BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

January 13, 2009

IN RE:	)	
	)	
PETITION OF TENNESSEE AMERICAN WATER	)	**DOCKET NO.**
COMPANY TO CHANGE AND INCREASE CERTAIN	)	**08-00039**
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

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This matter came before Chairman Tre Hargett, Director Eddie Roberson and Director Mary W. Freeman of the Tennessee Regulatory Authority (the "Authority" or "TRA"), the voting panel assigned to this docket, at a regularly scheduled Authority Conference held on September 22, 2008, for consideration of the *Petition* filed on March 14, 2008 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 $1,655,541, 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. <u>TRAVEL OF THE CASE</u>

On March 14, 2008, Tennessee American Water Company filed its *Petition* seeking approval by the TRA 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 place into effect customer rates that will produce an overall rate of return of 8.514% on a rate base of $119,881,506."[2] According to TAWC, the additional gross revenues would be approximately $7,644,859 for the attrition period ending August 31, 2009.[3]

TAWC is a public utility as defined in Tenn. Code Ann. § 65-4-101 and is engaged in providing residential, commercial, industrial and municipal water service, including public and private fire protection service to the City of Chattanooga and surrounding areas, serving

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[1] *Petition,* p. 2 (March 14, 2008).
[2] *Petition,* p. 5 (March 14, 2008).
[3] *Petition*, pp. 4 and 6 (March 14, 2008).

approximately 74,535 customers as of November 30, 2007. The Company is subject to the jurisdiction and supervision of the TRA pursuant to Chapter 4 and Chapter 5 of Title 65 of the Tennessee statutes. The rates of the customers located in the State of Georgia are not regulated by the Public Service Commission of the State of Georgia, but are set by this Authority.[4]

TAWC is a wholly-owned subsidiary of American Water Works Company, Inc. ("AWWC"). AWWC is the largest water utility holding company in the United States, providing water and waste water services to 15.6 million people in thirty-two (32) states and Ontario, Canada.[5]

On March 31, 2008, the Authority issued a Data Request to TAWC requesting certain information in support of the *Petition* in accordance with the Minimum Filing Guidelines for a petition to increase rates. TAWC responded on April 11, 2008 requesting an extension of two weeks for questions 51, 52, 53, 66 and 73.

At a regularly scheduled Authority Conference held on April 7, 2008, Chairman Eddie Roberson, Director Tre Hargett and Director Ron Jones,[6] the panel assigned to this docket, voted unanimously to suspend the proposed tariff from April 13, 2008 to July 11, 2008, convene a contested case proceeding and 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.

On April 1, 2008, the Consumer Advocate and Protection Division of the Office of the Attorney General ("Consumer Advocate" or "CAPD") filed a Petition to Intervene. The Chattanooga Manufacturers Association ("CMA") and The City of Chattanooga ("the City") filed petitions to intervene on April 4, 2008 and April 16, 2008, respectively. The City based its

[4] *Petition*, p. 1 (March 14, 2008).
[5] *Petition*, p. 2 (March 14, 2008).
[6] Upon the expiration of Director Jones' term as a Director on July 1, 2008, Director Mary W. Freeman replaced former Director Jones on the voting panel in this docket.

intervention request on the assertion that "the City of Chattanooga is a customer of TAWC and the legal rights, duties, privileges, immunities or other legal interests of the City of Chattanooga and its citizens may be determined in these proceedings."[7] CMA asserted that, as a trade association in existence for 106 years and representing over 250 manufacturers and businesses, approval of the Company's request to increase certain rates and charges would "adversely affect ratepayers including, but not limited to CMA members and other similarly situated entities."[8] No objection or opposition was filed as to the petitions to intervene. On April 11, 2008, the Hamilton County Commission ("Commission") filed with the Authority Resolution 408-17, adopted by the Commission on April 10, 2008, opposing the rate increase sought by TAWC and asking the Authority to hold public hearings in Hamilton County regarding the requested rate increase.

On May 1, 2008, the Hearing Officer issued an Order granting the petitions of the Consumer Advocate, the City and CMA to intervene and establishing a procedural schedule.[9] The Hearing Officer's Order also provided for an initial round of discovery and permitted the Consumer Advocate to propound discovery requests in excess of the number prescribed in TRA Rule 1220-1-2-.11(5)(a), for a total of eighty questions during the first round of discovery. Finally, the Hearing Officer's Order directed the parties to submit an agreed proposed protective order or separate proposed protective orders by May 6, 2008.[10] After having failed to reach an agreed proposed protective order, TAWC and the Intervenors filed separate protective orders on May 6, 2008 for review by the Hearing Officer. The Intervenors also filed on May 6, 2008 a *Joint Motion to Modify the Procedural Schedule* and *Joint Objections of the Intervenors to*

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[7] *Petition to Intervene by the City of Chattanooga*, p. 2 (April 16, 2008).
[8] *Petition to Intervene by the Chattanooga Manufacturers Association*, p. 2 (April 3, 2008).
[9] *Order Granting Petitions to Intervene and Establishing a Procedural Schedule*, p. 4 (May 1, 2008).
[10] *Order Granting Petitions to Intervene and Establishing a Procedural Schedule*, p. 5 (May 1, 2008).

Discovery Question Limitations for the Initial Round of Discovery (*"Joint Objections"*). A Protective Order was entered by the Hearing Officer on May 23, 2008.

The Hearing Officer issued an Order on May 9, 2008 in response to the *Joint Objections* to provide guidance to the parties relative to the discovery process in the Procedural Schedule. The *Joint Objections* requested relief to lift the first-round discovery limitations. The Hearing Officer did not grant the relief requested, but was not opposed to the Intervenors pooling their discovery requests in the amount of one hundred sixty requests total, so as to maximize the total number of discovery requests propounded upon TAWC.[11]

Ultimately, the Consumer Advocate propounded discovery requests in excess of the 160 allotted along with a motion for permission to exceed the limit. TAWC filed an objection to the motion, but while the motion for additional discovery was being considered, the Company agreed to provide responses to the Consumer Advocate's additional discovery requests. Other parties, including TAWC, propounded discovery requests in the first round. During the course of discovery between the parties, numerous objections and motions regarding discovery requests and responses were filed by the parties.

Following a Status Conference on June 4, 2008 wherein these motions were considered, the Hearing Officer issued an *Agreed Order Regarding Discovery and Disposing of Certain Outstanding Motions Following June 4, 2008 Status Conference* ("*Agreed Order*"). The *Agreed Order* provided for the parties to file responses to discovery, resolve certain disputes and appear before the Hearing Office to argue any remaining disputes. To further facilitate the process of the discovery between the parties, a Status Conference was held on June 19 and 20, 2008, at which time the Hearing Officer heard oral arguments concerning discovery matters, including additional motions to compel and amendments to the Protective Order.

[11] *Order on Joint Objection to Discovery Question Limits in May 1, 2008 Order*, p. 3 (May 9, 2008).

After receiving requests from the Intervenors to expand the time for filing pre-filed testimony by four weeks, the Hearing Officer issued an *Order Granting, In Part, Joint Motion of Intervenors to Expand Time to Submit Testimony and Modifying the Procedural Schedule* on July 3, 2008. The Order extended the deadline for the Intervenors to file testimony to July 14, 2008 and modified the procedural schedule as to other filing dates to account for the additional time extended to the Intervenors.[12] On July 9, 2008, the Intervenors filed a joint petition seeking an interlocutory appeal of the Hearing Officer's July 3, 2008 Order and requesting additional time to file pre-filed testimony.

On July 11, 2008, TAWC filed its opposition to the joint petition for interlocutory review filed by the Consumer Advocate and the City as well as CMA's *Appeal of the Time Limits Set by the Hearing Officer*. TAWC stated that it acted fully in accordance with Hearing Officer's orders to bring this matter to completion within the statutory time frame. TAWC argued that the schedule proposed by the Intervenors would not allow it sufficient time to rebut pre-filed testimony and prepare for the final hearing.

The parties reached an agreement to extend the time for the Intervenors to file pre-filed testimony. Based on an agreement by the parties on July 11, 2008, the Hearing Officer modified the procedural schedule to accommodate all parties in this docket. The filing date for the Intervenors' pre-filed testimony was extended to July 18, 2008. The second round of discovery commenced on July 24, 2008 with responses or objections due on July 31, 2008.[13] In agreeing to the new amended procedural schedule, the Intervenors withdrew all outstanding motions of appeal.

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[12] *Order Granting, in Part, Joint Motion of Intervenors to Expand Time to Submit Testimony and Modifying Procedural Schedule*, p. 1 (July 3, 2008).
[13] *Order Further Modifying Procedural Schedules,* p. 2 (July 11, 2008).

Supplemental discovery responses and objections as to the first round of discovery continued to be filed by the Company and the Intervenors through July 17, 2008. The Intervenors submitted the pre-filed testimony of their witnesses and exhibits on July 18, 2008.

In accordance with the Hearing Officer's July 11, 2008 Order, a Status Conference was scheduled on August 4, 2008 to resolve outstanding discovery requests and to discuss settlement of issues. During the Status Conference, the parties reached resolution as to outstanding discovery matters as reflected in the Hearing Officer's August 15, 2008 Order. On August 13, 2008, the Company submitted its rebuttal testimony in accordance with the modified procedural schedule.

On August 15, 2008, a Pre-Hearing Conference was held, at which time certain pre-hearing matters were heard. On August 14, 2008, the City filed a motion to strike the Company's pre-filed testimony of Mark Manner on the grounds that the identity and nature of testimony of this witness was not timely disclosed by the Company. TAWC responded to the motion to strike stating that it was unaware of the need to use Mark Manner as a witness until the Intervenors had filed their pre-filed testimony and that the identity of the witness was disclosed as soon as possible. The Hearing Officer denied the motion to strike but permitted the Intervenors to rebut the testimony through their witnesses.[14]

On August 14, 2008, TAWC filed a motion in limine seeking to exclude certain portions of the testimony of an Intervenor witness, Michael J. Majoros on the ground that the witness lacked the requisite qualifications to testify as an expert regarding the Sarbanes-Oxley Act. The Hearing Officer denied TAWC's motion, ruling that the question of qualifications could be addressed through cross-examination of the witness.[15]

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[14] *See Order on August 15, 2008 Pre-Hearing Conference*, pp. 5-8 (August 29, 2008).

[15] *See Order on August 15, 2008 Pre-Hearing Conference*, pp. 8-9 (August 29, 2008).

Also on August 14, 2008, CMA filed a motion to strike portions of the Company's rebuttal testimony which CMA regarded as improperly adjusting certain expenses months after the initial rate increase filing without making additional adjustments for changes in other parts of the case. TAWC responded that it was not seeking to recover additional expenses and was not adjusting its overall rate increase request. The Hearing Officer denied CMA's motion to strike finding that under certain regulatory theories, regulators were required to take into consideration reasonable expected expenses and investments when setting rates.[16] An order permitting questions from the Authority Staff was issued on August 15, 2008.

II. THE HEARING AND POST HEARING FILINGS

On July 31, 2008, the Authority issued a Notice of Hearing reflecting the decision of the panel to hold the hearing in Chattanooga, Tennessee for the week of August 18, 2008. The Hearing was held in Chattanooga on August 18, 2008 through August 22, 2008. The hearing was continued in Nashville on August 26, 2008 and concluded on August 27, 2008. Post-Hearing Briefs were filed on September 2, 2008. The panel heard testimony from Company witnesses: John Watson, Michael Miller, Sheila A. Miller, Robert Shiltz, Dr. Edward Spitznagel, Jr., Joe Van den Berg, Paul Herbert, John Spanos, Mark Manner and Michael Vilbert. Witnesses from the Consumer Advocate were: Dr. Steve Brown, Terry Buckner and Charles King. The City/CMA witnesses were Michael Majoros and Glynn Stoeffel, and CMA presented witness Michael Gorman.

