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150 Third Avenue South, Suite 2800  
Nashville, TN 37201  
(615) 742-6200

David Killion  
PHONE: (615) 742-7718  
FAX: (615) 742-0414  
E-MAIL: [dkillion@bassberry.com](mailto:dkillion@bassberry.com)

February 8, 2011

**VIA HAND DELIVERY**

filed electronically in docket office on 02/08/11

Chairman Mary W. Freeman  
c/o Sharla Dillon  
Tennessee Regulatory Authority  
460 James Robertson Parkway  
Nashville, Tennessee 37243

**Re: Docket No. 10-00189: *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***

Dear Chairman Freeman:

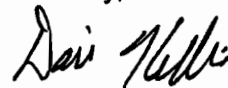
Enclosed please find an original and five (5) sets of copies of Tennessee American Water Company's Rebuttal Testimony filed on behalf of the following witnesses: Bernard L. Uffelman, James H. Vander Weide, James I. Warren, Sheila A. Miller, Patrick L. Baryenbruch, Paul R. Herbert, Dr. Edward L. Spitznagel, John S. Watson and Michael A. Miller.

Two disks are included with this submission. The first disk, labeled "Docket Manager Disk" contains PDF images of the testimony of each witness. The second disk contains all of the documents submitted in their native formats.

Please file the original and four copies of this Rebuttal Testimony and stamp the additional copy as "filed." Then please return the stamped copy to me by way of our courier.

Should you have any questions concerning this matter, please do not hesitate to contact me at the email address or telephone number listed above.

Sincerely,



David Killion

Enclosures

1                   **TENNESSEE-AMERICAN WATER COMPANY**  
2                   **TENNESSEE REGULATORY AUTHORITY DOCKET NO. 10-00086**  
3                   **REBUTTAL TESTIMONY OF MICHAEL A. MILLER**  
4  
5

6  
7   Q.   WHAT IS YOUR NAME AND BUSINESS ADDRESS?

8   A.   Michael A. Miller, 1600 Pennsylvania Avenue, Charleston, West Virginia.  
9

10   Q.   DID YOU FILE DIRECT TESTIMONY IN THIS CASE?

11   A.   Yes.  
12

13   Q.   WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

14   A.   I will address the obvious attempt of the intervenors to inappropriately and artificially  
15       deflate any reasonable cost of service of the Company in this case. In many cases,  
16       intervenor witnesses' positions and basis for adjustments sought to the Company's filing  
17       are not correct. Some witnesses, however, provide significant banter about the  
18       Company's filing and motives for filing this rate case, including in my opinion,  
19       unsupported, unfair and inappropriate attacks on the Company and its witnesses'  
20       credibility and reputation. It is the Company's intention to stick to the facts and process  
21       its case in a professional and credible manner, but some reply to these tactics is warranted  
22       and appropriate, as will be evidenced in this testimony and that of other Company  
23       witnesses. The Directors should easily discern that in many cases the intervenors'  
24       testimony is short on facts, substance, support and the use of established rate making  
25       principles. Instead, the CAPD and City witnesses attempt to mask the absence of  
26       reasonable conclusions based on the facts in this case.

27               Neither the CAPD, nor any party to this case, provides any rebuttal to the fact that  
28       TAWC will have invested over \$17.0 million in capital improvements through the  
29       attrition year in this case above the level on which rates are currently based. In addition,  
30       no party has rebutted the facts that (i) there has been a 33% increase in power costs from  
31       the Chattanooga EPB since the last case, (ii) there has been a 25% increase in paving  
32       costs due to an Ordinance passed by the City of Chattanooga, (iii) there has been a 22%

1 increase in group insurance premiums, or (iv) there has been a 42% increase in pension  
2 costs (which also significantly impacts the costs from AWWSC).

3 The CAPD's witnesses have attempted to create their own revenues and expenses  
4 by choosing different base periods than the Company (2004 for management fees) on  
5 which to make their calculations, and they simply ignore numerous known and  
6 measurable adjustments that are appropriate for inclusion in the attrition year for this  
7 case, with little or no mention for their reasoning or support for their position.

