BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

June 25, 2004

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**

FINAL ORDER APPROVING RATE INCREASE AND RATE DESIGN AND APPROVING RATES FILED BY TENNESSEE AMERICAN WATER COMPANY

This matter came before Director Pat Miller, Director Sara Kyle, and Director Ron Jones, of the Tennessee Regulatory Authority ("Authority" or "TRA"), the voting panel assigned to this docket, at a regularly scheduled Authority Conference held on August 4, 2003, for consideration of the *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* ("*Petition*") filed on February 7, 2003. As more fully described herein and for the reasons set forth below, a majority of the panel voted to grant the request of Tennessee American Water Company ("TAWC" or the "Company") to increase its rates. Additionally, a majority of the panel voted to approve a rate design implementing the increased rates. At an Authority Conference held on August 18, 2003, the revised rates were put into effect according to the tariff filed by TAWC on August 5, 2003.

BACKGROUND

Authority's September 26, 2000 Order in TRA Docket No. 99-00891

On October 25, 1999, TAWC and the City of Chattanooga ("Chattanooga") entered into a settlement agreement of a previously-filed condemnation lawsuit[1] wherein Chattanooga sought to acquire certain assets of TAWC. Section 2.B of the settlement agreement stated as follows:

> [The Company] 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 $50.00 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.

In accordance with the settlement agreement TAWC submitted a tariff filing to the Authority for approval. TAWC's filing was submitted on November 17, 1999 and was assigned Docket No. 99-00891. Through the tariff filing, TAWC proposed to decrease, in quarterly reductions, its annual charges to Chattanooga for fire hydrants from the rate of $301.20 per hydrant to a reduced rate of $50.00 per hydrant. At the time of the tariff filing, TAWC provided 4,491 fire hydrants to Chattanooga and surrounding areas. According to TAWC, the reductions would result in an annual revenue impact of negative $1,127,964.[2]

TAWC's tariff filing was considered by the TRA at a regularly scheduled Authority Conference held on January 11, 2000. At that Conference, a majority[3] of the Directors voted to approve the proposed reduction in annual fire hydrant charges to Chattanooga and ordered that

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[1] *See City of Chattanooga v Tennessee-American Water Company et al*, Case No 99-C-1081, Circuit Court of Hamilton County, Division IV

[2] *See In re. Tariff Filing to Reduce Fire Hydrant Annual Charges as Part of a Settlement Agreement Between the City of Chattanooga and Tennessee-American Water Company*, Docket No 99-00891, Company's Response to Authority Data Request, December 20, 1999, Attachment A

[3] Director Lynn Greer voted not to approve the tariff Director Greer did, however, state, "I do strongly agree though with Chairman Malone's portion of his motion that says that he believes the ratepayers should not bear any cost in any future rate case I strongly support that decision " *See In re Tariff Filing to Reduce Fire Hydrant Annual Charges as Part of a Settlement Agreement Between the City of Chattanooga and Tennessee-American Water Company*, Docket No 99-00891, Transcript of Authority Conference, p. 27 (January 11, 2000)

the reduction be borne by the stockholders of TAWC and not by the Company's ratepayers.[4] In its Order approving TAWC's tariff filing, the Authority recognized that the lost revenues would be imputed into TAWC's subsequent rate filings, thus reflecting the decision of the Company and its stockholders to absorb the contribution loss.[5] The Order specifically stated:

> The Company's ratepayers shall not at any time, through increases in rates, fees, schedules or otherwise, bear any of the cost resulting from this Tariff filing by Tennessee-American Water Company to voluntarily reduce its fire hydrant charges to the City of Chattanooga.[6]

Paragraph 2 of the ordering clauses required the following:

> 2. The lost contribution to Tennessee-American Water Company resulting from the reduction in fire hydrant charges along with any expenses incurred as a result of the underlying litigation with the City of Chattanooga shall be borne, in full, by the stockholders of Tennessee American Water Company;

The Authority's Order became final after no party or person sought reconsideration or appeal.

Travel of this Case (Docket No. 03-00118)

TAWC's *Petition*

TAWC filed its *Petition* for a rate increase in this docket on February 7, 2003. Through its *Petition* TAWC sought TRA approval of an increase in annual revenues of $3,866,813 and an overall rate of return of 8.559 percent (8.559%) with an 11.00 percent (11%) return on equity during the attrition year ending March 31, 2004. In the proposed tariffs filed by TAWC, the additional annual revenues would be recovered by increased charges to all classes of customers.

