CHAMBLISS, BAHNER & STOPHEL, P.C.
MERITAS LAW FIRMS WORLDWIDE

1000 Tallan Building
Two Union Square
Chattanooga, TN 37402
Tel 423.756.3000
www.cbslawfirm.com

Frederick L. Hitchcock
Tel 423.757.0222
Fax 423.508.1222
rhitchcock@cbslawfirm.com

Electronically filed 9/2/08

September 2, 2008

Via E-mail and USPS

Chairman Tre Hargett
c/o Ms. Sharla Dillon
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243

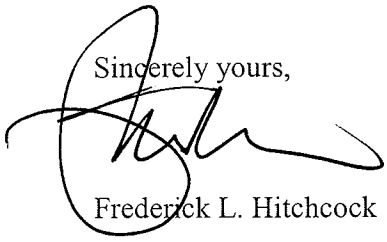
Re: Docket No. 08-00039
In Re: Petition of Tennessee American Water Company to Change and Increase Certain Rates

Dear Chairman Hargett:

Enclosed please find an original and five (5) copies of the City of Chattanooga's Post Hearing Brief. I would appreciate you stamping the extra copy of this document as "filed," and returning it to me in the enclosed, self-addressed and stamped envelope.

With best regards, I am

Sincerely yours,



Frederick L. Hitchcock

FLH:kwr
Enclosures
cc: Ryan L. McGehee, Esq. (w/encl)
Timothy C. Phillips, Esq. (w/encl)
David C. Higney, Esq. (w/encl)
R. Dale Grimes, Esq. (w/encl)
Ross Ian Booher, Esq. (w/encl)
J. Davidson French, Esq. (w/encl)
Adam Futrell, Esq. (w/encl)
Erin Everitt, Esq. (w/encl)
Henry M. Walker, Esq. (w/encl)
Michael A. McMahan, Esq. (w/encl)

IN THE TENNESSEE REGULATORY AUTHORITY
AT NASHVILLE, TENNESSEE

IN RE:	)	
	)	
PETITION OF TENNESSEE	)	
AMERICAN WATER COMPANY TO	)	
CHANGE AND INCREASE CERTAIN	)	
RATES AND CHARGES SO AS TO	)	**DOCKET NO. 08-00039**
PERMIT IT TO EARN A FAIR AND	)	
ADEQUATE RATE OF RETURN ON	)	
ITS PROPERTY USED AND USEFUL IN	)	
FURNISHING WATER SERVICE TO	)	
ITS CUSTOMERS	)	

CITY OF CHATTANOOGA'S POST HEARING BRIEF

The City of Chattanooga ("City"), by and through counsel, submits the following Post Hearing Brief.

I.
Summary of Argument

In this submission, the City addresses the history and motivation of TAWC's extraordinary rate requests, noting the effort of TAWC and its parent to make up through rate increases the huge losses that have resulted from the parent's imprudence. The City discusses the legal standards applicable to the Authority's consideration of TAWC's requests, TAWC's burden of proof, and the Authority's right to reconsider past rate decisions. The City then focuses on TAWC's demands for recovery of three major cost elements – affiliate charges, capital expenses, and rate case costs – explaining as to each why TAWC's requests are unjustified, are excessive, or are not authorized by applicable law. The City also offers brief comments concerning the rate of return issue.

II.
Perspective: TAWC's Extraordinary Rate Increase Requests

It is important to place the extraordinary rate increase of TAWC in perspective. TAWC's parent, American Water Works Company ("AWWC") completed in late April, six weeks after TAWC's rate increase request was filed, a public stock offering in which it sold 58 million shares at $21.50 per share, raising more than $1.2 Billion. Exhibit 9 at p. 12.

TAWC's parent has managed its business so imprudently that it has had to write off more than $1.1 billion since 2003, producing operating losses since that time of more than $775 million. Exhibit 7, p. 29 of 30.

American Water's Earnings and Losses					
($ in Thousands)	2003	2004	2005	2006	2007
Net Income (Loss) from Continuing Operations	$42,140	$59,100	($275,130)	($155,850)	($342,275)
Write-Offs	($3,555)	($55,276)	($378,057)	($217,501)	($501,515)

Source: TN-COC-01-Q02 ATTACHMENT, p. 29 of 30

TAWC's parent is promising its stock purchasers that it will solve its losses by "managing rate cases" -- meaning that TAWC and its other subsidiaries will seek large rate increases. See Exhibit 7, p. 9 of 30. TAWC's current rate increase request, filed six weeks before AWWC's stock sale was completed, matches a broad pattern.

American Water's Aggressive Filing of Rate Cases				
	2006	2007	Thru March 2008	2008-2011
New Jersey	Filed		Filed	Planned
Pennsylvania		Filed		Planned
Missouri	Filed		Filed	Planned
Illinois		Filed		Planned
Indiana	Filed			Planned
California	Filed	Filed	Filed	Planned
West Virginia		Filed		Planned
Other States	5 Filed	8 Filed	12 Filed	Planned
Amount Sought	$189.7	$171.2	$231.3	

Source: TN-COC-01-Q02 ATTACHMENT, p. 21 of 30

The number of, and amount sought in, rate cases filed by AWWC subsidiaries in just the first three months of 2008 exceeded the level of 2006 and 2007. In the last sixty-one months, TAWC has filed four rate cases. The current rate case seeks a larger increase than any other rate case in TAWC's history in both absolute dollar terms and as a percentage. If TAWC were granted its proposed rate increase, its rate revenue would be increased by $11,724,724, or 35.07% since May 14, 2007. Through August 25, 2008, by comparison, gas prices have increased 19.26%. Of course, gas prices go up and down, unlike the rate increase sought by TAWC.

