

BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

June 10, 2008

IN RE:)
)
)
 PETITION OF TENNESSEE AMERICAN WATER) DOCKET NO.
 COMPANY TO CHANGE AND INCREASE CERTAIN) 06-00290
 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)

ORDER

TABLE OF CONTENTS

I.	TRAVEL OF THE CASE.....	1
A.	DISCOVERY ISSUES.....	2
B.	PROTECTIVE ORDERS	4
C.	REQUEST TO HOLD HEARING ON MERITS IN CHATTANOOGA.....	9
D.	PRE-HEARING MOTIONS.....	11
	1. TAWC'S MOTION TO STRIKE SUPPLEMENTAL TESTIMONY OF TERRY BUCKNER	11
	2. TAWC'S <i>MOTION IN LIMINE</i> TO EXCLUDE AS EVIDENCE HIGHLY CONFIDENTIAL MATERIALS.....	13
II.	THE HEARING AND POST-HEARING FILINGS.....	14
A.	HEARING OFFICER'S RULINGS ON <i>MOTION TO STRIKE</i> AND <i>MOTIONS IN LIMINE</i>	15
B.	POST-HEARING TESTIMONY AND FILINGS	19
III.	CRITERIA FOR ESTABLISHING JUST AND REASONABLE RATES	20
IV.	TEST PERIOD AND ATTRITION PERIOD	20
V.	CONTESTED ISSUES	21
	V(A). <u>REVENUES</u>	21

V(B).	EXPENSES	22
V(B)1.	GROWTH FACTOR	22
V(B)2.	SALARIES AND WAGES	24
V(B)3.	PURCHASED WATER.....	24
V(B)4.	FUEL AND POWER.....	25
V(B)5.	CHEMICALS	25
V(B)6.	WASTE DISPOSAL	25
V(B)7.	MANAGEMENT FEES.....	26
V(B)8.	GROUP INSURANCE	27
V(B)9.	PENSION EXPENSE	28
V(B)10.	REGULATORY EXPENSE	28
V(B)11.	INSURANCE OTHER THAN GROUP.....	29
V(B)12.	CUSTOMER ACCOUNTING	29
V(B)13.	UNCOLLECTIBLE EXPENSE	30
V(B)14.	RENT.....	31
V(B)15.	GENERAL OFFICE EXPENSE	31
V(B)16.	MISCELLANEOUS.....	32
V(B)17.	MAINTENANCE EXPENSE.....	33
V(B)18.	DEPRECIATION EXPENSE	33
V(C).	<u>TAXES AND FEES</u>	34
V(C)1.	GROSS RECEIPTS TAX.....	34
V(C)2.	TRA INSPECTION FEES	35
V(C)3.	PROPERTY TAXES.....	35
V(C)4.	FRANCHISE TAXES	36
V(C)5.	FICA TAX	36
V(C)6.	UNEMPLOYMENT TAX.....	37
V(C)7.	STATE EXCISE TAX	38
V(C)8.	FEDERAL INCOME TAX	38
V(C)9.	ALLOWANCE FOR FUNDS USED DURING CONSTRUCTION.....	38
V(D).	<u>NET OPERATING INCOME</u>	38
V(E).	<u>RATE BASE</u>	39
V(E)1.	UTILITY PLANT IN SERVICE.....	39
V(E)2.	CONSTRUCTION WORK IN PROGRESS.....	40
V(E)3.	UTILITY PLANT CAPITAL LEASE	40
V(E)4.	NET LIMITED-TERM UTILITY PLANT	41
V(E)5.	WORKING CAPITAL.....	41
V(E)6.	ACCUMULATED DEPRECIATION.....	41
V(E)7.	ACCUMULATED AMORTIZATION OF UTILITY CAPITAL LEASE.....	42

V(E)8.	ACCUMULATED DEFERRED INCOME TAXES.....	42
V(E)9.	CUSTOMER ADVANCES FOR CONSTRUCTION	42
V(E)10.	CONTRIBUTIONS IN AID OF CONSTRUCTION.....	42
V(E)11.	UNAMORTIZED INVESTMENT TAX CREDIT	42
V(F).	<u>REVENUE CONVERSION FACTOR</u>	43
V(G).	<u>RATE OF RETURN</u>	44
V(H).	<u>REVENUE DEFICIENCY</u>	47
V(I).	<u>RATE DESIGN</u>	48
ORDERING PARAGRAPHS		50

This matter came before Chairman Sara Kyle, Director Pat Miller and Director Ron Jones of the Tennessee Regulatory Authority (the “Authority” or “TRA”), the voting panel assigned to this docket, at a regularly scheduled Authority Conference held on May 15, 2007, for consideration of the *Petition* filed on November 22, 2006 by Tennessee American Water Company (“TAWC” or “the Company”) in which the Company seeks Authority approval to increase rates. Upon consideration of the entire record, including all exhibits and the testimony of the witnesses, a majority of the panel concluded that the Company had a Revenue Deficiency of \$4,079,865, which should be recovered through uniform increases to base rates and volumetric rates for all customer classes. These conclusions, as well as other decisions concerning the Revenues, Expenses, Taxes and Fees, Net Operating Income, Rate Base, Revenue Conversion Factor, and Rate of Return are fully discussed below.

I. TRAVEL OF THE CASE

On November 22, 2006, the Company filed its *Petition* in which it seeks approval by the Authority of proposed increased rates, alleging that “[t]he Company’s existing rates and charges will not provide, and cannot be made to provide, sufficient revenues to cover all the costs incurred in providing adequate quality water service including its cost of capital.”¹ The Company sought to put into effect “customer rates that will produce an overall rate of return of 8.466% on a rate base of \$100,583,193.”² According to TAWC, the additional gross revenues would be approximately \$6,379,887.³ At a regularly scheduled Authority Conference held on December 4, 2006, the panel voted unanimously to convene a contested case proceeding and to appoint General Counsel or his designee as Hearing Officer for the purpose of preparing this matter for hearing, including handling preliminary matters and establishing a procedural schedule to completion.

¹ *Petition* at 2 (November 22, 2006).

² *Id.* at 5.

³ *Id.*

On December 12, 2006, the Consumer Advocate and Protection Division of the Office of the Attorney General (“CAPD” or “Consumer Advocate”) filed a *Petition to Intervene*. No objection or opposition to the *Petition to Intervene* was filed. On December 21, 2006, the Hearing Officer entered an Order granting the Consumer Advocate’s *Petition to Intervene* and setting an initial Status Conference for January 8, 2007. The City of Chattanooga (“Chattanooga” or “the City”) and Chattanooga Manufacturers Association (“CMA”) filed petitions to intervene on December 28 and December 29, 2006, respectively. During the Status Conference held on January 8, 2007, the Hearing Officer granted the intervention petitions of Chattanooga and CMA, addressed the parameters of discovery and considered several procedural schedules proposed by the parties. Thereafter, the Hearing Officer established a Procedural Schedule which called for discovery to commence on January 22, 2007 and included a Hearing date of the week of April 16, 2007. On January 19, 2007, the Hearing Officer entered the Protective Order which had been agreed upon by the parties.

A. Discovery Issues

The parties commenced discovery in accordance with the Procedural Schedule. Objections to discovery were filed and motions to compel discovery followed. A second Status Conference was held on February 9, 2007 to resolve discovery disputes. The parties reached agreements during the Status Conference concerning most of the discovery requests in dispute. The Hearing Officer heard oral arguments from the parties regarding the motions to compel discovery seeking information and materials pertaining to an Initial Public Offering (“IPO”) which had come to light in the Company’s petition filed in another TRA matter, Docket No. 06-00119.⁴

In objecting to certain discovery requests regarding the IPO, TAWC argued that the action of the Authority in TRA Docket No. 06-00119 resolved all issues relating to the IPO, and therefore, the

⁴ See *In re: Petition of Tennessee-American Water Company for Approval of Change of Control*, Docket No. 06-00119, *Petition* (April 21, 2006).

IPO was not relevant to the rate case. Chattanooga responded to TAWC's objections by asserting that the discovery requests relating to the IPO were reasonably calculated to discover whether the cost of capital and cost of equity of TAWC would be adversely affected or impacted by the IPO. Chattanooga contended that, because RWE Aktiengesellschaft ("RWE") is the ultimate parent of TAWC and the opinions of RWE could affect its subsidiary, RWE's view of the value of TAWC, and other elements of the American Water Works Company's ("AWWC") system, as well as RWE's conclusions regarding rates of return, were relevant to the subject matter of this proceeding.

During the Status Conference, the Hearing Officer ruled on discovery not involving the IPO.⁵ After taking under advisement the discovery requests, objections and motions to compel pertaining to the IPO, the Hearing Officer issued a separate order regarding those discovery issues on March 1, 2007.⁶ Because of the sensitive nature of certain information to be produced by the Company related to the IPO, the Hearing Officer entered a *Supplemental Protective Order* in conjunction with the March 1, 2007 *Order Granting Motions to Compel Discovery Relating to Initial Public Offering (IPO) Information and Materials* ("Order Compelling Discovery").

In the *Order Compelling Discovery*, the Hearing Officer found that information concerning transactions occurring at the parent level or between a parent and its subsidiary may be relevant to the subject matter of a rate case proceeding and that this would be particularly true when a subsidiary's capital structure is potentially impacted by decisions of the parent. For these reasons, the Hearing Officer determined, as relevant and reasonable, discovery of information and documentation relating to whether and to what extent the anticipated IPO of TAWC's parent company may impact or affect the Company's rates, policies, service, operations, financing, and other matters impacting the public interest.

⁵ See *Order Resolving, in Part, Objections to Discovery Requests* (February 15, 2007).

⁶ *Order Granting Motions to Compel Discovery Relating to Initial Public Offering (IPO) Information and Materials* (March 1, 2007).

A *Second Modified Procedural Schedule* issued on March 1, 2007 provided for a second round of discovery to commence on March 14, 2007 and set another Status Conference to consider outstanding motions, objections to discovery and other pre-hearing matters. That Status Conference was convened on March 23, 2007, and was concluded on March 27, 2007 due to the considerable number of pending motions, objections and other matters to be considered. Additional discovery disputes were addressed at the Pre-Hearing Conference held on April 12, 2007.

B. Protective Orders

The *Supplemental Protective Order*, issued on March 1, 2007, provided an enhanced level of protection for certain information and documentation, including documents filed with the Securities and Exchange Commission, designated as “Highly Confidential Information,” which might be produced pursuant to the *Order Compelling Discovery*. The *Supplemental Protective Order* required a party receiving Highly Confidential Information to execute a Nondisclosure Statement in advance of obtaining copies of the production.

On March 8, 2007, TAWC filed certain documentation in compliance with the *Order Compelling Discovery*, pending execution of Nondisclosure Statements by the parties, in accordance with the *Supplemental Protective Order*. Nondisclosure Statements were signed and filed by counsel for CMA and counsel for the City on March 12 and March 14, 2007, respectively. The Consumer Advocate declined to execute the Nondisclosure Statement and instead, on March 9, 2007, filed *Consumer Advocate’s Motion to Reconsider Supplemental Protective Order, or in the Alternative, for Interlocutory Review by the Tennessee Regulatory Authority*. The City joined in that motion on March 14, 2007. In response to the attempts to modify the protections afforded certain information through the *Supplemental Protective Order*, TAWC filed *Tennessee American Water Company’s Emergency Motion for Stay of Order Granting Motions to Compel Discovery Relating to Initial Public Offering Information and Materials or, in the Alternative, for Emergency Interlocutory Review*

by the Tennessee Regulatory Authority on March 16, 2007. TAWC also filed, on March 22, 2007, *Tennessee American Water Company's Emergency Motion for Stay of Any Order Materially Altering the Supplemental Protective Order or, in the Alternative for Emergency Interlocutory Review by the Tennessee Regulatory Authority.*

At the March 23, 2007 Status Conference, the Consumer Advocate and the Company put forth their respective positions regarding whether the *Supplemental Protective Order* should remain in effect. Initially, the Consumer Advocate questioned the authority of the Hearing Officer to designate certain documentation as Highly Confidential Information. The Consumer Advocate argued that the original *Protective Order* was sufficient for the production of confidential or commercially sensitive information in this docket.

The Consumer Advocate argued further that the nondisclosure requirement in the *Supplemental Protective Order* should not apply to the Attorney General or certain members of that office because such a requirement would improperly restrict the Attorney General in the performance of the duties of that position. The Consumer Advocate also raised the question of whether executing the nondisclosure statement would in some way remove the immunity that is provided to state officers and employees for liability for acts or omissions within the scope of the officer's or employee's employment with the state of Tennessee as provided for in Tenn. Code Ann. § 9-8-307(h). The Company expressed concern that if the nondisclosure requirement was not applied to all persons in the Attorney General's Office, then the *Supplemental Protective Order* would not provide the enhanced protection that must be in place to allow the Company to produce the Highly Confidential Information.

