position that the prior order requires the TRA to reduce the established revenue requirement by $1.1 million.

To accept the position of the City and the CMA would result in an unconstitutional taking of TAWC's property in violation of established United States Supreme Court decisions, which have been previously followed by this Authority, the Tennessee Public Service Commission, and have been supported by the Courts and decisions rendered in the State of Tennessee. These United States Supreme Court decisions, Bluefield Water Works & Improvement Co. v. Public Service Commission, 262 U.S. 679, 43 S. Ct. 675, 67 L. Ed. 1176 (1923), and Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 64 S. Ct. 281, 88 L. Ed. 333 (1944), stand for the following:

> Rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the service are unjust, unreasonable and confiscatory and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment. This is so well settled by numerous decisions of this Court that citation of the cases is scarcely necessary.

Bluefield, 262 U.S. at 690.

When the rate base and reasonable rate of return are established, as in this case, the TRA

must allow recovery of the resulting revenue requirement in order for the rates charged to yield a reasonable return on the value of the property used. The arguments of two of the Intervenors that the established revenue requirement should be reduced by $1.1 million ignores these principles. Following the Intervenors' position will lead this Authority into constitutional error.[2]

B. The prior Order in Docket No. 99-00891 does not require a $1.1 million reduction of TAWC's approved revenue requirement.

The proceeding in Docket No. 99-00891 was not a rate case. It was not filed as such; it was not conducted as such; and it was not pursued according to T.C.A. § 65-5-201. The parties to that proceeding were the City and the TAWC. They were joint Petitioners seeking the approval of a tariff by the TRA in which the Company proposed a gradual reduction of its rates to the City for fire protection service pursuant to a formal written settlement agreement resolving litigation between those parties. At the TRA, there were no Intervenors. There was no proof by the parties nor any determination by the TRA of the proper rate base of the Company, the proper rate of return on investments, revenue deficiencies or requirements, or any other matter necessary for a rate case. It was merely a proceeding in which the Company was attempting to carry out its part of a settlement agreement with the City.

The City had previously filed a condemnation proceeding against TAWC, apparently because the City's mayor noticed "that we were paying well in excess of a million dollars a year on fire hydrant fees." TR, Vol. II, at 209. The litigation became protracted and expensive to both sides. One of the City's witnesses, former Mayor Jon Kinsey, described his view after nearly a year of litigating the condemnation case: "[I]t became evident to me that it was going to

[2] The proposal of CMA witness Michael Gorman that TAWC write down the value of its plant that is used to provide fire protection service as an impaired asset, which Mr. Gorman himself warns is "not common," appears at best to be an accounting gimmick that would be harmful to the Company and its customers. More importantly, Mr. Gorman's theory requires the Company to write down the value of its rate base to a level below the agreed upon and approved amount in this case of $87,062,756. Accordingly, the TRA must reject as irrelevant Mr. Gorman's proposed scheme for getting around the clear and serious constitutional problem of reducing the Company's established revenue requirement by $1.1 million.

be a very long effort [for the City] to gain control of the system for our community." TR, Vol. II, at 210. Accordingly, the parties entered into a settlement agreement with respect to that litigation on October 25, 1999. The agreement contained a number of provisions setting forth the consideration passing between the parties and specifying that a condition of the agreement was for the City to dismiss the lawsuit with prejudice on or before Friday, October 29, 1999. Jon Kinsey Direct Testimony, Appendix 2 (pre-filed) (Settlement Agreement Between City of Chattanooga and Tennessee American Water Company) at ¶ 1(A)). That settlement agreement further provided as follows:

> TAWC and the City will file a joint petition with the Tennessee Regulatory Authority ("TRA") seeking permission to reduce over a two-year period the current charge of $301.00 a year per fire hydrant to $50 a year per fire hydrant at the end of that period. If the TRA does not approve this provision, then this section is null and void.

Id. at ¶ 2(B) (emphasis added). The settlement agreement concluded with the following:

> If any provision or term of this agreement is found to be invalid by a court of law and/or is not approved by the TRA, the remainder of the agreement shall remain in full force and effect.