8 The general topics of my testimony are as follows:

- |    |   |           |
|----|---|-----------|
| 9  | 1. General Observations About The Impact Of the CAPD, |           |
| 10 | The City, and the CRMA's Cost of Service              |           |
| 11 | Recommendations in This Proceeding                    | Page – 3  |
| 12 | 2. Appropriate Test-Year, Discovery Issues and        |           |
| 13 | Company's Filing in this Case                         | Page – 12 |
| 14 | 3. Capital Structure                                  | Page – 17 |
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| 17 | 6. Recommendations on the Capital Structure           |           |
| 18 | And Weighted Cost of Capital in this Case             | Page – 30 |
| 19 | 7. Accumulated Deferred Income Taxes and Associated   |           |
| 20 | Impact on Current Income Taxes                        | Page – 33 |
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| 24 | 11. Revenues  | Page – 58 |
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| 27 | 14. Annual Incentive Plan                             | Page – 79 |
| 28 | 15. Pension Expense                                   | Page – 88 |
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| 30 | 17. Employee Levels for the Attrition Year            | Page – 92 |
| 31 | 18. The Relationship Between TAWC and AWR             | Page – 95 |

**GENERAL OBSERVATIONS ABOUT THE IMPACT OF THE CAPD, CITY AND  
CRMA'S COST OF SERVICE RECOMMENDATIONS IN THIS PROCEEDING**

Q. CAN YOU ILLUSTRATE THE FORECASTED FINANCIAL RESULTS UNDER U.S. GAAP ACCOUNTING FOR TAWC IN THE ATTRITION YEAR IF THE CAPD'S REVENUE REQUIREMENT WAS ADOPTED IN THIS CASE?

A. Yes. I provided in my direct testimony Exhibit MAM-1 which provided historical financial statement achieved returns on equity investment for TAWC from 2001-2009, and forecasted data for 2010 and the 2011 Attrition Year assuming no rate increase. I have updated that information on Rebuttal Exhibit MAM-1 to include the 2010 actual U.S. GAAP return on equity, and forecasts for the 2011 Attrition Year based on the \$588,954 rate increase recommended by the CAPD in their original testimony and the \$1,007,136 rate increase recommended in their revised testimony. The results of this analysis produce achieved ROE's for the Attrition Year of -0.26% (a loss) based on the CAPD's original recommendation and 0.23% based on the revised CAPD recommendation.

Q. DOES THE COMPANY BELIEVE THE PROJECTED FINANCIAL RESULTS FOR THE ATTRITION YEAR ARE ADEQUATE OR REASONABLE?

A. No. It is unrealistic that the CAPD could expect the Company to adequately operate and replace its facilities at service levels acceptable to the Company's customers, the TRA, Health Agencies, TDEC or numerous other regulatory agencies that oversee the Company's operations or attract the capital necessary to carry out that service obligation at negative or less than 1% returns. These returns are 926 and 877 basis points, respectively, below the **inadequate** ROE of 9% proposed by the CAPD.

Under the CAPD's proposal, the Company would have little if any earnings in 2011. The Company believes that would be a disastrous result, and a result that is not even remotely supported by the facts or the Company's cost of service in this case. The end result of the CAPD's recommendation could not possibly meet the standards of fair

1 and reasonable regulation established in the landmark U.S. Supreme Court cases of  
2 Bluefield and Hope.

3 The CAPD's approaches to the cost of capital, capital structure, and attrition year  
4 revenues/expenses are far removed from established rate making principles and past TRA  
5 rate making policy/procedure in many instances. When the CAPD takes such positions it  
6 necessarily adds to the cost the case.

7 I would point out that the projected ROEs for 2011 are significantly below the  
8 current cost of LT Debt and even under the current rates for Treasury Bonds. The  
9 Company believes such returns would make it nearly impossible to attract the capital  
10 necessary to carry out its public service obligation, and therefore can not be in the best  
11 interests of the Company's customers.