As part of the Hearing in Chattanooga, the panel reserved certain times for public comment. Though several hours were set aside specifically for the panel to hear from members of the public, a limited number of comments were provided.

[16] *See Order on August 15, 2008 Pre-Hearing Conference*, pp. 9-11 (August 29, 2008).

During the Hearing, the Company revised its forecast several times, resulting in a final projected Revenue Deficiency of $7,748,953. The Consumer Advocate also revised its forecast during the Hearing, resulting in a final projected Revenue Surplus of $1,486,624.

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.[17] The Authority must also approve rates that provide regulated utilities the opportunity to earn a just and reasonable return on their investments.[18]

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 decide the test period(s) which are appropriate. The test period establishes the operating results for which normalizing adjustments and known and reasonable changes are made to forecast operating results for the attrition period, based on current rates.

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[17] Tenn. Code Ann. § 65-5-201 (Supp. 2002).

[18] *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).

The Company selected a historical test period of the twelve months ended November 30, 2007 and an attrition period of the twelve months ending August 31, 2009. The Consumer Advocate used a test period of the twelve months ended March 31, 2008 and an attrition period of the twelve months ending August 31, 2009.

The TRA is not limited to adopting one test period for use throughout this case. The panel found that either the normalized test period for the twelve months ended November 30, 2007 as proposed by the Company or the Consumer Advocate's March 31, 2008 normalized test period were both acceptable and voted to use the test period which best fits the individual items being forecasted.

Both the Company and the Consumer Advocate were in agreement as to the attrition period; the panel voted to adopt the forward looking attrition period of the twelve months ending August 31, 2009.

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.

V(a). REVENUES

The Company projected attrition period Revenues at current rates of $37,142,460. To determine revenue, monthly rates/prices are multiplied by annualized volumes. The monthly meter rates differ based on billed volume of cubic feet. TAWC calculated the operating revenue based on a test period of the twelve months ended November 30, 2007. The operating revenue is based on metered sales, private fire service, miscellaneous service revenues, rents from property, and other water revenues. The Company used a bill analysis that reflected the actual billing determinants for the test year, the twelve months ended November 30, 2007.[19] Thereafter, TAWC made normalized test year adjustments, weather normalization adjustments for the residential and commercial customer classes, eliminated net change in accrued revenues, eliminated Walden's Ridge revenues, and added revenue to account for estimated customer growth during the attrition year.[20]

The Consumer Advocate projected attrition period Revenues of $39,492,768. For the residential and commercial classes, the Consumer Advocate forecasted number of bills per meter size and usage per block by trending the twelve month ended values for each at July 31, 2004, December 31, 2005, December 31, 2006, December 31, 2007, and March 31, 2008 through August 31, 2009 to arrive at its forecasted billing determinants for the attrition period. The Consumer Advocate made no normalizing adjustments.[21] For the industrial, other public authority, other water utilities, and fire service classes, the Consumer Advocate used test period amounts for the attrition period. The Consumer Advocate used a test period of twelve months ended March 31, 2008.

The panel adopted attrition period Revenues of $38,934,309. In doing so, the panel used a combination of the Company's, the Consumer Advocate's, and its own forecasts. The panel found neither the Company's nor the Consumer Advocate's methodology for forecasting residential and commercial average usage persuasive and instead performed its own analysis, examining average usage trends for the residential and commercial classes over the four years

[19] Sheila A. Miller, Pre-filed Direct Testimony, p. 5 (March 14, 2008).
[20] Sheila A. Miller, Pre-filed Direct Testimony, p. 6 (March 14, 2008).
[21] Terry Buckner, Pre-filed Direct Testimony, Workpapers R-Residential Trend and R-Commercial Trend (July 18, 2008). The Consumer Advocate filed revisions on August 15, 2008 making one normalizing adjustment to attrition period revenues for other water utilities.

ended March 31, 2005, 2006, 2007, and 2008. The Authority adopted residential class attrition period revenues based on this methodology and the Company's forecasted number of bills. For the commercial class, the analysis produced a result almost identical to the Company's forecast; therefore, the Authority adopted TAWC's commercial class attrition period revenue forecast.

As to the weather normalization adjustment ("WNA"), the Company made representations that the model it used in forecasting residential and commercial average usage had been previously adopted by the Authority. Notwithstanding an occasional concurrence by Intervenor witnesses, this assertion is incorrect. In earlier TAWC rate case dockets, Docket Nos. 03-00118[22] and 04-00288,[23] TAWC's revenues were settled. Although the parties in those dockets settled on the amounts proposed by TAWC, the settlements did not mention any agreed upon methodology for calculating those revenues. The Company's revenue forecast was adopted in Docket No. 06-00290; however, the Authority did not adopt or endorse TAWC's WNA model. In this docket, the panel did not adopt the Company's entire revenue forecast or the Company's WNA model. Nevertheless, the Authority adopted the Company's commercial class attrition period revenue in this docket because, despite disagreeing with the Company's methodology, the result was reasonable. In determining the attrition period Revenues, the panel found that the Walden's Ridge revenues should be included in the attrition period because all regulated revenues should be included, regardless of whether or not rates will change as a result of the rate case. Further, the panel found that the Walden's Ridge revenues should be treated consistently with the Signal Mountain revenues, which were included by the Company.

[22] *See In re: Petition of Tennessee American Water Company to Change and Increase Certain Rates and Charges so as to Permit It to Earn a Fair and Adequate Rate of Return on Its Property Used and Useful in Furnishing Water Service to Its Customers*, Docket No. 03-00118, *Final Order Approving Rate Increase and Rate Design and Approving Rates Filed by Tennessee American Water Company*, p. 13 (June 25, 2004).

[23] *See In re: Petition of Tennessee American Water Company to Change and Increase Certain Rates and Charges so as to Permit It to Earn a Fair and Adequate Rate of Return on Its Property Used and Useful in Furnishing Water Service to Its Customers*, Docket No. 04-00288, *Order Approving Settlement Agreement*, p. 7 (July 21, 2005).

V(b). EXPENSES

V(b)1. SALARIES AND WAGES

The Company forecasted Salaries and Wages Expense of $5,058,987[24] during the attrition period. The Company's forecast is based on an increase of three employees from 111 to 114. Attrition year wage levels for the pay classes were calculated by prorating known wage rate increases that will occur during the attrition period. Union employees' wages are governed by the existing bargaining agreements. Non-union hourly and clerical employees' wage rates are increased 3.6% on April 1 of each year, and the current annual salaries of the salaried employees (who are exempt from overtime pay) are subject to wage increases on April 1 of each year.[25]

The Consumer Advocate forecasted Salaries and Wages Expense of $4,877,597.[26] The Consumer Advocate's forecasted attrition period expense is based on the actual March 31, 2008 employee count of 109 employees[27] and does not include any projected increase in employee levels during the attrition period. The Consumer Advocate priced out salaries and wages by individual employee, using the actual wage rates in effect as of March 2008 and projecting through the attrition period using known increases as identified by the Company.

The panel adopted the Consumer Advocate's forecast of $4,877,597 for the Salaries and Wages Expense during the attrition period. Consistent with recent Authority decisions, the panel adopted the forecast based upon a price-out of the current employees as of March 31, 2008, with 20.6% capitalized and reduced by the incentive payroll solely attributable to meeting financial goals. The panel further determined to adopt the current employee level of 109, rather than the

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[24] Sheila A. Miller, TN-TRA-02-Q001-Adjustment to Operation and Maintenance Expenses-Summary (May 28, 2008).
[25] Sheila A. Miller, Pre-filed Direct Testimony, pp. 7-8 (March 14, 2008).
[26] Terry Buckner, Pre-filed Direct Testimony, Exhibit CAPD, Schedule 5 (July 18, 2008).
[27] Terry Buckner, Pre-filed Direct Testimony, p. 39 (July 18, 2008).

Company's requested level of 114 employees, because public utilities can be subject to economic downturns and must hold the line on expenses and employee growth during lean times.

V(b)2. Purchased Water

The Company forecasted Purchased Water Expense of $52,110. This amount represents four months of the 2008 Purchased Water budget of $51,762 and eight months of the 2009 Purchased Water budget of $52,284.[28]

The Consumer Advocate's original forecast for Purchased Water Expense was $52,230. This amount represents the actual twelve months ended March 31, 2008 expense grown by the Consumer Advocate's growth/inflation factor compounded to 14 months to compute a projected amount for the twelve months ending August 31, 2009.[29] Subsequently, the Consumer Advocate corrected its growth factor from 3.7% to 4.3%,[30] which increased CAPD's Purchased Water forecast from $52,230 to $52,621.

The panel adopted the Company's attrition period forecast of $52,110 for Purchased Water Expense which was based on the Company's expected needs for the attrition period. The panel found that the difference, less than one percent, between the Company's forecast and the Consumer Advocate's forecast, which was based upon twelve months of growth ended March 31, 2008 actual amount, confirmed the reasonableness of the Company's budgeted amount.

V(b)3. Fuel and Power

The Company originally projected total attrition year Fuel and Power Expense of $1,986,259. Subsequently, the Company adjusted its Fuel and Power Expense projection based on a decrease to the estimated Chattanooga Power Board rates effective April 1, 2008 from 7.5%

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[28] Sheila A. Miller, TN-TRA-02-Q001-Purchased Water Summary (May 28, 2008).
[29] Terry Buckner, Pre-filed Direct Testimony, CAPD work papers, p. 179 (July 18, 2008).
[30] CAPD Responses to TRA Staff Data Request #7 (August 4, 2008).

(estimated) to 6% (actual), the current fuel cost adjustment ("FCA"), effective July 1, 2008 (which was not known to the Company when the case was filed) and a revised estimate of the FCA expected during the attrition period. The effect of the adjustment was to lower Fuel and Power Expense from $1,986,730 to $1,922,043, a decrease of $64,216.[31]

The Consumer Advocate originally forecasted $2,319,730 for Fuel and Power Expense.[32] This amount represents the actual twelve months ended March 31, 2008 expense for Purchased Power grown by the Consumer Advocate's growth/inflation factor compounded to fourteen months to compute a projected amount of $2,452,450 for the twelve months ending August 31, 2009. The Consumer Advocate then adjusted the amount by a 5.43% decrease to account for an unacceptable unaccounted-for water percentage. TAWC reported a lost and unaccounted-for percentage of 27.5% for the twelve months ended November 30, 2007[33] and 20.43% for the test period ended March 2008. The 20.43% figure is substantially higher than the 15% that the Consumer Advocate accepted as the recommended level.[34] Subsequently, the Consumer Advocate corrected its growth factor from 3.7% to 4.3%,[35] which increased the Consumer Advocate's Fuel and Power Expense forecast from $2,319,282 to $2,337,108.

The CMA objected to the late-filed inclusion of the Company's updated projection for the Fuel and Power expense. The CMA proposed that an acceptable lost and unaccounted-for water percentage should be no greater than 15% for an annual period for use in the calculation of Fuel and Power Expense. CMA asserted that the Company's level of unaccounted-for water is excessive because: [36]

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[31] TAWC Responses to TRA Staff Data Request #5 issued July 29, 2008. TN-TRA-05-Q001-Amended Exhibit (page 13 of 18) and TN-TRA-05-Q001-Attachment 6 (August 5, 2008).
[32] Terry Buckner, Pre-filed Direct Testimony, CAPD work papers, p. 180 (July 18, 2008).
[33] Michael Gorman, Pre-filed Direct Testimony, p. 14 (July 18, 2008).
[34] CAPD Responses to TRA Staff Data Request #9 (August 4, 2008).
[35] CAPD Responses to TRA Staff Data Request #7 (August 4, 2008).
[36] Michael Gorman, Pre-filed Direct Testimony, pp. 14-15 (July 18, 2008)

- "Survey of State Agency Water Loss Reporting Practices," a document published by American Water Works Association, shows that not one respondent allowed a percentage of 27.5%. Most specified a range of 10% to 15%.