Id. at ¶ 3 (emphasis added). Thus while dismissal of the lawsuit with prejudice was a condition of the settlement, approval of the proposed reduction of the fire hydrant rate was not a condition. If the TRA had refused to approve that reduction, the settlement nevertheless would have remained in full force and effect.

Consistent with that settlement agreement, TAWC filed a tariff with the TRA to make quarterly incremental reductions in the fire hydrant tariff to phase in the total rate reduction of approximately $1 million in each year it was in effect. The tariff does not require the final rate reduction to remain in effect for any specific period of time. TR, Vol. II, Exhibit 6. Then-

Mayor Kinsey sent a letter to the President of TAWC stating that he had received a copy of the proposed tariff "which I have reviewed and find satisfactory. We agree that the tariff will comply with Item 2B of our settlement agreement dated October 25, 1999, if approved by the TRA." TR, Vol. II, Exhibit 7. Former Mayor Kinsey testified in this case that he understood that tariffs "remain in effect until they're replaced by subsequent tariffs." TR, Vol. II, at 219. He also testified that the settlement agreement does not say that it requires TAWC to absorb $1.1 million in losses indefinitely. TR, Vol. II, at 217. Regardless, while the tariff remained in effect, it reduced the city's obligation for fire hydrant fees by more than $1 million per year, almost the entire amount the City previously had paid for the service.

On behalf of TAWC, Michael A. Miller, the Company's Vice President and Treasurer, Chief Financial Officer, and a CPA, testified that TAWC never believed it would be required to forego this revenue beyond its next rate case, which was not expected for several years after the January 2000 hearing on the fire hydrant tariffs. Moreover TAWC believed it would, and in fact it did, match the reduction in revenues from the fire hydrant rate with increased revenues from sales growth and reduction in costs. TR, Vol. I, at 62-64, 67-68. Accordingly, at the hearing before the TRA, the Company represented that it would not seek to make up the fire hydrant rate reduction to the City by seeking rate increases as to other customers until other factors caused the Company to commence a rate case. Id.

In contending that the previous Order of the TRA precludes TAWC from recovering its full revenue requirement in this case and requires a reduction of $1.1 million in that revenue requirement in perpetuity, the City and CMA have misconstrued the Order. It contains no such requirement. Instead, it says that "in order to afford the Company the opportunity to achieve its presently authorized return that either revenue streams from other sources must be increased or

the Company and its stockholders must agree to absorb the shortfall." Docket No. 99-00891, Order at 2-3 (dated September 26, 2000). It further states that "consistent with the Company's representations, . . . the loss of revenue resulting from rate reduction to the City of Chattanooga [will] be borne by the Company's shareholders and not by the Company's ratepayers, either now or at any time in the future." Docket No. 99-00891, Order at 4. Thus, the Order only prohibits the Company from recovering from "rate payers" the actual revenues lost by the reduction in the fire hydrant rate to the City. This does not support the position of the City and the CMA in this case.

First, TAWC is not attempting to recover the loss of revenue resulting from the rate reduction to the City. That revenue loss was incurred in what the Company's witnesses referred to as the "stub period." The stub period was the period between the effective date of the tariff reducing the fire hydrant rate over a two-year period and the time this Authority approves new rates in the Company's subsequent rate case. TAWC is clearly not attempting to recover those lost revenues from the stub period in this rate case. They were like a one-time non-recurring item such as a storm or other catastrophic event. Moreover, during the stub period, TAWC produced sales growth and cost savings that exceeded the amount of the revenue lost due to the reduction of the fire hydrant rate. In this rate case, the ratepayers are receiving the full benefit of those increased sales revenues and cost savings.

Second, under even the most restrictive reading of the language of the Order, TAWC would not be prohibited from recovering the cost of fire protection service from the City itself by assigning the full cost of such service to public fire protection. In fact, that is the position taken by the AG on rate design under the $2.7 million revenue requirement scenario. Consistent with the previous Order in Docket No. 99-00891, the Company could have taken the same position

and sought to increase fire hydrant rates in this case back to the same level that existed prior to the reduction approved in 2000 in Docket No. 99-00891. Instead, however, TAWC has offered a different rate design, modeled after that used in other states, that recovers the full cost of fire protection but spreads the allocation of that cost between the City and ratepayers who actually benefit from fire protection service. Again, that is a separate rate design issue unrelated to the revenue requirement issue.