12 What prudent investor would make investments in a Company with this financial  
13 forecast? The answer is no prudent investor would. The TRA should not expect AWW  
14 to continue to invest under this picture either. If the Company could attract capital under  
15 this scenario it would not be from AWCC or any other investor at the favorable rates that  
16 come with the AWW/AWCC investment grade bond rating, it would be at "junk bond"  
17 grades which would result in much higher rates for the customers.

18  
19 Q. PLEASE ADDRESS THE HISTORICAL EARNINGS SHORTFALL SHOWN ON  
20 REBUTTAL EXHIBIT MAM-1?

21 A. The achieved earnings compared to the authorized ROE should concern the Authority.  
22 TAWC's financial position is not currently strong. This is no longer just a short-term  
23 issue, but it borders on a chronic problem that can not be appropriately addressed without  
24 appropriate recovery of the cost of providing service in this case. The financial results  
25 since 2006 have been influenced by any number of issues, such as: (i) declining  
26 customer usage trends even when weather normalization is applied, (ii) escalating costs  
27 for power; chemicals; employee benefits; oil prices and the impact on fleet fuel, delivery  
28 of products, etc; (iii) increased costs for maintenance paving based on the City  
29 ordinances; (iv) increased general taxes due to financial problems faced by various taxing  
30 authorities; (v) increased cost of capital due to the financial crisis; and (vi) necessary  
31 capital investment.

1           Those financial results have also been impacted by decisions of the Authority  
2 regarding appropriate rate recovery, both directly and indirectly. The Company was  
3 required to write-off significant amounts of rate case expense and management audit  
4 costs after the 2008 Rate Case Order. The Authority did not recognize weather  
5 normalization in the 2008 Rate Case, which had been utilized by the Company in  
6 establishing rates for nearly 20 years. I am sure the Authority believed this was the right  
7 decision at the time, but this resulted in an approximate \$3.0 million short-fall in  
8 revenues during 2009 and 2010 from the levels on which current rates were established.  
9 Management Fees were established at \$800,000 below the 2008 Attrition Year level  
10 requested by the Company until a new management audit ordered by the Authority could  
11 be completed. I say this simply to indicate that this is a new rate case in which many of  
12 those past issues are again being litigated and that the Company respectfully asks the  
13 Authority to consider these issues carefully in this proceeding. The Company believes  
14 the Authority knows TAWC provides good service to its customers, and only a  
15 financially stable utility can sustain that service record. The Company believes the  
16 Authority has before it strong and credible evidence in this case to support its rate  
17 increase request, which will be further bolstered by the Company's rebuttal testimony in  
18 this case.

19  
20 Q. DOES MR. BUCKNER ADDRESS THIS EARNINGS SHORTFALL IN HIS  
21 TESTIMONY?

22 A. Yes. Mr. Buckner addresses this with the Q&A on page 58 of his testimony, beginning  
23 on line 18. He references a 4.24% rate of return per the September 2010 TRA 3.06  
24 Surveillance report and a 4.29% rate of return per the March 2010 TRA 3.06 Surveillance  
25 Report. He goes on to indicate that the Company's reported return is prospectively  
26 understated due to non-recurring O&M expenses, understated Accumulated Deferred  
27 Taxes and excessive management fees.

28  
29 Q. DO YOU AGREE WITH MR. BUCKNER'S ASSESSMENT?

30 A. No, for a number of reasons. Mr. Buckner's referenced rates of return are for the rate of  
31 return on rate base, not achieved Return on Equity. He provides no support for his claim

1 of non-recurring expenses, although the Company believes he is referring to the write-  
2 offs of 2008 rate case expense and the management audit which occurred in September  
3 2008, which would not be present in the September 2010 Report. His reference to  
4 understated ADITs is apparently related to his initial position regarding the SFAS 109 tax  
5 assets, which reflect the future rate recovery of the temporary difference related to excess  
6 tax depreciation taken on pre-1981 property. Those assets reflect the temporary timing  
7 difference for tax over book depreciation which had been flowed-through to the  
8 customers in the year that the tax deduction occurred by this Authority (and its  
9 predecessor the TN PSC) and should properly be recovered in current tax expense for this  
10 case now that those temporary timing differences are reversing. He has now **partially**  
11 corrected his basis for this assertion in his revised testimony.