The Hearing Officer initially found that because of the nature of Highly Confidential Information being produced through discovery in this case, a need existed for a supplemental

protective order that would provide enhanced protection.⁷ The Hearing Officer directed the parties, at the conclusion of the proceedings on March 23, 2007, to work together to propose specific language for the *Supplemental Protective Order* based upon the particular findings of the Hearing Officer.

Upon reconvening the Status Conference on March 27, 2007, the Consumer Advocate and the Company each provided to the Hearing Officer a separate proposed amended protective order and stated that they could not reach an agreement on certain language to be included therein. In the absence of an agreed amended order, the Hearing Officer proceeded to rule on the Consumer Advocate's specific objections to the *Supplemental Protective Order* raised in the reconsideration motion and on other pending motions filed by the parties relating to the production of Highly Confidential Information.

Addressing the Consumer Advocate's initial challenge, the Hearing Officer reaffirmed that the authority of a hearing officer to designate or rule upon a designation of Highly Confidential Information pursuant to the process set forth in the *Protective Order* and *Supplemental Protective Order* is established in the Tennessee Administrative Procedures Act⁸ and the procedural rules of the TRA.⁹ The Hearing Officer also reaffirmed the distinction that exists between the Highly Confidential Information requested in this matter, and the customary confidential information, such as trade secret or commercially sensitive information, which is generally filed with the TRA and adequately protected under standard protective orders.

The Consumer Advocate argued that, in issuing the *Supplemental Protective Order*, the TRA would be creating an exception to the Public Records Act. The Hearing Officer pointed out that the

⁷ The Hearing Officer noted that the Highly Confidential Information involves information, which if provided to the public or to persons not a part of this lawsuit, could result in violations of and perhaps prosecution under federal law.

⁸ Tenn. Code Ann. § 4-5-301 *et seq.*

⁹ Tenn. Comp. R. & Regs. 1120-1-2-.11

General Assembly expressly provided for exceptions to the requirement of producing records under the Public Records Act.¹⁰ Specifically, the Tennessee Rules of Civil Procedure qualify as a statutory exception to the Public Records Act, and protective orders, entered pursuant to the Tennessee Rules of Civil Procedure, are recognized as valid and proper exceptions to the Public Records Act. Inasmuch as the Tennessee Rules of Civil Procedure apply to the TRA through the Tennessee Administrative Procedures Act, and the proceedings in this docket are governed by the Tennessee Administrative Procedures Act, the protective orders entered in this docket pursuant to Tenn. Code Ann. § 4-5-311 constitute a valid exception to the Public Records Act.

The Consumer Advocate also expressed a concern that under the *Supplemental Protective Order* the Attorney General would be required to execute and be subject to the terms of a nondisclosure agreement. The parties discussed at length the role of the Attorney General when the Consumer Advocate appears as a party before the Tennessee Regulatory Authority. Counsel for the Consumer Advocate pointed out that the investigative role of the Attorney General, which exists apart from the Consumer Advocate and Protection Division, may be hampered if the Attorney General and certain members of that office are required to execute a nondisclosure agreement.

Based upon the statements made by the Consumer Advocate, the Hearing Officer determined that language would be inserted into the *Supplemental Protective Order* that would distinguish the roles of the Attorney General and would not require the Attorney General or persons in the Attorney General's Office, outside of the Consumer Advocate and Protection Division, to execute the Nondisclosure Statement. Nevertheless, any member of the Attorney General's Office would remain subject to the terms of the *Protective Order* that was entered initially on January 19, 2007. The Hearing Officer also modified the *Supplemental Protective Order* to include additional language addressing TAWC's concern regarding public records requests directed to the Attorney General's

¹⁰ Tenn. Code Ann. § 10-7-503(a).

Office. The Hearing Officer did not find merit in the Consumer Advocate's argument that the *Supplemental Protective Order* requires members of the Attorney General's Office to enter into a confidentiality agreement in contradiction to the Public Records Act. Tenn. Code Ann. § 65-4-118(d) specifically permits the Consumer Advocate to enter into agreements that would protect confidential information and trade secrets.¹¹

The Hearing Officer also determined that language should be inserted into the *Supplemental Protective Order* to address the issue regarding whether or not immunity for state officers and employees under Tenn. Code Ann. § 9-8-307(h) would be jeopardized. The revised language provided that common law and statutory defenses available to state officers and employees would remain intact and would not be affected by the *Supplemental Protective Order*.

Based on the foregoing determinations, the Hearing Officer denied the Consumer Advocate's request that the *Supplemental Protective Order* be vacated but modified certain portions of the *Supplemental Protective Order* to provide clarifying language and define the scope of the Nondisclosure Statement. Because of the modifications, the Hearing Officer also denied the Consumer Advocate's request for an interlocutory review of the *Supplemental Protective Order*.

Based on the denial of the Consumer Advocate's request to vacate the *Supplemental Protective Order* and finding no new grounds upon which to reconsider the decision that the IPO information was relevant to discovery, the Hearing Officer denied TAWC's *Motion to Reconsider Order Compelling Discovery*. The Hearing Officer also determined that because the protections under the *Supplemental Protective Order* would remain in place, TAWC's *Motion to Stay Order Compelling Discovery* also should be denied. Based upon the rulings regarding the Consumer Advocate's motions regarding the *Supplemental Protective Order*, TAWC agreed at the March 27, 2007 Status Conference that its motion asking the Hearing Officer to stay any order that might be

¹¹ Tenn. Code Ann. § 65-4-118(d) provides: "The consumer advocate division may enter into agreements regarding the nondisclosure of trade secrets or other confidential commercial information obtained by the division."

entered that would materially alter the terms of the *Supplemental Protective Order* had been rendered moot. On March 31, 2007, the Hearing Officer entered an *Amended Supplemental Protective Order* which acknowledged the need to afford enhanced protection to certain documentation and information and which incorporated the modifications determined by the Hearing Officer.

C. Request to Hold Hearing on Merits in Chattanooga

On December 29, 2006, CMA filed a Request to hold the hearing on the merits of this rate case in Chattanooga. CMA asserted in its Request that the Company's proposed rate increase would have an adverse effect on "citizens, residents and ratepayers throughout the Chattanooga area"¹² and that "[a] change of venue will enhance substantially any interested ratepayers' opportunity to be heard."¹³ TAWC issued a statement in opposition to CMA's request on January 5, 2007, arguing against the Request primarily on the basis of the inconvenience and cost of holding the hearing in a location other than Nashville. TAWC maintained that Nashville would be the best location for the hearing because,

(1) it is the location of the offices, staff, and resources of the TRA, (2) it is the location of the attorneys for the Petitioner, (3) it is the location of the majority of the attorneys for the Intervenors, (4) it is the most convenient location for the witnesses of the Petitioner, and (5) it best serves the interests of justice.¹⁴

CMA's Request was addressed during the Status Conference held on January 8, 2007, when the Hearing Officer heard oral arguments from the parties.

The Consumer Advocate stated during the January 8, 2007 Status Conference that it did not oppose the Request to hold the hearing in Chattanooga. The City supported CMA's Request, and on January 10, 2007, the City filed its own Request to hold the hearing in Chattanooga.¹⁵ In its Request, filed on behalf of the Mayor of the City of Chattanooga, the City stated:

¹² *Chattanooga Manufacturers Association's Request that Contested Case Hearing be Conducted in Chattanooga, Tennessee*, p. 1 (December 29, 2006).

¹³ *Id.* at 2.

¹⁴ *Id.* at 3.

¹⁵ *City of Chattanooga's Request that Contested Case Hearing be Conducted in Chattanooga, Tennessee* (January 10, 2007).

. . . holding a hearing in this matter in Chattanooga presents an educational opportunity for the TRA and the citizens of southeast Tennessee. . . . Although the activities of the TRA that have a peculiar local impact may be reported in the local paper, and, occasionally in other media outlets, it is reasonable to assume in that holding a hearing in Chattanooga will provide a vehicle for educating the public about the purpose and role of the TRA.¹⁶

TAWC filed its Supplemental Statement in opposition to the requests of the City and CMA on January 11, 2007.¹⁷ In its Supplemental Statement, the Company favored a public input meeting in Chattanooga as opposed to holding the entire hearing on the merits in Chattanooga which, according to the Company, would “. . . cause a costly, unnecessary, and unjustified burden on Chattanooga ratepayers and state taxpayers.”¹⁸

The Hearing Officer ruled on the Requests, finding that the TRA is not restricted by statute or rule in setting the location of meetings and hearings. Tenn. Code Ann. § 65-1-103(a) permits the Authority to hold sessions

. . . at such times and places as may be necessary for the proper discharge of their duties, or as the convenience of the parties, in the judgment of the Tennessee regulatory authority, may require.

TRA Rule 1220-1-1-.06 further expressly permits the Authority to conduct public hearings at locations other than Nashville, Tennessee, upon the Authority’s own motion or upon the motion of a party, as the Authority may deem appropriate.

In granting the Requests of CMA and the City, the Hearing Officer determined that

A Chattanooga location would afford ratepayers of the Company a ready opportunity to observe the hearing and become better educated concerning the ratemaking process. Ratepayers could actually participate in the process by offering public comments during the hearing. It is reasonable to assume that the costs associated with travel to and lodging, if necessary, in Nashville would prevent many ratepayers from attending and participating in a public hearing in Nashville.¹⁹

¹⁶ *Id.* at 1.

¹⁷ *Supplemental Statement of Tennessee American Water Company in Opposition to Chattanooga Manufacturers Association’s and City of Chattanooga’s Request that Contested Case Hearing be Conducted in Chattanooga, Tennessee* (January 11, 2007).

¹⁸ *Id.* at 1.

¹⁹ *Order Setting Hearing on the Merits in Chattanooga, Tennessee*, p. 6 (March 9, 2007).

The Hearing Officer concluded that conducting the hearing in Chattanooga would be in the public interest and that the costs involved “must be weighed against the benefits of holding the hearing in a location where interested members of the public, particularly ratepayers, have an opportunity to participate in the process.”²⁰ In addition, the Hearing Officer cited the City’s participation in this docket and its express request to hold the hearing in Chattanooga as significant factors in determining the location of the hearing.

D. Pre-Hearing Motions

1. TAWC’s Motion to Strike Supplemental Testimony of Terry Buckner

The Company filed its Direct Testimony with the *Petition* on November 22, 2006. The Intervenors filed Direct Testimony on March 5, 2007. On April 9, 2007, the Company filed its Rebuttal Testimony. After the close discovery, the Consumer Advocate filed *Supplemental Revised Direct Testimony of Michael D. Chrysler* and *Supplemental Direct Testimony of Terry Buckner* on April 3, 2007. The Consumer Advocate also filed *Supplemental Direct Testimony of Steve Brown* on April 9, 2007.

A portion of Mr. Buckner’s supplemental testimony raised for the first time in the proceeding an issue regarding TAWC’s Enterprise Customer Information System (“E-CIS”) asserting that it would be improper to include the E-CIS costs in the rate base. Mr. Buckner relied upon a 2004 decision by the Indiana Utility Regulatory Commission (“IURC”) in testifying that the Authority should remove the E-CIS costs from TAWC’s rate base.²¹ The Company filed a *Motion to Strike from the Record and/or to Exclude as Evidence the Supplemental Direct Testimony of Terry Buckner Related to the Tennessee American Water Company’s Customer Information System* (“*Motion to Strike*”) on April 5, 2007. The Consumer Advocate filed its response to the *Motion to Strike* on April 11, 2007.

²⁰ *Id.* at 6.

²¹ In his supplemental testimony, Mr. Buckner relied upon his own interpretation of decisions of the Indiana Utility Regulatory Commission and the Indiana Court of Appeals in testifying that TAWC’s rate base for E-CIS should be reduced by over one million dollars. Supplemental Direct Testimony of Terry Buckner, pp. 3-4 (April 3, 2007).

In its *Motion to Strike*, TAWC asserted that there was no justifiable reason for the Consumer Advocate to file Mr. Buckner's supplemental testimony one month after the pre-filed testimony of the Intervenors was required to be filed in accordance with the Procedural Schedule. According to TAWC, the Consumer Advocate was aware of the E-CIS costs and of the IURC decision regarding E-CIS for over two years and, in fact, had agreed with TAWC's rate base calculation in an earlier TAWC rate case, Docket No. 04-00288, which had included costs related to the E-CIS. TAWC argued that it had been prejudiced by the late insertion of the E-CIS issue in the proceeding and asked the Hearing Officer to strike and exclude as evidence only those portions of Mr. Buckner's supplemental testimony which raised the E-CIS cost issue and which provided changes to the Consumer Advocate's Rate Base and Depreciation Expense calculations.

The Consumer Advocate asserted in its response to the *Motion to Strike* that the significance of the IURC's E-CIS decision was not discovered by Mr. Buckner until after his direct testimony was filed on March 5, 2007. The Consumer Advocate asserted further that because the Company actually responded to the E-CIS issue in Michael Miller's rebuttal testimony filed on April 9, 2007, TAWC had sufficient time to present its position on the issue.