- "Benchmarking Performance Indicators, Distribution System Water Loss," a document provided by the Company in its Supplemental Response to COC-4, indicates that the median range in the 25^{th} to 75^{th} percentile of reporting companies reflects distribution system water losses of typically less than 15%. This sample included utility companies in the West, South, Midwest and Northeast regions.

The CMA concluded that a water loss percentage of 27.5% makes TAWC one of the worst operating water systems, compared to those in either survey above.

Additionally, the CMA objected to the inclusion of the updated exhibits provided by TAWC on August 5, 2008 in response to Staff data requests. According to the CMA, "the Company inappropriately seeks to introduce 'single-issue' ratemaking into this proceeding."[37]

Recognizing the importance of conserving water, which is one of the state's most valuable natural resources, the panel established a baseline efficiency standard. Based on the evidence presented, the panel limited the unaccounted-for water percentage to fifteen percent. In so doing, the panel adopted $1,892,131 as the Fuel and Power Expense for the attrition period. The panel based this amount on the volumes associated with attrition period revenues of $38,873,946, which includes 463,797 CCF for water volumes delivered to Walden's Ridge,[38] adjusted to include the revised fuel and power rates submitted by the Company, and a water loss percentage of fifteen percent. In accepting the Company's revised fuel and power rates, the panel relied on *South Central Bell Telephone Co. v. Tennessee Public Service Commission*, wherein the Court of Appeals upheld a determination by the Chancellor that "the test period results must be adjusted to take into account known changes that are likely to occur in the immediate future."[39] The Court of Appeals held that the Tennessee Public Service Commission

[37] *Chattanooga Manufacturers Association's Post-Hearing Memorandum of Law*, p. 2 (September 2, 2008).
[38] TAWC's Response to TRA Verbal Request made during the Hearing (August 27, 2008) Question No. 2.
[39] *South Cent. Bell Tel. Co. v. Tennessee Pub. Serv. Comm'n*, 579 S.W.2d 429, 434-35 (Tenn. Ct. App. 1979).

does not have to accept numbers offered by the public utility deemed by the Commission to be unnecessary, improvident or improper. Instead, the Commission should "take into consideration the estimated effect of reasonably expected expenses and investments."[40]

V(b)4. CHEMICALS

The Company originally projected total attrition year Chemical Expense of $1,049,272.[41] Subsequently, the Company adjusted its projection based on the new 2009 contract chemical prices. The effect of the adjustment was to increase Chemicals expense from $1,049,272 to $1,559,222.[42]

The Consumer Advocate initially forecasted $1,052,351 for Chemical Expense. This amount represents the actual twelve months ended March 31, 2008 expense for chemicals grown by the Consumer Advocate's growth/inflation factor compounded to fourteen months to compute a projected amount of $1,074,475 for the twelve months ending August 31, 2009.[43] The Consumer Advocate then adjusted the amount to account for an unacceptable unaccounted-for water percentage. TAWC reported a lost and unaccounted-for percentage of 20.43% for the test period ended March 2008. The 20.43% is substantially higher than the 15% that the CAPD accepted as the recommended level.[44] Subsequently, the Consumer Advocate corrected its growth factor from 3.7% to 4.3%,[45] which increased CAPD's Chemical Expense forecast from $1,052,351 to $1,060,227.

The CMA objected to the late-filed inclusion of the Company's updated projection for the Chemical Expense. The CMA proposed that an acceptable lost and unaccounted-for water percentage should be no greater than fifteen percent for an annual period for use in the

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[40] *Id.* at 435.
[41] Sheila A. Miller, Pre-filed Direct Testimony, p. 10 (March 14, 2008).
[42] *Tennessee American Water Company's Post Hearing Brief*, pp. 26-27 (September 2, 2008).
[43] Terry Buckner, Pre-filed Direct Testimony, CAPD work papers, pp. 185-186 (July 18, 2008).
[44] CAPD Responses to TRA Staff Data Request #9 (August 4, 2008).
[45] CAPD Responses to TRA Staff Data Request #7 (August 4, 2008).

calculation of Chemical Expense. By contrast, the Company recorded an unaccounted-for percentage of 27.5% for the twelve month period ended November 30, 2007.[46]

Consistent with its determination regarding the Fuel and Power Expense, the panel limited the unaccounted-for water percentage at fifteen percent. Further, in making its decision, the panel relied on *South Central Bell Telephone Co. v. Tennessee Public Service Commission*.[47] In so doing, the panel denied the CMA's motion to strike the Company's revised chemical rates and instead relied on the revisions as known and measurable amounts. The panel adopted $1,492,460 as the Chemical Expense for the attrition period. The panel based this amount on the volumes associated with attrition period Revenues of $38,873,946, adjusted to include the revised chemical rates submitted by the Company, and a water loss percentage of fifteen percent.

V(b)5. Waste Disposal

The Company forecasted Waste Disposal Expense of $179,088. This amount is based upon the actual amount paid during the test period of $161,721, adjusted to reflect a 3% increase effective October 2007 and another expected 3% increase effective April 2008, resulting in the attrition period adjustment of $17,367.[48]

The Consumer Advocate's original forecast for Waste Disposal Expense was $168,275. This amount was based upon the Company's booked amounts for the twelve months ended March 31, 2008 grown by the CAPD annual growth/inflation factor compounded to 14 months, to compute a projected amount for the twelve months ending August 31, 2009.[49] Subsequently, the Consumer Advocate corrected its growth factor from 3.7% to 4.3%,[50] which increased the Consumer Advocate's Waste Disposal Expense forecast from $168,275 to $169,535.

[46] Michael Gorman, Pre-filed Direct Testimony, p. 14 (July 18, 2008).
[47] *South Cent. Bell Tel. Co. v. Tennessee Pub. Serv. Comm'n*, 579 S.W.2d 429 (Tenn. Ct. App. 1979).
[48] Sheila A. Miller, Pre-filed Direct Testimony, p. 10 (March 14, 2008) and Sheila A. Miller, TN-TRA-02-Q001-Wastedisposal-Summary (May 28, 2008).
[49] Terry Buckner, Pre-filed Direct Testimony, CAPD work papers, p. 188 (July 18, 2008).
[50] CAPD Responses to TRA Staff Data Request #7 (August 4, 2008).

The panel voted to adopt the Company's attrition period forecast of $179,088 because this amount reflected the actual increases in rates from the City of Chattanooga Sanitary Board.

V(b)6. MANAGEMENT FEES[51]

The Company projected attrition period Management Fees of $4,335,190. This amount is based on the historical test period expenses of $4,789,601 and the elimination of non-recurring expenses of $729,713.[52] In addition, the Company eliminated salary and salary-related overheads for the Non-Revenue Water ("NRW") Manager.[53] To the normalized historical test period amount, the Company applied an inflation factor of 3.5% per year to reflect the expected salary and salary-related overhead increases for the attrition period.[54] An additional adjustment was made to the attrition period forecast to reflect the difference between the FAS 87 pension expense billed to TAWC by AWWSC during the test period and the pension expense under ERISA.[55]

The Company also stated that it had retained the services of the firm of Booz Allen Hamilton ("Booz Allen") to perform the management audit of the charges allocated by the service company to TAWC, as directed by the Authority in Docket No. 06-00290. The Company asserted that the audit report (the "Booz Allen Report") attests that the allocated costs were prudent, that they were allocated to TAWC by a reasonable methodology, and that they

[51] Management fees are the charges from American Water Works Service Company ("AWWSC") 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 TAWC. *See* Michael A. Miller, Pre-filed Direct Testimony, p. 13 (March 14, 2008).

[52] Non-recurring expenses include the STEP project, the STAR project, the Business Change project, the Divestiture, and implementation costs related to Sarbanes-Oxley compliance.

[53] The Non-Revenue Manager has been transferred to Tennessee American and therefore his cost has been added to the direct employee cost at Tennessee American.

[54] Michael A. Miller, Pre-filed Direct Testimony, p. 11 (March 14, 2008).

[55] ERISA utilizes a cash basis for recording pension expense and is the method historically used by the TRA in the regulation of TAWC. The pension amount is based on the minimum contribution amount per the 2008 American Water Actuarial Study performed by the firm Towers/Perrin for the pension year ended June 30, 2008. Michael A. Miller, Pre-filed Direct Testimony, p. 12 (March 14, 2008).

were very reasonable when compared to other utilities.[56] The Booz Allen Report was filed in this docket along with the Company's *Petition.*

The Consumer Advocate forecasted Management Fees of $3,453,223 for the attrition period. The Consumer Advocate used the 2005 forecasted Management Fees of $3,062,940 from TRA Docket No. 04-00288 as its base. This amount was then grown at an annual inflation/growth rate of 3.87% in 2006, 3.23% in 2007, and 3.05% for 2008 and 2009, to arrive at its forecasted amount for the attrition period.[57] The Consumer Advocate argued that the growth in TAWC's management fees has far out-stripped inflation and has not produced the synergy in savings that the Company claimed would result by using the service company.[58]

The City retained the services of a consultant to review the Booz Allen Report filed in this case. The objective of this review was to form an opinion whether the management audit met the Sarbanes-Oxley ("SOX") requirements of the audit ordered by the Authority in Docket No. 06-00290. Based on its evaluation, the City recommended disallowance of all costs related to the Booz Allen Report and all AWWSC management fees and allocated costs until the Company obtains an audit that conforms to the specifications of the TRA and the new audit report is examined in a later proceeding.[59] The City claimed, in part, that Booz Allen is not an independent public accounting firm; Booz Allen did not conduct an "audit" as required by the TRA or SOX; and Booz Allen did not conduct an audit in conformance with the rules of the Public Accounting Oversight Board.[60] The CMA did not offer testimony on this issue, but stated that it supported the positions of the Consumer Advocate and the City relative to management fees.[61]

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[56] Michael A. Miller, Pre-filed Direct Testimony, pp. 11-14 (March 14, 2008).
[57] Terry Buckner, Pre-filed Direct Testimony, CAPD work papers, p. 189 (July 18, 2008).
[58] Transcript of Proceedings, v. XVI, p. 1649 (August 26, 2008).
[59] Michael J. Majoros, Pre-filed Direct Testimony, p. 3 (July 18, 2008).
[60] Michael J. Majoros, Pre-filed Direct Testimony, pp. 8-9 (July 18, 2008).
[61] *Chattanooga Manufacturers Association's Post Hearing Memorandum of Law*, p. 1 (September 2, 2008).

Because of unresolved questions regarding management fees assessed by the service company and requested by TAWC in Docket No. 06-00290, the TRA ordered TAWC to perform a management audit to determine whether all costs allocated to TAWC were incurred as a result of prudent or imprudent management decisions by TAWC's parent and to address the reasonableness of the methodology used to allocate costs to TAWC.[62] During the Hearing in this docket, the Company's witness testified, "The purpose here was very specific to provide an independent assessment of the costs incurred by TAWC of the service company costs that have been allocated and directly charged to Tennessee American from the service company."[63] In order to compare the costs incurred by AWWC and charged to TAWC, the Company stated that a set of peer companies was established for comparison. The Company asserted that, because there were no strictly water companies that could be used for comparison, the Company looked beyond and formulated a set of companies as peers for comparison. The study looked at the services performed by the parent to ensure there was no duplication or overlap of the services provided by TAWC. Further, the study reviewed the allocation factors, to determine whether the functions performed were necessary, budget and control mechanisms were in place and costs were benchmarked. The Company argued that the management audit was in compliance with SOX and similar to accepted audits performed in other states.[64]

A majority of the panel found that the management audit performed did not adequately address the issue of prudency of the management fees, and that the audit was not an independent audit as ordered in Docket No. 06-00290. The Booz Allen witness, Joe Van den Berg, who

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[62] The Authority's June 10, 2008 Order in Docket No. 06-00290 stated at pages 26-27:

> 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 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.