12 His position on management fees is apparently based on the idea that the  
13 methodology utilized by the Authority in the Company's 2008 rate case was final and  
14 precedent setting. All of these this will be addressed in detail later in this testimony.  
15 Regardless, the CAPD's positions in this area have nothing to do with the U.S. GAAP  
16 financial statement achieved returns on equity shown in both my direct Exhibit MAM-1  
17 and Rebuttal Exhibit MAM-1.

18  
19 Q. WHAT RETURN ON EQUITY DOES THE CAPD INDICATE IN ITS  
20 RECOMMENDATION?

21 A. The CAPD indicates in its original testimony filing that an increase in rates of \$588,954  
22 produces a rate of return of 6.97% on rate base and 9.0% on Equity. The revised filing  
23 indicates a rate increase of \$1,007,136 produces a rate of return of 6.79% on rate base  
24 and 9.0% on Equity.

25  
26 Q. PLEASE EXPLAIN HOW THE CAPD'S RECOMMENDATION IS VIEWED  
27 DIFFERENTLY WHEN APPLIED TO THE U.S. GAAP FINANCIAL STATEMENTS  
28 OF THE COMPANY?

29 A. The CAPD recommendation does not produce a 9.0% ROE on Equity when viewed from  
30 the U.S. GAAP basis for the 2011 Attrition Year Financial Statements. The CAPD's  
31 claimed 9.0% Achieved ROE is a "mirage" that quickly disappears when assessed from a

1 U.S. GAAP basis. I have developed a schedule identified as Rebuttal Exhibit MAM-2  
2 which unmask the true impact of the CAPD's revised testimony when viewed from the  
3 U.S. GAAP perspective financial statements for the 2011 Attrition Year.

4  
5 Q. PLEASE DEMONSTRATE THE OUTCOME SHOWN ON REBUTTAL EXHIBIT  
6 MAM-2?

7 A. The first column provides the necessary information to undertake this analysis obtained  
8 from the CAPD's revised testimony filing and exhibits of Mr. Buckner and Dr. Klein. I  
9 then considered a number of the positions taken by the CAPD witnesses and how they  
10 will be reflected differently on the U.S. GAAP statements of the Company. These  
11 adjustments are shown in the columns indicated for Notes 2-7 and are described in more  
12 detail in the following bullet points.

- 13 • Note 2 – Captures the difference between the 13-month average attrition year total  
14 capital of TAWC and the rate base proposed by the CAPD. If the Company  
15 invests the capital as it has indicated in the attrition year as produced from the  
16 Company's known and measurable financing plan, it will be required to absorb  
17 the cost of that capital to the extent it exceeds authorized Rate Base.
- 18 • Note 3 – Captures the erosion on TAWC's earnings that will occur if the CAPD's  
19 double-leveraged capital structure is applied to the stand-alone capital structure of  
20 TAWC. I would note that the revenue requirement associated with the CAPD's  
21 double leveraged capital structure generates a \$1.547 million dollar reduction in  
22 the CAPD's revenue requirement when applied to the stand-alone TAWC capital  
23 structure (as shown and calculated on Rebuttal Exhibit MAM-3). I would also  
24 note that the CAPD methodology proposed in their case generates an equity ratio  
25 of 33.72%, compared to 44.035% on the TAWC stand-alone capital structure and  
26 41.517% authorized by the Authority in the Company's 2008 Rate case. This is a  
27 draconian and harmful recommendation in this case which is addressed by Dr.  
28 Vander Weide and later in this testimony.
- 29 • Note 4 – Captures the impact of the CAPD's recommendation to disallow \$1.555  
30 million of management fees. The CAPD clings to the position that any increase  
31 in management fees above inflation since 2004 is excessive and could not