The Company and the Consumer Advocate presented oral argument on the *Motion to Strike* at the Pre-Hearing Conference held on April 12, 2007. There was no motion or request to strike or exclude the supplemental pre-filed testimony of Michael Chrysler or Dr. Steve Brown or those portions of Terry Buckner's supplemental testimony which did not relate to the E-CIS costs. The Hearing Officer took the *Motion to Strike* under advisement. Following the Pre-Hearing Conference, the *Consumer Advocate's Motion to Allow Supplemental Testimony* ("*Motion*") was filed on April 13, 2007. On April 16, 2007, the Company filed *Tennessee American Water Company's Response to Consumer Advocate's Motion to Allow Supplemental Testimony*. The Consumer Advocate's *Motion*, as well as the *Motion to Strike* were addressed by the Hearing Officer at the commencement of Hearing on April 17, 2007.

2. TAWC's *Motions in Limine* to Exclude as Evidence Highly Confidential Materials

On April 11, 2007, TAWC filed two motions *in limine* which sought to exclude or limit the introduction into evidence certain documentation classified as Highly Confidential Information. Those motions were: *Tennessee American Water Company's Motion in Limine to Exclude as Inadmissible Evidence Related to the Initial Public Offering of American Water Works Company* ("Motion to Exclude IPO Documents") and *Tennessee American Water Company's Motion in Limine to Exclude as Inadmissible All Highly Confidential RWE Presidium and Supervisory Board Minutes* ("Motion to Exclude RWE Minutes"), (collectively, "TAWC's *Motions in Limine*").

In its *Motion to Exclude IPO Documents*, TAWC argued that materials related to the IPO of AWWC were not relevant to the rate case and that admission of such materials would cause confusion and result in unfair prejudice to TAWC. The Company asserted in the *Motion to Exclude RWE Minutes* that the minutes were irrelevant to this rate case, highly confusing and prejudicial, and constituted inadmissible hearsay. In addition to these grounds, TAWC argued that the Intervenor should not be permitted to use Highly Confidential materials at the time of the Hearing because they had failed to designate such materials in accordance with the *Amended Supplemental Protective Order*.

Oral argument on TAWC's *Motions in Limine* was heard during the Pre-Hearing Conference on April 12, 2007. Nevertheless, because of the filing of those motions so close in time to the convening of the Pre-Hearing Conference, the Hearing Officer permitted the Intervenor to file written responses after the Pre-Hearing Conference. On April 16, 2007, the following filings were made in response to TAWC's *Motions in Limine*: *Consumer Advocate's Response to Tennessee American Water Company's Motion in Limine to Exclude as Inadmissible Evidence Related to the Initial Public Offering of American Water Works*; *Chattanooga Manufacturers Association's Reply to Petitioner's Response Concerning Notice as to Materials Designated by Petitioner as Highly Confidential Information* and *CMA's Response to Petitioner's Motion in Limine Seeking to Exclude*

All But the Materials Designated as Highly Confidential That Petitioner Deems to be Relevant for This Hearing; and City of Chattanooga's Response to TAWC's Motions Relating to Identification and Use of Documents Designated by TAWC as "Highly Confidential Information."

In their filings, the Intervenor asserted that because the IPO would have an effect on the ability of AWWC to invest in TAWC and because the amount of equity that may flow from the IPO is a variable unknown and based on market conditions, the IPO would be relevant to this matter and information related to the IPO should be available to the TRA in considering the rate increase request of TAWC. In addition, the Intervenor argued that the IPO documents should be admitted for use in an analysis of the Company's capital structure and for the purpose of impeaching TAWC's expert witnesses.

The Intervenor also argued that the designation procedure in the *Amended Supplemental Protective Order* should not interfere with or violate the parties' due process rights in terms of impeding their ability to conduct effective cross-examination of TAWC's witnesses. The Intervenor asserted that requiring them to identify with specificity before the Hearing those Highly Confidential materials which they may use to cross-examine and impeach a witness would intrude upon their attorney work product privilege and impair the presentation of their cases by forcing them to reveal their case strategy. The Intervenor proposed that objections as to the admissibility of documents could be resolved during the Hearing at the time such documents are proffered without the necessity of disclosing the mental impressions or case strategy of the Intervenor's attorneys. In light of the written responses of the Intervenor being filed on April 16, 2007, additional oral argument on TAWC's *Motions in Limine* was held at the commencement of the Hearing on April 17, 2007.

II. THE HEARING AND POST-HEARING FILINGS

The Hearing in this matter was held in Chattanooga, Tennessee, before the voting panel on April 17 through 20, 2007. The Hearing concluded in Nashville on April 26, 2007. Participating in the Hearing were the following parties and their respective counsel:

Tennessee American Water Company – R. Dale Grimes, Esq. and Ross I. Booher, Esq., Bass, Berry & Sims, PLC, 315 Deaderick Street, Suite 2700, Nashville, TN 37238-3001.

Consumer Advocate and Protection Division - Vance Broemel, Esq. and Stephen R. Butler, Esq., Office of the Attorney General, 425 5th Ave. N, John Sevier Building, P.O. Box 20207, Nashville, TN 37202.

City of Chattanooga, Tennessee – Michael A. McMahan, Esq., Office of the City Attorney, 801 Broad Street, Suite 400, Chattanooga, TN 37402.; and **Frederick L. Hitchcock, Esq.,** Chambliss, Bahner & Stophel, P.C., 1000 Tallan Building, Two Union Square, Chattanooga, TN 37402.

Chattanooga Manufacturers Association (CMA) – Henry M. Walker, Esq., Boulton, Cummings, Conners & Berry, PLC, 1600 Division Street, Suite 700, P.O. Box 340025, Nashville, TN 37203; and **David C. Higney, Esq.,** Grant, Konvalinka & Harrison, P.C., 9th Floor, Republic Centre, 633 Chestnut Street, Chattanooga, TN 37450-0900.

The Hearing convened on April 17, 2007, at which time members of the public presented comments pertaining to the quality of water service provided by TAWC and TAWC's request for a rate increase.²²

A. Hearing Officer's Rulings on *Motion to Strike* and *Motions in Limine*

Following the presentation of public comments, the Hearing Officer heard from the parties additional oral argument regarding TAWC's *Motion to Strike* and *Motions in Limine* and the Intervenor's responses to those motions. The Hearing Officer also heard argument on the Consumer Advocate's motion to permit it to file the supplemental testimony of Terry Buckner. Thereafter, the Hearing Officer ruled on the pending motions in the following manner.

The Hearing Officer pointed out that the Consumer Advocate filed its *Motion to Allow Supplemental Testimony* on April 13, 2007, after the April 12 Pre-Hearing Conference during which the parties argued TAWC's *Motion to Strike*. Procedurally, the Hearing Officer found that the Consumer Advocate's *Motion*, was untimely filed because the supplemental testimony of Mr. Buckner had already been filed ten days earlier and argument on TAWC's *Motion to Strike* had already commenced.

²² Transcript of Public Hearing, pp. 8-30 (April 17, 2007).

As to TAWC's *Motion to Strike*, the Hearing Officer noted that the Company requested that the Hearing Officer strike only a portion of Mr. Buckner's supplemental testimony. The supplemental testimony of Mr. Buckner was filed significantly outside the time frame provided for in the procedural schedule, as was the supplemental testimony of Mike Chrysler and Dr. Steven Brown. Nevertheless, there was no motion to strike the supplemental testimony of either of those witnesses. Thus, it appeared that TAWC's claim of unfairness caused by the untimely filing of Mr. Buckner's supplemental testimony was linked to TAWC's argument of prejudice or harm resulting from the Consumer Advocate's delay in raising the E-CIS cost issue.

The Hearing Officer found that the Company's objections to Mr. Buckner's supplemental testimony boiled down to two major points. First, Mr. Buckner's testimony belatedly injected a new issue into the proceeding, thereby preventing TAWC from being able to adequately address the issue or rebut the testimony. Second, Mr. Buckner's interpretation of the IURC's decision was incorrect and misleading.

Mr. Buckner stated, at page 3 of his supplemental testimony, "In Cause Number 42520, the Indiana Utility Regulatory Commission, IURC, found the E-CIS to be 'an imprudent decision.'"²³ From a review of the IURC's decision, the Hearing Officer concluded that Mr. Buckner's interpretation and testimony regarding the IURC decision was incorrect.²⁴ Because it was clear to the Hearing Officer that the IURC did not find the inclusion of E-CIS to be "an imprudent decision," the Hearing Officer struck that portion of Mr. Buckner's testimony relating to the IURC decision. Mr. Buckner was permitted to testify regarding E-CIS, but he could not rely upon the IURC decision for his conclusions. The Hearing Officer determined that Mr. Buckner's conclusions regarding the E-CIS costs would have to be based on his own analysis and assessment, and if there was no

²³ Supplemental Direct Testimony of Terry Buckner, p. 3 (April 3, 2007).

²⁴ In addition, the Hearing Officer determined that the IURC decision should not have been raised in this proceeding through Mr. Buckner's testimony. Instead, it is the role of an attorney to argue the interpretation of the case law and its applicability to the facts of a particular case.

independent basis, such would go to the weight of his testimony. As to the remaining portions of Mr. Buckner's testimony, the Hearing Officer allowed that testimony to stand.

The Hearing Officer stated that the late discovery of the issue and failure to raise the issue earlier in the proceeding could be bases for discrediting the testimony of Mr. Buckner on cross examination. The Hearing Officer further determined that, because of the lateness of the Consumer Advocate's filing which raised the new issue, TAWC would be permitted to address the E-CIS issue either in its direct case or after cross examination of Mr. Buckner. TAWC was permitted to rebut Mr. Buckner's testimony through testimony of its own witnesses during the Hearing. Those portions of Mr. Buckner's testimony not related to the E-CIS issues were not stricken because they were not included in TAWC's *Motion to Strike*.

The Hearing Officer found two major issues were raised by TAWC's *Motions in Limine*. First, there was the substantive issue of the relevancy of the Highly Confidential documents sought to be used. Second, there was a procedural issue regarding whether the Intervenors should be prohibited from using certain documents because of a failure to identify with specificity in advance of the Hearing the documents the Intervenors intended to use during the Hearing.

TAWC's *Motions in Limine* were based in part on the Company's argument that the documentation and information in question were not relevant to the issues in this case. The Authority may exclude irrelevant and immaterial evidence. Nevertheless, Tenn. Code Ann. § 4-5-313 provides,

In contested cases: (1) the agency shall admit and give probative effect to evidence admissible in a court, and when necessary to ascertain facts not reasonably susceptible to proof under the rules of court, evidence not admissible thereunder may be admitted if it is of a type commonly relied upon by reasonably prudent men in the conduct of their affairs. The agency shall give effect to the rules of privilege recognized by law and to agency statutes protecting the confidentiality of certain records, and shall exclude evidence which in its judgment is irrelevant, immaterial or unduly repetitious[.]

The Hearing Officer concluded that the Tennessee Rules of Evidence can be applied to contested cases before the Authority and that under the Rules of Evidence, in order for evidence to be relevant, the evidence must satisfy two criteria. First, the evidence must have the “tendency to make the existence of any fact . . . more probable or less probable than it would be without the evidence,” and second, evidence must be material, that is, the fact sought to be proven must be “of consequence to the determination of the action.”²⁵ “Evidence offered in a cause, or a question propounded, is material when it is relevant and goes to the substantial matters in dispute, or has a legitimate and effective influence or bearing on the decision of the case.”²⁶ The Hearing Officer found that the Highly Confidential Information was relevant to the issues to be decided in this rate case and denied TAWC’s *Motions in Limine* on the grounds that it appeared that the subject matter of the certain documents was relevant to the issues in this case and would be admissible in the proceeding, in the least for use as impeachment materials during cross examination of witnesses.

The procedural issue raised by TAWC involved whether the Intervenors could be required to specify Highly Confidential Information or documents which they intended to rely upon during the Hearing. The Hearing Officer did not find that the parties were in error in failing to specify a particular document or particular documents that they intended to rely upon in their cross examination of the witnesses. To require the Intervenors to reveal, in advance of the cross examination of a witness, those specific documents that would be used in the cross-examination would be encroaching upon the mental impressions of the attorney in the preparation of the case.²⁷ The Hearing Officer proceeded to rule that the Intervenors could use Highly Confidential Information in their cross examination of the witnesses. Nevertheless, because of the situation

²⁵ Tennessee Rules of Evidence 401.

²⁶ Black’s Law Dictionary, Third Edition (1933), p. 1168, “Material” citing *Connecticut Fire Ins. Co. of Hartford, Conn. v. George*, S2 Okl. 432, 153 pp. 116, 119.

²⁷ Tenn. R. Civ. P. 26 provides that “. . . the court shall protect against disclosure the mental impressions, conclusions, opinions, or legal theories of any attorney or other representative of a party concerning the litigation.”

existing during the Hearing, where certain persons would be either attending or participating in some fashion in the Hearing who have not executed nondisclosure statements, the Hearing Officer determined that persons who had not executed nondisclosure statements must not be present during testimony involving the Highly Confidential Information.