[63] Transcript of Public Hearing, v. 7, p. 840 (August 20, 2008).

[64] Transcript of Public Hearing, v. 7, pp. 841-856 (August 20, 2008).

performed the management audit required by the TRA also provided testimony on behalf of TAWC in other dockets, both before the TRA and other utility commissions. For this reason, the panel determined that the independence of the selected audit firm was impaired.[65] Further, the audit did not address the primary concerns of the Authority that the costs were the result of prudent management decisions. By admission of the Company's witness, the audit report was an "assessment" or review of the costs incurred by the American Water Works Service Company subject to potential allocation to TAWC.[66] The panel did not find a sufficient basis in the Company's testimony to support the Company's request that management fees should be increased by $355,365.

The record shows that from 2004 to the Company's forecasted attrition period in this docket, management fees have increased seventy-three percent during the five and one-half year time period. There was a fifty-nine percent increase between the 2004 fees and the fees approved in Docket No. 06-00290. Therefore, a majority of the panel[67] voted to set the Management Fee attrition year expense amount at $3,529,933. This amount was based on the Company's forecasted 2005 Management Fee amount from Docket No. 04-00288 as used by the Consumer Advocate in this docket. The majority of the panel voted to change the growth factor to include all customer growth instead of one-half of customer growth, as used by the Consumer Advocate.

Because the panel determined that the Company had not complied with the Authority's directive in Docket No. 06-00290, the panel ordered the Company to develop a Request For Proposal ("RFP") for a comprehensive management audit by an independent certified public

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[65] The Booz Allen witness testified for the Company in the last rate case.

[66] Joe Van den Berg, Pre-filed Direct Testimony, pp. 2-3 (March 14, 2008).

[67] Director Freeman did not vote with the majority. Instead, she found that management fees should be held to the same amount as that adopted in Docket No. 06-00290, $3,979,825. In support of her position, Director Freeman stated that the Company's audit of management fees that was ordered by the Authority in Docket No. 06-00290 did not provide evidence to support an increase in management fees. She further noted that numerous calculations in determining the Company's revenue deficiency would be impacted by her adoption of this figure.

accountant. The RFP for the audit shall include, but not be limited to, an investigation of AWWSC's management performance and decisions relating to internal processes and internal controls with an attestation and recommendation of any needed management changes and implementation thereof. Further, the audit shall evaluate and attest to the charges allocated to TAWC, including the efficiency of processes and/or functions performed on behalf of TAWC, as well as the accuracy and reasonableness of the allocation factors utilized.[68] This RFP should be filed in this docket no later than six months from September 22, 2008, for approval by the Authority. The issuance of the RFP shall occur subsequent to an approval of the RFP by the Authority.

Further, the panel determined that if, during the bidding process, the RFP results in a bid which might not yield a benefit to TAWC customers, the Authority could order that the management audit not be performed. In this regard, the panel discussed other alternatives available to the Authority, including the participation in a multi-state audit which may be authorized by regulatory agencies in those states served by companies owned by American Water Works Company.

V(b)7. Group Insurance

The Company projected Group Insurance Expense of $1,714,550.[69] This amount was calculated by applying the November 30, 2007 insurance rates to the employee coverage, based upon salary and wage information, and subtracting the employee contribution toward employee healthcare coverage. Consistent with a percentage of labor not charged to expense (20.28%, see

[68] The panel determined that the Company should contact Authority staff in the event the Company has any questions regarding the scope of the audit.
[69] Sheila A. Miller, TN-TRA-02-Q001-Group Insurance-Summary (May 28, 2008).

Section V(b)1, Salaries and Wages), this percentage of insurance costs was excluded from the group insurance expense.[70]

The Consumer Advocate initially projected Group Insurance Expense of $1,660,506. Group Insurance Expense is based upon the Company-booked amounts for the twelve months ended March 31, 2008 grown by the Consumer Advocate annual growth/inflation factor compounded to fourteen months to compute projected amounts for the twelve months ending August 31, 2009.[71] Subsequently, the Consumer Advocate corrected its growth factor from 3.7% to 4.3%,[72] which increased the Consumer Advocate's Group Insurance Expense from $1,660,506 to $1,672,934.

Consistent with its decision regarding the Salary and Wage Expense, the panel adopted the Consumer Advocate's forecasted Group Insurance Expense of $1,672,934 for the attrition period.

V(b)8. PENSION EXPENSE

The Company forecasted Pension Expense of $1,161,108 for the attrition period.[73] This amount represents the actual pension funding as of December 2008 of $1,456,476 less 20.28% that is capitalized.

The Consumer Advocate forecasted $1,156,422 for Pension Expense. The Consumer Advocate adopted the Pension funding amount of $1,456,476 that was allocated to TAWC based on the February, 2008 actuarial study filed by the company.[74] The Consumer Advocate's 20.60% capitalization factor was then applied to this amount and the capitalized portion was eliminated from Operations and Maintenance expenses.

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[70] Sheila A. Miller, Pre-filed Direct Testimony, pp. 10-11 (March 14, 2008).
[71] Terry Buckner, Pre-filed Direct Testimony, CAPD work papers, pp. 193-195 (July 18, 2008).
[72] CAPD Responses to TRA Staff Data Request #7 (August 4, 2008).
[73] Shelia A. Miller, TN-TRA-02-Q001-Pensions-Summary (May 28, 2008).
[74] Terry Buckner, Pre-filed Direct Testimony, CAPD work papers, p. 197 (July 18, 2008).

Consistent with its decision regarding the Salary and Wage Expense which incorporated a 20.6% capitalization rate, the panel adopted the Consumer Advocate's forecasted Pension Expense of $1,156,442 for the attrition period.

V(b)9. Regulatory Expense

The Company projected $543,384 for Regulatory Expense in conjunction with this docket. This amount represents the total of the amortization of various rate case expenses sought by the Company in this case.[75]

The Consumer Advocate forecasted $341,868 for Regulatory Expense for the attrition period.[76] The Consumer Advocate expressed concern over the escalation of rate case costs, citing the allowed recovered expense amounts of $225,000 in Docket No. 03-00118 and $400,000 in Docket No. 06-00290, together with the $550,000 being sought in this case. The Consumer Advocate believes much of the Company's costs associated with these dockets are incurred for the protection of the shareholders' interests while being assessed to the ratepayer.[77]

The CMA projected Regulatory Expense of $287,111 for the attrition period. The CMA recommended amortizing the total expense of $861,333 over three years for a Regulatory Expense of $287,111 for the attrition period.[78] CMA recommended a consistent three-year amortization of all expenses for ease of tracking by the Authority.[79]

The Intervenors assert that the attorneys' fees claimed by TAWC as a part of the Company's regulatory or rate case expense are not reasonable and should not be granted. Both the City and the Consumer Advocate relied on the case of *House v. Edmondson*[80] in arguing that

[75] Michael A. Miller, Pre-filed Direct Testimony, pp. 20-21 (March 14, 2008).
[76] Terry Buckner, Pre-filed Direct Testimony, pp. 50-51 (July 18, 2008).
[77] Terry Buckner, Pre-filed Direct Testimony, p. 51 (July 18, 2008).
[78] Michael Gorman, Pre-filed Direct Testimony, p. 18 (July 18, 2008).
[79] Michael Gorman, Pre-filed Direct Testimony, p. 18 (July 18, 2008).
[80] *See House v. Edmondson*, 245 S.W.3d 372 (Tenn. 2008).

under the "American rule" the Company should not be allowed to recover its own attorneys' fees in this proceeding.[81]

The panel found that it is appropriate for the shareholders to bear some of the expense of the Company's rate case. Rejecting the application of the *House* case, the panel noted that there is a clear distinction between the nature of the proceedings in *House* and the administrative nature of the proceedings in this docket. The panel noted that in the future the Authority should closely examine the costs associated with rate case filings to determine the portions to be recovered from rate payers and shareholders. The panel voted to allow one-half of this docket's rate case expense of $275,000 in the calculation of the Regulatory Expense. The panel voted to have one-half of the rate case expense, the cost of the service study, the cost of the depreciation study, and the unamortized balance of the previous case amortized over a three year period. Thus, the panel adopted $194,852 as the Regulatory Expense for the attrition period.

V(b)10. INSURANCE OTHER THAN GROUP

The Company's proposed level for Insurance Other Than Group Expense for the attrition year is $583,492 and is based on four months of the Company's 2008 budget and eight months of the Company's 2009 budget.[82] The Consumer Advocate's initial forecast of $530,410 for Insurance Other Than Group Expense is based upon the Company-booked amounts for the twelve months ended March 31, 2008 grown by the Consumer Advocate's annual growth/inflation factor compounded to fourteen months to compute projected amounts for the twelve months ending August 31, 2009.[83] Subsequently, the Consumer Advocate corrected its

[81] "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 a part of the prevailing party's damages." *House*, at p. 377, citing *John Kohl & Co. v. Dearborn & Ewing*, 977 S.W.2d 528, 534 (Tenn. 1998).
[82] Sheila A. Miller, TN-TRA-02-Q001-Insurance Other Than Group-Summary (May 28, 2008).
[83] Terry Buckner, Pre-filed Direct Testimony, CAPD work papers, pp. 202-205 (July 18, 2008).

growth factor from 3.7% to 4.3 %[84] which increased the Consumer Advocate's Insurance Other Than Group from $530,410 to $534,380.

The panel voted to adopt the Consumer Advocate's attrition period projection of $534,380 for Insurance Other than Group Insurance Expense to utilize the later test year.

V(b)11. CUSTOMER ACCOUNTING

The Company projected Customer Accounting Expense of $738,845. Customer Accounting Expense for the historical test year was $704,362. The Company applied the twenty-one month inflation factor of 3.94% to these expenses, excluding uncollectibles and normalizing adjustments for postage and wireless service to arrive at an increase of $15,381.[85]

The Consumer Advocate initially forecasted $758,111 in Customer Accounting Expense. This amount was based upon test year amounts for customer accounts with normalizing adjustments to annualize the Wireless Service First billing and account for inflation.[86] Subsequently, the Consumer Advocate corrected its growth factor from 3.7% to 4.3 %,[87] which increased CAPD's Customer Accounting from $758,111 to $763,785.

The panel voted to adopt the Consumer Advocate's Customer Accounting Expense of $763,785 for the attrition period to utilize the later test year including normalizing adjustments.

V(b)12. UNCOLLECTIBLE EXPENSE

The Company projected Uncollectible Expense of $531,590 for the attrition period.[88] The Company uncollectible percentage of 1.489% was derived by taking a three year average of the net charge-offs, less recoveries as a percentage of total revenues. That percentage was

[84] CAPD Responses to TRA Staff Data Request #7 (August 4, 2008).
[85] Sheila A. Miller, TN-TRA-02-Q001-Customer Accounting-Summary (May 28, 2008).
[86] Terry Buckner, Pre-filed Direct Testimony, CAPD work papers, pp. 206 (July 18, 2008).
[87] CAPD Responses to TRA Staff Data Request #7 (August 4, 2008).
[88] Sheila A. Miller, TN-TRA-02-Q001-Uncollectible Expense-Summary (May 28, 2008).

applied to the proposed revenue increase of $7,644,859 to arrive at the attrition year adjustment to uncollectible expense of $113,834.[89]

The Consumer Advocate forecasted $434,712 for Uncollectible Expense for the test period. This amount was calculated by multiplying the ratio of Uncollectible Expense and Revenue. The ratio of Uncollectible Expense is based upon Company-booked uncollectible amounts for the twelve months ended March 31, 2008 to total revenue of $39,519,255[90] shown on the March 31, 2008 TRA 3.06 monthly report filed by the Company. Subsequently, the Consumer Advocate corrected its revenue at current rates from $39,519,255 to $39,518,799[91] thereby decreasing its Uncollectible Expense projection from $434,712 to $434,707 for the test period.