In support of its *Petition*, TAWC filed sworn testimony, together with exhibits, of the following witnesses: Michael A. Miller, Vice President and Treasurer/Comptroller of TAWC; Roy L. Ferrell, Sr.; Paul Moul, managing consultant; Sheila A. Valentine, Senior Financial

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[4] *See In re: Tariff Filing to Reduce Fire Hydrant Annual Charges as Part of a Settlement Agreement Between the City of Chattanooga and Tennessee-American Water Company*, Docket No 99-00891, *Order Approving Tariff*, p 5 (September 26, 2000) (hereinafter *Order Approving Tariff*)

[5] *Order Approve Tariff*, p. 3, n 6

[6] *Id* at 5.

Analyst for TAWC; Monty Bishop, TAWC Operations Manager; Paul R. Herbert, Vice President, Gannett Fleming, Inc.; James E. Salser, consultant; Edward Spitznayle, Ph.D.; and William L'Ecuyer, President of TAWC. TAWC also filed proposed tariff revisions reflecting changes and increases to rates and charges by the Company.

Chattanooga and the Consumer Advocate and Protection Division of the Office of the Attorney General ("Consumer Advocate") each filed a petition to intervene on February 25, 2003. The Chattanooga Manufacturers Association ("CMA") filed a petition to intervene on February 26, 2003.

TAWC's *Petition* was considered at a regularly scheduled Authority Conference held on March 3, 2003, at which time the panel voted unanimously to suspend TAWC's proposed tariff and to appoint Director Ron Jones as the Hearing Officer for the purpose of preparing this matter for Hearing.[7] The Hearing Officer held a Status Conference on March 12, 2003 at which time the petitions to intervene were granted, without objection. From that Status Conference an Order was issued on March 17, 2003, in which the Hearing Officer established a procedural schedule for discovery and the filing of testimony and set this matter for Hearing on June 30 and July 1, 2003.

The parties conducted discovery in the form of interrogatories and requests for production of documents pursuant to the Hearing Officer's procedural schedule.[8] Thereafter, the intervening parties submitted pre-filed testimony as follows: the Consumer Advocate filed the direct testimony of Michael D. Chrysler, Mark H. Crocker and Steve N. Brown, Ph.D.; CMA filed the direct testimony of Michael Gorman, consultant; Randy Crowder, Quality Assurance

[7] In appointing Director Jones as the Hearing Officer in this docket, the panel acknowledged that a contested case was being convened in accordance with Tenn Code Ann. § 65-5-203.

[8] The original procedural schedule was subsequently amended by an order entered by the Hearing Officer on June 12, 2003.

Manager for Bob Stowe Mills, Inc.; Ray Childers, President, Chattanooga Manufacturers Association; Dan Nuckolls, Operations Director for Koch Foods, LLC; and Craig Cantrell, Plant Manager for Velsicol Chemical Corporation; and Chattanooga filed the direct testimony of Jon Kinsey, former Mayor of Chattanooga; Daisy Madison, Treasurer and Deputy Finance Officer for Chattanooga; Jim Mac Coppinger, Fire Chief for Chattanooga; and Marlin L. Mosby, Jr., financial consultant. Rebuttal testimony of Dr. Brown and Mr. Gorman was filed by the Consumer Advocate and CMA, respectively. TAWC filed rebuttal testimony of Michael Miller, Paul Moul, Paul Herbert and Chris Klein, Ph.D.[9]

On June 27, 2003, TAWC and the Consumer Advocate filed with the Authority a *Proposed Settlement Agreement ("Agreement")* relating to specific issues and in which those parties stipulated to the following:

1. That Tennessee-American is entitled to earn a 7.73% return on investments with a 9.9% return on equity, as shown in attached Schedule 1.

2. The Attorney General and Tennessee-American further stipulate and agree that a 7.73% return on investment generates a revenue deficiency of either: (1) $1,617,447 in 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 per public fire hydrant, in TRA Docket No. 99-00891; or (2) $2,745,411 in the event the TRA decides to reverse the imputation of the fire hydrant annual cost or otherwise approve an overall settlement with an adjustment that would offset the loss in public fire service revenues. The revenue deficiency with and without the imputation of the fire hydrant annual cost is shown in Schedule 2.[10]

[9] Dr Klein's testimony was stricken upon the Motion of the Consumer Advocate *See Order Granting Motion to Strike* (June 27, 2003)

[10] *Proposed Settlement Agreement*, pp. 1-2 (June 27, 2003)

The Hearing

The Hearing in this matter was held before the voting panel on June 30 and July 1, 2003. Participating in the Hearing were the following parties and their respective counsel:

> **Tennessee American Water Company** - T. G. Pappas, Esq. and R. Dale Grimes, Esq., Bass, Berry and Sims, PLC, 315 Deaderick Street, AmSouth Center, Suite 2700, Nashville, Tennessee 37238-3001;
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> **Consumer Advocate and Protection Division** - Vance Broemel, Esq. and Shilina B. Chatterjee, Esq., Office of the Attorney General, P.O. Box 20207, Nashville, Tennessee 37202;
>
> **Chattanooga Manufacturers Association** - Henry Walker, Esq., Boult, Cummings, Conners & Berry, PLC, 414 Union Street, Suite 1600, Nashville, Tennessee 37219 and David C. Higney, Esq., Grant, Konvalinka & Harrison, P.C., 633 Chestnut Street, 9th Floor, Chattanooga, Tennessee 37450; and
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> **City of Chattanooga, Tennessee** - Michael A. McMahan, Esq. and Phillip A. Noblett, Esq., Special Counsel, 801 Broad Street, Suite 400, Chattanooga, Tennessee 37402.

At the outset of the Hearing, the attorneys for Chattanooga and the CMA each expressed their respective clients' support for the *Agreement.*[11] After hearing from all of the parties, the panel voted unanimously to accept the *Agreement.*[12] By acceptance of the *Agreement*, the Authority determined the rate base to be $87,062,756, the return on investment to be 7.73% and the return on equity to be 9.9%. Approval of the *Agreement* also removed from the proceeding the issues relating to the cost of capital, revenues and expenses.

Thereafter, during the Hearing, the parties reached an additional agreement identifying an appropriate rate design for use in the event that the Authority determined the revenue deficiency to be $1,617,447. This rate design was set forth in Exhibit 3 received into the record during the Hearing. All of the parties did not reach an agreement as to an appropriate rate design in the

[11] Transcript of Proceedings, Vol I, p. 11 (June 30, 2003).
[12] *Id* at 44.

event that the Authority determined a revenue deficiency in any other amount.[13] Nevertheless, a rate design was entered into the record as Exhibit 4 that reflected a model breakdown of rates per customer classification in the event the revenue deficiency was determined to be $2,745,411.[14]

Upon the acceptance of the *Agreement,* the Authority articulated the two issues remaining for determination as: the question of continued imputation of the reduction of fire hydrant charges and the appropriate rate design for implementing the rate increase.

Acceptance of the *Agreement* eliminated the need for live testimony from all of the witnesses who submitted pre-filed testimony; however, without objection from the parties, the panel voted unanimously to admit into the evidentiary record the pre-filed direct and rebuttal testimony of all witnesses, with the exception of Dr. Chris Klein whose testimony was excluded by order of the Hearing Officer.[15] The panel heard live testimony from certain witnesses on the issues of the imputation of fire hydrant revenues and rate design. Counsel for TAWC called Michael Miller and Paul Herbert as witnesses. The Consumer Advocate called Dr. Steve Brown as its witness. Counsel for Chattanooga called Daisy Madison and Ray Childers as its witnesses. CMA called Michael Gorman as a witness. All witnesses were subject to cross examination by the parties and questions from members of the voting panel. Rebuttal testimony was heard on July 1, 2003. In rebuttal, TAWC called Michael Miller. Chattanooga called Jim Mac Coppinger and Jon Kinsey. At the conclusion of the testimony, the panel ordered that post-hearing briefs be filed addressing the imputation of fire hydrant revenues and rate design. The parties filed post-hearing briefs on July 11, 2003.

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[13] *Id* at 46
[14] *Id*
[15] *Order Granting Motion to Strike* (June 27, 2003).

POSITIONS OF THE PARTIES

TAWC

Through testimony and its post-hearing brief, TAWC has asserted the following: the 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; the prior Order in Docket No. 99-00891 does not require a $1.1 million reduction of TAWC's approved revenue requirement; ordering 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, 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.

TAWC argued that, under the facts and circumstances presented, a rate increase is warranted because the Company is entitled to a fair rate of return on all of its investment either used and useful in the provision of service to its customers.[16] TAWC argued that, considering the stipulated rate base of $87,062,756 and the stipulated rate of return on investments of 7.73 percent (7.73%) with a 9.9 percent (9.9%) return on equity, the stipulated revenues of the Company produce a revenue deficiency of $2,745,411.[17] TAWC further argued that the disallowance of $1.1 million of the established $2.7 million revenue requirement would prevent TAWC from earning its approved rate of return on its approved reasonable rate base, thereby resulting in an unconstitutional taking of property.[18]

In addressing the Authority's Order in Docket No. 99-00891, TAWC argued that the Order would not preclude the Company from recovering its full revenue requirement in this