B. Post-Hearing Testimony and Filings

During the Hearing, the panel heard further argument from the parties as to the extent, if any, that Mr. Buckner should be permitted to testify regarding the E-CIS costs. These arguments were raised in the course of objections to specific questions presented to witnesses and in the context of TAWC's appeal to the panel of the Hearing Officer's ruling striking a part of Mr. Buckner's supplemental testimony. The panel determined that the scope of the questions regarding the E-CIS costs would be determined as objections to specific questions were raised. In addition, in upholding the Hearing Officer's ruling and permitting Mr. Buckner to testify regarding any independent basis for his conclusions regarding E-CIS, the panel determined that the Company could submit additional testimony on the E-CIS. Because TAWC's additional testimony would be submitted after the conclusion of the Hearing, the Intervenors were permitted to take the depositions of the Company's witnesses on the E-CIS issue. Thereafter, the parties would submit briefs to the panel on the question of whether TAWC's costs related to the E-CIS were recoverable in this rate case.

TAWC filed the testimony of A. Joseph Van Den Berg and John S. Watson on April 26, 2007 to present the Company's position on inclusion of the E-CIS costs. The Intervenors took the depositions of Mr. Van Den Berg and Mr. Watson on May 4, 2007.

The parties filed briefs addressing the E-CIS cost issue on May 9, 2007. With the filing of additional testimony, the taking of depositions and the submission of post-hearing briefs, the panel proceeded to deliberate this case at a regularly scheduled Authority Conference held on May 15, 2007.

III. CRITERIA FOR ESTABLISHING JUST AND REASONABLE RATES

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.²⁸ The Authority must also approve rates that provide regulated utilities the opportunity to earn a just and reasonable return on their investments.²⁹

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.

Applying these criteria, and upon consideration of the entire record, including all exhibits and the testimony of the witnesses, the panel made the following findings and conclusions.

IV. TEST PERIOD AND ATTRITION PERIOD

In a rate case the Authority must, as a preliminary determination, decide which test period is appropriate. The purpose in the selection of a test period is to provide an indication of the rate of return that is likely to be produced under the existing rate structure in the reasonably foreseeable future. The test period takes into consideration the estimated effect of reasonably expected revenues, expenses and investments.

The Company selected a historical test period of the twelve months ended June 30, 2006 and an attrition period of the twelve months ending February 29, 2008. The Company made normalizing adjustments to the test period as well as additional adjustments to forecast attrition period results.³⁰

²⁸ Tenn. Code Ann. § 65-5-201 (Supp. 2002).

²⁹ 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).

³⁰ Sheila A. Miller, Pre-filed Direct Testimony, p. 4 (November 22, 2006).

The CAPD used a test period of the twelve months ended December 31, 2006 for Revenues.³¹ The CAPD used a test period of the twelve months ended October 31, 2006 for the majority of Operations and Maintenance Expenses.³² For labor related expenses, the CAPD adopted the Company's actual employee level as of January 31, 2007.³³ The CAPD forecast for Plant in Service and Accumulated Depreciation was based on actual balances at December 31, 2006 plus monthly additions and retirements as provided by the Company. The attendant depreciation expense was calculated upon the resulting balances.³⁴ Like the Company, the CAPD used an attrition period of the twelve months ending February 29, 2008.³⁵

The panel rejected the multiple test periods utilized by the CAPD to forecast Revenues and Expenses and accepted the Company's uniform test period of the twelve months ended June 30, 2006 for Revenues and Expenses, except in the instance of Insurance Other Than Group where abnormal monthly bookings were noted. Further, the panel voted to accept the test period of the twelve months ended June 30, 2006 for Rate Base components to which the Company and the CAPD agree in their projections. For Rate Base components to which there was dispute among the Parties, the panel adopted the actual average thirteen month ending balances at December 31, 2006. Finally, the panel voted to adopt the forward looking attrition period of the twelve months ending February 29, 2008.

V. CONTESTED ISSUES

The position of the parties and the determinations of the voting panel are set out below for each of the following contested issues: Section V(a) - Revenues, Section V(b) - Expenses, Section V(c) - Taxes and Fees, Section V(d) - Net Operating Income, Section V(e) - Rate Base, Section V(f) - Revenue Conversion Factor, Section V(g) - Rate of Return, Section V(h) - Revenue Deficiency, and Section V(i) - Rate Design.

³¹ Michael D. Chrysler, Pre-filed Supplemental Revised Direct Testimony, un-numbered p. 1 (April 3, 2007).

³² Terry Buckner, Pre-filed Direct Testimony, p. 12 (March 5, 2007).

³³ Terry Buckner, Pre-filed Direct Testimony, p. 6 (March 5, 2007).

³⁴ Terry Buckner, Pre-filed Direct Testimony, p. 15 (March 5, 2007).

³⁵ Terry Buckner, Pre-filed Direct Testimony, pp. 2-3 (March 5, 2007).

V(a). REVENUES

The Company projects attrition period Revenues at current rates of \$33,432,287. The Company used a bill analysis reflecting the actual billing determinants for the test year, twelve months ended June, 30, 2006, and made normalizing adjustments and added revenue for the estimated number of new customers to be added during the attrition year.³⁶

In its pre-filed Direct Testimony, the CAPD accepted the Company's attrition period revenue forecast at current rates of \$33,432,287.³⁷ In its Supplemental Revised Direct Testimony, the CAPD increased its projection of attrition period Revenues at current rates to \$33,711,956.³⁸ The CAPD calculated a growth factor for each class of customer and applied this to the test period to arrive at its attrition period Revenues.

The panel accepted the Company's attrition period Revenue forecast at current rates of \$33,432,287 as it determined that the Company had properly taken into account normalizing adjustments for nonrecurring usage and properly matched the test period utilized by the Company.

V(b). EXPENSES

V(b)1. GROWTH FACTOR

The Company used the Value Line Forecast for the US Economy Consumer Price Index to develop its Inflation Factor. The Company used 10/12th of the 2007 rate of 2.4% and 2/12th of the 2008 rate of 2.2% to arrive at the 2.367% annual Inflation Factor.³⁹ For expenses that the Company grows using its Inflation Factor, it first normalizes the twelve months ended June 30, 2006, then applies its annual Inflation Factor to compute projected amounts for the twelve months ending February 29, 2008.

³⁶ Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 2, Schedule 1 (November 22, 2006).

³⁷ Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 2, Schedule 1 (November 22, 2006); Terry Buckner, Pre-filed Direct Testimony, Exhibit CAPD-RTB, Schedule 3 (March 5, 2007).

³⁸ Michael D. Chrysler, Pre-filed Supplemental Direct Testimony, un-numbered p. 1 (April 3, 2007).

³⁹ Sheila A. Miller, Pre-filed Direct Testimony, p. 11 (November 22, 2006).

For twelve of the expense categories, the CAPD primarily adopted the Company's booked amounts for the twelve months ended October 31, 2006 and grew each amount for customer growth and inflation growth. The CAPD included in its Growth Factor $\frac{1}{2}$ of the annual growth in customer counts, which equates to .655%, and the average Gross Domestic Product Deflator for the twelve months ending September 2006, which is 3.09%, to compute its annual Growth Factor of 3.745%. Next, the CAPD compounded its Growth Factor to apply to actual twelve months ended October 31, 2006 booked expense amounts to produce projected amounts for the attrition period ending February 29, 2008. In performing the compounding computation, the CAPD divided its annual Growth Factor of 3.745% by 12 resulting in a monthly factor that was then compounded to reflect 14 months growth. The CAPD used a combined growth rate from October 31, 2006 through February 29, 2008 of approximately 4.4%.⁴⁰

The panel concluded that an appropriately normalized test period of the twelve months ended June 30, 2006 should be used as a base to grow expenses that are forecasted to the attrition period by the application of a factor. The panel excluded Insurance Other Than Group from this determination because the test year for that particular expense contained abnormal monthly activity. Further, based on its findings that the Consumer Advocate included customer growth in its projection and that the Authority had used a similar growth factor in Docket No. 05-00258,⁴¹ the panel adopted the annual growth and inflation factor of 3.745% as projected by the CAPD to be used to develop a proper compounded growth rate of 6.2417%.⁴²

⁴⁰ Terry Buckner, Pre-filed Direct Testimony, p. 4 (March 5, 2007).

⁴¹ *In re: Petition of the Consumer Advocate to Open an Investigation to Determine Whether Atmos Energy Corp. Should be Required by the Tennessee Regulatory Authority to Appear and Show Cause that Atmos Energy Corp. is not Overearning in Violation of Tennessee Law and that It is Charging Rates that are Just and Reasonable*, Docket No. 05-00258 (September 16, 2006).

⁴² $(.0309 + .00655) / 12 * 20$.

V(b)2. SALARIES AND WAGES

The Company projects Salaries and Wages Expense of \$4,702,966.⁴³ The Company's forecasted attrition period Salaries and Wages Expense is based on a projected employee count of 111 employees. The Company increased wages for all employees by 3% to arrive at wage rates for the attrition period.

The CAPD projects Salaries and Wages Expense of \$4,397,377.⁴⁴ The CAPD's forecasted attrition period Salaries and Wages Expense is based on the actual January 31, 2007 employee count of 105 employees. The CAPD increased wages for union employees by 3% in November and increased salaries and wages for all non-union employees by 3% in April. In his Supplemental Direct Testimony, CAPD made minor corrections that increased the CAPD Salaries and Wages projection from \$4,397,377 to \$4,405,253.⁴⁵

A majority of the panel found that the Company's forecast of \$4,702,966, which included the Company's projected employee level and overtime, should be reduced by the CAPD's \$29,390 adjustment to incentive payroll solely attributed to the meeting of financial goals. The majority found this to be consistent with the Authority's decisions in recent cases. Therefore, a majority of the panel concluded that the Salaries and Wages Expense for the attrition period is \$4,673,576.⁴⁶

V(b)3. PURCHASED WATER

The Company forecast for Purchased Water is \$52,331. This amount represents the actual twelve months ended June 30, 2006 expense without adjustment.⁴⁷ The CAPD forecasts \$49,660 for Purchased Water. This amount represents the actual twelve months ended October 31, 2006 expense grown by the CAPD growth/inflation factor.⁴⁸

⁴³ Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 2, Schedule 3 (November 22, 2006).

⁴⁴ Terry Buckner, Pre-filed Direct Testimony, Exhibit CAPD-RTB, Schedule 5 (March 5, 2007).

⁴⁵ Terry Buckner, Pre-filed Supplemental Direct Testimony, p. 5 (April 3, 2007).

⁴⁶ Director Jones dissented from the majority decision and filed a separate opinion explaining his position.

⁴⁷ Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 2, Schedule 3 (November 22, 2006).

⁴⁸ Terry Buckner, Pre-filed Direct Testimony, Exhibit CAPD-RTB, Schedule 5 (March 5, 2007).

After its review of the record, the panel adopted the Company's attrition period forecast of \$52,331 for Purchased Water Expense because it is based on the June 30, 2006 test period.

V(b)4. FUEL AND POWER

The CAPD accepted the Company's attrition period forecast for Fuel and Power Expense of \$1,734,958.⁴⁹ The panel accepted the agreed upon attrition period forecast for Fuel and Power Expense of \$1,734,958.

V(b)5. CHEMICALS

The CAPD accepted the Company's attrition period forecast for Chemicals Expense of \$952,795.⁵⁰ The panel accepted the agreed upon attrition period forecast for Chemicals Expense of \$952,795.

V(b)6. WASTE DISPOSAL

The Company forecast of \$174,265 for Waste Disposal is based upon the 2007 budget for the cost from the City of Chattanooga Sanitary Board to treat the water plant residuals⁵¹ and includes a 16.5% increase in sewer rates approved by the City of Chattanooga in September 2006.⁵² The CAPD forecast of \$153,521 for Waste Disposal is based upon the Company booked amounts for the twelve months ended October 31, 2006 grown by the CAPD annual growth/inflation factor compounded to 14 months to compute projected amounts for the twelve months ending February 29, 2008.⁵³ After review of the record, the panel adopted Waste Disposal Expenses of \$174,265 for the attrition period as that figure reflects the Company's 16.5% increase in rates from the City of Chattanooga.

⁴⁹ Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 2, Schedule 3, (November 22, 2006); Terry Buckner, Pre-filed Direct Testimony, Exhibit CAPD-RTB, Schedule 5 (March 5, 2007).

⁵⁰ Terry Buckner, Pre-filed Direct Testimony, Exhibit CAPD-RTB, Schedule 5 (March 5, 2007).

⁵¹ Sheila A. Miller, Pre-filed Direct Testimony, p. 11 (November 22, 2006).

⁵² John S. Watson, Pre-filed Direct Testimony, p. 17 (November 22, 2006).

⁵³ Terry Buckner, Pre-filed Direct Testimony, Workpaper E-WD-1 (March 5, 2007).