The panel voted to adopt an Uncollectible Expense at current rates of $417,756 based upon the Company-booked amount for the twelve months ended November 30, 2007, plus a normalizing factor. The uncollectible factor of 0.011657 was used to reflect normalized test year uncollectibles divided by normalized test year total sales of water to allow for the incremental increase in Uncollectible Expense.

V(b)13. RENT EXPENSE

The Company projected attrition period Rent Expense of $11,336.[92] Rent expense for the historical test year was $30,037. The Company proposed four normalizing adjustments to this category of expense. The first adjustment eliminates the $75 extra quarterly payment for the easement of the Brainard Road Tank. The second adjustment eliminates expenses for a pager, postage equipment and truck radios in the amount of $23,767, contracts that the Company did not renew. The third adjustment is an elimination of miscellaneous office equipment that was

[89] Robert A. Shiltz, Pre-filed Direct Testimony, p. 4 (March 14, 2008).
[90] Terry Buckner Workpaper E-UNC-1 (July 18, 2008).
[91] CAPD Responses to TRA Staff Data Request #10 (July 29, 2008).
[92] Sheila A. Miller, TN-TRA-02-Q001-Rents-Summary (May 28, 2008).

moved to general office expense in the amount of $439 and a correction of three quarterly payments for copier rental that were charged to maintenance expense in the amount of $5,405; these two adjustments result in a net $4,966 increase. The fourth adjustment of $175 annualizes a new lease agreement for postage equipment.[93]

The Consumer Advocate initially projected attrition period Rent Expense of $17,487. This amount is based upon actual booked expense for the twelve months ended March 31, 2008, grown by its annual inflation/growth factor compounded to fourteen months, to compute projected amounts for the twelve months ending August 31, 2009.[94] The CAPD forecast does not include any normalizing adjustments that were presented by the Company. Subsequently, the Consumer Advocate corrected its growth factor from 3.7% to 4.3 %,[95] which increased its projected Rent Expense from $17,487 to $17,618.

The panel voted to adopt the Company's attrition period forecast of $11,336 for Rent Expense because this amount recognizes the test year amount adjusted for known and measurable changes during the attrition period.

V(b)14. GENERAL OFFICE EXPENSE[96]

The Company projected General Office Expense of $245,926[97] for the attrition period. Starting with an historical test year amount of $244,966, the Company made adjustments for known and measurable changes and normalization of postage and then applied an inflation factor of 2.3% to the expense (excluding postage).[98]

[93] Robert A. Shiltz, Pre-filed Direct Testimony, p. 4 (March 14, 2008).
[94] Terry Buckner, Pre-filed Direct Testimony, CAPD work papers, pp. 218-220 (July 18, 2008).
[95] CAPD Responses to TRA Staff Data Request #7 (August 4, 2008).
[96] This expense category includes costs associated with the general expenses for the office. 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.
[97] Sheila A. Miller, TN-TRA-02-Q001-General Office Expense-Summary (May 28, 2008).
[98] Robert A. Shiltz, Pre-filed Direct Testimony, p. 4 (March 14, 2008).

The Consumer Advocate projected attrition period General Office Expense of $254,139. The Consumer Advocate projection is based upon actual booked expense for the twelve months ended March 31, 2008 grown by the Consumer Advocate's annual growth/inflation factor compounded to fourteen months to compute projected amounts for the twelve months ending August 31, 2009.[99] Subsequently, the Consumer Advocate corrected its growth factor from 3.7% to 4.3 %[100] which increased the Consumer Advocate's General Office Expense from $254,139 to $256,041.

The panel voted to adopt the Consumer Advocate's projection for General Office Expense of $256,041 because this amount is based upon a later test period and applies an appropriate inflation factor.

V(b)15. MISCELLANEOUS

The Company originally projected Miscellaneous Expense of $1,990,204 for the attrition period. Subsequently, the Company corrected its inflation factor to 3.94%,[101] and thereby its projection to $2,028,760.[102] Ultimately, the Company reduced its projection from $2,028,760 to $2,018,623.[103] Miscellaneous expense for the historical test year totaled $1,931,046. The Company proposed seven adjustments to this category to arrive at its forecast.[104]

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[99] Terry Buckner, Pre-filed Direct Testimony, CAPD work papers, pp. 221-240 (July 18, 2008).

[100] CAPD Responses to TRA Staff Data Request #7 (August 4, 2008).

[101] The Company originally compounded its inflation factor to 12 months but then compounded the inflation factor to 21 months to properly reflect expense during the attrition period.

[102] Sheila A. Miller, TN-TRA-02-Q001-Miscellaneous Expenses-Summary (May 28, 2008).

[103] Originally the new inflation factor of 3.94% was applied to an ending balance that had also included the inflationary increase of the 2.3%. The Company made a correction which decreased TAWC's Miscellaneous Expense from $2,028,760 to $2,018,623.

[104] The Company proposes the following adjustments: (1) An adjustment reflecting the 3.94% inflation factor adjustment of $68,072 for all expenses except 401K expense, Defined Contribution expense and the Retiree Medical Reimbursement Plan; (2) A net adjustment of $52,949 applies to the 401K expense, Defined Contribution, and Retiree Medical Reimbursement; (3) An adjustment to eliminate penalties in the amount of $124,992 and lobbying expense of $15,601; (4) An adjustment to include a five year amortization of the management audit in the amount of $57,000 annually; (5) An adjustment to increase expense to annualize the maintenance fee to the Tennessee Department of Environment and Conservation in the amount of $22,645; (6) An adjustment of $27,000 to reflect the 2007 fuel cost at current fuel prices; and (7) An adjustment to reflect a security charge transferred from general office in the amount of $504. Robert A. Shiltz, Pre-filed Direct Testimony, p. 5 (March 14, 2008).

The Consumer Advocate originally projected attrition period Miscellaneous Expense of $1,789,687. The Consumer Advocate projection is based upon actual booked expense for the twelve months ended March 31, 2008, normalized based on information provided by the Company,[105] and grown by the Consumer Advocate's annual growth/inflation factor compounded to fourteen months to compute projected amounts for the twelve months ending August 31, 2009.[106] Subsequently, the Consumer Advocate corrected its growth factor from 3.7% to 4.3%[107] which increased the Consumer Advocate's Miscellaneous Expense from $1,789,687 to $1,802,072.

The panel adopted the Consumer Advocate's forecast of $1,802,072 for Miscellaneous Expense for the attrition period. The panel voted to adopt this amount because it was based on more recent normalized actual results and is consistent with the panel's findings regarding management fees by excluding amortization of the management audit cost from Miscellaneous Expense.

V(b)16. OTHER MAINTENANCE EXPENSE

This expense category covers costs associated with maintaining the property of the Company, including repair parts, tools, maintenance supplies, contracted services, paving, maintenance agreements, and other miscellaneous maintenance expenses. The Company projected Other Maintenance Expense of $936,345[108] for the attrition period. Maintenance expense for the historical test year was $1,211,604. After making adjustments and arriving at a normalized balance, the Company applied an inflation factor compounded to twelve months of

[105] Normalizing adjustments were made for lobbying and penalties. *See* Response to TRA Data Request, August 4, 2008.
[106] Terry Buckner, Pre-filed Direct Testimony, CAPD work papers, pp. 241-282 (July 18, 2008).
[107] CAPD Responses to TRA Staff Data Request #7 (August 4, 2008).
[108] Sheila A. Miller, TN-TRA-02-Q001-Other Maintenance Expense-Summary (May 28, 2008).

2.3% to arrive at an attrition year adjustment of $20,720. Subsequently, the Company corrected its inflation factor to 3.94%, resulting in a corrected attrition year adjustment of $35,493.[109]

The Consumer Advocate projected attrition period Other Maintenance Expense of $815,968. The Consumer Advocate's projection is based upon actual booked expense for the twelve months ended March 31, 2008, and removing $402,495 in a normalizing adjustment[110] and grown by the Consumer Advocate's annual growth/inflation factor compounded to fourteen months to compute projected amounts for the twelve months ending August 31, 2009.[111] Subsequently, the Consumer Advocate corrected its growth factor from 3.7% to 4.3 %,[112] which increased CAPD's Other Maintenance Expense from $815,968 to $822,075.

The panel voted to adopt the Consumer Advocate's forecast for Other Maintenance Expense of $822,075 for the attrition period because this amount was based on more current actual results normalized and grown by an appropriate inflation factor.

V(b)17. Depreciation and Amortization Expense

The Company projected Depreciation and Amortization Expense for the attrition period of $4,730,347, which excludes the Utility Plant for Walden's Ridge. This projection is based on a test year expense of $4,915,650, test period adjustments of $131,855 and attrition period adjustments of negative $317,157.[113] The Company retained the firm of Gannett/Fleming to perform a depreciation study related to the assets utilized in providing water service to customers in Chattanooga. The Company applied the study's recommended depreciation ratios to all account balances to generate the depreciation expense forecast.[114] The depreciation study was filed in this docket. The Company used the straight line remaining life method of depreciation

[109] Sheila A. Miller, TN-TRA-02-Q001-Other Maintenance Expense-Summary (May 28, 2008).
[110] This adjustment was provided by TAWC.
[111] Terry Buckner, Pre-filed Direct Testimony, CAPD work papers, pp. 283-289 (July 18, 2008).
[112] CAPD Responses to TRA Staff Data Request #7 (August 4, 2008).
[113] Sheila A. Miller Direct Testimony, Exhibit No. 2, Schedule 1(March 14, 2008).
[114] Transcript of Public Hearing, v. V, p. 593 (August 20, 2008).

with the average service life procedure to determine the proposed depreciation rates.[115] The Company asserts that this method results in systematic recovery of the asset cost over the remaining useful life of the asset.[116]

The Consumer Advocate projected Depreciation and Amortization Expense of $4,366,120[117] for the attrition period. The Consumer Advocate's projection is based upon March 31, 2008 Plant in Service balances and forecasted additions and retirements through the attrition period.[118] The Consumer Advocate filed a depreciation rate study using the Average Group Life procedure.[119] The Consumer Advocate claims the depreciation rate used can be the reciprocal of the estimated service life of the asset being retired.[120]

The panel voted to adopt the Consumer Advocate's forecast for Depreciation and Amortization Expense of $4,366,120 for the attrition period. The panel found this amount is based upon more recent actual balances at March 31, 2008, includes forecasted additions and retirements provided by the Company through the attrition period, and does not depreciate fully depreciated accounts. This results in an acceptable inflation factor that can be adjusted in newly calculated depreciation rates every five years and does not place the inflationary burden for the life of the asset on the current ratepayers.

V(c). TAXES AND FEES

V(c)1. GROSS RECEIPTS TAX

The Company stated that Gross Receipts Tax was based on projected jurisdictional revenues for TAWC including Other Operating revenues. The revenues, adjusted for the Franchise Tax, Excise Tax, and a $5,000 exemption, were multiplied by the current 3% tax rate

[115] John J. Spanos, Pre-filed Direct Testimony, p. 81 (March 14, 2008).
[116] John J. Spanos, Pre-filed Direct Testimony, p. 81 (March 14, 2008).
[117] Terry Buckner, Pre-filed Direct Testimony, Work paper E-DEP, page 298 (July 18, 2008).
[118] Terry Buckner, Pre-filed Direct Testimony, p. 54 (July 18, 2008).
[119] Charles W. King, Pre-filed Testimony, pp. 5-6 (July 18, 2008).
[120] Charles W. King, Pre-filed Testimony, p. 5 (July 18, 2008).

to arrive at the attrition year level. The forecasted amount was prepared using 83% of the Gross Receipts Tax Return based on 2007 revenues. The remaining 17% is based on 2008 budgeted revenues and adjusted for any rate increase included in this filing.[121]

The Consumer Advocate projected Gross Receipts Tax for the attrition period of $357,833.[122] The Consumer Advocate forecasted amount is based the actual methodology used to calculate Gross Receipts Taxes split over the two tax periods in which the tax will be incurred.