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[16] *Petitioner Tennessee American Water Company's Post Hearing Brief*, p 4 (July 11, 2003).
[17] *Id* at 5-6
[18] *Id* at 6.

matter or require a reduction of the $1.1 million in that revenue requirement in perpetuity.[19] TAWC stated that the Order in Docket No. 99-00891 only prohibits the Company from recovering from ratepayers the actual revenues lost by the reduction in the fire hydrant rate to Chattanooga.[20]

TAWC witness Miller testified that in agreeing to a reduction of fire hydrant revenues, "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."[21] TAWC stated that it is not attempting to recover loss of revenue from the reduction in the fire hydrant rate to Chattanooga, which occurred during the "stub period."[22] The Company maintained that the Authority's Order in Docket No. 99-00891, if interpreted as the imputation of the hydrant revenue "in perpetuity," would "equate to untold millions" in lost revenue and "place the Company in a position where it would not have an opportunity in this case or any future rate cases to achieve a fair and reasonable return on its investments."[23]

The Company argued that even other parties in Docket No. 99-00891 understood the agreement to be only temporary, or during a certain time period until TAWC files for a rate case. In this regard, the Company relied on the statements in the record of Docket No. 99-00891 made by Chattanooga's attorney and the Mayor of Chattanooga at the time, Mr. Kinsey.

In opposition to a proposal offered by CMA witness Michael Gorman, TAWC responded that ordering the Company to write off a portion of its assets in order to give the appearance that

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[19] *Id* at 9.
[20] *Id* at 10.
[21] According to TAWC, "[t]he 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 " Transcript of Proceedings, Vol I , pp 63-63 (June 30, 2003)
[22] *Petitioner Tennessee American Water Company's Post Hearing Brief*, p 10 (July 11, 2003).
[23] Pre-filed Rebuttal Testimony of Michael A Miller, pp 19-20 (June 23, 2003)

it is achieving its approved rate of return would be inappropriate and would amount to a confiscation of its assets.[24]

In its post hearing brief, TAWC stated that it did not oppose either the rate design set forth in Exhibit 3 reflecting the $1,617,447 revenue increase or the rate design in Exhibit 4 reflecting the $2,745,411 revenue increase.[25] Nevertheless, TAWC argued that the Company is entitled to an increase in rates to allow it to recover $2,745,411 and that Exhibit 4 provides the appropriate rate design for allocating that rate increase.

Chattanooga

Chattanooga argued in its post hearing brief that TAWC voluntarily waived any claim that it might otherwise have to the approximately $1.1 million in revenues for fire protection services, which represents the difference between the proposed rate increases of $2,745,411 and $1,617,447, when TAWC and Chattanooga voluntarily entered into the settlement agreement resolving Chattanooga's condemnation action to acquire TAWC's assets.[26] Chattanooga argued further that the TRA properly held that the $1.1 million loss in revenue should be borne by TAWC's stockholders.[27]

With regard to rate design, Chattanooga stated that the rate design set forth in Exhibit 3 reflecting the $1,617,447 rate increase fulfills the revenue requirements of TAWC and properly puts the loss of the fire hydrant revenue on TAWC's stockholders.[28] In the alternative, Chattanooga argued that should the panel determine to allow a revenue increase of $2,745,411 then the rate design set forth in Exhibit 4 is properly supported by the record in this matter.[29]

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[24] TAWC assumes that it would have to write-off $8 0 to $10 0 million of assets that would still be used and useful in providing services
[25] *Petitioner Tennessee American Water Company's Post Hearing Brief*, p 18 (July 11, 2003).
[26] *Post Hearing Brief of City of Chattanooga*, p 15 (July 11, 2003)
[27] *Id*
[28] *Id.*
[29] *Id* at 16

Consumer Advocate

The Consumer Advocate argued that a TRA decision in this docket to uphold the Order in Docket No. 99-00891 and continue the $1.1 million fire protection reduction would not prohibit TAWC from earning a fair rate of return. According to the Consumer Advocate, there was no conclusive proof that the residential and commercial customers were not paying their full share of costs. The study on which TAWC witness Herbert relied for his "cost causer" opinion did not use studies of actual loads placed on the system by classes of customers.[30] Instead, the witness relied upon data from out-of-state water companies without any proof that these companies served cities with loads similar to Chattanooga. The Consumer Advocate also pointed out that residential and commercial consumers were never a part of the settlement arrangement between TAWC and Chattanooga concerning the fire hydrant fees.[31]