V(b)7. MANAGEMENT FEES⁵⁴

The Company's filing includes management fees of \$4,064,421.⁵⁵ The Company started with the historical test-year expenses of \$4,006,278 and eliminated non-recurring expenses of \$260,268 for the STEP project, the STAR project, the Business Change project, the Divestiture, and implementation costs related to Sarbanes-Oxley compliance. AWWC has undertaken these initiatives to improve service and growth opportunities for its operating companies; however, there are expenses that will not be recurring during the attrition year for this case. To that adjusted historical test-year base period (twelve months ended June, 2006), the Company used an inflation factor of 5% per year to reflect the expected management fee cost for the attrition year.⁵⁶

The CAPD used the 2005 forecasted Management Fee in TRA Docket 04-00288 of \$3,062,940 as its base. The 2005 forecasted Management Fee was then grown at an annual inflation/growth rate of 3.75% and adjusted the result for non-recurring costs which the Company identified for the twelve months ended June 30, 2006 and 30% of allocated incentive pay, as discussed in the Salaries and Wages section above, to calculate its forecasted amount of \$3,021,111 for the attrition period.⁵⁷

After review of the record, the panel concluded that the Management Fee for the attrition period should be \$3,979,825. The amount is based upon the actual Management Fee booked for the twelve months ended June 30, 2006, as adjusted for: (1) non-recurring items and (2) the annual growth/inflation factor proposed by the CAPD of 3.745% compounded for 20 months. Additionally, the panel concluded that TAWC should have a management audit performed in compliance with Sarbanes-Oxley requirements and submit the results to the Authority in one year or, if the audit is not

⁵⁴ Management fees are the charges from American Water Works Service Company for services provided under the 1989 Service Company contract. Those services consist of services related to accounting, administration, communication, corporate secretarial, engineering, finance, human resources, information systems, operations, rates and revenue, risk management, water quality and other services as agreed to by the Company. These services are billed at cost to Tennessee American.

⁵⁵ Data Response, Item 13, TN-TRA-01-Q013-Management Fees, p. 1 of 2 (December 28, 2006).

⁵⁶ Michael A. Miller, Pre-filed Direct Testimony, p. 11 (November 22, 2006).

⁵⁷ Terry Buckner, Pre-filed Direct Testimony, Workpaper E-MANAGEMENT FEES (March 5, 2007).

complete in one year, submit a status report on the audit in one year. This audit should determine whether all costs allocated to TAWC were incurred as a result of prudent or imprudent management decisions by TAWC's parent and should address the reasonableness of the methodology used to allocate costs to TAWC.

V(b)8. GROUP INSURANCE

The Company projects Group Insurance Expense of \$1,513,667.⁵⁸ The Company's forecasted attrition period Group Insurance Expense is made up of two components, Group Insurance and Post Employee Benefits Other Than Pensions (OPEBs). The Company applied the group insurance rates in effect at June 30, 2006 to the pro-forma insurance coverages based upon its projected employee count and salary and wage information for the attrition period. The Company calculated attrition year Group Insurance to be \$1,006,020. The Company prorated the 2007 and 2008 costs to calculate an attrition year OPEB expense of \$507,647.

The CAPD projects Group Insurance Expense of \$1,386,168.⁵⁹ The CAPD's forecasted attrition period Group Insurance Expense is made up of two components, Group Insurance and OPEBs. The CAPD took the Company's actual expense for Group Insurance for the 12 months ended October 31, 2006 and applied its growth factor to calculate attrition year Group Insurance of \$804,744. The CAPD took the Company's actual OPEB expense for the 12 months ended October 31, 2006 and applied its growth factor and then reduced the amount by the Company's attrition period adjustment to calculate attrition year OPEB expense of \$581,424.

After review of the record, the panel adopted the Company's projection for Group Insurance Expense of \$1,513,667 based upon the Company's projected employee level.

⁵⁸ Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 2, Schedule 3 (November 22, 2006).

⁵⁹ Terry Buckner, Pre-filed Direct Testimony, Exhibit CAPD-RTB, Schedule 5 (March 5, 2007).

V(b)9. PENSION EXPENSE

The Company is requesting pension cost of \$595,798 for the ERISA contribution related to the defined benefit portion of the American Water Pension Plan expected during the attrition year. The Company determined the attrition year expense by prorating the 2007 and 2008 cost to determine the attrition period amount.⁶⁰

The CAPD adopted the Pension funding amount as prescribed in the latest actuarial report filed by the Company.⁶¹ The CAPD further states that based on the latest level of contribution, the Company's portion of funded Pension Expense net of capitalization is \$12,662.

A majority of the panel concluded that the Pension Expense for the attrition period should be \$0 based upon the latest Actuarial Report from Towers Perrin dated August 2006⁶² showing that the minimum required employer contribution is \$0.⁶³ The majority noted that this determination is consistent with the Authority's past treatment of Pension Expense.

V(b)10. REGULATORY EXPENSE

The Company projects Regulatory Expense of \$269,298. The Company estimates the cost of the preparation and presentation of the current filing to be \$400,000. The Company proposes to amortize these costs over a three year period resulting in an annual cost of \$133,333. Also, included in the attrition year cost is the Cost of Service Study Expense in the amount of \$40,000 which the Company proposes to amortize over five years resulting in an annual cost of \$8,000. Total attrition year expense is \$141,333 plus the balance of \$127,965 resulting from the 2004 rate case that is currently being amortized.

The CAPD forecast of \$191,333 for Regulatory Expense is based upon the Company booked amounts for the twelve months ended October 31, 2006 grown by the CAPD annual growth/inflation

⁶⁰ Michael A. Miller, Pre-filed Direct Testimony, p. 13 (November 22, 2006).

⁶¹ Data Response, Item 36 (December 28, 2006).

⁶² Hearing Exhibit 25.

⁶³ Director Jones dissented from the majority decision and filed a separate opinion explaining his position.

factor compounded to 14 months to compute projected amounts for the twelve months ending February 29, 2008.⁶⁴ After review of the record, the panel adopted the actual price out of Regulatory Expense of \$269,298 as proposed by the Company.

V(b)11. INSURANCE OTHER THAN GROUP

The Company's proposed level for Insurance Other Than Group Expense⁶⁵ for the attrition year is \$523,940 and is based on the Company's 2007 budget.⁶⁶ The CAPD forecast of \$462,968 for Insurance Other Than Group Expense is based upon the Company booked amounts for the twelve months ended October 31, 2006 grown by the CAPD annual growth/inflation factor compounded to 14 months to compute projected amounts for the twelve months ending February 29, 2008.⁶⁷

After review of the record, the panel concluded that neither the Company nor CAPD projections were acceptable due to the abnormal bookings to account # 557000 in both parties' test periods and the failure by both Parties to normalize expenses in this account. The panel determined that the appropriate amount for Insurance Other Than Group Expense for the attrition period is \$517,911 based upon current monthly expense levels at October 31, 2006 and application of the CAPD growth/inflation factor properly compounded to 16 months.

V(b)12. CUSTOMER ACCOUNTING

The Company projects Customer Accounting Expense of \$606,702.⁶⁸ Customer Accounting Expense for the historical test year was \$585,288. The Company applied the inflation factor of 2.367% to these expenses, excluding uncollectibles and postage to arrive at an increase of \$7,017. The net effect of the Customer Accounting Expense for the attrition year is an increase of \$21,414.⁶⁹ The CAPD forecast of \$719,633 for Customer Accounting Expense is based upon the Company

⁶⁴ Terry Buckner, Pre-filed Direct Testimony, Workpaper E-REG1 (March 5, 2007).

⁶⁵ This expense category includes costs for general liability, workers compensation, and property insurance.

⁶⁶ Sheila A. Miller, Pre-filed Direct Testimony, p. 12 (November 22, 2006).

⁶⁷ Terry Buckner, Pre-filed Direct Testimony, Workpapers E-OI-0 – E-OI-4 (March 5, 2007).

⁶⁸ Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 2, Schedule 3 (November 22, 2006).

⁶⁹ Sheila A. Miller, Pre-filed Direct Testimony, p. 12 (November 22, 2006).

booked amounts for the twelve months ended October 31, 2006 grown by the CAPD annual growth/inflation factor compounded to 14 months to compute projected amounts for the twelve months ending February 29, 2008.⁷⁰

After a review of the record, the panel concluded that the Customer Accounting Expense for the attrition period should be \$631,581. The panel based its conclusion upon acceptance of the actual twelve months ended June 30, 2006 expense of \$585,288; acceptance of the Wireless Service First normalizing adjustment of \$1,361; rejection of the Company proposed postage normalization adjustment of \$13,036; inclusion of a proper postage normalization adjustment of \$7,826; and adoption of the annual growth/inflation factor developed by the CAPD compounded to 20 months, which equates to 6.2417%.

V(b)13. UNCOLLECTIBLE EXPENSE

The Company uncollectible percentage of 1.277% was derived by taking a three year average of the net charge offs, less recoveries, as a percentage of total revenues. That percentage was applied to the proposed revenue increase of \$6,379,887 to arrive at the attrition year adjustment to Uncollectible Expense of \$81,478.⁷¹ The Company projects Uncollectible Expense of \$702,743 for the attrition period by adding the \$81,478 adjustment for proposed rates to the \$621,265 attrition period at current rates amount.⁷² The CAPD forecast of \$558,836 for Uncollectible Expense is based upon the Company booked amount of \$535,392 for the twelve months ended October 31, 2006 grown by the CAPD annual growth/inflation factor compounded to 14 months to compute projected amounts for the twelve months ending February 29, 2008.⁷³

After a review of the record, the panel adopted an Uncollectible Expense at current rates of \$618,452, which is based upon the Company booked amount for the twelve months ended June 30,

⁷⁰ Terry Buckner, Pre-filed Direct Testimony, Workpapers E-CA-0 – E-CA-13 (March 5, 2007).

⁷¹ Sheila A. Miller, Pre-filed Direct Testimony, p. 12 (November 22, 2006).

⁷² Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 2, Schedule 3 (November 22, 2006).

⁷³ Terry Buckner, Pre-filed Direct Testimony, Workpapers E-UNC-1 (March 5, 2007).

2006 and a normalizing adjustment. The panel further noted that any incremental increase in Uncollectible Expense will be accounted for by the application of the Revenue Conversion Factor.

V(b)14. RENT

The Company projects attrition period Rent Expense⁷⁴ of \$38,011. The Company adjusts the actual twelve months ended June 30, 2006 Rent Expense of \$38,043 to eliminate the extra quarterly payment for the easement of the Brainard Road Tank and to include 12 months expense for wireless service.⁷⁵ The CAPD projects attrition period Rent Expense of \$39,896 based upon actual booked expense for the twelve months ended October 31, 2006 of \$38,222 grown by its annual inflation/growth factor of 3.745% compounded for 14 months.⁷⁶ The panel adopted the Company's forecast of Rent Expense of \$38,011 since it is based upon actual results which have been properly normalized.

V(b)15. GENERAL OFFICE EXPENSE

The Company projects General Office Expense⁷⁷ of \$194,066⁷⁸ for the attrition period. The Company projection was based upon the twelve months ended June 30, 2006 actual expense of \$575,179 adjusted for non-recurring items.⁷⁹ An inflation factor of 2.367% was applied to the remaining expenses (excluding postage) to arrive at an attrition year expense of \$194,066.

The CAPD projects attrition period General Office Expense of \$221,848. The CAPD projection is based upon actual booked expense for the twelve months ended October 31, 2006 of \$212,541 after removing non-recurring expenses for the STEP Project and Miscellaneous Charges

⁷⁴ Rent Expense includes the costs associated with the renting of mobile radios, postage equipment, copiers, and land.

⁷⁵ Sheila A. Miller, Pre-filed Direct Testimony, pp. 12 - 13 (November 22, 2006).

⁷⁶ Terry Buckner, Pre-filed Direct Testimony, Workpapers E-RENT0 – E-RENT3 (March 5, 2007).

⁷⁷ This expense category includes costs associated with the general expenses for the offices. These include report forms, office supplies, computer supplies, overnight mail expenses, janitorial services, telephone expense, electrical expense, employee expenses, credit line fees, bank service charges, and other miscellaneous general office expenses.

⁷⁸ Data Response, Item 13, TN-TRA-01-Q013-MISC EXPENSES, p.4 of 8 (December 28, 2006).

⁷⁹ Normalizing adjustments were made to eliminate relocation expenses, the write-off of the STEP Project, and severance pay.

that are included in the Company's test period. The adjusted test year expense was then grown by the CAPD annual inflation/growth factor of 3.745% compounded for 14 months.⁸⁰

After review of the record, the panel concluded that the General Office Expense for the attrition period is \$201,342. The panel based this amount on the Company's methodology using the actual General Office Expense booked for the twelve months ended June 30, 2006 adjusted for non-recurring items and application of the annual growth/inflation factor proposed by the CAPD of 3.745% compounded for 20 months.