In addition, the Order from the previous case states that it is "consistent with representations" made by the Company before the TRA when the fire hydrant tariff was considered. As testified by Mr. Miller:

> The Company represented at the Hearing that it did not anticipate a rate increase for three or four years, that it would generate growth savings to offset the lower revenue requirement – or lower revenue from fire protection during the stub period and that factors other than the reduced fire protection would drive the need to increase rates. The growth savings are imbedded in the current filing and flow to the ratepayers in the current case, thus lowering the overall revenue requirement that we're seeking.
>
> I believe that the Company was only referring to the stub period between the tariff date and the rate hearing sometime in the future and was not agreeing to any permanent reduction in its otherwise approved revenue requirement. The Company is not seeking to recover any of the over $3 million of revenue that it has foregone in this stub period up and through the effective date of this Order.

TR, Vol. I, at 63-64.

Moreover, the statements made by representatives of the City at that previous hearing are consistent both with the representations made by the Company then and with the Company's position in the current rate case. First, at the previous hearing former Mayor Kinsey supported the Company's representations that it intended to make up the loss of revenue caused by the reduction in fire hydrant rates by growth of sales to new and existing customers. Former Mayor

Kinsey stated:

> I believe that we have seen growth in our community and will continue to see it to cover the shortfall that has been there. The Company's largest customer, for example, is in the middle of $60 million expansion. We have made great efforts to revitalize our ground field [sic] area to bring in new industry into our City, and we've been very successful in that. In 1998, for example, we led the state in new manufacturing jobs, and, of course, much of that is water customers.

TR, Vol. II, Exhibit 8 (Transcript of Excerpt of Directors' Conference, January 11, 2000 ("Transcript") at 17). In addition, then Mayor Kinsey also recognized TAWC would seek a rate change in the future and at that point "everyone would look at the cost of services of a lot of different things." TR, Vol. II, Exhibit 8 (Transcript at 18). Finally, he stated that the fire hydrant reduction was good for ratepayers at that time because "there is no increase in cost to any rate payer at this point at all." TR, Vol. II, Exhibit 8 (Transcript at 18) (emphasis added). Former Mayor Kinsey reaffirmed these points at the hearing of this rate case in response to questions from Director Sara Kyle, agreeing that in January 2000 he knew and anticipated that a "rate case would develop down the road concerning the revenues of fire hydrants," but that he simply did not expect it would occur as soon as it had. TR, Vol. II, at 213. That this was the understanding and expectation of the City at the hearing on January 11, 2000, was even more clearly articulated by the City's counsel at that time, Mr. Henry Walker, who now represents the CMA in the present rate case. According to Mr. Walker back then:

> Now, the question is when they come back for a rate case whether it's two or three or four years from now, if they feel it is appropriate to raise hydrant rates, they can present a cost study, and they can show you at that time that its not covering their cost and then you can decide what to do about it.

TR, Vol. II, Exhibit 8 (Transcript at 19-20) (emphasis added). At that time, Mr. Walker also went on to say:

> And one of the last things I want to comment is I recognize that, you know, you're saying what does this do for the rate payers? Well, what it does is it gives immediate reduction in City expenses for the next two years with no rate increase to the ratepayers. If it later is imposed on the ratepayers, that's up to you.

TR, Vol. II, Exhibit 8 (Transcript at 20) (emphasis added).

In consideration of all the foregoing evidence it is clear that the TRA and the parties fully intended that TAWC would never recover from the ratepayers the revenues lost from the fire hydrant rate reduction during the period of time until a rate case was necessitated by other factors - - the stub period. In full compliance with this intent, TAWC does not seek to recover those lost revenues in this rate case.