The panel voted to adopt Gross Receipts Tax of $357,833 for the attrition period revenue at current rates and an additional $14,883 for the attrition period revenue at new rates because these amounts reflect the methodology actually used to calculate these taxes.

V(c)2. TRA Inspection Fees

The Company stated the TRA Inspection Fee is paid in advance and based on the previous year's revenues. This calculation was also matched to the attrition period in this rate filing. One-third (September 2008 through December 2008) was based on 2007 revenues and two thirds (January 2009 through August 2009) was based on projected 2008 jurisdictional revenues. The revenues were 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 Company's 2007 return.[123]

The Consumer Advocate projected TRA Inspection Fees for the attrition period of $75,588. The panel voted to adopt TRA Inspection fees for attrition period revenue at current rates of $74,171 and an additional $3,289 for the attrition period at new rates.

[121] Sheila A. Miller, Pre-filed Direct Testimony, p. 12 (March 14, 2008).
[122] Terry Buckner, Pre-filed Direct Testimony, Workpaper T-OTAX7 (July 18, 2008).
[123] Sheila A. Miller, Pre-filed Direct Testimony, p. 12 (March 14, 2008).

V(c)3. PROPERTY TAXES

The Company projected Property Taxes for the attrition period of $2,800,840.[124] The Consumer Advocate projected Property Taxes for the attrition period of $2,842,849. The panel voted to adopt Property Taxes of $2,896,268 for the attrition period. Accepting the Company's methodology, the Property Taxes adopted by the panel are based on an attrition period Rate Base of $121,689,263 and application of the effective tax rate of 2.38% calculated by the Company.

V(c)4. FRANCHISE TAXES

The Company used the balances at December, 2007 as a basis for one third of the attrition year tax and used the projected balance at December, 2008 as a basis for calculating the remaining two thirds. Those values were then multiplied by the statutory rate of $.25 per $100.[125]

The Consumer Advocate projected Franchise Taxes for the attrition period of $397,550.[126] The Consumer Advocate calculated Franchise Taxes using actual plant in service and accumulated depreciation net of forecasted plant additions and retirements.[127]

The panel voted to adopt Franchise Taxes of $400,236 for the attrition period. The amount is based on the ratio of the Franchise Taxes paid according to the Company's 2006 Franchise Tax return[128] to the twelve month-to-date average Rate Base of $100,295,787 as reported on the December, 2006 TRA Monthly 3.06 Surveillance Report (0.3289%) as applied to the attrition period average Rate Base of $121,689,263.

[124] Sheila A. Miller, Pre-filed Direct Testimony, Exhibit No. 2, Schedule 5 (March 14, 2008).
[125] Sheila A. Miller, Pre-filed Direct Testimony, p. 13 (March 14, 2008).
[126] Terry Buckner, Pre-filed Direct Testimony, Workpaper T-OTAX8 (July 18, 2008).
[127] Terry Buckner, Pre-filed Direct Testimony, p. 55 (July 18, 2008).
[128] TAWC April 11, 2008 Response to Staff data request dated March 31, 2008 (Minimum Filing Guidelines, Item 13, TN-TRA-01-Q013, p. 21 of 47).

V(c)5. FICA TAX[129]

The Company projected FICA Tax of $378,917.[130] The Company forecasted its attrition period FICA Tax by applying the current tax rates to its attrition period Salaries and Wages.

The Consumer Advocate initially projected FICA Tax of $342,649.[131] The CAPD forecasted its attrition period FICA Tax by applying the current tax rates to its attrition period Salaries and Wages Expense. Subsequently, the Consumer Advocate revised its forecast to $366,896. The panel voted to adopt the Consumer Advocate's forecast of $366,896 for FICA Tax for the attrition period based upon its adoption of the Consumer Advocate's forecast for Salary and Wage Expense.

V(c)6. UNEMPLOYMENT TAX

The Company projected Unemployment Tax of $7,634.[132] The Company forecasted its attrition period Unemployment Tax by applying the current tax rates to its attrition period Salaries and Wages Expense. The Consumer Advocate projected Unemployment Tax of $7,270. The Consumer Advocate forecasted its attrition period Unemployment Tax by applying the current tax rates to its attrition period Salaries and Wages Expense.[133] The panel voted to adopt the Consumer Advocate's forecast of $7,270 for Unemployment Tax for the attrition period based upon its adoption of the Consumer Advocate's forecast for Salary and Wages Expense.

V(c)7. STATE EXCISE TAX

The panel agreed with the position adopted by the Consumer Advocate[134] that the timing differences for State Excise Tax as proposed by the Company would result in recovery of FAS 109 expenses that should be borne by future ratepayers. Therefore, the panel adopted an Excise

[129] Federal Insurance Contributions Act Tax.
[130] Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 2, Schedule 5 (March 14, 2008).
[131] Terry Buckner, Pre-filed Direct Testimony, Exhibit CAPD-RTB, Schedule 8 (July 18, 2008).
[132] Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 2, Schedule 5 (March 14, 2008).
[133] Terry Buckner, Exhibits, Schedule 6 (August 14, 2008).
[134] *Consumer Advocate Corrected Post-Hearing Brief*, p. 58 (September 3, 2008).

Tax for the attrition period of $434,632. This amount is calculated based upon forecasted results from operations at current rates for the attrition period, adjusted for interest expense, permanent differences and application of the statutory tax rate of 6.5%.

V(c)8. Federal Income Tax

The Company's calculation is different from the Consumer Advocate's because of the timing differences included by the Company for FAS 109 that are not included by the Consumer Advocate. The Consumer Advocate asserted that adopting the timing differences as proposed by the Company would result in recovery of expenses that the TRA has decided should be borne by future ratepayers.[135] The panel adopted Federal Income Tax for the attrition period of $2,111,835. 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's proposed amount for AFUDC is $463,690 and is based upon the Company's 2007/2008 budget. This adjustment was made to reflect the AFUDC as an above the line item for ratemaking purposes.[136]

The Consumer Advocate originally projected AFUDC for the attrition period of $150,312 based upon the actual twelve month-to-date amount reported on the November 2007 Monthly Surveillance Report filed with the TRA.[137] The Consumer Advocate revised its forecast to $463,690 based on information in updated exhibits submitted by the Company on August 14, 2008. The panel voted to adopt an AFUDC of $463,690 as proposed by the Company and agreed to by the Consumer Advocate.

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[135] *Consumer Advocate Corrected Post-Hearing Brief*, p. 58 (September 3, 2008).
[136] Robert A. Shiltz, Pre-filed Direct Testimony, pp. 5-6 (March 14, 2008).
[137] Terry Buckner, Pre-filed Direct Testimony, Workpaper E-REC-1 (July 18, 2008).

V(d). <u>NET OPERATING INCOME</u>

Based upon the preceding determinations, the panel found that Net Operating Income is $8,727,809 for the attrition period prior to the application of taxes for the additional attrition period revenues.

V(e). <u>RATE BASE</u>

V(e)1. UTILITY PLANT IN SERVICE (UPIS)

In its *Petition* and pre-filed direct testimony, the Company projected an average attrition period balance for UPIS of $203,998,392.[138] This amount is calculated by taking the UPIS balance per books at November 30, 2007 and adding its budgeted plant additions and retirements by month through August 31, 2009. The Company then calculated the average of its projected thirteen (13) months UPIS balance for the period ending August 31, 2009 to arrive at its UPIS for the attrition period.

In its direct testimony, the Consumer Advocate projected an average attrition period balance for UPIS of $209,341,111.[139] This amount is calculated by taking the UPIS balance per books at March 31, 2008 and adding TAWC's budgeted plant additions and retirements by month through August 31, 2009. The Consumer Advocate then calculated the average of its projected thirteen months UPIS balance for the period ending August 31, 2009 to arrive at its UPIS for the attrition period. The panel voted to adopt the Consumer Advocate's attrition period balance Utility Plant in Service of $209,341,111 because inclusion of Walden's Ridge Plant in Service of $4,455,821 and a later actual balance at March 31, 2008 better reflect the amount expected during the attrition period.

[138] Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 1, Schedule 2 (March 14, 2008).
[139] Terry Buckner, Pre-Filed Direct Testimony, Exhibit CAPD-RTB, Schedule 3 (July 18, 2008).

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

In its *Petition*, TAWC included an attrition period amount for CWIP of $9,083,000.[140] The Company calculated its CWIP amount by taking its CWIP balance per Company books at November 30, 2007 and forecasting its project work for utility plant that will not be in service as of August 31, 2009. [141] Subsequently, the Company proposed a CWIP amount of $6,968,779 based on a revised construction forecast and correction of an error in the CWIP beginning balance.

The Consumer Advocate forecasted CWIP using a thirteen month CWIP average based on the balance of $1,798,540 at March 31, 2008 and adding the monthly budgeted additions for Citico Phase I construction project.[142] The thirteen month average for the attrition year totaled $5,758,682.[143] Subsequently, the Consumer Advocate adjusted its attrition year CWIP to $5,284,789 to reflect the projects initially forecasted by the Company.

The City of Chattanooga and the CMA recalculated the Company's original CWIP amount of $9,083,000 to reflect a thirteen month average CWIP of $7,996,461. There were no adjustments to the CWIP amount for any corrections and/or adjustments proposed by the Company or CAPD.

The panel voted to adopt Consumer Advocate's attrition year CWIP amount of $5,284,789. This amount reflects the actual CWIP balance per books at March 31, 2008 plus the Company's originally forecasted monthly plant additions, capital spending and added projects.

V(e)3. UTILITY PLANT CAPITAL LEASE

The Company projected an average attrition period balance for Utility Plant Capital Lease of $1,590,500. This projection is based upon the balance per Company books at

[140] Exhibit to *Petition*, Exhibit No. 1, Schedule 2, page 1 of 3 (March 14, 2008).
[141] Sheila A. Miller, Pre-filed Direct Testimony, Page 14 (March 14, 2008).
[142] Terry Buckner, Pre-Filed Direct Testimony, pp. 58-59 (July 18, 2008).
[143] CAPD Exhibit, Schedule 2 (July 18, 2008).

November 30, 2007 held constant.[144] In calculating its attrition year rate base, the Consumer Advocate included Utility Plant Capital Lease of $1,590,500 as projected by the Company.[145] The panel adopted the parties' agreed-upon amount for Utility Plant Capital Lease of $1,590,500 in the attrition period.

V(e)4. WORKING CAPITAL

In its *Petition*, the Company included $1,991,406 for working capital.[146] In its direct testimony[147] and Company exhibits, the Company stated it calculated working capital from the following: Average Cash of $214,257; Preferred Insurance, Prepaid Taxes and Materials and Supplies in the amount of $471,236; Deferred Regulatory Expense in the amount of $1,020,269; Unamortized Debt in the amount of $290,559; Other Deferred Debits totaling $852,184; Lead/ Lag Study of $604,000. The above components total $3,452,505 and represent the amount the Company states that it needs to fund daily operations. The Company, however, also receives sewer collections from customers in advance of payments being remitted to the State of Tennessee and City of Chattanooga. These Incidental Collections total $1,461,099.[148] These collections are deducted from the amount necessary to fund daily operations resulting in a working capital amount of $1,991,406 ($3,452,505 less $1,461,099).