V(b)16. MISCELLANEOUS

The Company projects Miscellaneous Expense of \$1,792,405⁸¹ for the attrition period. The Company projection was based upon the twelve months ended June 30, 2006 actual expense of \$1,798,639 adjusted for normalizing items.⁸² The Company did not apply the inflation factor to the 401K expense, Defined Contribution expense, or the Retiree Medical Reimbursement Plan. Next, the Company applies its annual inflation factor adjustment of 2.367% resulting in an increase of \$37,357. The test period amounts for the 401K expense, Defined Contribution expense, and the Retiree Medical Reimbursement Plan are then added back followed by the projected attrition year increases totaling \$88,951 for these items resulting in the forecasted attrition period amount.⁸³

The CAPD projects attrition period Miscellaneous Expense of \$1,710,268. The CAPD projection is based upon actual booked expense for the twelve months ended October 31, 2006 of \$1,638,520. The test year expense was grown by the CAPD annual inflation/growth factor of 3.745% compounded for 14 months.⁸⁴

⁸⁰ Terry Buckner, Pre-filed Direct Testimony, Workpapers E-GO-0 – E-GO-23 (March 5, 2007).

⁸¹ Company response to TRA Minimum Filing Guidelines, Item 13, TN-TRA-01-Q013-MISC EXPENSES, p. 5 of 8.

⁸² The Company makes five normalizing adjustments: (1) adds an additional \$24,000 expense for airtime of cello units, (2) adjusts the negative \$8,375 account balance for EIP Contribution Expense, (3) adjust the negative \$182 account balance for Directors Expense, (4) eliminates the amortization of security costs of \$107,407 which ended July 2006, and (5) eliminates Penalties of \$57,693 which are not an expense includable for rate making purposes.

⁸³ Sheila A. Miller, Pre-filed Direct Testimony, pp. 13-14 (November 22, 2006); Company response to TRA Minimum Filing Guidelines, Item 13, TN-TRA-01-Q13-MISC EXPENSES, p. 5 of 8.

⁸⁴ Terry Buckner, Pre-filed Direct Testimony, Workpapers E-MISC0 – E-MISC48 (March 5, 2007).

After a review of the record, the panel concluded that the Miscellaneous Expense for the attrition period is \$1,853,556. The panel based its conclusion on the Company's methodology using the actual Miscellaneous Expense booked for the twelve months ended June 30, 2006 adjusted in the manner proposed by the Company and application of the annual growth/inflation factor proposed by the CAPD of 3.745% compounded for 20 months.

V(b)17. MAINTENANCE EXPENSE

The Company projects Maintenance Expense⁸⁵ of \$749,879⁸⁶ for the attrition period. The Company projection was based upon the twelve months ended June 30, 2006 actual expense of \$1,110,461 adjusted for one normalizing item.⁸⁷ The annual inflation factor was applied to the remaining balance to arrive at the attrition period projection.

The CAPD projects attrition period Maintenance Expense of \$747,665. The CAPD projection is based upon actual booked expense for the twelve months ended October 31, 2006 of \$716,299. The test year expense was grown by the CAPD annual inflation/growth factor of 3.745% compounded for 14 months.⁸⁸

After review of the record, the panel determined that the Maintenance Expense for the attrition period is \$778,265. The panel based its determination upon the Company's methodology using the actual Maintenance Expense booked for the twelve months ended June 30, 2006 adjusted for the one normalizing item proposed by the Company and application of the annual growth/inflation factor proposed by the CAPD of 3.745% compounded for 20 months.

V(b)18. DEPRECIATION EXPENSE

Although in initial testimony the parties held different positions regarding the correct amount for this expense, at the Hearing the Company provided revised financial exhibits that changed the

⁸⁵ This expense category includes costs associated with maintaining the property of the Company. This would include repair parts, tools, maintenance supplies, contracted services, paving, maintenance agreements, and other miscellaneous maintenance expenses.

⁸⁶ Data Response, Item 13, TN-TRA-01-Q013-MISC EXPENSES, p.8 of 8 (December 28, 2006).

⁸⁷ The Company makes one normalizing adjustment to eliminate the net negative salvage expense of \$377,919.

⁸⁸ Terry Buckner, Pre-filed Direct Testimony, Workpapers E-MAIN0- – E-MAIN2- (March 5, 2007).

Depreciation Expense to \$4,936,937,⁸⁹ which is in agreement with the Consumer Advocate's projection prior to the exclusion of the E-CIS Plant. The panel adopted the figure of \$4,936,937 for Depreciation Expense. This amount is based upon more recent actual balances at December 31, 2006, includes forecasted additions and retirements provided by the Company through the attrition period, and includes depreciation associated with the E-CIS investment.

V(c). TAXES AND FEES

V(c)1. GROSS RECEIPTS TAX

The Company projects Gross Receipts Tax for the attrition period of \$384,576.⁹⁰ The Company states that Gross Receipts Tax was based on projected jurisdictional revenues for TAWC including Other Operating revenues. The revenues for the 12 month period from September 2006 to August 2007, as adjusted for the Franchise Tax, Excise Tax and the \$5,000 exemption, were multiplied by the current 3% tax rate to arrive at the attrition year level.⁹¹

The CAPD projects Gross Receipts Tax for the attrition period of \$326,853.⁹² The CAPD forecasted amount is based on one-third of the actual Gross Receipts Tax return as filed with the Tennessee Department of Revenue for the tax period July 1, 2006 through June 30, 2007. The remaining two-thirds of the Gross Receipts Tax were based on twelve months to date revenue as of November 30, 2006.⁹³

After review of the record, a majority of the panel⁹⁴ concluded that the Gross Receipts Tax associated with the attrition period Revenue at current rates is \$396,741. This amount is based upon gross revenues and uncollectible revenues for the attrition period at current rates, the Tennessee percentage of Entire Company Revenue of 95% and the effective Gross Receipts Tax rate for the

⁸⁹ Hearing Exhibit 38, Exhibit 1, Schedule 2, p. 1 of 3.

⁹⁰ Data Response, Item 13, TN-TRA-01-Q013-GENERAL TAXES, p. 23 of 130 (December 28, 2006).

⁹¹ Sheila A. Miller, Pre-filed Direct Testimony, p. 14 (November 22, 2006).

⁹² Terry Buckner, Pre-filed Direct Testimony, Workpaper T-OTAX7 (March 5, 2007).

⁹³ Terry Buckner, Pre-filed Direct Testimony, p. 14 (March 5, 2007).

⁹⁴ Director Jones dissented from the majority's calculation of the dollar amount, but agrees with the methodology used to perform the calculation.

2005 reporting period. Additionally, a majority of the panel determined that an additional Gross Receipts Tax of \$51,464 be allowed on the difference between the jurisdictional attrition period Revenue at new rates and the attrition period Revenue at current rates.

V(c)2. TRA INSPECTION FEES

The Company projects TRA Inspection Fees for the attrition period of \$64,957.⁹⁵ The TRA Inspection Fee was based on projected 2006 jurisdictional revenues. This was reduced by uncollectibles and a \$5,000 exemption to arrive at taxable revenues. The result was multiplied by the Tennessee statutory rates that were taken from the 2006 return.⁹⁶ The CAPD projects TRA Inspection Fees for the attrition period of \$64,706.⁹⁷

A majority of the panel⁹⁸ determined that the TRA Inspection Fee associated with the attrition period Revenue at current rates is \$63,336. This amount is based upon gross revenues and uncollectible revenues for the attrition period at current rates, the Tennessee percentage of Entire Company Revenue of 95% and the current exemption and tax rates. The majority further determined that an additional TRA Inspection Fee of \$8,087 should be allowed on the difference between the jurisdictional attrition period Revenue at new rates and the attrition period Revenue at current rates.

V(c)3. PROPERTY TAXES

The Company projects Property Taxes for the attrition period of \$2,635,280.⁹⁹ Property Taxes for the test year were \$2,368,800. This amount was under-accrued during the historical test year necessitating a normalized adjustment of \$77,915. An effective Property Tax Rate based on the latest Property Tax returns was applied to the mid-point of the attrition year Rate Base to arrive at the attrition year adjustment of \$188,565.¹⁰⁰

⁹⁵ Data Response, Item 13, TN-TRA-01-Q013-GENERAL TAXES, p. 1 of 130 (December 28, 2006).

⁹⁶ Sheila A. Miller, Pre-filed Direct Testimony, p. 14 - 15 (November 22, 2006).

⁹⁷ Terry Buckner, Pre-filed Direct Testimony, Workpaper T-OTAX2 (March 5, 2007).

⁹⁸ Director Jones dissented from the majority's calculation of the dollar amount, but agrees with the methodology to perform the calculation.

⁹⁹ Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 2, Schedule 5 (November 22, 2006)

¹⁰⁰ Sheila A. Miller, Pre-filed Direct Testimony, p. 14 (November 22, 2006).

The CAPD projects Property Taxes for 2007 of \$2,552,758.¹⁰¹ CAPD Exhibit T-OTAX-1 provides a historical summary of Property Taxes paid by the Company, gross assessment values, composite tax rate, and reported Rate Base amounts. The schedule reflects taxes due by TAWC for 2005 and 2006.

After review of the record, the panel concluded that Property Taxes for the attrition period are \$2,732,213 based on an attrition period average Rate Base of \$104,282,949 and application of the effective tax rate calculated by the Company of 2.62%.

V(c)4. FRANCHISE TAXES

The Company projects Franchise Taxes of \$303,980. The Company utilized the balances as of June 30, 2006 as a basis for the tax, applied the Schedule F ratio factor from the latest actual amended return, made an adjustment for Rentals from Schedule G from the latest actual amended return and multiplied the result by the statutory rate of \$.25 per \$100.¹⁰²

The CAPD projects Franchise Taxes for 2007 of \$352,833.¹⁰³ The CAPD calculated Franchise Tax using actual plant in service and accumulated depreciation net of forecasted plant additions and retirements.¹⁰⁴

After a review of the record, the panel determined that Franchise Taxes for the attrition period are \$341,840. This amount is based on the attrition period average Rate Base of \$104,282,949 and application of the ratio of 2005 actual Franchise Taxes paid to the average 2005 Rate Base.

V(c)5. FICA TAX

The Company projects FICA Tax of \$352,445.¹⁰⁵ The Company forecasted its attrition period FICA Tax by applying the current tax rates to its attrition period Salaries and Wages.

¹⁰¹ Terry Buckner, Pre-filed Direct Testimony, Workpaper T-OTAX1 (March 5, 2007).

¹⁰² Data Response, Item 13, TN-TRA-01-Q013-GENERAL TAXES, p. 4 of 130 (December 28, 2006).

¹⁰³ Terry Buckner, Pre-filed Direct Testimony, Workpaper T-OTAX8 (March 5, 2007).

¹⁰⁴ Terry Buckner, Pre-filed Direct Testimony, p. 14 (March 5, 2007).

¹⁰⁵ Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 2, Schedule 5 (November 22, 2006).

The Consumer Advocate projects FICA Tax of \$342,649.¹⁰⁶ The CAPD forecasted its attrition period FICA Tax by applying the current tax rates to its attrition period Salaries and Wages. In its revised Exhibits provided at the Hearing, the CAPD revised its forecast to \$331,426.

After review of the record, a majority of the panel¹⁰⁷ determined that the FICA Tax for the attrition period is \$350,242. This amount is based on the Company forecasted FICA Tax of \$352,445 adjusted for the .625% reduction for incentive payroll solely attributed to the meeting of financial goals as proposed by the CAPD.

V(c)6. UNEMPLOYMENT TAX

The Company projects Unemployment Tax of \$7,346.¹⁰⁸ The Company forecasted its attrition period Unemployment Tax by applying the current tax rates to its attrition period Salaries and Wages.

The CAPD projects Unemployment Tax of \$7,167.¹⁰⁹ The CAPD forecasted its attrition period Unemployment Tax by applying the current tax rates to its attrition period Salaries and Wages. In its revised Exhibits provided at the Hearing, the CAPD revised its forecast to \$6,968.

After a review of the record, a majority of the panel¹¹⁰ determined that Unemployment Tax for the attrition period is \$7,300. This amount is based on the Company forecasted Unemployment Tax of \$7,346 adjusted for the .625% reduction for incentive payroll solely attributed to the meeting of financial goals as proposed by the CAPD.

¹⁰⁶ Terry Buckner, Pre-filed Direct Testimony, Exhibit CAPD-RTB, Schedule 8 (March 5, 2007).

¹⁰⁷ Director Jones dissented from the majority's calculation of the dollar amount because it includes an adjustment for the financial portion of the AIP, an adjustment he rejected for salaries and wages.

¹⁰⁸ Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 2, Schedule 5 (November 22, 2006).

¹⁰⁹ Terry Buckner, Pre-filed Direct Testimony, Exhibit CAPD-RTB, Schedule 8 (March 5, 2007).

¹¹⁰ Director Jones dissented from the majority's calculation of the dollar amount because it includes an adjustment for the financial portion of the AIP, an adjustment he rejected for salaries and wages.

V(c)7. STATE EXCISE TAX

A majority of the panel¹¹¹ concluded that Excise Tax for the attrition period is \$172,194. This amount is based upon forecasted results from operations at current rates for the attrition period determined in this case, adjusted for interest expense and permanent differences and application of the statutory tax rate of 6.5%.