On the other hand, nothing in the evidence or in the language of the TRA's Order in Docket No. 99-00891 requires a permanent revenue reduction in the annual amount of over $1 million, year after year after year, as long as TAWC provides water service to Chattanooga. Given all the circumstances, it is inconceivable that the Company would make that kind of deal to settle the condemnation suit. In such a nonsensical deal, TAWC would have agreed to give the City, in perpetuity, almost everything it had been paying for fire protection service - - in essence, a total collapse in the lawsuit by TAWC, when in fact TAWC was vigorously litigating the case while the City, per then Mayor Kinsey, faced the realization that "it was going to be a very long effort" to try to prevail in its condemnation suit. TR, Vol. II, at 210. No reasonable person could expect TAWC to succumb to such a deal. Even more telling, in light of the fact that the rate reduction was not even a prerequisite for the settlement between the City and TAWC to remain in full force in effect or for the City to dismiss its condemnation suit with prejudice, it is inconceivable that the City expected to receive such a multi-million dollar windfall ad infinitum. Further, it is inconceivable that the Company would have ever agreed to

an arrangement that required it to start off with a $1.1 million deficit after every rate case. Certainly, it is inconceivable that the TRA would have deliberately entered an Order that would prevent the Company from ever attaining its reasonable return on investment in any future rate case.

This rate case was filed 37 months after that hearing on January 11, 2000, the effective date of the tariff reducing the rates on the fire hydrant service. The Company has lost revenues from those tariff reductions in excess of $3 million. At the hearing in this docket, questions were asked regarding why the Company did not appeal or ask for a reconsideration of the order in the fire hydrant case. It should be noted that the Company was ordered to place the tariffs in effect January 11, 2000. The Order of the TRA was not issued until September 26, 2000, some eight months and 15 days later.

C. CMA witness Gorman's suggestion that the TRA could simply order TAWC to write off a portion of its assets in order to give the appearance that it is achieving its approved rate of return is inappropriate and inapplicable.

Mr. Gorman provided testimony to suggest there is a magical accounting solution to the Company's assertion that failure to recover its cost-based revenue requirement of $2.745 million would preclude the Company from obtaining a fair and reasonable return on its investment. As previously demonstrated, if TAWC is not permitted to recover its cost-based revenue requirement, it would amount to confiscation of its assets as outlined in the landmark United States Supreme Court cases of Bluefield and Hope. Mr. Gorman's magical accounting cure, as outlined in the rebuttal testimony of TAWC's witness Michael A. Miller at the hearing, is not a cure at all, but would constitute a different method of unconstitutional confiscation. Mr. Gorman's "cure" would require the Company to: (i) forego a cost-based revenue requirement of $1.1 million for as long as it does business in Chattanooga, (ii) write-off $8.0 to $10.0 million of

assets that would still be used and useful in providing service to all classes of customers going forward, and (iii) forego paying any dividends to its stockholders for a period that exceeds three years or ask the stockholders to invest an additional $5.0 to $6.0 million of equity to "cure" the capital structure problem created by Mr. Gorman's proposed cure. The TRA should look through the smoke screen conjured by Mr. Gorman and see his cure for what it is, another form of confiscatory rate making policy that deprives the Company of its right to a fair an reasonable return on its investment.

Mr. Gorman's testimony on this issue had not previously been disclosed in discovery responses or pre-filed testimony and should be stricken. Nonetheless, TAWC attempted to rebut this surprise testimony after an overnight recess, through its witness, Michael A. Miller. Mr. Miller testified that the scenario described by Mr. Gorman was covered in Financial Accounting Standard (FAS) 121. He noted that assets specific to fire protection were not easily identifiable, and an allocated portion of mains, tanks, boosters, and plant capacity are used to provide fire protection, as well as, provide water service to all other customer classifications. Because the specific assets that provide fire protection are not easily identifiable and are used to generate cash flows from other customer classifications, it is unclear under FAS 121 that any asset impairment would be recognized.