Gas Prices vs. TAWC Proposal Since May 14, 2007	
Gas Prices Have Increased (Thru 8/25/09)	19.26%
Gas Prices Have Increased (Thru 8/11/09)	22.65%
TAWC Proposes That Water Rates Increase	35.07%
TAWC Proposes That Water Revenue Increase	$11,724,724

Source: U.S. DOE Energy Information Administration; available online at http://tonto.eia.doe.gov/oog/ftparea/wogirs/xls/pswrgvwall.xls#'Data 1'!A1

TAWC has the right to seek rates to recover necessary and prudent expenditures through rates that are just and reasonable. It is not just and it is not reasonable to raise rates in Chattanooga to fill a gap in income caused by more than $1.1 billion in write-downs, produced net losses of more than $750 million.

III.
Argument

A. TAWC Has Not Met Its Burden of Proof Under Tennessee Law

TAWC's request for a rate increase should be denied because the utility has failed to prove that that the increase sought is just and reasonable. As the proponent of a rate increase, the burden of proving the increase in rates is just and reasonable falls squarely on TAWC shoulders. Tenn. Code Ann. § 65-5-103 states in pertinent part:

> (a) When any public utility shall increase any existing individual rates, joint rates, tolls, fares, charges, or schedules thereof, or change or alter any existing classification, the authority shall have power either upon written complaint, or upon its own initiative, to hear and determine whether the increase, change or alteration is just and reasonable. *The burden of proof to show that the increase, change, or alteration is just and reasonable shall be upon the public utility making the same.* In determining whether such increase, change or alteration is just and reasonable, the authority shall take into account the safety, adequacy and efficiency or lack thereof of the service or services furnished by the public utility.

(emphasis added.)

Additional statutory authority and rules likewise place the burden of proving that the increase in rates is just and reasonable on TAWC as the party asserting the affirmative of the issue. *See* Tenn. Code Ann. § 65-2-109(5) (2004) and Tenn. Comp. R. & Regs. Rule 1220-1-2-.16(2) (2008) (both provisions providing that the burden of proof shall be on the party or parties asserting the affirmative of an issue).

In no case does the City or the other Intervenors have the burden of proving that TAWC is seeking rates that are not just and reasonable. The Intervenors have no responsibility to prove what TAWC's rates should be or to prove which of TAWC's claimed costs are allowable under Tennessee law. To succeed in their opposition, the Intervenors need only establish that TAWC has not succeeded in placing into the record adequate competent evidence to prove that each element of its cost is necessary and is prudent, both in type and amount, and that the rates that it requests are just and are reasonable.

B. The Authority Has the Power to Vary from Past Decisions

TAWC has suggested that each of its rate increase requests must be laid upon an unassailable foundation of the rate increases that preceded it. This is not the law. Tenn. Code Ann. §65-5-101(a) makes clear, that that the TRA has the power to fix just and reasonable rates and to reduce and reject rates that are "unjust, unreasonable, excessive, insufficient, or unjustly discriminatory or preferential, howsoever the same may heretofore been fixed or established." Tenn. Code Ann. §65-5-101(a) (emphasis supplied).

In determining whether previously established or proposed rates are just and reasonable the statute commands that "the authority shall take into account the safety, adequacy and efficiency or lack thereof of the service or services furnished by the public utility." Id.

{emphasis supplied). As the proponent of rate increases, TAWC has the burden of showing that the types and levels of its expenses, and the rates sought to recover those expenses, are just and reasonable and are not excessive and do not demonstrate a lack of efficiency.

As set forth in greater detail herein, the City has focused specifically on TAWC's failure to meet its burden of proof as to two major categories of expenses, affiliate payments and rate case costs. The City has also shown that TAWC has failed to meet its burden of proof as to the necessity and prudence of TAWC's huge projected increase in capital expenses. For the reasons set forth herein, the Authority should reject recovery of all affiliate payments and rate case costs such costs in this proceeding, including those costs embedded in previously-approved rates and those sought to be recovered in the additional rates TAWC has requested in this case. The Authority should likewise refuse to approve rates to recover TAWC's proposed increases in capital expenses above historical levels.

C. TAWC Has Not Justified Payments to Affiliates

1. The Authority's Direction to TAWC

In Docket No. 06-00290, the City and other Intervenors questioned the purpose and amount of fees and expenses paid by TAWC to its parent and affiliates. The Intervenors contended that TAWC had failed to carry its burden of proof in establishing that those fees and expenses were necessary, were reasonable, and resulted from prudent management decisions. As a result, the Intervenors contended that TAWC had failed to carry its burden of proof proving that rates recovering such fees and expenses were just and reasonable.

The Intervenors' contentions were addressed in the May 15, 2007 Authority Conference. Director Jones addressed the issue as follows:

> Expenses with respect to the management fees, I dissent from that motion in one respect. The intervenors here have fully satisfied me that further inquiry

must be made into whether the underlying functions performed by the services company are necessary, efficiently executed, and a result of prudent management decisions.

The record in this docket was void of information upon which to answer these very, very important questions. This conclusion, I believe, is consistent with your motion. Contrary with the motion, however, is my opinion that this issue is of such critical importance that the results of a management audit should not be put off until some unknown time in the future when Tennessee American Water Company chooses to file a rate case. It is my position that Tennessee American Water Company should file the results of the management audit you identified in your motion as described by no later than May 15, 2008, and I would certainly encourage the majority in voting on that part to amend its motion to require that.

I would also say that in this particular case that was one of the major difficulties in looking at those expenses and making determinations to start with as to the appropriateness of their full inclusion. I think the management audit will certainly reveal certain aspects of that.

May 15, 2007 Authority Conference at p. 17-18.

The motion to which Director Jones was referring was the motion of Director Miller, which instructed TAWC as follows:

> Additionally, I move that the Authority direct TAWC to have a management audit performed in compliance with Sarbanes-Oxley requirements and to submit the audit results concurrent with any future rate case filing. 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.

Director Miller's Motion adopted May 15, 2007.

Responding to Director Jones suggestions, Director Miller amended his motion to require that the specified management audit be completed within one year, rather than requiring that it be completed for the next rate filing.[1] The Directors obviously never imagined that TAWC would file a rate increase less than 10 months later.

[1] The directive in this form was included in the June 10, 2008, Order entered by the Authority in Docket 06-00290.