V(c)8. FEDERAL INCOME TAX

A majority of the panel¹¹² concluded that Federal Income Tax for the attrition period is \$790,562. This amount is based upon forecasted results from operations at current rates for the attrition period determined in this case, adjusted for interest expense, permanent differences, excise tax and ITC amortization and application of the statutory tax rate of 35%.

V(c)9. ALLOWANCE FOR FUNDS USED DURING CONSTRUCTION (AFUDC)

The Company projects AFUDC for the attrition period of \$83,747 based upon the 2007/2008 budget. The CAPD projects AFUDC for the attrition period of \$150,312 based upon the actual 12 months-to-date amount reported on the November 2006 Monthly Surveillance Report filed with the TRA.¹¹³ After review of the record, the panel concluded that the proper AFUDC is \$123,261 based upon the actual 12 months-to-date amount reported on the December 2006 TRA Monthly 3.06 Surveillance Report.

V(d). NET OPERATING INCOME

A majority of the panel¹¹⁴ found that based upon the preceding determinations Net Operating Income is \$5,774,350 for the attrition period based upon current rates.

¹¹¹ Director Jones dissented from the majority's calculation of the dollar amount, but agrees with the methodology used to perform the calculation.

¹¹² Director Jones dissented from the majority's calculation of the dollar amount, but agrees with the methodology used to perform the calculation.

¹¹³ Terry Buckner, Pre-filed Direct Testimony, Workpaper E-REC-1 (March 5, 2007).

¹¹⁴ Director Jones dissented from the majority's calculation of the dollar amount, but agrees with the methodology used to perform the calculation.

V(e). RATE BASE

V(e)1. UTILITY PLANT IN SERVICE

In Direct Testimony the Company projects an average attrition period balance for Utility Plant in Service of \$185,005,497.¹¹⁵ This projection is based upon the balance per books at June 30, 2006 and increased for the net effect of budgeted additions and retirements through August 31, 2007 to arrive at the Utility Plant in Service balance at the midpoint of the attrition period.

In Direct Testimony, the CAPD projects an average attrition period balance for Utility Plant in Service of \$189,828,780.¹¹⁶ This projection is based on the thirteen month average of the attrition period Utility Plant in Service. The CAPD began with the balance per books at December 31, 2006 and increased it for the net effect of budgeted additions and retirements through February 29, 2008. The CAPD forecast includes Capital Leases, which the Company shows as a separate line item.

In Supplemental Revised Direct Testimony, the CAPD argues for the exclusion of the Company's E-CIS actual cost in excess of its original estimated cost. The CAPD reduced its Rate Base projection relating to the E-CIS from \$1,490,980 to \$147,682, which is TAWC's share of the original E-CIS estimated cost.¹¹⁷

In Rebuttal Testimony, the Company states that it agrees with the CAPD methodology using the 13-month average because that method is the correct method to calculate Rate Base. The Company strongly disagrees with the E-CIS Rate Base deduction proposed by the CAPD.

At the Hearing the Company provided revised financial exhibits which changed the Utility Plant in Service to \$188,238,289.¹¹⁸ This amount is only \$9 more than the CAPD's original Utility Plant in Service projection.

¹¹⁵ Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 1, Schedule 2 (November 22, 2006).

¹¹⁶ Terry Buckner, Pre-filed Direct Testimony, Exhibit CAPD-RTB, Schedule 2 (March 5, 2007).

¹¹⁷ Terry Buckner, Pre-filed Supplemental Revised Direct, pp. 3-4 (April 3, 2007).

¹¹⁸ Hearing Exhibit 38, Exhibit 1, Schedule 2, p. 1 of 3.

The panel rejected the CAPD exclusion of the E-CIS investment from Rate Base on the grounds that E-CIS provides benefit to TAWC customers. As a customer service tool, E-CIS was implemented at a reasonable cost. Inclusion of E-CIS costs is reasonable and consistent with costs incurred for such customer information systems. The panel adopted the CAPD's attrition period forecast for average Utility Plant in Service of \$189,828,780 as originally filed in Direct Testimony since it is based on the most current information available.

V(e)2. CONSTRUCTION WORK IN PROGRESS ("CWIP")

The CAPD accepted the Company's attrition period forecast for CWIP of \$2,608,585 in its original Direct Testimony.¹¹⁹ In Supplemental Revised Direct Testimony the CAPD updated the CWIP to the December 31, 2006 amount of \$1,580,421 to mirror the starting point for the CAPD Plant in Service.¹²⁰ The Company agrees with the CAPD methodology using the 13-month average balance to calculate Plant in Service.¹²¹

The panel accepted the CAPD's use of the December 31, 2006 Construction Work in Progress ("CWIP") of \$1,580,421 balance since it mirrors the starting point used by the CAPD to project Plant in Service.

V(e)3. UTILITY PLANT CAPITAL LEASE

The Company projects an average attrition period balance for Utility Plant Capital Lease of \$1,590,500. This projection is based upon the balance per books at June 30, 2006 held constant.¹²² The CAPD included Utility Plant Capital Lease of \$1,590,500, as projected by the Company in its Utility Plant in Service average attrition period balance.¹²³ The panel adopted the Company's attrition period forecast for Utility Plant Capital Lease of \$1,590,500, which the CAPD included in Utility Plant in Service rather than as a separate Rate Base line item.

¹¹⁹ Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 1, Schedule 2 (November 22, 2006); Terry Buckner, Pre-filed Direct Testimony, Exhibit CAPD-RTB, Schedule 2 (March 5, 2007).

¹²⁰ Terry Buckner, Pre-filed Revised Supplemental Direct Testimony, p. 4 (April 3, 2007).

¹²¹ Michael A. Miller, Pre-filed Rebuttal Testimony, p. 34 (April 9, 2007).

¹²² Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 1, Schedule 2 (November 22, 2006).

¹²³ Terry Buckner, Pre-filed Direct Testimony, Exhibit CAPD-RTB, Schedule 2 (March 5, 2007).

V(e)4. NET LIMITED-TERM UTILITY PLANT

The CAPD accepted the Company's attrition period forecast for Net Limited-Term Utility Plant of \$(20,953).¹²⁴ The panel accepted the agreed upon attrition period forecast for Net Limited-Term Utility Plant of \$(20,953).

V(e)5. WORKING CAPITAL

The CAPD accepted the Company's attrition period forecast for Working Capital of \$962,583.¹²⁵ At the Hearing, the Company provided revised financial exhibits that changed Working Capital to \$964,794.¹²⁶ This amount is \$2,211 more than the original projection. The Company provided no basis for the increase. The panel accepted the original agreed upon attrition period forecast for Working Capital of \$962,583 since the Company's late filed revisions were unsupported.

V(e)6. ACCUMULATED DEPRECIATION

The Company projects Accumulated Depreciation for the attrition period of \$56,170,309.¹²⁷ The Company began with the actual June 30, 2006 balance adjusted for negative salvage and added projected Deprecation Expense.¹²⁸

The CAPD projects Accumulated Depreciation for the attrition period of \$54,713,939.¹²⁹ The CAPD forecast of Accumulated Depreciation was calculated based on the actual balances as of December 31, 2006 plus the additions and retirements provided by the Company and calculated the Depreciation Expense through the attrition period.¹³⁰ In Supplemental Revised Direct Testimony, the CAPD reduces its projected Accumulated Depreciation for the attrition period from \$54,713,939 to \$52,502,858 due to the exclusion of the E-CIS investment.

¹²⁴ Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 1, Schedule 2 (November 22, 2006); Terry Buckner, Pre-filed Direct Testimony, Exhibit CAPD-RTB, Schedule 2 (March 5, 2007).

¹²⁵ *Id.*

¹²⁶ Hearing Exhibit 38, Exhibit 1, Schedule 2, p. 1 of 3.

¹²⁷ Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 1, Schedule 2 (November 22, 2006).

¹²⁸ Data Response, TN-TRA-01-Q013-RATE BASE BACK-UP, p. 1 of 14 (December 28, 2006).

¹²⁹ Terry Buckner, Pre-filed Direct Testimony, Exhibit CAPD-RTB, Schedule 2 (March 5, 2007).

¹³⁰ Terry Buckner, Pre-filed Direct Testimony, p. 15 (March 5, 2007).

The panel adopted the CAPD's attrition period forecast for average Accumulated Depreciation of \$54,713,939 as originally filed in CAPD's Direct Testimony since it is based on the most current information available and it includes the Accumulated Depreciation associated with the E-CIS investment.

V(e)7. ACCUMULATED AMORTIZATION OF UTILITY CAPITAL LEASE

The CAPD accepted the Company's attrition period forecast for Accumulated Amortization of Utility Capital Lease of \$980,808.¹³¹ The panel accepted the agreed upon attrition period forecast for Accumulated Amortization of Utility Capital Lease of \$980,808.

V(e)8. ACCUMULATED DEFERRED INCOME TAXES

The CAPD accepted the Company's attrition period forecast for Accumulated Deferred Income Taxes of \$18,833,369.¹³² The panel accepted the agreed upon attrition period forecast for Accumulated Deferred Income Taxes of \$18,833,369.

V(e)9. CUSTOMER ADVANCES FOR CONSTRUCTION

The CAPD accepted the Company's attrition period forecast for Customer Advances for Construction of \$5,593,604.¹³³ The panel accepted the agreed upon attrition period forecast for Customer Advances for Construction of \$5,593,604.

V(e)10. CONTRIBUTIONS IN AID OF CONSTRUCTION ("CIAC")

The CAPD accepted the Company's attrition period forecast for CIAC of \$7,946,162.¹³⁴ The panel accepted the agreed upon attrition period forecast for Contributions in Aid of Construction ("CIAC") of \$7,946,162.

¹³¹ Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 1, Schedule 2 (November 22, 2006) and Terry Buckner, Pre-filed Direct Testimony, Exhibit CAPD-RTB, Schedule 2 (March 5, 2007).

¹³² *Id.*

¹³³ *Id.*

¹³⁴ *Id.*

V(e)11. UNAMORTIZED INVESTMENT TAX CREDIT (“UITC”)

The Company projects an average attrition period balance for UITC of \$38,767. The Company calculation is based upon the UITC balance in account 255101 at June 30, 2006, less monthly amortization through the mid-point of the attrition period.¹³⁵

The CAPD projects an average attrition period balance for UITC of \$1,141,720.¹³⁶ The CAPD notes that the Company only included the UITC balance in account 255101, yet the Company’s amortization of ITC for federal income tax purposes includes accounts 255101, 255102 and 255103.¹³⁷ The panel adopted an average attrition period balance of \$0 for UITC since the Company reduces its Federal Income Tax Expense by the total amount of the ITC amortization.

V(f). REVENUE CONVERSION FACTOR

The Company proposes a Gross Revenue Conversion Factor of 1.71513466.¹³⁸ The Company included the Uncollectible Factor, the effective tax rate for Gross Receipts Tax, State Excise Tax and FIT in its calculation of the Revenue Conversion Factor. Additionally, the Company applied factors for Forfeited Discounts, Uncollectibles, Gross Receipts Tax, State Excise Tax and FIT to the amount of the determined Revenue Deficiency based on Revenues at current rates.

The CAPD proposes a Revenue Conversion Factor of 1.642301.¹³⁹ This factor is based upon a Forfeited Discount Factor of 0.0113, an Uncollectible Ratio of 0.0093, which appears to be the factor used in Docket 04-00288, a State Excise Tax Factor of 0.065, and a Federal Income Tax Factor of 0.35.

The panel adopted the methodology used by the CAPD to calculate the Revenue Conversion Factor, as well as the Forfeited Discount Factor of 0.0113, a State Excise Tax Factor of 0.065, and a Federal Income Tax Factor of 0.35 as proposed by the CAPD. The panel adopted the Uncollectible

¹³⁵ Data Response, TN-TRA-01-Q013-RATE BASE BACK-UP, p. 9 of 14 (December 28, 2006).

¹³⁶ Terry Buckner, Pre-filed Direct Testimony, Workpaper RTB-ITC (March 5, 2007).

¹³⁷ Terry Buckner, Pre-filed Direct Testimony, pp. 16 and 17 (March 5, 2007).

¹³⁸ Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 1, Schedule 1 (November 22, 2006).

¹³⁹ Terry Buckner, Pre-filed Direct Testimony, Exhibit CAPD-RTB, Schedule 8 (March 5, 2007).

Factor proposed by the Company of 0.01277. Based on these determinations, the panel concluded that the Revenue Conversion Factor is 1.648074.

The panel also adopted the Company's position regarding the application of the Gross Receipts Tax Factor, State Excise Tax rate and FIT rate to the amount of the calculated Revenue Deficiency based on Revenues at current rates. The panel also included the TRA Inspection Fee incremental rate of .2% in its calculation of the Revenue Increase since this fee would also be paid on the amount of the Revenue Increase.

