

BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

March 12, 2010

IN RE:

**TENNESSEE AMERICAN WATER
COMPANY'S REQUEST FOR PROPOSAL
FOR MANAGEMENT AUDIT**

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**DOCKET NO.
09-00086**

ORDER APPROVING CONTRACTOR TO PERFORM MANAGEMENT AUDIT

This matter came before Chairman Sara Kyle, 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 December 14, 2009 for consideration of *Tennessee American Water Company's Request for Approval of Schumaker-Work & Greer to Perform the Management Audit ("TAWC Request")* filed by Tennessee American Water Company ("TAWC" or "Company") on October 28, 2009.

BACKGROUND

On March 14, 2008, TAWC filed a petition in Docket No. 08-00039¹ seeking an increase in its rates, including an increase in management fees of \$355,365 over the amount that was approved in its prior rate case.² In Docket No. 06-00290, the Authority granted the Company management fees in the amount of \$3,979,825 and ordered TAWC to have a management audit performed to determine whether costs allocated to TAWC were the result of prudent

¹ 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. 08-00039 (hereinafter "Docket No. 08-00039").

² See, Docket No. 08-00039, *Order*, p. 18 (January 13, 2009). TAWC requested recovery of \$4,335,190 for management fees. Management fees are charges from American Water Works Service Company ("AWWSC" or "Service Company") for services provided to affiliate companies under the 1989 Service Company contract. These services consist of accounting, administration, communication, corporate secretarial, engineering, finance, human resources, information systems, operations, rates and revenue, risk management, water quality and other "agreed upon" services.

management decisions by American Water Works Service Company.³ Specifically, the panel in Docket No. 06-00290 ordered:

. . . TAWC should have a management audit performed in compliance with Sarbanes-Oxley [“SOX”] requirements. . . This audit should determine whether all costs allocated to TAWC were incurred as a result of prudent or imprudent management decisions by TAWC’s parent and should address the reasonableness of the methodology used to allocate costs to TAWC.⁴

The audit report of Booz Allen Hamilton (“BAH”), ordered by the panel in Docket No. 06-00290, was filed as part of the Company’s petition for a rate increase in Docket No. 08-00039 and was sponsored by the testimony of Mr. Joseph Van Den Berg. In the pre-filed testimony and during the hearing, City of Chattanooga’s witness, consultant Mr. Michael Majoros, asserted that Mr. Van Den Berg’s firm did not conduct a management audit in compliance with SOX requirements. Mr. Majoros cited a list of reasons for his conclusion, the most notable that BAH is not an independent public accounting firm as required by SOX and that Mr. Van Den Berg’s report is not independent, since he has also provided testimony on behalf of TAWC in other dockets, both before the TRA and before other utility commissions.⁵

Based on the evidence presented, the panel determined in Docket No. 08-00039 that the Company had not complied with the Authority’s directive in Docket No. 06-00290. The panel ordered TAWC to develop and submit for the Authority’s approval a Request for Proposal (“RFP”) for a comprehensive management audit performed by an independent certified public accountant. The panel stated:

³ *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. 06-00290, *Order*, pp. 26-27 (June 10, 2008).

⁴ *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. 06-00290, *Order*, pp. 26-27 (June 10, 2008).

⁵ Docket No. 08-00039, *Order*, pp. 18-22 (January 13, 2009).

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. 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.⁶

Further, the panel directed the Company to contact the Authority Staff in the event that the Company had any questions regarding the scope of the audit.⁷

TRAVEL OF THIS CASE

On March 23, 2009, TAWC filed its Request for Proposal for a Management Audit ("*Draft RFP*") in Docket No. 08-00039. The *Draft RFP* was considered at the regularly scheduled Authority Conference held on June 15, 2009. At that time, the panel voted to open a new docket for consideration of TAWC's Request for Proposal; to have Authority Staff contact regulatory agencies in other states served by companies owned by American Water Works Company to determine potential interest in participating in a multi-state audit; and to permit interested parties to file comments concerning the Authority's proposed changes to the *Draft RFP*.⁸ This docket (No. 09-00086) was opened, and all filings related to the *Draft RFP* have been moved into this docket.

On June 19, 2009, the TRA sent a letter to eighteen state regulatory agencies requesting that any agency interested in participating in a multi-state audit contact Darlene Standley, Chief

⁶ *Order*, p. 22 (January 13, 2009).

⁷ *Id.*, footnote 68.

⁸ Docket No. 08-00039, *Order Moving Request for Proposal to New Docket*, pp. 3-4 (July 16, 2009).

of the TRA Utilities Division.⁹ On July 1, 2009, a status conference was held in this docket to consider the Company's filing. On July 20, 2009, the Company filed *Tennessee American Water Company's Comments Regarding Recent Communications Filed in this Docket Regarding a Multi-State Audit*. The Authority issued its *Order Approving Request for Proposal* on September 8, 2009.