Mr. Miller testified that the FAS 121 summary said, "The statement also requires that a rate regulated enterprise recognize an impairment for the amount of costs excluded when a regulator excludes all or part of a cost from the enterprise's rate base." The TRA in its September 26, 2000 Order did not indicate any rate base reduction related to the fire protection tariff, nor does the Company believe that it was the intent of the TRA to impose such a consequence. Moreover, the parties have stipulated and the Directors approved in this case a rate

base of approximately $87,063,000, precluding any further reductions to the Company's rate base, or any finding that its entire rate base was not used and useful in providing service. It would therefore be inconsistent and inappropriate for the TRA to now justify not permitting the Company an opportunity to achieve a fair and reasonable return on its assets by using an accounting adjustment, FAS 121, to eliminate a portion of its rate base investment that will still be used and useful in providing service to all customer classes.

Mr. Gorman and Mr. Miller testified that to their knowledge FAS 121 had only been applied in the electric industry and then only in relation to moving certain generation assets previously recognized as regulated rate base to the non-regulated, competitive environment. The difference in the circumstances of the electric companies and the Company in this case are significant. First, the electric companies were moving from a regulated to an unregulated, competitive market, a situation diametrically opposite to that of the Company. Second, presumably the electric companies were willing to accept such accounting treatment banking on the prospect of recouping losses through rates charged in the unregulated, competitive environment. TAWC will have no such opportunity in this case. Regardless, the hypothetical scenario of Mr. Gorman is inappropriate and would deprive the Company of its constitutionally protected right to a fair and reasonable return on assets that will still be providing service to all classes of customers.

What Mr. Gorman is really asking the TRA to do is ignore the testimony of the Company regarding the settlement agreement with the City, the representations of the City and the Company at the January 11, 2000 hearing, and the Company's position in this case that it should be permitted to recover its demonstrated cost-based revenue requirement. His proposed solution should be rejected out of hand.

D. Even if the TRA in Docket No. 99-00891 ordered TAWC never to recover the cost of its fire protection service in a future rate case, the TRA is entitled to, and should, decline to follow that Order in this case.

The evidentiary record in this case does not support the positions taken by the City and the CMA concerning their interpretation of the TRA Order in Docket No. 99-00891. Even if it did, the TRA in this case should decline to follow such an interpretation that would preclude TAWC from recovering its approved revenue requirement in this or any future rate case. Preventing the Company from recovering the full approved revenue requirement prevents the Company from achieving a reasonable return on its investment in violation of the Fourteenth Amendment of the Constitution of the United States.

In addition, reasoned decision-making in utility rate cases requires the TRA to consider each case seeking rate adjustments on its merits in light of the facts and circumstances proven in that particular case. Moreover, regulatory bodies have the ability to change their approaches to matters of policy. For example, allowing one class of customers to subsidize the rates paid by another class of customers may be deemed appropriate regulatory policy at one time, but not so at a later time.

The courts of Tennessee have recognized that regulatory agencies are not bound by their own prior orders. For example in Alltel Tennessee, Inc. v. Tennessee Public Service Commission, 1990 WL 20132 (Tenn. Ct. App. 1990), the petitioner had been permitted to use one methodology in determining its costs in a prior rate case, but the Public Service Commission refused to allow that methodology to be used in a subsequent case. On appeal, the case was characterized as one in which the Commission engaged in a complete reversal of its position for which the petitioner, Alltel, argued that there was no justification. Judge Cantrell, speaking for the Court of Appeals, summed up the applicable law as follows:

> AllTel concedes that the PSC is not barred by stare decisis but argues that a change from a settled rule demands a principled explanation of the reasons for the change. . . . We agree with the rule cited by Alltel but we think the rule amounts simply to another way of saying that an Agency's decision cannot be arbitrary. "[T]he Commission's view of what is best in the public interest may change from time to time in such a case, if the conclusion is challenged as arbitrary, it would seem that the Court, in the process of adjudicating that issue, can require a statement premises for and the reasoning toward the general policy.". . .

Id. (citations omitted). The Court of Appeals went on to say that the Commission's allowing Alltel to use a certain methodology in a single case did not establish a settled rule or policy that was reversed in the subsequent proceeding. The Court, however, concluded that in any event, the PSC had adequately explained the reason it changed its position from one case to another, and upheld the Agency's decision.