2. **The BAH Report Was Not a Management Audit.**

The record in this docket clearly established that TAWC has not complied with this requirement. Instead, it has paid more than $300,000 for a report that was not a management audit, was not performed in compliance with Sarbanes-Oxley requirements, did not address all costs allocated to TAWC, and did address whether all such costs were a result of prudent or imprudent management decision. Instead, TAWC paid a consulting firm more than $300,000 to repackage a report approach never before used in a water utility case and never before referred to as a "management audit."

The National Association of Regulatory Utility Commissioners ("NARUC") established two decades ago the definition of a "management audit" for utility regulatory purposes.

> A management audit is a systematic and objective review, conducted by the independent external auditor of an organization's management and its operations, or a specific segment of them, in relation to specified objections and relevant standards. The purpose of the review is (a) to evaluate performance, (b) to identify opportunities for improvement, and (c) to develop recommendations for improvement and further action.

NARUC Management Audit Manual, Vol. I (1988), p. 9 (Available at www.naruc.org\store). *See* Vol. XX, at pp. 2000-2002.

The NARUC Management Audit Manual also set forth the standards for completion of an appropriate management audit.

> Regardless of the type of management audit being conducted, or the specific objectives, the audit should be conducted in accordance with generally accepted auditing standards to ensure it will be received as professional, competent, and credible in the eyes of the regulatory body, the utility companies and the general public.

NARUC Management Audit Manual, Vol. I (1988), p. 15.

With its petition in this Docket, TAWC offered a report completed by Booz Allen Hamilton (the "BAH Report") and the testimony of Mr. Joseph Van den Berg, in which he asserted that the BAH Report was a "management audit" meeting the directive of the Authority. It demonstrably is not.

The NARUC Management Audit Manual defined a "management audit" as "a systematic and objective review" of the management operations of TAWC and its affiliates "in relation to specified objectives and relevant standards." In this case, the Authority defined the specified objectives as (i) "whether all costs allocated to TAWC were incurred as a result of prudent or imprudent management decisions by TAWC's parent" and (ii) "the reasonableness of the methodology used to allocate costs to TAWC."

The Management Audit Manual also specified that all "management audits" were to be "conducted in accordance with generally accepted auditing standards to ensure it will be received as professional, competent, and credible in the eyes of the regulatory body, the utility companies and the general public." In this case, in addition to generally accepted auditing standards, the Authority specified that the audit be completed "in compliance with Sarbanes-Oxley Requirements".

Mr. Van den Berg acknowledged that reports using the same format and approach had never been referred to by BAH as "management audits". Vol. 8 at 883-884. Similar reports had been submitted to regulatory authorities in Illinois and Texas as "independent analyses of the allocation of shared services costs for the operating companies from the parent." Vol. 8 at 883. Mr. Van den Berg admitted that the BAH Report was the first such report ever referred to as a "management audit". Vol. 8 at 884-885.

Mr. Van den Berg admitted that he had sworn in response to one of the City's discovery requests that neither he nor BAH had ever completed a publicly available management audit. Vol. 8 at 880-881; Exhibit 25. No modification was ever made to this response. When asked in a later request for copies of all management audits, whether publicly available or not, TAWC and Mr. Van den Berg identified only "independent analyses" completed for electric and telecommunications utilities and did not refer to any of these as management audits. Vol. 8 at 882-886, Exhibit 26.

Mr. Van den Berg admitted that he was not responsible for providing testimony in support of any of the "independent analyses" relating to electric utilities identified in Exhibit 26. Vol. 8 at 886-887.

Mr. Van den Berg admitted that BAH had never completed an "independent analyses", much less a "management audit" for a water company. Vol. 8 at 879.

Because of his obvious lack of experience in completing management audits, Mr. Van den Berg was apparently ignorant of the definition established by the NARUC Management Audit Manual 20 years ago.

The BAH Report did not establish any definitions of prudence, imprudence, or reasonableness. Vol. 8, at p. 873:14. When asked for his definition of prudent, Mr. Van den Berg responded with a circular argument that prudence was what was established by the BAH Report. Vol. 8, at pp. 876:17–877:2. When asked to identify where the words "prudent" or "imprudent" even appeared in the BAH Report, he could identify only one page on which the words appeared, a reference on page 3 of the BAH Report describing what the Authority sought. Mr. Van den Berg claimed that he knew of no other definition of "prudence" or "imprudence". Vol. 8, at p. 878.

The NARUC definition of a management audit requires that it identify areas for improvement and include recommendations to management. Mr. Van den Berg claimed that the BAH Report included recommendations for improvement, but he struggled to find any in the Report. He first identified only the following statement:

> . . . researching the drivers of the AWWSC cost increase, our analysis did discover a need for a record detailing the rationale for new positions. "Rationale should be based upon required services outlined by the service agreement, which would be coming from the operating companies."

Vol. 8 at p. 940 (quoting BAH Report at p. 51 of 59).

Mr. Van den Berg claimed the absence of the referenced process was not an imprudent management decision. *Id.* He offered no explanation about its impact on the "duplication analysis", and he stated that BAH did not quantify the value or impact of making the change. *Id.*

Only after coaching by TAWC's attorney was Mr. Van den Berg able to identify a second "recommendation", which he claims is stated on the bottom of page 37. Vol. 8 at pp. 942-943 (referring to language on p. 37 of 59 of the BAH Report). At best, the recommendation is inferred, not stated.

3. **The BAH Report Is Not Supported By Logic or Evidence.**

The BAH Report was structured around seven elements, which BAH and Mr. Van den Berg contend together constitute a "management audit". As discussed below, these elements are not individually supported by logic or evidence and do not collectively constitute the management audit ordered by the Authority.

(a) Element One: The "Functions" Analysis Has No Relevance to Prudent Management Decisions.

Mr. Van den Berg claimed that a first key element of the BAH Report was an analysis of whether the functions performed by American Water Works Service Company ("AWWSC") for

TAWC were functions normally performed for a corporation.[2] Mr. Van den Berg admitted that "the only relevance of this particular question to the issue of prudence or imprudence is that they're doing the same stuff any prudent corporation would do." Vol. 8 at 891:17-891:22.