In rebuttal testimony, the Company revised its forecast of working capital by eliminating average cash of $214,257, prepaid insurance of $97,506 and unamortized debt expense of $290,559.[149] The Company also changed its lead/lag study to reflect a 24.43 days lag for sewer billing. These adjustments revised the Company's working capital requirement to $1,139,171.[150]

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[144] Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 1, Schedule 2 (March 14, 2008).
[145] Terry Buckner, Pre-filed Direct Testimony, (July 18, 2008).
[146] Exhibit to *Petition*, Exhibit No. 1, Schedule 2, Page 1 of 3 (March 14, 2008).
[147] Sheila A. Miller, Pre-filed Direct Testimony, pp. 14-15 (March 14, 2008).
[148] Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 1, Schedule 2 (March 14, 2008).
[149] Michael A. Miller, Rebuttal Testimony, p. 49 (August 14, 2008).
[150] Michael A. Miller, Rebuttal Testimony, p. 59 (August 14, 2008).

Subsequently, the Company stated it had inadvertently omitted the revised lag days for sewer billings and therefore projected a final working capital requirement is $1,164,171.

The Consumer Advocate forecasted a working capital requirement of $911,278 in its pre-filed testimony. The Consumer Advocate included thirteen month averages for the test period ended March 31, 2008 for the following items in developing its working capital requirement: Average Cash of $376,556, Prepaid Insurance of $93,244, Prepaid Taxes of $164,678 and Materials and Supplies of $315,711.[151] The Consumer Advocate forecasted $650,928 for Deferred Regulatory Expense.[152]

The Consumer Advocate stated that the Unamortized Debt expense was reported as $290,559 in error by TAWC because TAWC did not use a thirteen month average for the attrition period. The CAPD used a thirteen month average for computing its $232,405 Unamortized Debt Expense.[153] The Consumer Advocate also argued that fees for the Management Audit should be removed from other deferred debits and therefore not included in working capital. This reduces other deferred debits from the Company's amount to $595,689.[154]

The Consumer Advocate asserted that the lead/lag study provided by the Company should be altered to reflect the payment lag for the current portions of state excise tax and federal income tax based on the statutory payment requirements of a calendar year's liability paid. The Consumer Advocate used the Company's remaining lead/lag days in its calculation with its respective amounts for revenues, expenses and taxes. These changes resulted in a lead/lag forecasted amount of $835,058.[155] This change, along with the aforementioned balances used by the Consumer Advocate, resulted in a daily requirement of funds of $3,264,269. The incidental

[151] Terry Buckner, Pre-filed Direct Testimony, pp. 59-60 (July 18, 2008), CAPD Workpaper RB-Working Capital Requirement.
[152] Terry Buckner, Pre-filed Direct Testimony, pp. 61-62 (July 18, 2008).
[153] Terry Buckner, Pre-filed Direct Testimony, p. 61 (July 18, 2008).
[154] Terry Buckner, Pre-filed Direct Testimony, p. 61-62 (July 18, 2008).
[155] Terry Buckner, Pre-filed Direct Testimony, p. 63 (July 18, 2008).

collections calculated by the Consumer Advocate include not only sewer collections but also sales and use tax collections, resulting in incidental collections of $2,352,991. Subsequently, the Consumer Advocate revised its working capital requirement by eliminating cash and prepaid insurance. The Consumer Advocate also reduced its lead/lag amount by $131,941 to reflect updated operation and maintenance expenses and reduced incidental collections by $290,114. Finally, the Consumer Advocate corrected a working capital error of $76,221 to arrive at its final working capital forecast of $599,651.

The City of Chattanooga and CMA calculated a negative working capital balance of $1,686,347[156] by removing the average cash balance, deferred regulatory expense, and unamortized debt expenses, and other deferred debits from the working capital allowance.[157]

The panel voted to adopt a Working Capital Requirement of $318,827 for the attrition period. This amount is based upon eliminating both cash and prepaid insurance from working capital allowances and accepting the CAPD's amounts of prepaid taxes, materials and unamortized debt expense as of March 31, 2008, which better reflect amounts for the attrition period. The panel also accepted the CAPD's amount for other deferred debits, which excludes the $285,000 in fees related to the management audit. Consistent with the panel's decision for recovery of rate case expense, the panel included $584,556 of deferred rate case expense.

The Company used its 2002 lead/lag study in this case. The CAPD, City and Company suggested changes to the lead and lag days. The panel decided against changing a select few amounts without seeing an entire study and, therefore, did not adopt any recommended changes to the number of lead/lag days that were presented in the 2002 study. Accordingly, the 2002 lead/lag days were applied to the panel's adopted amounts for revenues, expenses and taxes. The panel also adopted the CAPD's calculation of incidental collections of $2,062,877.

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[156] Michael Gorman, Pre-filed Direct Testimony, p. 5 (July 18, 2008).
[157] Michael Gorman, Pre-filed Direct Testimony, pp. 5-6 (July 18, 2008).

V(e)5. Accumulated Depreciation

The Company projected accumulated depreciation for the attrition period of $63,563,205.[158] This amount was calculated by taking the accumulated depreciation balance at November 30, 2007 and adding monthly forecasted depreciation (using the Company's UPIS forecast) through the attrition period utilizing current depreciation rates through August 31, 2008 and the new rates from September 1, 2008 through August 31, 2009.

The Consumer Advocate projected accumulated depreciation for the attrition period of $62,426,348.[159] The methodology utilized by the Consumer Advocate is identical to that used by TAWC. The difference between the projections of the Company and the Consumer Advocate is attributable to the Consumer Advocate's use of a later accumulated depreciation balance at March 31, 2008, the inclusion of Walden's Ridge plant, and the utilization of different depreciation rates.

Consistent with its decision to adopt the Consumer Advocate's UPIS, depreciation rates and depreciation expense for the attrition period, the panel voted to adopt the Consumer Advocate's attrition year accumulated depreciation of $62,426,348.

V(e)6. Retired work in process (RWIP)

The Company included a negative amount of $151,351 for RWIP in its rate base calculations.[160] The Consumer Advocate did not address RWIP in its direct testimony and did not include an amount in its rate base calculations. The panel voted to adopt the Company's unchallenged RWIP amount of $151,351.

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[158] Sheila A. Miller, Pre-filed Direct Testimony, Exhibit 1, Schedule 2 (March 14, 2008).
[159] Terry Buckner, Pre-filed Direct Testimony, pp. 64-65 (July 18, 2008).
[160] Exhibit to *Petition*, Exhibit No. 1, Schedule 2, Page 1 of 3 (March 14, 2008).

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

The Company projected $1,139,858 for accumulated amortization of utility capital lease. This projection was calculated by taking the amount of accumulated balance per books at November 30, 2007 and adding monthly amortizations of the utility capital lease through the attrition period. The thirteen month average was then taken to derive the amount of attrition period accumulated amortization of utility capital lease. The Consumer Advocate accepted the Company's forecast. The panel adopted the agreed upon attrition period forecast for accumulated amortization of utility capital lease of $1,139,858.

V(e)8. ACCUMULATED DEFERRED INCOME TAXES (ADIT)

The Company projected an attrition period amount of $16,931,771 for ADIT in Exhibit No. 1, Schedule 2 of the *Petition*. The Consumer Advocate originally calculated ADIT of $17,533,305 by taking the actual balances as of March 31, 2008 and the projected balances through the attrition year. The change for the attrition year is the projected tax depreciation less book depreciation multiplied by the statutory and federal tax rates. Forecasted timing differences were spread evenly through the attrition period. A thirteen month average was calculated for the attrition year.[161] Subsequently, the Consumer Advocate amended its ADIT as it related to net negative salvage and restated its projection of ADIT as $15,242,359.[162]

The Company argued that the Consumer Advocate failed to take into account Financial Accounting Standard (FAS) 109 in its calculation of accumulated deferred income taxes. The Consumer Advocate stated that not only did the Company incorrectly apply FAS 109, but the Company's calculations do not use the appropriate enacted tax rates.[163] The Consumer Advocate

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[161] Terry Buckner, Pre-filed Direct Testimony, pp. 65-66 (July 18, 2008).
[162] CAPD Data Response (August 15, 2008).
[163] *Consumer Advocate and Protection Division's Post-Hearing Brief*, p. 56 (September 2, 2008).

also argued that amortization of regulatory assets would have the effect of circumventing Authority ratemaking decisions.

The panel adopted the Consumer Advocate's revised ADIT of $15,242,359 for the attrition period. In so doing, the panel rejected the Company's argument that application of FAS 109 had been misapplied by the Consumer Advocate. While financial accounting for tax purposes must conform to all financial accounting standards and requirements, including those set forth in FAS 109, the panel found there is different treatment of numerous items for regulatory purposes related to establishing rates including the application of FAS 109.

V(e)9. CUSTOMER ADVANCES FOR CONSTRUCTION

The Company projected an attrition period amount of $6,793,935 in Exhibit No. 1, Schedule 2 of the *Petition* for Customer Advances for Construction. According to this schedule, the Company took the balance per books at November 30, 2007 and added the projected amount of Customer Advances for Construction through the attrition period. A thirteen month average was then calculated to arrive at the attrition period amount.

The Consumer Advocate utilized the same approach, except that it began with the balance per books at March 31, 2008. The Consumer Advocate added the Company-provided changes in monthly Customer Advances for Construction through the attrition period. As a result, the Consumer Advocate projected a thirteen month average of $7,628,149 for Customer Advances for Construction for the attrition period.[164]

The panel voted to adopt the Consumer Advocate's projection of $7,628,149 for the attrition period for Customer Advances for Construction. The panel found that the Consumer Advocate's later test period was a more accurate reflection of the amount expected during the attrition period.

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[164] Terry Buckner, Pre-filed Testimony, Exhibit CAPD, Schedule 2, Workpaper RB-CAC (July 18, 2008).

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

The Company projected an attrition period amount of $8,399,016 for CIAC in Exhibit No. 1, Schedule 2 of the *Petition*. According to this schedule, the Company takes the balance per books at November 30, 2007 and adds the projected amount of CIAC through the attrition period. A thirteen month average was then calculated to arrive at the attrition period amount.

The Consumer Advocate utilized the same approach, except that it began with the balance per books at March 31, 2008. The Consumer Advocate added the Company-provided changes in monthly CIAC through the attrition period. As a result, the Consumer Advocate projected a thirteen month average of $8,459,113 for CIAC for the attrition period.[165]

The panel voted to adopt the Consumer Advocate's projection of $8,459,113 for the attrition period for CIAC. The panel determined the use of the Consumer Advocate's later test period is a more accurate reflection of the amount expected during the attrition period.

V(e)11. UNAMORTIZED INVESTMENT TAX CREDIT ("UITC")

The Company projected an attrition period amount of $37,993 in Exhibit No. 1, Schedule 2 of the *Petition* for the Unamortized Investment Tax Credit. This projection is the balance per Company books at November 30, 2007, as the Company anticipated no change in this amount through the attrition period.

The Consumer Advocate projected $33,994 for the Unamortized Investment Tax Credit for the attrition period. This amount was calculated by taking the Company's November 30, 2007 balance, amortizing that amount through the attrition period, and then taking a thirteen month average.[166] Upon review of the Consumer Advocate's calculation, however, it appears that a twelve-month average was taken.

[165] Terry Buckner, Pre-filed Testimony, Exhibit CAPD, Schedule 2, Workpaper RB-CAC (July 18, 2008).
[166] Terry Buckner, Pre-filed Testimony, Exhibit CAPD, Schedule 2, Workpaper RB-ITC (July 18, 2008).

The panel utilized the Consumer Advocate's approach and a thirteen month average and voted to adopt $34,123 for the attrition period Unamortized Investment Tax Credit.

V(e)12. UTILITY PLANT ACQUISITION ADJUSTMENT

The Company projected an attrition period amount of $67,365 in Exhibit No. 1, Schedule 2 of the *Petition* for the Utility Plant Acquisition Adjustment. This projection was based upon the balance per Company books at November 30, 2007 and adjusting the balance by the amount of amortization through the attrition period. The Consumer Advocate included the same amount in its exhibits.[167]

The panel voted to adopt $67,365 as the Utility Plant Acquisition Adjustment for the attrition period.