Clearly, in this case, the TRA should not adopt an interpretation of its prior order that leads to the unintended and unconstitutional result pressed by the City and the CMA.

THE RATE DESIGN ISSUE

At the urging of the Directors, the parties worked to hammer out agreements as to the rate design applicable respectively to the $1.6 million and $2.7 million revenue levels. These are set forth in Exhibits 3 and 4. The AG declined to agree to the rate design for the $2.7 million scenario, but otherwise all parties agreed to both.

TAWC believes that the rate designs contained in Exhibits 3 and 4 are consistent with its efforts to move all classes of customers to their cost of service level. In both instances this results in the industrial class of customers having a lower percentage rate increase than other classes.

The Company's position on cost of service is fully supported by the testimony of its

witness, Paul Herbert. The only attempts to challenge Mr. Herbert's cost of service study were by AG witness Dr. Steven Brown and City witness Fire Chief Jim Coppinger.

Dr. Brown questioned the use of estimates in determining extra capacity (or demand) factors relative to coincidence peak day and peak hour factors. Mr. Herbert persuasively defended his study, relying on his experience, the generally accepted practices of estimation in the water industry, and the authority of the American Water Works Association Manual M1. TR, Vol. I, at 125-126. CMA witness Gorman corroborated Mr. Herbert's testimony that his cost study conforms with the American Water Works Manual. TR, Vol. I, at 149.

City witness Coppinger seemed to suggest that the cost of fire protection service should be measured by the volume of water used. TR, Vol. II, at 202-203. He conceded, however, that in order to provide fire protection service the City has to have water mains, pumping facilities, and storage facilities. TR, Vol. II at 205-206. Moreover, Mr. Herbert, on behalf of TAWC testified in support of his view of the cost of fire protection service as follows:

> The cost of service associated with providing public fire service has little to do with the actual amount of water used for fire purposes. The cost of public fire service is based on the direct cost associated with public fire hydrants, such as operation and maintenance expenses, depreciation and return on investment. It also includes an allocable portion of the distribution systems such as mains, pumping and storage facilities. These facilities are designed and sized in order to provide the instantaneous demand required when a fire emergency occurs.

TR, Vol. I, at 126-127.

Accordingly, Mr. Herbert's cost of service study is essentially unchallenged. To the extent the TRA wishes to consider rate designs other than those submitted in Exhibits 3 and 4, it should follow the guidance of Mr. Herbert's cost of service study.

As previously stated, the Company has proposed a rate design that moves all classes of

customers closer to the cost of serving those customers. In addition, it has proposed a treatment of the fire protection service that would allocate 25% of the cost to a municipality with 75% of the cost being shared by the ratepayers who actually receive the benefits of fire protection service. This is modeled after a methodology used in other states. The AG attempted to question this allocation by implying that it was inconsistent with the Company's cost-causer rate design theory, suggesting that it would be more consistent with cost-causer principles if the City paid 100% as if only City-owned buildings received the benefit of fire protection service. Apparently, the AG believes it inappropriate to have residential and commercial ratepayers pay any portion of fire protection service even though they undoubtedly receive most of the benefit of fire protection service. The obvious flaws in this position speak for themselves. However, TAWC is willing to accept any reasonable rate design devised by the TRA.

CONCLUSION

For all the foregoing reasons, the TRA should rule that TAWC is entitled to increased rates that allow it to recover its entire established revenue deficiency of $2,745,411. Anything less will result in an unconstitutional taking of TAWC's property. In addition, the TRA should adopt the rate design as set forth in Exhibit 4 to the Hearing Transcript.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of Petitioner Tennessee American Water Company's Post-Hearing Brief has been served, via the method(s) indicated, on this the 11th day of July, 2003, upon the following:

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H
SEE COURT OF APPEALS RULES 11 AND 12

Court of Appeals of Tennessee, Middle Section at Nashville.