The "functional" analysis completed by BAH was not a "systematic and objective review" of anything.

(b) Element Two: There Is No Evidence In the Record That Any "Benefits" Analysis Was Completed.

Mr. Van den Berg claimed that a second critical element of the BAH Report was to determine whether the functions being performed provided a benefit to TAWC. Mr. Van den Berg admitted that the only data collected concerning any such benefits was a survey that was supposedly completed by some 30 to 35 TAWC and AWWSC employees. Vol. 8 at 893-894, 898, 902. Mr. Van den Berg asserted that interview notes were created as a result of these interviews. Vol. 8 at 894-895, 898. All of these interview notes and other work papers were required to be produced by the City's First Discovery Request No. 17 (Exhibit 27). The materials produced do not include any survey instruments, notes, or other information concerning the alleged interviews. *See* TAWC Responses to COC First Discovery Requests, filed May 28, 2008.

Mr. Van den Berg admitted that no other objective data was collected concerning the asserted benefits of TAWC services other than the undisclosed survey:

Q: All right, sir. Let me rephrase the question and ask it this way. Did you collect any data from Tennessee American Water Company concerning these benefits, other than the survey you've described?

A: I don't believe so, no.

Q: Okay.

[2] The elements of the BAH analysis are listed in Van den Berg's prefiled testimony at pp. 3-4.

A: I don't believe so.

Vol. 8 at 902:19-902:25

Since TAWC failed to provide as part of its discovery responses prior to the hearing any of the survey information, and since Mr. Van den Berg admitted that the survey was the only objective data collected concerning any alleged benefit to TAWC provided by AWWSC services, the records is devoid of any facts to support Mr. Van den Berg's assertion that AWWSC's services provided benefits to TAWC. The record does not establish that the "benefit" analysis completed by BAH was a "systematic and objective review" of anything.

Mr. Van den Berg admitted that he and BAH undertook no analysis of whether the level or quantity of services being billed by AWWSC to TAWC was the appropriate or prudent level or quantity of services. Vol. 8 at 904:21-905:5; 906:9-906:19.

In spite of the Authority's direction that the management audit evaluate "whether all costs allocated to TAWC were incurred as a result of prudent or imprudent management decisions by TAWC's parent", Mr. Van den Berg deliberately ignored the relevant management decisions.

Mr. Van den Berg admitted that he and BAH did not review the bills that were rendered by AWWSC to TAWC. Vol. 8 at 917-918. He admitted that he and BAH did not "undertake any analysis of any of these months, during 2005 and 2006, to determine whether the amounts charged were the correct amounts – the correct volume of services needed by Tennessee American Water Company." Vol. 8 at 918. Mr. Van den Berg admitted that he and BAH "did not undertake any study whatsoever to determine whether the amounts paid by Tennessee American Water Company were the correct – were for the correct volume or quantity of service." Vol. 8 at 919. He asserted that determining the correct volume or quantity of services allocated to TAWC was the responsibility of management and was "not part of the management audit of the allocated costs." *Id.* See, generally, Vol. 8, 917-935.

Q: Did you look at any of these expenses to determine whether the decisions that resulted in their being charged to Tennessee American Water Company were prudent or imprudent?

A: No. We looked to make sure that the aggregate level was prudent or imprudent and that the management controls were in place, between the operating company and the service company, to manage the individual elements.

Vol. 8 at 932.

(c) Element Three: No "Duplication" Analysis Was Completed, As TAWC Costs Were Not Analyzed.

Mr. Van den Berg claimed that a third critical element of the BAH Report was an analysis of whether there was any duplication or overlap between services provided by AWWSC and those provided by TAWC. However, Mr. Van den Berg admitted that he had no idea how much was spent by TAWC for its own labor and benefits in 2005 or 2006 and how that compared to prior years. Vol. 8 at 936. He summed up the complete absence of analysis with this testimony:

Q: You didn't look at the labor and benefit and what it was being spent for locally by Tennessee American Water Company, did you?

A: No. Not part of the scope of our analysis.

Q: Not part of your duplication or overlap analysis that you said you did?

A: No. That is correct. Because that was based on activity.

Vol. 8 at 937-938.

(d) Element Four: No Meaningful Analysis of Allocation Methodology Was Completed.

No meaningful analysis of the per customer allocation methodology was undertaken by BAH, although the BAH Report contains a cryptic reference to the fact that other shared services organizations use more than a single allocation factor. He claimed that BAH recommended "by

inference, that it is appropriate to look at additional allocation factors" other than number of customers. Vol. 8 at pp. 942-943 (referring to language on p. 37 of 59 of the BAH Report). This "recommendation" addressed the fourth critical element of BAH's analysis, whether AWWSC's costs were fairly allocated to TAWC, but was only an "inference". BAH only looked at the overall allocation formula, not at decisions to allocate particular employees or expenses to TAWC. Vol. 8, at p. 938.

(e) Elements Five and Six: No Real Analysis Was Completed of Budget and Cost Control Processes; No Analysis Was Made of TAWC Cost Trends; No Analysis Was Made of Capital Charges.

Mr. Van den Berg asserted that a fifth critical element of BAH's analysis was whether budgeting and control processes provide for effective cost management and that a sixth element was whether cost trends provided evidence of effective cost control. However, he admitted that he and BAH did not look at all at the budgeting processes at TAWC. Vol. 8 at pp. 945:16–946:13. As noted above, he admitted that he had no idea how much TAWC paid for its own labor and benefits in 2005 and 2006 or how those amounts compared to prior years. Vol. 8 at 936. Further, he claimed that the control process in place was TAWC President John Watson.

Q: Okay. Now, describe for me, if it's -- if you don't know anything about the budgeting process at Tennessee American, what process does Tennessee American use to control, monitor and prevent inappropriate charges being assigned to it by American Water Works Service Company?