1 possibly be offset with reductions, avoided costs or shifts in functions from  
2 TAWC to AWWSC, or that there are legitimate drivers of the increased costs.  
3 The CAPD's position also inappropriately indicates that the TRA established a  
4 precedent for management fees in the 2008 Rate Case, although the Authority  
5 clearly indicated then that they would revisit that issue once the new independent  
6 management audit was completed (a fact also addressed in the Court of Appeals'  
7 Decision). The Company continues to strongly believe the AWWSC costs are  
8 reasonable, have enhanced service and customer satisfaction, and are the least  
9 cost option for providing those services. There will be ample rebuttal testimony  
10 on this subject from Mr. Baryenbruch, Mr. Uffelman and later in this testimony.  
11 The Company is also pleased that due to the agreement of counsel it appears that  
12 Ms. Schumaker will appear at the hearing to provide testimony about the  
13 independent management audit she and her team performed, as outlined in the  
14 instructions and contract approved by the Authority.

- 15 • Note 5 – Disallowance of 70% of the AIP for TAWC employees, which is part of  
16 the overall “market-based” and “performance driven culture” compensation plan  
17 in place for TAWC employees. The Company believes strongly that the AIP is a  
18 critical part of a performance-based culture and drives efficiency, enhanced  
19 service, and enhanced customer satisfaction, all which benefit the customers of  
20 TAWC. This area will be covered later in this testimony.
- 21 • Note 6 – The CAPD refuses or fails to recognize the latest ERISA pension  
22 expense for the attrition year as determined by the Company's actuary,  
23 Towers/Watson. Whether that number is recognized in rates or not, that is the  
24 level on which the Company is currently making payments to the Pension Fund  
25 Trustee and certainly meets the known and measurable test. This topic will be  
26 covered later in this testimony.
- 27 • Note 7 – The CAPD only recognizes 104 employees based in part on past vacancy  
28 rates and retirement or termination of a number of critical positions which are  
29 currently being replaced. Mr. Watson will address in his testimony his efforts to  
30 fill those critical vacancies and the level of employees necessary to perform the  
31 duties required to maintain adequate service. I will also address the fact that

1 much of the historical vacancy rate when compared to the number of employees  
2 authorized by the Authority are related directly to the shift in functions from  
3 TAWC to AWWSC, as shifts in costs that Mr. Buckner claims has never  
4 happened. Vacancies that appear on Mr. Buckner's analysis of employee levels  
5 that are related to the shift in functions to AWWSC certainly provide no support  
6 for a vacancy rate, and certainly are not justification or support that those  
7 vacancies will continue to occur in the attrition year.

8  
9 After accounting for these adjustments that will be present in the Company's 2011  
10 U.S. GAAP financial statements (whether reflected in rates or not), Rebuttal Exhibit  
11 MAM-2 indicates an achieved ROE of 1.12% and an interest coverage ratio of only  
12 1.45X when the CAPD's rate increase is viewed from the financial statements  
13 prepared in compliance with U.S. GAAP. Again the Company respectfully asks that  
14 the Authority look through the forest and roadblocks the CAPD and City place in the  
15 road to fair and reasonable rates for TAWC in this case. Nobody wins (the TRA, the  
16 customers, or the Company) when rates are established that do not place the  
17 Company on reasonably solid financial footing, force the Company to curtail  
18 services, or limit their ability to attract capital at reasonable rates.

19 The Company can not place the CAPD's rate case documents in front of the  
20 investors who may have interest in investing debt and equity capital in the Company.  
21 Only the audited financial statements based on U.S. GAAP can meet that requirement  
22 and are the only financial statements on which the Company can (**or can not**) attract  
23 additional capital.

24  
25 Q. CAN YOU BRIEFLY DISCUSS THE IMPACT THAT THE RECOMMENDATION  
26 OF THE CITY AND CRMA WOULD HAVE ON THE COMPANY'S ABILITY TO  
27 OBTAIN A FAIR OPPORTUNITY TO ACHIEVE ITS AUTHORIZED ROE?