In its post hearing brief, the Consumer Advocate restated its agreement that the revenue deficiency for TAWC is either $1,617,447 in the event that the TRA continues to impute the reduction of fire hydrant revenue or $2,745,411 in the event that the TRA decides to no longer impute the reduction of the fire hydrant revenue.[32] The Consumer Advocate asserted its support for the rate design set forth in Exhibit 3 reflecting the $1,617,447 rate increase and argued that the TRA should adopt this rate increase rather than the $2,745,411 increase. The Consumer Advocate objected to the rate design set forth in Exhibit 4 reflecting the $2,745,411 increase on the basis that the rate design would produce an unacceptable rate increase for consumers by shifting the approximately $1.1 million of fire protection costs to residential and commercial customers.[33]

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[30] Transcript of Proceedings, Vol. I, pp 120-121 (June 30, 2003)
[31] *Consumer Advocate's Post-Hearing Brief*, p 6 (July 11, 2003).
[32] *Id* at 3
[33] *Id* at 4.

CMA

CMA asserted the position that the TRA's Order in Docket No. 99-00891 clearly meant that the lost revenue resulting from the reduction in fire hydrant charges shall be borne, in full, by the stockholders and that the Company's ratepayers shall not at any time bear any of the cost resulting from the tariff filing by TAWC to voluntarily reduce its fire hydrant charges to Chattanooga.

In its post-hearing brief, CMA focused on the issue of whether the Authority should continue to impute the lost fire hydrant revenue and argued that TAWC's stockholders should continue to absorb the costs associated with lost fire hydrant revenues. For that reason, CMA supported the adoption of the rate design agreed to and set forth in Exhibit 3.[34]

CMA witness Michael Gorman testified that the TRA's decision to reduce hydrant rates does not mean that the Company will never have the opportunity to earn a fair return. He explained that the Company has options such as (1) a write off of the value of its Tennessee assets to reflect the fact that the Company is no longer allowed to earn a return on a portion of its assets,[35] (2) an equity infusion from the parent company to cure the credit rating, or (3) a suspension of dividend payments to the stockholders to restore the common equity balance.[36]

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[34] *Post Hearing Brief of Chattanooga Manufacturers Association*, p 5 (July 11, 2003)
[35] According to TAWC, if writing off its assets was an option, the Company would write off about $8 to $10 million worth of assets. Transcript of Proceedings, Vol II, p 187 (July 1, 2003)
[36] Transcript of Proceedings, Vol I, pp 146-147 (June 30, 2003)

Findings And Conclusions

Except for the issues relating to the restoration of the Company's voluntary rate reduction to Chattanooga in Docket 99-00891 and rate design in this docket, the parties were able to reach a resolution to settle all other issues in this case. While Chattanooga and the CMA were not signatory parties to the *Agreement*, both parties stated, at the Hearing, their acceptance of the terms of the *Agreement*. Upon consideration of the entire record, including all exhibits and the briefs of the parties, the panel made the following findings and conclusions.

Restoration of the Voluntary Rate Reduction for Public Fire Protection Service to Chattanooga

In Docket No. 99-00891, the TRA approved the tariff filing by the Company that voluntarily reduced rates to Chattanooga by $1,127,964 per year for public fire protection service. As part of its *Petition*, TAWC requested the TRA reinstate this revenue stream. The parties to this case were unable to reach a settlement on this issue.

In issuing the Authority's Order in Docket No. 99-00891, the TRA Directors were unanimous in their position that the ratepayers of TAWC should not bear the cost of the fire hydrant rate reduction.[37] The Tennessee Court of Appeals has recognized that an agency may change its position over time regarding whether a matter is best in the public interest. In *Alltel Tennessee, Inc. v. Tennessee Public Service Commission*, the Tennessee Court of Appeals held that the Tennessee Public Service Commission ("TPSC") would not be "barred by stare decisis," provided that the TPSC did not act arbitrarily in changing from an established rule.[38]

The evidence in the record of this docket clearly demonstrates that the Company's intentions "to recover the lost margin resulting from the approval of [the] Tariff by increasing

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[37] *Order Approving Tariff*, p 4, n.8.

[38] *Alltel Tennessee, Inc v Tennessee Public Service Commission*, No 89-298-II, 1990 WL 20132 (Tenn Ct App March 7, 1990) The Court stated that an agency decision would not be considered arbitrary if a reasoned explanation is provided along with the change of policy. *Id* at *3

sales of water to existing customers and by gaining new customers"[39] did not completely come to fruition. In addition, the Company suffered other expenses and revenue reductions over the past three years since the approval of the tariff.

In determining whether TAWC should receive all or part of the revenue requirement that it seeks, the Authority need not base its decision on an interpretation of the Order in Docket No. 99-00891. Notwithstanding the clear objective of the Order in Docket No. 99-00891 of imputing lost revenues to the shareholders, the Authority finds little support today for continuing this imputation in perpetuity.