V(f). REVENUE CONVERSION FACTOR

The panel voted to adopt an overall Revenue Conversion Factor of 1.650838 based upon the Consumer Advocate's methodology, a Forfeited Discount Factor of 0.008470 to reflect the Normalized Test Year Late Payment Penalty divided by Normalized Test Year Total Sales of Water, an Uncollectible Factor to 0.011657 to reflect Normalized Test Year Uncollectibles divided by Normalized Test Year Total Sales of Water, state excise tax of 6.5%, and FIT of 35%.

V(g). RATE OF RETURN (ROE)

TAWC requested an overall rate of return of 8.514%.[168] Based upon its data, the Company proposed a capital structure for TAWC comprised of: 50.66% long-term debt; 5.20% short-term debt; 1.16% preferred equity; 24.71% common equity comprised of common stock; and 18.27% common equity in the form of retained earnings.[169]

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[167] Terry Buckner, Pre-filed Testimony, Exhibit CAPD, Schedule 2 (July 18, 2008).
[168] Michael A. Miller, Pre-filed Direct Testimony, Exhibit MAM-3 (March 14, 2008).
[169] Michael A. Miller, Pre-filed Direct Testimony, Exhibit MAM-3 (March 14, 2008).

TAWC proposed a short-term debt cost of 5.2% based upon market forecasts for 2009 and recent short-term debt rates from American Water Capital Corporation ("AWCC").[170] The proposed cost of long-term debt was 6.26% and includes a proposed $16 million debt offering at 6.0% to be issued in early 2009.[171]

In deriving its recommended cost of capital of 8.514%, TAWC claims that its return on equity should be set at 11.75%.[172] The Company estimated the cost of equity using the discounted cash flow ("DCF") model and two risk positioning models, the capital asset pricing model ("CAPM") and the empirical capital asset pricing model ("ECAPM").[173] Further, the Company argued that the appropriate capital structure to use in this case is the stand-alone capital structure of TAWC.[174]

Concerning the CAPM, the Company maintained that the Consumer Advocate inaccurately stated that the academic community no longer accepts the CAPM. Concerning the DCF model, the Company noted that analyst forecasts are better predictors of future earnings than historical growth.[175]

The Consumer Advocate recommended an overall cost of capital of 6.66%.[176] The 6.66% overall return is based upon a double-leveraged capital structure, the debt costs described above and a 7.5% equity return.

The Consumer Advocate employed a double-leverage methodology to determine the capital structure for TAWC. Based on data from the March 31, 2008 10-Q filing for TAWC's parent AWWC, the Consumer Advocate set the equity ratio at 42.96%, the long-term debt ratio

[170] Michael A. Miller, Pre-filed Direct Testimony, p. 5 and Exhibit MAM-3 (March 14, 2008).
[171] Michael A. Miller, Pre-filed Direct Testimony, pp. 5-7 (March 14, 2008).
[172] Michael A. Miller, Pre-filed Direct Testimony, p. 8 (March 14, 2008).
[173] Dr. Michael Vilbert, Pre-filed Direct Testimony, p. 2 and pp. 20-26 (March 14, 2008).
[174] Michael A. Miller, Pre-filed Rebuttal Testimony, p. 17 (August 13, 2008).
[175] Dr. Michael Vilbert, Pre-filed Rebuttal Testimony, p. 36 (August 13, 2008).
[176] Dr. Steve Brown, Pre-filed Direct Testimony, pp. 6-7 (July 18, 2008).

at 55.14% and the ratio of short-term debt at 1.9%.[177] The Consumer Advocate calculated the cost of short-term debt for AWWC using the average of the 30-day, three-month, and six-month LIBOR rate as of July 2008 which yielded 2.87%[178] The cost of long-term debt for AWWC was calculated by using data on debt series listed in its March 31, 2008 quarter-ended 10-Q. When individual debt items on the 10-Q are indicated as having variable rates or are debt series that were issued at different rates, the effective rate was calculated by averaging the weighted cost of debt evaluated at the end-points of the range of interest rates listed. As a result of this analysis, the Consumer Advocate arrived at a long-term debt cost of AWWC of 5.86%.[179]

As part of the double-leverage calculation, the Consumer Advocate asserted that 7.6% of TAWC's capitalization is provided by debt holders outside the AWWC corporate family.[180] By implication, 92.4% of TAWC capital is provided by AWWC. The Consumer Advocate argued that the appropriate equity return is 7.5% based upon an implementation of the DCF model using historical dividend growth.[181] The Consumer Advocate asserted that the DCF is preferable to the CAPM as it tracks the actual flow of payments to Company shareholders.[182]

The CMA and the City noted that TAWC's proposed capital structure is not consistent with the double-leverage capital structure adopted by the TRA in Docket No. 06-00290.[183] The CMA and the City proposed a capital structure for TAWC's parent AWWC comprised of 65.77% long-term debt, 5.09% short-term debt, 0.06% preferred stock, and 29.07% common stock.[184]

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[177] Dr. Steve Brown, Pre-filed Direct Testimony, pp. 4-6 (July 18, 2008).
[178] Dr. Steve Brown, Pre-filed Direct Testimony, pp. 6-8 (July 18, 2008).
[179] Dr. Steve Brown, Pre-filed Direct Testimony, pp. 1-2 (July 18, 2008).
[180] Dr. Steve Brown, Pre-filed Direct Testimony, pp. 6-7 (July 18, 2008).
[181] Dr. Steve Brown, Pre-filed Direct Testimony, pp. 17-19 (July 18, 2008).
[182] Dr. Steve Brown, Pre-filed Direct Testimony, p. 16 (July 18, 2008).
[183] Michael Gorman, Pre-filed Direct Testimony, p. 23 (July 18, 2008).
[184] Michael Gorman, Pre-filed Direct Testimony, Exhibit MPG-8 (July 18, 2008).

To establish a long-term debt rate, the CMA and the City used the long-term debt cost of the subsidiary TAWC to proxy the long-term debt cost of AWWC.[185] The Intervenors estimated AWWC's short-term debt cost to be 3.25%, reflecting recent reductions in short-term interest rates.[186] With respect to the return on equity, the Intervenors estimated a range of equity returns from 9.0% to 10.7%.[187] Based upon this range of estimates, the Intervenors recommended the midpoint of the range -- 9.9% -- for use in this proceeding.[188] In forming his recommendation, the CMA's witness utilized proxy groups derived from water utilities and natural gas utilities.[189]

The panel determined 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 TAWC's capitalization held by parties outside the American Water Works system to be 7.39% at a weighted cost of 8.36%. For the 92.61% of TAWC's capitalization provided by its parent company, the panel voted to adopt a capital structure consisting of 52.46% long-term debt, 2.66% short-term debt, 0.05% preferred stock and 44.83% equity. In addition, the panel adopted long-term debt cost of 6.26%, a short-term debt cost of 3.85%, and the cost of preferred stock of 5%. Further, the panel voted to adopt an equity return of 10.2%. Using these values, the panel adopted an overall rate of return of 7.99% for the Company.

V(h). Revenue Deficiency

Based upon the preceding determinations, the panel found that the Revenue Deficiency is $1,655,541 for the attrition period.

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[185] Michael Gorman, Pre-filed Direct Testimony, p. 25 (July 18, 2008).
[186] Michael Gorman, Pre-filed Direct Testimony, p. 25 (July 18, 2008).
[187] Michael Gorman, Pre-filed Direct Testimony, pp. 47-48 (July 18, 2008).
[188] Michael Gorman, Pre-filed Direct Testimony, pp. 47-48 (July 18, 2008).
[189] Michael Gorman, Pre-filed Direct Testimony, pp. 27-28 (July 18, 2008).

V(i). Rate Design

The Company filed a Cost of Service Allocation Study as of November 30, 2007. The Study shows that under proposed rates Residential and Other Water Utilities (Wholesale Water Sales) are being subsidized by Commercial, Other Public Authority and Private Fire Protection.

The Company supported a rate design based upon an across-the-board uniform increase with the exception of Other Water Utilities. The percentage increase is less for the Other Water Utilities class because Signal Mountain and Walden's Ridge do not receive any portion of the rate increase. Within the Residential and Commercial classes, TAWC proposed different percentage rate increases for different service districts.

The Intervenors supported the same percentage rate increase across all customer classes and within each class. The City and CMA argued that the cost of service study examined and allocated costs at the rate class level not at the service district level. The Intervenors also criticized the cost study for improperly removing Walden's Ridge from the study without removing all of the associated costs.

The panel voted to deny the Company's proposed tariff and instructed the Company to file a new tariff within thirty days with new rates reflecting a 4.37% increase to the overall revenues in each class allocated as follows:

(1) a 4.37% increase to each base and volumetric rate for each customer class, with the exception of the Other Water Utilities class;

(2) a 4.37% increase to the rates for Catoosa and Fort Oglethorpe;

(3) a 12.77% increase to the rates for Signal Mountain at the earliest date allowed by the contract;

(4) a 12.77% increase to the rates for Walden's Ridge at the earliest date allowed by the contract; and

(5) a decrease to commercial revenues of approximately $75,000 effective September, 2009, to account for the additional revenue recovered by annualizing the Signal Mountain and Walden's Ridge rate increase.

IT IS THEREFORE ORDERED THAT:

1. The rates filed by Tennessee American Water Company on March 14, 2008 are denied.

2. For purposes of the rates herein, the test period shall be either the normalized test period for the twelve months ended November 30, 2007 or the March 31, 2008 normalized test period depending on which best fits the individual items being forecasted.

3. The forward looking attrition period shall be the twelve months ending August 31, 2009.

4. For purposes of the rates herein, the rate base is $121,689,263, and the net operating income is $8,727,809 at current rates.

5. Capitalization held by parties outside the American Water Works Company system is set at 7.39% with a cost of 8.36%.

6. A capital structure comprised of 44.83% equity, 52.46% long-term debt with such debt costing 6.26%, 2.66% short-term debt with such debt costing 3.85%, 0.05% preferred stock with such debt costing 5%, and an equity return of 10.2% is set for American Water Works Company, Tennessee American Water Company's parent.

7. For purposes of the rates herein, the capital structure and cost rates indicated above produce a fair rate of return of 7.99%.

8. For purposes of the rates herein, the Revenue Conversion Factor is 1.650838, resulting in a Revenue Deficiency of $1,655,541, the amount needed for the Company to earn a fair return on its investment during the attrition year.

9. The Revenue Deficiency shall be addressed by new rates reflecting a 4.37% increase to the overall revenues in each class allocated as follows:

(1) 4.37% increase to each base and volumetric rate for each customer class, with the exception of the Other Water Utilities class;

(2) 4.37% increase to the rates for Catoosa and Fort Oglethorpe;

(3) 12.77% increase to the rates for Signal Mountain at the earliest date allowed by the contract;

(4) 12.77% increase to the rates for and Walden's Ridge at the earliest date allowed by the contract; and

(5) decrease to commercial revenues of approximately $75,000 effective September 2009, to account for the additional revenue recovered by annualizing the Signal Mountain and Walden's Ridge rate increase.

10. Tennessee American Water Company shall develop a Request For Proposal ("RFP") for a comprehensive management audit by an independent certified public accountant and file the RFP in this docket no later than six months from September 22, 2008 for approval by the Authority before issuing the RFP.

11. Tennessee American Water Company is directed to file tariffs with the Authority that are designed to produce an increase of $1,655,541 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 of the date of decision, September 22, 2008.

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.

Tre Hargett, Chairman

Eddie Roberson, Director

Mary W. Freeman, Director[190]

[190] Director Freeman disagreed with the majority regarding the management fee and noted that numerous calculations in determining the Company's revenue deficiency would be impacted by her adoption of a different management fee. Otherwise, Director Freeman concurred with the majority.