A: John Watson has the responsibility, as a member of the board of the service company, to review the budget for the service company charges that are going to be applied to Tennessee American. He then -- and I don't have the process. He then takes those into account and his own budgetary process for Tennessee American.

Q: All right, sir. So it's your testimony that a budget is prepared for the charges from American Water Works Service Company that are going to go to Tennessee American and that that budget is observed, and that is a control that keeps the budget -- that keeps too much charges from being assigned to Tennessee American. Is that your testimony?

A: It allows that the service agreement between the two is in place and managed, and then John -- and then Tennessee American will determine whether they want to take those charges or not.

Vol. 8 at 946-947.

Mr. Van den Berg asserted that a "budget-control process" was in place and was being followed:

Q: Isn't the most fundamental budget-control process following your budget?

A: That is correct. And that process was in place for them to do that.

Q: Okay.

A: Yes.

Q: It's your testimony that American Water Works Service Company and Tennessee American are following the budget for service-company charges for Tennessee American Water Company. Is that your testimony?

A: Yes, it is.

Vol. 8 at 948.

However, Exhibit 31 makes it clear that AWWSC and TAWC are not following the budget established for service company fees. The Exhibit, produced in response to the City's First Discovery Request No. 24, shows that the budget for all service company charges for 2006 of $4,218,632 was exceeded by $1,026, 042, or more than 24 percent. Performance was even worse in 2007, when the budget of $3,435,976 was exceeded by $1,560,195, or more than 45 percent.

The examination of Mr. Van den Berg concerning Exhibit 31 established that the BAH Report did not analyze " all costs allocated to TAWC" as Director Miller's Motion required. BAH did not consider at all charges of AWWSC that were capitalized.

Q: Okay. Did you analyze the reasons for these capital expenditure charges?

A: We did not. Our analysis was based on the O and M recurring expenses, rather than the capital, which are usually onetime events or cyclical, rather than ongoing charges.

Vol. 8 at 955.

Mr. Van den Berg was presented Exhibit 32, which provides details of AWWSC charges that were capitalized. He confirmed that BAH did not look at capital expenditures and did not look at the question of whether AWWSC was regularly assessing charges to TAWC relating to capital expenses. Vol. 8 at pp. 956-958.

(f) Element Seven: No Adequate Justification Was Offered for Limiting Any Benchmarking Analysis to Electric Utilities.

Mr. Van den Berg asserted in his testimony that the final element of the BAH analysis was a review of whether costs are comparable to other service companies. Mr. Van den Berg reported that the evaluated this element by comparing AWWSC costs to those of a group of 20 electric utility service companies.

Mr. Van den Berg acknowledged that the operational aspects of the water business and the electric business are different, but he expressed the opinion that "the shared services functions are extremely similar." Vol. 9 at p. 964-965. Of course, except for the service company charges related to capital expenditures, all of "shared services" provided by AWWSC relate to the operational aspects of TAWC's water business. Vol. 8 at 955 ("Our analysis was based on the O and M recurring expenses . . . .")

Mr. Van den Berg could not point to any book or study, any published article, or any research that supports his opinion that the operation of an electric utility is very similar to the operation of a water utility. He suggested that vendors who wished to sell computer systems to both electric and water utilities would vouch for his opinion. Vol. 9 at pp. 965-966. After refusing to answer the question repeatedly, he finally claimed that a company named "Chartwell"

did surveys that supported his opinion that operation of an electric utility is very similar to the operation of a water utility. Vol. 9 at 971-973. A review of the web site of Chartwell, Inc. belies Mr. Van den Berg's assertion. Chartwell advertises a series of reports for sale, virtually all of which deal with energy utilities. A single "best practices" report listed in the news release summaries appeared to deal with a water utility, but did not appear to deal with both water and electric utilities. *See* http://www.energylibrary.com/index.cfm/ID/1/Home. No studies, treatises, published articles, or research supporting Mr. Van den Berg's assertion are in the record. The reality is that TAWC hired BAH to apply a cost-justification methodology that has never included cost data from water utilities and has never been used to compare the costs of an energy utility – or charges paid by an energy utility – to a water utility. Vol. 8, at p. 879.

Mr. Van den Berg and BAH failed to apply comparative cost data available from water utilities. He acknowledged that there were a variety of ways that TAWC could serve its customers. Vol. 9 at p. 975. He acknowledged that the vast majority of utilities serve their customers directly without use of a shared services company. *Id.*

Mr. Van den Berg acknowledged that the BAH Report did not evaluate the issue of whether services provided by AWWSC could be provided less expensively by using local resources employed directly by TAWC. Vol. 9, at p. 976. He admitted that he did not "undertake an analysis of the management decisions that have been made to use American Water Works Services to provide particular functions as opposed to hiring those resources locally." Vol. 9, at p. 980.

No analysis was completed, for example, of issues raised by the continuing increase in local TAWC costs along with increases in AWWSC fees. Mr. Watson admits that the customer base has grown less than nine tenths of one percent since the last rate case, currently about

74,400 customers. He claims additional efficiency in the number of service calls (sixty orders per day) that employees are making, utilizing Toughbook computers and GIS dispatch capabilities utilizing SCADA technology. He reports that TAWC is installing radio-meters that may be read hundreds of feet away saving labor expenses and reducing the number of estimated bills. Yet when asked what he was doing as President of TAWC to reduce employee costs, he claimed that he could not do so without reducing service metrics. Vol. 1 at pp. 115-116, 120-121, 128. It was obvious from Mr. Watson's testimony that he had not seriously considered reducing labor costs at TAWC or cutting the cost of services received from the service company. TAWC asserts that it is increasing the efficiency of its employees, but it demonstrates an unwillingness to reduce its local labor costs or the costs of AWWSC services. The BAH Report failed to analyze any such conflicts.

Mr. Van den Berg acknowledged that it was feasible to have structured any benchmarking analysis to match up TAWC and AWWSC costs with costs reported in the American Water Works Association benchmarking studies. Vol. 9, at p. 986:5-986:11. He admitted, however, that the comparison in the BAH Report compared only AWWSC costs to the electric utility sample and did not include TAWC costs. Mr. Van den Berg admitted that he did not know what TAWC's customer service costs were. Vol. 9, at p. 989:2-989:20.