ALLTEL TENNESSEE, INC., Crockett Telephone Company, Peoples Telephone Company, West Tennessee Telephone Company, and Ooltewah-Collegedale Telephone Company, Petitioners,
v.
TENNESSEE PUBLIC SERVICE COMMISSION, Respondent.

March 7, 1990.

No. 89-298-II Public Service Commission, Appealed from the Tennessee Public Service Commission.

Hermann Ivester, H. Edward Skinner, Valerie F. Boyce, Evester, Skinner & Camp, P.A., Little Rock, Ark., T.G. Pappas, W.J. Michael Cody, Bass, Berry & Sims, Nashville, for petitioners.

Henry Walker, Nashville, for respondent.

OPINION

CANTRELL, Judge.

***1** Five local telephone companies have petitioned this Court to review orders of the Tennessee Public Service Commission setting rates for the petitioners' intrastate telephone services. The petitioners' primary contention is that the PSC used an illegal "residual" methodology in arriving at the costs involved in the petitioners' intrastate services.

A.
The telephone system and the regulatory scheme

Each telephone company operating a local exchange supplies a service that can be divided into two parts: a local part and an interstate part. The interstate part comes into play when intrastate long distance calls are made using the equipment of the local company. The part of the company service that is local is regulated by the state regulatory body, in this case the TPSC. The part of the system involved in interstate service is under the jurisdiction of the Federal Communications Commission. *Louisiana Public Service Commission v. PSC,* 476 U.S. 355, 106 S.Ct. 1890, 90 L.Ed.2d 369 (1986).

In either case, the company is entitled to charge its customers for its services at a rate that will allow the company to earn a fair rate of return on its investment. *Simpson v. Shepard,* 230 U.S. 352, 33 S.Ct. 729, 57 L.Ed.2d 1511 (1913). Thus, it is necessary to know which costs and expenses belong to the local operation and which to the operation of the interstate portion of the business.

The FCC, along with a federal-state joint board, decides what part of the local plant costs results from supplying interstate service. *See N.A.R.U.C. v. FCC,* 737 F.2d 1095 (D.C.1984). The FCC allows smaller carriers to estimate their costs by using an average schedule developed by the FCC to reflect the cost of a "hypothetical exchange company." *Id.* at 1095. By using this schedule, a smaller carrier can estimate, with the approval of the FCC, the costs involved in providing interstate service.

B.
The present controversy

The petitioners all use the "average schedule" method to determine their interstate costs. At the present time the schedule allocates twenty-six percent of a local carrier's costs to the interstate jurisdiction and seventy- four percent to the intrastate jurisdiction. Each petitioner, however, proposes to use an actual cost separation study to determine the costs involved in its intrastate operations. In the case of Alltel Tennessee, Inc., it's study shows that approximately eighty-three percent of its costs arise out of its local operations. That is the figure it asks the PSC to use in setting rates for its local service.

The PSC takes the position that the petitioners are seeking a windfall. The order in each of the cases before us sets rates for the petitioners' intrastate service by using the "residual" method of

calculating the carrier's interstate cost. Under this method, the Commission merely subtracts the average schedule costs allocated to the interstate service from the company's total costs. What is left is used for the purpose of setting the company's intrastate rates.

***2** The petitioners have appealed directly to this Court pursuant to Tenn.Code Ann. § 4-5-322(b)(1). Their main contention is that the PSC has crossed into the forbidden area of federal jurisdiction by appropriating what it perceives to be excess earnings from the company's interstate operations for the use of the intrastate customers.

As to this question, the PSC urges this Court to defer to the FCC.

C.
The doctrine of primary jurisdiction

The doctrine of primary jurisdiction "generally requires that parties resort first to an administrative agency before they seek judicial action involving a question within the competency of that agency." *Freels v. Northrup,* 678 S.W.2d 55 (Tenn.1984). "In deciding whether to defer to the administrative agency, courts generally make two inquiries: (1) will deferral be conducive toward uniformity of decision between courts and the agency, and (2) will deferral make possible the utilization of pertinent agency expertise." *Id.* at 57.