The Authority is obligated to balance the interests of the utilities subject to its jurisdiction with the interests of Tennessee consumers, i.e., it is obligated to fix just and reasonable rates.[40] The Authority must also approve rates that provide regulated utilities the opportunity to earn a just and reasonable return on their investments.[41] Allowing a perpetual imputation of revenues lost from the reduction to fire hydrant rates would prevent the Authority from meeting these requirements. Such an imputation denies TAWC a fair return on its assets that are used and useful in the provision of water and public fire protection service to the ratepayers in Chattanooga. Consistent with the Authority's Order in Docket No. 99-00891 approving the reduction of fire hydrant rates, TAWC has foregone more than $3 million in revenues from the time it resolved the condemnation lawsuit with Chattanooga. Likewise, Chattanooga has directly benefited from this $3 million dollar reduction in charges paid to TAWC.[42]

While the record contains no evidence necessitating a modification of the Order in Docket No. 99-00891, there is evidence today to support the Company's claim that additional

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[39] *Order Approving Tariff* at 3.
[40] Tenn Code Ann § 65-5-201 (Supp 2002)
[41] *See Bluefield Water Works and Improvement Company v Public Service Commission of the State of West Virginia*, 262 U.S. 679, 43 S Ct. 675 (1923)
[42] Director Jones's vote was not based on a finding related to TAWC's foregone revenues or the benefit thereof to Chattanooga.

revenue requirement may be necessary. For these reasons, a majority of the panel found that the imputation of reduced fire hydrant rates to Chattanooga should be discontinued.

Criteria for Establishing Just and Reasonable Rates

The Authority considers petitions for a rate increase, filed pursuant to Tenn. Code Ann. § 65-5-203, in light of the following criteria:

1. The investment or rate base upon which the utility should be permitted to earn a fair rate of return;

2. The proper level of revenues for the utility;

3. The proper level of expenses for the utility; and

4. The rate of return the utility should earn.

The general standards to be considered in establishing the costs of common equity for a public utility are financial integrity, capital attraction and setting a return on equity that is commensurate with returns investors could achieve by investing in other enterprises of corresponding risk. The utility's cost of common equity is the minimum return investors expect, or require, in order to make an investment in the utility. The proper level of return on the Company's capital, including equity capital, must allow a return on capital that is commensurate with returns on investment in other enterprises having corresponding risk.[43]

Test Period

The objective of selecting a test period is to obtain financial data and adjust it as necessary to reflect the inter-relationship of revenues, expenses and investment expected to occur in the immediate future. In this case, the Company selected the twelve months ended July 31, 2002, as the historical test period and made two levels of adjustments. The first level of adjustment normalizes the test year and the second adjusts the normalized year to arrive at the

[43] *See Federal Power Commission v Hope Natural Gas Co* , 320 U S 591, 64 S Ct 281 (1944)

forecast for the attrition year, which is the twelve months ending March 31, 2004. In adopting the *Agreement* between the parties, the panel found that the test period as adjusted will provide the Company the opportunity to earn a fair rate of return on its investment.

Rate Base

Through the *Agreement*, the parties stipulated to a rate base for the attrition year of $87,062,756 as detailed below. The TRA found that the rate base in this case has been adjusted to reflect the investment and expenses of the Company for the attrition year test period and therefore is proper and should give the Company the opportunity to earn a fair rate of return on its investment to which it is entitled.

Additions:	
Utility Plant in Service	$146,234,775
Construction Work in Progress	801,659
Utility Plant Capital Lease	1,590,500
Limited Term Utility Plant – Net	-20,953
Working Capital	1,403,079
RWIP/Deferred Maintenance	34,191
Total Additions	**$150,043,251**
Deductions:	
Accumulated Depreciation	$44,221,915
Accumulated Amortization of Utility Capital Lease	565,511
Accumulated Deferred Income Taxes	11,070,493
Customer Advances for Construction	2,007,438
Contributions in Aid of Construction	5,064,245
Unamortized Investment Tax Credit	50,893
Total Deductions	**$62,980,495**
Rate Base	**$87,062,756**

Revenues and Expenses

The parties stipulated to certain facts derived from a review and investigation of the Company's books and records for the purposes of this case. The parties agree that the net operating income at present rates of the Company for the attrition period is $5,098,465 as detailed below. The TRA finds that the net operating income in this case has been adjusted to

reflect the appropriate attrition period level of revenues and expenses necessary for continued utility operations.