4. **The BAH Report Was Not Performed in Compliance With Generally Accepted Auditing Standards or Sarbanes-Oxley Requirements.**

Mr. Van den Berg testified that he only applied a single Sarbanes-Oxley requirement which he understood simply required that the "management audit" not be completed by AWWC's auditing firm. Vol. 8, at p. 873. The BAH Report ignored other requirements in Sections 302 and 404 of Sarbanes-Oxley, which required evaluation of material weaknesses and certifications of accuracy by management and by BAH. Vol. 9 at pp. 1013-1016. Indeed, Mr.

Van den Berg testified that he did not understand any Sarbanes-Oxley requirement other than the "independence" requirement that prohibited a company's regular auditor from undertaking a management audit. Vol. 9, at p. 1014-1015.

Mr. Van den Berg claimed that BAH found no material weaknesses in its review, a remarkable statement in light of the fact that AWWSC and TAWC were routinely and massively exceeding their budgets, *e.g.* Vol. 8 at 955 and Exhibit 31, and that there was no labor budget available for AWWSC employee levels in 2005 and 2006. Vol. 9, 1001-1006. It was even more remarkable for the fact that Mr. Van den Berg claimed to have reviewed publicly available filings, but apparently ignored reports by AWWC that both it and its subsidiaries had material weaknesses in internal control over financial reporting. Exhibit 35, the Form 424B4 filed by AWWC, recites that these weaknesses had been so serious that they prevented AWWC and its subsidiaries from complying with reporting covenants in debt agreements. Vol. 9, at pp. 1007-1012. It is clear that the reason that BAH found no material weaknesses is because it did not look for them. Vol. 9, at pp. 1011-1014.

As Mr. Majoros pointed out, no audit work was completed by BAH to test or verify the data provided by AWWSC. *E.g.* Majoros Prefiled Direct Testimony at pp. 5, 7, 9-11; Exhibit 57; Majoros Direct at Vol. XX, at pp. 1994-1999. Such independent and objective testing was required by the NARUC Management Audit Manual, by generally accepted auditing standards, and by Sarbanes-Oxley requirements. The BAH Report neither met the definition of a management audit, nor followed the standards established for such audits.

Mr. Manner's late-offered and very expensive testimony added nothing to the Authority's direction that the audit be "completed in compliance with Sarbanes-Oxley *requirements*" (emphasis supplied). He incorrectly argued that there was no definition of a management audit

and that generally accepted auditing standards do not apply to a management audit, positions that were effectively rebutted by Mr. Majoros' testimony and by the language of the NARUC Management Audit Manual. *E.g.* Majoros Direct Vol. XX, at pp. 1994-2003. Mr. Manner argued at length that no Sarbanes-Oxley requirements did, or could, apply, but he then presented testimony that AWWC had already fully complied with most Sarbanes-Oxley requirements. Manner Prefiled Direct at pp. 24-25. He testified that AWWC had voluntarily complied with most of the other Sarbanes-Oxley requirements. *Id.*

5. The BAH Report Did Not Determine Whether All Costs Allocated to TAWC Were A Result of Prudent or Imprudent Management Decisions.

The most remarkable revelation from the hearing is the fact that the BAH Report did not address the Authority's central question of whether all costs allocated to TAWC were a result of prudent or imprudent management decisions. First, there was no review at all of costs allocated to TAWC for capital expenses. Vol. 8, at pp. 955. Second, there was no review of the O&M expenses, either for personnel costs or other costs, that were charged to TAWC. The BAH Report did not examine any payroll charges to determine whether the cost charged to TAWC was the result of a prudent or imprudent management decisions. The BAH Report did not examine any expenses to determine whether the costs paid by TAWC were the result of prudent or imprudent management decisions. *E.g.* Majoros Direct at Vol. XX, pp. 1995-1996.

D. TAWC Did Not Establish That Capital Expenses are Necessary and Reasonable

TAWC has the burden of proving that the capital expenditures it has made and proposes to make are necessary and prudent and will result in assets that are used and useful for the delivery of service to its ratepayers. In this Docket, it argues that it should be compensated for

and permitted to earn a rate of return on huge new capital expenditures that far exceed the average annual capital expenditures made during the period 2001 through 2007.

In response to the City's First Discovery Request No. 4, TAWC provided a description of TAWC's capital expenditures for the years 2001 through 2007. Those expenditures averaged slightly more than $3,500,000 per year, or some $292,000 per month. The largest annual expenditure occurred in 2005, the year in which TAWC completed a major TDOT project that was "revenue supported". Exhibit 44. The annual expenditures are set forth in the following table:

TAWC Capital Expenditures						
2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
$2,139,363	**2,944,890**	**3,830,209**	**2,229,712**	**7,553,858**	**3,886,364**	**2,186,307**

By contrast, TAWC seeks to complete in the period December 31, 2007 through August 31, 2009, a period of 20 months capital projects costing a total of $20,464,381, or a pace of more than $1,020,000 per month. Exhibit 45. There is nothing in the record to support the massive acceleration of capital expenditures or to support any conclusion that the expenditures are necessary and prudent or that the resulting assets would be used and useful to the ratepayers.

TAWC completed its last Comprehensive Planning Study (the "CPS") in 2000. At the City's request, TAWC provided cross-references of the capital expenditures made from 2001 through 2007 to recommendations in the CPS. No similar document exists in the record as to capital expenditures proposed to be made during the period December 31, 2007 through August 31, 2009.

Because of the absence of any meaningful explanation or justification for the huge proposed increase in capital expenditures, the Authority should deny recovery of any expenditures, and of any rate of return on such expenditures.