On October 28, 2009, the Company filed the *TAWC Request*, in which the Company stated that it had issued the RFP to thirteen possible candidates and that three firms ultimately responded. The Respondents were WHN-Liberty, Shumaker-Work & Greer ("Shumaker-Work"), and NorthStar-TCBA-MFSG ("NorthStar"). The Company evaluated and scored each response on four categories: 1) qualifications, 2) proposed approach and work plan, 3) key personnel, and 4) pricing. According to the Company's evaluation, NorthStar and Shumaker-Work had similar and materially better scores than WHN-Liberty without considering price. Ultimately, the Company requested that the Authority approve Shumaker-Work to perform the management audit because Shumaker-Work's "not to exceed" price was significantly lower than the price submitted by the other two respondents.

FINDINGS AND CONCLUSIONS

Based on the entire record, the panel voted unanimously to approve a Tennessee-specific¹⁰ management audit to be performed by Shumaker-Work. The panel further directed the Company to include the language set out in Exhibit 1, which is incorporated by reference as if set out

⁹ To-date correspondence between the TRA and other regulatory agencies regarding the multi-state audit have been filed in this docket on June 19, 24, 25 and 30, 2009, July 7, 8, 9, 15, 24, and 29, 2009, and August 11 and 12, 2009. Additionally, during the August 4, 2009 Authority Conference, Director Roberson stated that he had had some brief conversations with other state representatives at the recent meeting of the National Association of Regulatory Utility Commissioners.

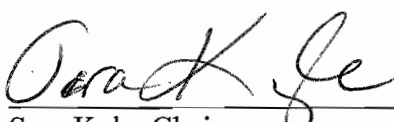
¹⁰ After reviewing the bids submitted by the Company, the panel found that (1) given that the price for a Tennessee-specific management audit was not excessive and (2) that there had been limited response from other states expressing interest in the possibility of a multi-state audit it was prudent to go forward with a Tennessee-only audit.

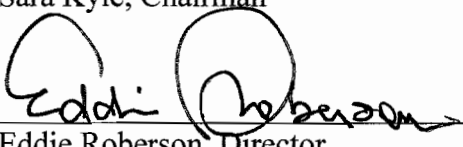
herein, into the final contract. Finally, the panel directed that the Company file with the Authority a copy of the executed contract between it and Shumaker-Work.¹⁰

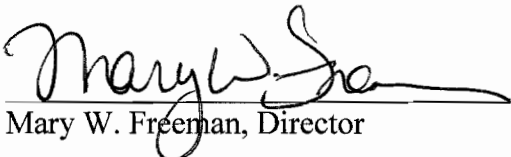
IT IS THEREFORE ORDERED:

1. A Tennessee-specific management audit of Tennessee American Water Company is approved to be performed by Shumaker-Work & Greer.

2. Tennessee American Water Company shall file a copy of the executed contract¹¹ between it and Shumaker-Work & Greer, which shall include the terms set out in Exhibit 1.


Sara Kyle, Chairman


Eddie Roberson, Director


Mary W. Freeman, Director

¹⁰ As set out in the RFP, the Authority must ratify the contract before it is enforceable. *Order Approving Request for Proposal*, Exhibit 1, p. 12 (September 8, 2009).

¹¹ See Footnote 10.

ATTACHMENT 1

The final report will include an assessment/attestation regarding:

- 1. The status and sufficiency of AWWSC's management performance and decisions relating to internal processes and internal controls;**
- 2. The efficiency of operating procedures and communication between TAWC and AWWSC;**
- 3. AWWSC performance with industry standards and best management practices;**
- 4. The appropriateness of organizational structure of AWWSC/TAWC and reporting alignment;**
- 5. The development of AWWSC's long-range and short-range operational plans to assure the effective and efficient performance of the functions;**
- 6. The appropriateness of AWWSC's staffing and skill sets; and**
- 7. TAWC's controls and systems to analyze and control costs from AWWSC.**

The final report will include an evaluation and opinion of:

- 1. The accuracy and reasonableness of total AWWSC charges (including expenses) allocated to TAWC;**
- 2. The necessity, reasonableness/prudence, and efficiency of processes and/or functions performed by AWWSC on behalf of TAWC; and**
- 3. The accuracy and reasonableness of the allocation factors utilized to allocate AWWSC charges to regulated and non-regulated subsidiaries, and allocated regulated AWWSC charges to TAWC, including review of work previously performed regarding allocation methods which will be supplied by AWW.**

The final report will:

- 1. Make specific recommendations and the estimated remediation costs regarding the findings of the management audit, if any.**