Although the primary jurisdiction doctrine is usually applied in the federal courts, the practice of state court deferral to federal agencies has a long history. *Seatrain Lines, Inc. v. Gloria Manufacturing Corp.,* 279 S.E.2d 166 (Va.1981); *Marony v. Applegate,* 42 N.Y.S.2d 768 (N.Y.1943); *Hippensteel v. System Federation,* 59 N.W.2d 278 (Mich.1953).

In this case, pertinent to the primary jurisdiction question, the record shows that one federal district court has already dismissed a case involving these same parties to allow the issue to be presented to the FCC. *Alltel Tennessee, Inc., et al. v. Tennessee Public Service Commission, et al.,* Civil Case 3-89-03-01 (M.D.Tenn.1989). Another federal district court faced with the same issue came to the same conclusion. *Mid-Plains Telephone Co. v. Public Service Commission of Wisconsin,* Docket 89-C-318-S (W.D.Wisc.1989). As a result of the Wisconsin decision, Mid-Plains Telephone Company has filed a petition with the FCC seeking a declaratory ruling that the residual methodology employed by the Wisconsin Commission violates the FCC's orders and legal precedent.

Under the circumstances, it seems appropriate for this Court to apply the primary jurisdiction doctrine and defer to the FCC on the question of whether the PSC's residual methodology violates federal law. We are satisfied that the two requirements of *Freels v. Northrup* are met. Deferral will promote uniformity of decisions and will invoke the expertise of the FCC in deciding a question that is peculiarly within its jurisdiction. Therefore, we decline to decide this issue.

D.
The remaining State questions
1.

There are two other issues raised by the petitioners that should be decided in this proceeding. The first is one raised by Alltel that the PSC arbitrarily and capriciously changed its methodology from that used in a prior order. In 1980, in Docket No. U-6940, Alltel used a cost study to arrive at the expenses attributable to its intrastate operations and the PSC adopted those costs in setting the company's intrastate rates. The present action of the Commission represents a complete reversal for which Alltel argues there is no justification.

***3** Alltel concedes that the PSC is not barred by stare decisis, but argues that a change from a settled rule demands a principled explanation of the reasons for the change. *Laclede Gas Co. v. Federal Energy Regulatory Commission,* 722 F.2d 272 (5th Cir.1984). We agree with the rule cited by Alltel but we think the rule amounts simply to another way of saying that an agency's decision cannot be arbitrary. "[T]he commission's view of what is best in the public interest may change from time to time ... in such a case, if the conclusion is challenged as arbitrary, it would seem that the court, in the process of adjudicating that issue, can require a statement of the premises for and the reasoning toward the general policy." *Pinellas Broadcasting Co. v. FCC,* 230 F.2d 205, 206 (D.C.Cir.1956).

The record in this case does not reflect that the

Commission had formulated a settled policy that allowed an average schedule company to base its intrastate rates on a cost separation study. It is true that it had allowed Alltel to do so once before, but it does not appear that the issue was raised at that time. With nothing more than that in the record, we cannot conclude that the PSC had established a policy which was reversed in this proceeding.

Further, we think the PSC adequately explained the reason it acted as it did in these cases. The explanation is that the position taken by the petitioners results in an overcharge to the rate payers within the Commission's jurisdiction. We think that is explanation enough--assuming that the Commission is correct on the question of residual rate making.

2.

Finally, the petitioners' challenge the factual basis for the Commission's orders. The petitioners argue that there is no evidence in the record that the residual methodology is legally sustainable. We think the argument made with respect to this issue is a reargument of the first issue. If the FCC approves the residual methodology for average scheduled companies, the PSC was correct in proceeding as it did. Therefore, we find this issue to be without merit.

Under the doctrine of primary jurisdiction we defer to the FCC on the question of the legality of the PSC's residual methodology. On the other issues raised in this appeal we affirm the action of the Commission. The cause is remanded to the PSC for any further proceedings that may become necessary after the primary issue is decided by the FCC. Tax the costs on appeal to the petitioners.

TODD, P.J., and KOCH, JJ., concur.

1990 WL 20132, 113 P.U.R.4th 524, 1990 WL 20132 (Tenn.Ct.App.)

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