Revenues:	
Sales of Water	$28,952,398
Other	806,059
Forfeited Discounts	282,161
Total Revenues	**$30,040,618**
Expenses:	
Operation & Maintenance	$16,145,398
Depreciation & Amortization	4,121,753
Taxes Other Than Income	3,430,304
State Excise Tax	126,131
Federal Income Tax	1,170,306
Total Expenses	**$24,993,892**
Allowance for Funds Used During Construction	**$51,739**
Net Operating Income	**$5,098,465**

Fair Rate of Return

In determining a fair rate of return, the Authority must conduct an in-depth analysis and give proper consideration to numerous factors, such as capital structure, cost of capital and changes which can reasonably be anticipated in the foreseeable future. The Authority has the obligation to make this determination based upon the controlling legal standard set forth in the landmark cases of *Bluefield Water Works and Improvement Company v. Public Service Commission of the State of West Virginia*[44] and *Federal Power Commission v. Hope Natural Gas Company,*[45] which have been specifically relied upon by the Tennessee Supreme Court.[46] In the *Bluefield* case, the United States Supreme Court stated:

[44] *Bluefield Water Works and Improvement Company v Public Service Commission of the State of West Virginia*, 262 U.S. 679, 43 S Ct. 675 (1923).
[45] *Federal Power Commission v Hope Natural Gas Company*, 320 U S. 591, 64 S Ct 281 (1944)
[46] *Southern Bell Telephone & Telegraph Co v Public Service Commission*, 304 S W 2d 640, 647 (1957).

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risk and uncertainties; but it has no constitutional rights to profits such as are realized or anticipated in highly profitable or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.[47]

Later, in the *Hope* case, the United States Supreme Court refined these guidelines, holding that:

> From the investor or company points of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain its credit and to attract capital.[48]

The parties, for the purposes of this case, have agreed on a capital structure and cost that produces an overall rate of return for the Company of 7.73% as detailed below. After reviewing the necessary factors, the TRA found that this rate of return is fair and reasonable and meets the tests articulated in the *Bluefield* and *Hope* cases.

	Ratio	Cost Rate	Weighted Cost Rate
Parent:			
Debt	56.00%	9.90%	5.54%
Common Equity	44.00%	6.00%	2.64%
Total	**100.00%**		**8.18%**
Tennessee-American			
Short Term Debt	6.20%	3.50%	0.22%
Long Term Debt	20.80%	7.62%	1.59%
Preferred Stock	1.60%	5.01%	0.08%
Common Equity	71.40%	8.18%	5.84%
Total	**100.00%**		**7.73%**

[47] *See Bluefield Water Works and Improvement Company v Public Service Commission of the State of West Virginia*, 262 U S 679, 43 S.Ct. 675 (1923).
[48] *Federal Power Commission v Hope Natural Gas Company*, 320 U S 591, 603 (1944)

Revenue Deficiency

Based upon the rate base, net operating income, and fair rate of return agreed to by the parties, the TRA found that the revenue deficiency for this case should be calculated to be $2,745,411 as shown below. The TRA therefore found that the Company needs additional annual revenues in the amount of $2,745,411 in order to earn a fair return on its investment during the attrition year.

Rate Base	$87,062,756
Fair Rate of Return	7.73%
Required Net Operating Income	**$6,729,951**
Current Net Operating Income	5,098,465
Net Operating Income Deficiency	$1,631,486
Retention Factor	1.682767
Total Revenue Deficiency	**$2,745,411**

Rate Design

It is clear from the testimony of the TAWC witnesses and statements by their counsel that the Company desired to move more toward a rate design that would reflect the "cost causer" principle. The company witnesses and the CMA witness all agree that fire protection rates are not covering their costs as developed by Mr. Herbert. The proposed tariff for fire protection covers only 25% of the cost of that service. No other class of customer receives such a large discount. The witnesses all agree that the cost of fire protection is between $313 and $316 per hydrant. This approximates the rate that was charged for fire protection ($301 per hydrant) prior to the voluntary rate reduction put into effect by TAWC to settle the condemnation proceeding. Because the goal of the fire hydrant tariff reduction was to settle the condemnation proceeding between Chattanooga and TAWC, all of the benefits flowed to those two parties during the time

the reduced revenue tariff has been in place.[49] Chattanooga has also benefited from the circumstance that there has not been an adjustment to water rates in Chattanooga since November 1, 1996.[50]

Through the Agreement in this docket, the parties reached a settlement that included a rate design that will produce additional revenues of approximately $1,617,447 as shown below. This amount does not include revenues from public fire protection service in an amount of $1,127,964.