IV.
TAWC Is Not Entitled To Recover Attorneys' Fees and Other Rate Case Costs

In this case, TAWC seeks to shift to its ratepayers, made up principally of the City and its citizens and the Chattanooga Manufacturers Association and its members, some $2,000,000 in legal fees and expenses attributable to this Docket and the recently-completed Docket 06-00290. Prefiled Rebuttal Testimony of M. Miller at p. 86.

Whatever the past history of such awards of fees and expenses by this Authority, the Tennessee Supreme Court made clear earlier this year that each party to litigation is required to bear its own litigation costs in the absence of a contractual or statutory provision shifting such costs to other parties. In *House v. Estate of Edmondson*, 245 S.W.3d 372 (Tenn. 2008), the Tennessee Supreme Court addressed the question of whether a successful party in a derivative action involving a for-profit corporation could recover its legal fees. The Supreme Court rejected the effort applying a strict interpretation of the "American Rule" and denying the application of the common trust doctrine as an exception to that rule. The Court explained:

> We begin our analysis of this issue by noting that Tennessee, like most jurisdictions, adheres to the "American rule." John Kohl & Co. v. Dearborn & Ewing, 977 S.W.2d 528, 534 (Tenn. 1998). The American rule provides that a party in a civil action may not recover attorney's fees absent a specific contractual or statutory provision providing for attorney's fees as part of the prevailing party's damages. Id.
>
> The American rule, which has been described by this Court as "firmly established in this state," State v. Brown & Williamson Tobacco Corp., 18 S.W.3d 186, 194 (Tenn. 2000), is based on several public policy considerations. First, since litigation is inherently uncertain, a party should not be penalized for merely bringing or defending a lawsuit. Fleischmann Distilling Corp. v. Maier Brewing Co., 386 U.S. 714, 718, 87 S. Ct. 1404, 18 L. Ed. 2d 475 (1967),

> *superseded by statute on other grounds*, Act of Jan. 2, 1975, Pub. L. No. 93-600, 88 Stat. 1955. Second, the poor might be unjustly discouraged from instituting actions to vindicate their rights if the penalty for losing included paying the fees of their opponent's lawyer. Id. Third, requiring each party to be responsible for their own legal fees promotes settlement. Allstate Ins. Co. v. Huizar, 52 P.3d 816, 818 (Colo. 2002). Fourth, the time, expense, and difficulty inherent in litigating the appropriate amount of attorney's fees to award would add another layer to the litigation and burden the courts and the parties with ancillary proceedings. Fleischmann, 386 U.S. at 718. Thus, as a general principle, the American rule reflects the idea that public policy is best served by litigants bearing their own legal fees regardless of the outcome of the case.

245 S.W.3d at 377.

Each of the four policy reasons for the American Rule apply with much force in this case. First, the ratepayers, represented by the Intervenors, should not be penalized for merely participating in this regulatory process. Second, the ratepayers and their representatives should not be unjustly discouraged from asserting their rights to require TAWC to justify its rate demands. Third, requiring each party to be responsible for their own attorney's fees encourages settlement. As this case so vividly illustrates, permitting TAWC to shift its expenses has encouraged great excess by TAWC in the preparation and presentation of their case. Fourth, the time and expense involved in determining the appropriate amount of attorney's fees would add another dimension to the litigation and would impose an unnecessary burden on the courts and the parties.

There exists no statute that authorizes the shift of TAWC's attorney's fees to the Intervenors and their citizens and members. The Supreme Court's decision in House establishes the applicable law in Tennessee, and the City respectfully asserts that the Authority is obligated to require that TAWC incur its own attorney fees and to reject its request that they be shifted to the Intervenors and their citizens and members.

The Authority should likewise reject TAWC's demand that its non-legal rate case expenses be shifted to the Intervenors and their citizens and members. Tenn. Code Ann. § 65-5-103 requires that TAWC bears the burden of proof that its costs are necessary and prudent and that its proposed rates collecting those costs are just and reasonable. In this Docket, TAWC has offered no proof that its rate case expenses are just and reasonable, much less carried its burden on the issue. The information that is in the record indicates that TAWC's rate case costs are out of control and demonstrate wild excess.

This is a case in which TAWC sought from the start to stack the deck in its favor through excess. The Excess started with a 970-page petition, preparation of which began barely a month after the Authority's decision in TAWC's last rate case. The petition was designed to overwhelm the Authority, its staff, and any potential intervenors, given the traditional effort of the Authority to resolve such requests within six months.

The Excess was reflected in the fact that this was the fourth petition filed by TAWC in just 61 months.

The Excess continued with reams of TAWC objections and motions, including frivolous motions for sanctions unsupported by any law or rule of procedure. The Excess continued with TAWC's launch of a public relations campaign, not designed to answer the substance of the criticisms of TAWC's excessive rate demands, but to attack the City of Chattanooga.

The Excess continued with the designation of 11 witnesses, including an economics expert paid more than $100,000 to offer testimony on a theoretical means of estimating cost of capital that has never been adopted by this Authority or any other utility regulatory body in the United States. This expert claimed that capital could not be attracted without an 11.75 percent

return on equity in spite of the fact that TAWC's parent raised more than $1.2 Billion with an return on equity of 6.5 percent. Exhibit 9, p. 1.[3]

The Excess continued with the BAH Report, a 59-page apologia asserting that whatever TAWC paid to its parent and affiliates was justified. TAWC sought to cure the fact that the BAH Report was not the management audit ordered by the Authority by simply changing its name to "management audit." The fact that it was not completed in accordance with "Sarbanes-Oxley requirements" as the Authority directed was first ignored and then defended by the last-minute addition of a $500/hour lawyer who testified that the Authority did not mean what it said when it mandated compliance with Sarbanes-Oxley requirements and that, even if it did mean it, it had no power to do so. The fact that the Authority ordered evaluation of the prudence or imprudence of management decisions was likewise ignored, as was the fact that the Authority directed the analysis to include "all costs" charged TAWC, not just O&M charges.

The Excess continued with a $20,000 "weather normalization" study that, as its author admitted under cross-examination, had no value if a utility was seeking frequent rate increases.