V(g). RATE OF RETURN

There are three steps to establishing the fair rate of return: (1) determine an appropriate capital structure; (2) determine the cost rates of each component of the capital structure: (i) short-term debt, (ii) long-term debt, (iii) preferred equity, and (iv) common equity; and (3) compute the overall cost of capital using a weighted average of the component rates to account for the proportion of each component.

There is no objective measure of the fair rate of return. Therefore, the TRA must exercise its judgment in making the appropriate determination. The Authority, however, is not without guidance in exercising its judgment. The principle factors that should be used in establishing a rate were set forth by the U.S. Supreme Court in *Bluefield Water Works & Improvement Company v. Public Service Commission*:

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 risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises 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.¹⁴⁰

¹⁴⁰ *Bluefield*, 262 U.S. at 692-93; See also *Duquesne Light Company v. Barasch*, 488 U.S. 299, 310 (1989).

In *Federal Power Commission v. Hope Natural Gas Company*, the U.S. Supreme Court determined that regulated firms are entitled to a return that is “just and reasonable.”¹⁴¹ The rate a firm is permitted to charge should enable it “to operate successfully, to maintain its financial integrity, to attract capital, and to compensate investors for the risks assumed.”¹⁴²

According to the Court in *Hope*, the general standards to be considered in establishing the fair rate of return 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 fair rate of return 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 be commensurate with returns on investment in other enterprises having corresponding risk.

Thus, pursuant to the *Hope* and *Bluefield* decisions, the general standards to be considered in establishing a fair rate of return 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 fair rate of return is the minimum return investors expect, or require, in order to make an investment in the utility.

TAWC requests an overall rate of return of 8.1%.¹⁴³ The Company’s overall rate of return is based upon a capital structure derived from data for TAWC. The company proposes a capital structure for TAWC comprised of: 53.07% long-term debt; 3.76% short-term debt; 1.32% preferred equity; 23.84% common equity comprised of common stock; and 18.02% common equity in the form of retained earnings.¹⁴⁴ The Company states that, as part of settlement agreements in divestiture

¹⁴¹ *Hope*, 320 U.S. at 605.

¹⁴² *Id.*

¹⁴³ Michael Miller, Pre-filed Rebuttal Testimony, p. 11 (April 9, 2007).

¹⁴⁴ Michael Miller, Pre-filed Rebuttal Testimony, Rebuttal Exhibit MAM-6 (April 9, 2007).

proceedings in other states, its parent company, AWWC, is required to have at least 45% common equity at the time of the IPO.¹⁴⁵

TAWC proposes a short-term debt cost of 5.4% based upon market forecasts for 2007.¹⁴⁶ The Company proposes the cost of long-term debt at 6.08%.¹⁴⁷ In deriving its recommended cost of capital of 8.1%, TAWC claims that its return on equity should be set at 11%.¹⁴⁸ The Company's cost of capital methodology involves adjusting the required equity return to account for the influence of both taxation and capital structure.¹⁴⁹

The CAPD employs a double-leveraging methodology to determine the capital structure for TAWC. CAPD suggests a cautious approach to the capital structure of TAWC's parent, due to the pending IPO and the parent's history of operating at low equity ratio. As a result, CAPD proposes a capital structure for the parent comprised of 30% equity and 70% debt.¹⁵⁰ Based upon the posited parent company capital structure and TAWC's capital structure, the CAPD proposes a final capital structure for TAWC comprised of 59.7% long-term debt and 25.6% equity supplied by the parent, and 14.7% long-term debt held by TAWC.¹⁵¹ The CAPD asserts that the current long-term debt cost within the AWWC system is 5.3%¹⁵² and calculates the cost of TAWC's debt held outside the AWWC system as 7.6%¹⁵³

The CAPD states that the appropriate equity return is 7.5% based upon an implementation of the DCF model using historical dividend growth.¹⁵⁴ The CAPD projects an equity return estimate of 6.3% by implementing the CAPM. The CAPD uses a long-term debt cost of 5.0% for the risk free

¹⁴⁵ Michael Miller, Pre-filed Rebuttal Testimony, pp. 23-25 (April 9, 2007).

¹⁴⁶ Michael Miller, Pre-filed Direct Testimony, p. 5 and Exhibit MAM-3 (November 22, 2006).

¹⁴⁷ Michael Miller, Pre-filed Rebuttal Testimony, Rebuttal Exhibit MAM-6 (April 9, 2007).

¹⁴⁸ Michael Miller, Pre-filed Direct Testimony, pp. 8-9 (November 22, 2006).

¹⁴⁹ Dr. Michael Vilbert, Pre-filed Direct Testimony, pp. 2-3 (November 22, 2006).

¹⁵⁰ Dr. Steve Brown, Pre-filed Direct Testimony, p. 13 (March 2, 2007).

¹⁵¹ Dr. Steve Brown, Pre-filed Direct Testimony, Revised Schedule 8 (March 2, 2007).

¹⁵² Dr. Steve Brown, Pre-filed Direct Testimony, p. 16 (March 2, 2007).

¹⁵³ Dr. Steve Brown, Pre-filed Direct Testimony, Revised Schedule 8 (March 2, 2007).

¹⁵⁴ Dr. Steve Brown, Pre-filed Direct Testimony, pp. 29-30 (March 2, 2007).

return component of the CAPM.¹⁵⁵ Based on an estimated market return of 8.5% and a current yield on U.S. securities of 5%, the CAPD states that the market risk premium is 3.5%. The CAPD uses a BETA measure of 0.37 derived from data taken from the NASDAQ internet site to complete the CAPM calculation of a 6.3% equity return.¹⁵⁶ In sum, the CAPD recommends an overall cost of capital of 6.2%.¹⁵⁷ The 6.2% overall return is based upon a double leveraged capital structure, the debt costs described above and a 7.5% equity return.

After review of the record, the panel concluded that the Company's rate of return should be set using a double leveraged capital structure. To implement the double leverage methodology, the panel set the portion of the Company's capitalization held by parties outside the AWWC system at 14.787% and costing 7.6%. For AWWC, the panel adopted a capital structure comprised of 45% equity with a return of 10.2% and 55% debt with debt costing 6.1% resulting in an overall rate of return of 7.89% for the Company.

Due to the extensive discussion regarding the pending IPO of AWWC and to monitor compliance with the representations made concerning the AWWC's capital structure, the panel, consistent with agreements made in other states, requires the Company to promptly notify the TRA if AWWC's equity ratio falls below 45% and, in any event, to file a report six months after the IPO indicating the current Capital Structure.

V(h). REVENUE DEFICIENCY

A majority of the panel¹⁵⁸ determined that based upon the preceding determinations the Revenue Deficiency is \$4,079,865 for the attrition period.

¹⁵⁵ Dr. Steve Brown, Pre-filed Direct Testimony, p. 57 (March 2, 2007).

¹⁵⁶ Dr. Steve Brown, Pre-filed Direct Testimony, p. 57 (March 2, 2007).

¹⁵⁷ Dr. Steve Brown, Pre-filed Direct Testimony, Revised Schedule 8, (March 2, 2007).

¹⁵⁸ Director Jones dissented from the majority's calculation of the dollar amount, but agrees with the methodology used to perform the calculation.

V(i). RATE DESIGN

The Company filed a Cost of Service Allocation Study as of June 30, 2006.¹⁵⁹ The Study shows that under proposed rates Residential and Other Water Utilities (Wholesale Water Sales) are being subsidized by Commercial, Industrial, Other Public Authority and Private Fire Protection.¹⁶⁰ The Company supports a rate design based upon an across-the-board uniform increase.¹⁶¹

CMA states that each class of customers should pay its fair share for actual water usage, based upon what it costs to actually provide service to the customer. CMA also contends that any customer class should not subsidize another customer class.¹⁶²

Second, CMA asserts that the Company's own comparison of the allocated cost of service to each class and the revenues generated by the equal percent increase shows that the Commercial, Industrial, Public Authority and Private Fire Protection classes are providing significant subsidies to the Residential and Wholesale customers of TAWC. CMA recommends that TAWC begin to phase out these subsidies in this rate case stating that the elimination of inter-class subsidies will promote equity, efficiency (cost-minimization), conservation and stability.¹⁶³

For illustrative purposes only, CMA uses TAWC's revenue proposal to show the impacts on each customer class and CMA's proposed adjusted cost of service study results. Based upon the overall requested increase and in order to reach full cost of service in one step, the Residential increase would be 42.36% while Commercial revenues would be increased by only 2.46%. The Industrial and Public Authority classes would get percent increases less than the system average increase, while Wholesale water customers would get an increase of 27.69%. CMA recommends that interclass subsidies be phased out gradually, over the next three rate cases. Based upon a 19.61% overall increase in revenue and reduction of subsidies by 33%, Residential customers would

¹⁵⁹ Paul R. Herbert, Pre-filed Direct Testimony, Exhibit No. PRH-1 (November 22, 2006).

¹⁶⁰ Paul R. Herbert, Pre-filed Direct Testimony, Exhibit No. PRH-1, Schedule A (November 22, 2006).

¹⁶¹ Paul R. Herbert, Pre-filed Direct Testimony, p. 11 (November 22, 2006).

¹⁶² Dan Nuckolls, Pre-filed Direct Testimony, p. 6 (March 5, 2007).

¹⁶³ Michael Gorman, Pre-filed Direct Testimony, p. 2 (March 5, 2007).

receive a 27.13% increase; Commercial customers would receive a 12.33% increase; Industrial customers would receive a 16.39% increase; Other Public Authority customers would receive a 16.15% increase; Other Water Utility customers would receive a 21.69% increase; and Private Fire Protection customers would receive an 11.42% increase.¹⁶⁴

After review of the record, the panel adopted a rate design based upon across-the-board uniform increases to base rates and volumetric rates for all customer classes to address the revenue deficiency stated above. The panel denied the Company's proposed tariff and required the Company to file a new tariff within thirty (30) days with new rates sufficient to produce the incremental revenues in the amount of the revenue deficiency cited above. The tariff filing must be accompanied by a detailed price out demonstrating that the new rates, based upon attrition year billing determinates, produce incremental revenues in the amount of the revenue deficiency determined above when compared to attrition year billing determinates at current rates. The panel further held that uncollectible revenues, forfeited discounts and taxes have been accounted for in its adopted revenue deficiency.

¹⁶⁴ Michael Gorman, Pre-filed Direct Testimony, pp. 8 - 9 (March 5, 2007).

IT IS THEREFORE ORDERED THAT:

1. The rates filed by Tennessee American Water Company on November 22, 2006 are denied.
2. For purposes of the rates herein, the test period shall be as follows:
 - (a) for Revenues and Expenses, except in the instance of Insurance Other Than Group, the test period shall be the uniform test period of the twelve months ended June 30, 2006;
 - (b) for Rate Base components to which the Company and the Consumer Advocate and Protection Division of the Office of the Attorney General agree in their projections, the test period shall be the twelve months ended June 30, 2006;
 - (c) for Rate Base components to which there was dispute among the parties, the test period shall be the actual average thirteen month ending balances at December 31, 2006; and
 - (d) the forward looking attrition period shall be the twelve months ending February 29, 2008.
3. For purposes of the rates herein, the rate base is \$104,282,949, and the net operating income is \$5,774,350 at current rates.
4. Capitalization held by parties outside the American Water Works Company system is set at 14.787% with a cost of 7.6%.
5. A capital structure comprised of 45% equity and 55% debt with debt costing 6.1% and an equity return of 10.2% is set for American Water Works Company, Tennessee American Water Company's parent.
6. For purposes of the rates herein, the capital structure and cost rates indicated above produce a fair rate of return of 7.89%.
7. For purposes of the rates herein, the Revenue Conversion Factor is 1.648074, resulting in a Revenue Deficiency of \$4,079,865, the amount needed for the Company to earn a fair return on its investment during the attrition year.

8. The Revenue Deficiency shall be addressed by uniform increases to base rates and volumetric rates for all customer classes.

9. The Company is directed to promptly notify the Authority if American Water Works Company's equity ratio falls below 45% and, in any event, to file a report six months after the IPO indicating the current Capital Structure.

10. Tennessee American Water Company shall have a management audit performed in compliance with Sarbanes-Oxley requirements and submit the results to the Authority in one year or, if the audit is not complete in one year, submit a status report on the audit in one year.

11. Tennessee American Water Company is directed to file tariffs with the Authority that are designed to produce an increase of \$4,079,865 in incremental revenues for service rendered and any tariffs necessary to be consistent with this Order.

12. The tariffs shall be filed within thirty days.

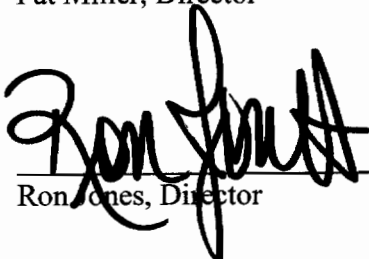
13. Any party aggrieved by the Authority's decision in this matter may file a Petition for Reconsideration with the Authority within fifteen days from the date of this Order.

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


Sara Kyle, Chairman


Pat Miller, Director

11-30-07


Ron Jones, Director