	Total Revenues	**Rate Increase %**	**Rate Increase**
Residential	$12,026,923	5.5866%	$671,893
Commercial	9,180,456	5.5866%	512,873
Industrial	3,169,070	4.3500%	137,855
Other Public Authority	2,345,806	5.5866%	131,050
Other Water Utility	856,218	5.5866%	47,833
Private Fire Service	1,117,875	5.5866%	62,451
Public Fire Service	256,049	20.9000%	53,514
Total	**$28,952,397**	**5.5866%**	**$1,617,469**
Revenue Deficiency			1,617,447
Difference			**$22**

Based upon the record in this matter, a majority of the panel found that it is appropriate to allow the Company to recover the previous voluntary reduction in revenues of $1,127,964, bringing the total revenue deficiency in this case to $2,745,411 ($1,617,447 + $1,127,964). The panel unanimously found that fifty percent (50%) of the restoration of the voluntary rate reduction or $563,982 ($1,127,964 x 50%) should be allocated to Chattanooga for public fire protection service. In addition, a majority of the panel found that the remaining $563,982 from the restoration of the voluntary rate reduction should be allocated to all customer classes, including Chattanooga, using the same rate design, as agreed to by the parties, that produced

[49] Some of the benefit of the reduced fire hydrant expense to the city could have flowed to the taxpayers (ratepayers) through lower tax bills though no evidence was presented to confirm that actually happened.
[50] Chattanooga's water rates were last adjusted by the Authority in Docket No 96-00959

$1,617,447 in additional revenues.[51] This rate design represents an overall increase in rates for all classes of customers. The TRA found that this rate design is just and reasonable and meets the standards set out in Tenn. Code Ann. § 65-5-203(a).

TAWC's Tariff Reflecting Rate Increases and Rate Design

On August 6, 2003, TAWC filed tariffs with the TRA in accordance with the findings and conclusions of the panel that produced a total increase in revenues of approximately $2,745,411, as shown below.

	Total Revenues	Rate Increase %	Rate Increase
Residential	$12,026,923	7.54%	$906,402
Commercial	9,180,456	7.54%	692,058
Industrial	3,169,070	5.89%	186,654
Other Public Authority	2,345,806	7.51%	176,180
Other Water Utility	856,218	7.51%	64,343
Private Fire Service	1,117,875	7.51%	84,006
Public Fire Service	256,049	248.25%	635,631
Total	**$28,952,397**	**9.48%**	**$2,745,274**
Revenue Deficiency			2,745,411
Difference			**-$137**

IT IS THEREFORE ORDERED THAT:

1. The Petition of Tennessee American Water Company is approved based upon the Authority's finding that a rate increase is warranted and that TAWC is entitled to a rate increase of $2,745,411.

2. The rate design, as set forth in Exhibit No. 3 of the evidentiary record, is adopted and shall be used to allocate $1,617,447 of the rate increase.

3. As to the remaining $1,127,964 of the rate increase, the amount of $563,982 shall be recovered directly from the City of Chattanooga through an increase to the fire hydrant rate.

[51] At the August 18, 2003 Authority Conference, Director Jones stated that he was not in agreement with a rate design that did not spread the $563,982 portion of the fire hydrant rate increase to be recovered from seven service categories "equally across all customer classes ratably . i.e , equal to all customers across the board " Transcript of Authority Conference, p. 10 (August 18, 2003)

The amount of $563,982 shall be recovered from each of the seven categories of service identified in Exhibit No. 3, using the same percentages for allocation as agreed by the parties for allocating the proposed rate increase of $1,617,447 in Exhibit No. 3.

4. The allocation of the total rate increase between the seven categories of services shall be as follows: (a) the residential, commercial, other public authority, other water utility and private fire service classes shall each be allocated an overall rate increase of 7.54 percent (7.54%); (b) the industrial service class shall be allocated an overall rate increase of 5.87 percent (5.87%); and (c) the public fire service class shall be allocated a rate increase of 248.44 percent (248.44%).

5. The tariff filed by Tennessee American Water Company on August 6, 2003, is in effect per the terms and conditions of that tariff.

6. Any party aggrieved by the Authority's decision in this matter may file a Petition for Reconsideration with the Authority within fifteen (15) days from the date of this Order.

7. Any party aggrieved by the Authority's decision in this matter has the right of judicial review by filing a Petition for Review in the Tennessee Court of Appeals, Middle Section, within sixty (60) days from the date of this Order.

* * *

Pat Miller, Director[52]

Sara Kyle, Director

Ron Jones, Director

[52] Director Miller declined to vote with the majority granting TAWC a revenue requirement in the amount of $2,745,411 00 for the reasons set forth in the *Dissent of Director Pat Miller* filed herewith Director Miller voted with the majority in approving the rate design as set forth above