The Excess continued as the hearing commenced with a platoon of TAWC lawyers, backed up by corps of staff and consultants, all of whom were busily billing their time in hopes that the ratepayers would pay.

---

[3] The unreasonableness of TAWC's request is exemplified in the cost of the testimony of Mr. Vilbert. Mr. Vilbert testified that he expected that his firm would receive a $100,000 fee for its testimony in this case that he expected would be passed on to the ratepayers. Vol. 3, at p. 327. By contrast, Mr. Gorman estimated that the statement of his firm for providing testimony on cost of capital would be approximately $25,000. Vol. XXII, at p. 2135. It is readily apparent that Mr. Vilbert is not being paid for his effort in arriving at reasonable recommendations, but is being paid for making a recommendation of 11.75% return on equity utilizing methods not adopted in any other jurisdiction. His recommendation would result in a return on equity higher than awarded any other subsidiary of AWW in other jurisdictions. The lack of substance of Vilbert's testimony is exemplified by his cross examination by Mr. Walker, in which Vilbert stated that he would recommend 16.75% ROE if double leverage was applied to such a thin equity thickness. Vol. 3 at pp. 341-42. The shareholders of AWW, not the ratepayers of TAWC, should bear the total expense of the testimony of Mr. Vilbert.

The Excess continued with reams of colorfully-designed presentations produced in great quantities at great expense and billed to the ratepayers, who would have happily sacrificed the collage of color for black and white copies at a nickel a page.

For all of this Excess in the proceeding and in the one so recently concluded in May of 2007, TAWC claims to have incurred nearly $2.5 million, of which it seeks recovery from the ratepayers of nearly $2 million.[4]

V.
Return on Equity

Although other Intervenors are addressing return on equity in more detail, the City wishes to briefly comment on the incongruous testimony of TAWC's expert on the subject. TAWC via its witness Mr. Vilbert says that it needs an 11.75 percent return on equity, but the lack of merit of this assertion was readily apparent from the hearing in this case. Mr. Vilbert asserted that such a high return on equity was needed to permit TAWC's parent to attract capital, and he offered complex – and unprecedented – economic arguments to support his theory. However, his theory completely fails in the face of the test of AWWC's ability to attract capital that occurred in late April, 2008, when AWWC sold 58 million shares of its common stock for $21.50 per share, raising more than $1.2 Billion. AWWC attracted this huge amount of capital with an average return on equity of ***only 6.5 percent!*** Exhibit 9. Mr. Vilbert testified that he was not aware of any water utility having a return on equity of 11.75 percent or better. Vol. 3, at p. 358. A search of Morningstar produced only one utility, Pennichuck Corp., earning 9.9 percent or greater. Vol. 3, at p. 363. Although TAWC castigates Dr. Brown for his recommended ROE of 7.5%, it is apparent that Dr. Brown's recommendation is above what AWW is currently achieving. The recommended rate of 9.9% by Mr. Gorman is generous under the circumstances.

[4] Miller rebuttal -- fees of $1.6 plus BAH expenses of $285,000.

The improper purpose of offering the return on equity testimony of Mr. Vilbert is demonstrated by the rebuttal testimony of Mike Miller. Mr. Miller suggested that he might compromise on a cost of capital of about 8.08% with a ROE of 10.4%. Vol. 13, at pp. 1452-53. Admittedly Mr. Miller was not recommending such a compromise, but stated "it would be a reasonable result." Vol. 13, at p. 1454:9-10. What is clear is that the ratepayers should not be asked to pay for the recommendation of Mr. Vilbert, which TAWC has effectively admitted is unreasonable.

VI.
Conclusion

For the reasons set forth herein, the City of Chattanooga requests that the Authority find that TAWC has not carried its burden of proving that its proposed rates are just and reasonable and that its rates be adjusted to remove all costs attributable to service company charges, attorneys fees and other rate case costs, and to increased capital expenditures above TAWC's recent average annual expenditures.

Respectfully submitted,

CITY OF CHATTANOOGA, TENNESSEE
RANDALL L. NELSON, CITY ATTORNEY

By: Mr. McMahan by FLH w/permission

Michael A. McMahan, BPR #000810
Valerie L. Malueg, BPR #023763
Special Counsel
801 Broad Street, Suite 400
Chattanooga, TN 37402
(423) 757-5338

CHAMBLISS, BAHNER & STOPHEL, P.C.

By: _____

Frederick L. Hitchcock, BPR #005960
Harold L. North, BPR #007022
1000 Tallan Building
Two Union Square
Chattanooga, TN 37402
(423) 756-3000

CERTIFICATE OF SERVICE

This is to certify that the undersigned has this day served a true and correct copy of the foregoing pleading by electronic mail and by depositing same in the United States mail, postage prepaid, and addressed to the following:

Ryan L. McGehee, Esq.
Office of the Attorney General
Consumer Advocate and Protection Division
P.O. Box 20207
Nashville, TN 37202-0207
ryan.mcgehee@state.tn.us

Timothy C. Phillips, Esq.
Office of the Attorney General
Consumer Advocate & Protection Division
P.O. Box 20207
Nashville, TN 37202
timothy.phillips@state.tn.us

David C. Higney, Esq.
Grant, Konvalinka & Harrison, P.C.
Ninth Floor, Republic Centre
633 Chestnut Street
Chattanooga, TN 37450-0900
dhigney@gkhpc.com

R. Dale Grimes, Esq.
Ross Ian Booher, Esq.
J. Davidson French, Esq.
Adam Futrell, Esq.
Erin Everitt, Esq.
BASS, BERRY & SIMS, PLC
315 Deadrick Street, Suite 2700
Nashville, TN 37238-3001
dgrimes@bassberry.com
rbooher@bassberry.com
dfrench@bassberry.com
afutrell@bassberry.com
eeveritt@bassberry.com

Henry M. Walker, Esq.
Boult, Cummings, Conners & Berry, PLC
1600 Division Street, Suite 700
P.O. Box 340025
Nashville, TN 37203
hwalker@boultcummings.com

This the 2nd day of September, 2008.

Frederick L. Hitchcock