28 A. Neither the City's witness, Ms. Dismukes, nor the CRMA's witness, Mr. Gorman, make  
29 overall revenue requirement recommendations. Ms. Dismukes proposes to reduce  
30 management fees by a total of \$4.861 million. If this were combined with the CAPD's  
31 recommendation to reduce management fees by \$1.555 million, it is obvious the

1 Company would be operating at a significant loss during 2011. The Company has a great  
2 many problems with Ms. Dismukes' assumptions, methodologies, lack of support for her  
3 numbers and positions, selection criteria and the lack of accurate information in her water  
4 sample group comparisons. Her testimony and conclusions will be addressed in-depth by  
5 Mr. Baryenbruch, Mr. Uffelman and later in this testimony. Mr. Gorman takes some  
6 positions on UFW, production costs, working cash and revenue (usage) levels which  
7 generally go along with the CAPD's recommendation with the exception of working  
8 cash. Again if these areas were combined with the CAPD and City positions they would  
9 add further to the resulting loss on TAWC's 2011 financial statements. A number of  
10 Company witness will address the testimony of Mr. Gorman, including Mr. Herbert  
11 regarding cost of service allocation.  
12

13 Q. WOULD YOU SUMMARIZE YOUR UNDERSTANDING OF THE BLUEFIELD  
14 AND HOPE CASES?

15 A. In my responsibility as Director of Rates for the Eastern Division, I have reviewed  
16 Bluefield and Hope extensively and been responsible for applying the regulatory  
17 principles contained therein to assess the impact on numerous rate case requests and  
18 results of rate cases. Bluefield establishes three criteria on which to determine whether  
19 rates of utilities established by regulatory agencies are just, reasonable and not  
20 confiscatory. Those three criteria are:

- 21 1. the comparable earnings test
  - 22 2. the financial integrity test, and
  - 23 3. the capital attraction test
- 24

25 Hope upheld the three basic tests established in Bluefield, except for purposes of  
26 applying the comparable earning test, the phrase "return to the equity owner on his  
27 investment" is substituted for the phrase "the return to the Company on the fair value of  
28 property." The standards established in the Bluefield and Hope cases continue to be the  
29 relevant standards for setting utility rates today.

30 Those standards are commonly referred to as the "Regulatory Compact." The  
31 Regulatory Compact can be summarized as follows: a public utility has a service

1 obligation to the general public, and in return for meeting that public service obligation,  
2 the utility is entitled to be provided rates that fairly and justly meet the utilities cost of  
3 providing that public service.

4 The Company takes its public service obligation very seriously. It can not deny  
5 that service to customers or discriminate in the provision of that service. It is required to  
6 maintain sufficient employees, maintenance and replacement of its facilities, and other  
7 expenses required to provide that service. It is the Company's belief that if that  
8 Regulatory Compact is not met with just and reasonable rates, its ability to meet its public  
9 service obligation is impaired and most importantly that it is not in the best interests of  
10 our customers. The intervenors' overall recommendations and positions on cost of  
11 service elements in this case in no way result in just and reasonable rates for the  
12 Company necessary to adequately carry out its public service obligation.

13  
14 Q. GIVEN THE CAPD, CITY AND CRMA RECOMMENDATIONS, CAN YOU  
15 SUGGEST SOME PERSPECTIVES THROUGH WHICH THE AUTHORITY  
16 SHOULD EVALUATE THEM?

17 A. Of course, the Authority should set the Company's rates by ascertaining its true cost of  
18 service. However, given the seriousness of this issue, the Company asks the Authority to  
19 consider and seek answers to the following questions:

- 20 1. If the Company's overall cost of capital on the capital invested in  
21 providing service to its customers (not the deflated WACC and ROE  
22 determined by the imposition of double leverage) is hundreds of basis  
23 points below other water utilities of similar risk, then will investors place  
24 additional capital in the Company?
- 25 2. If the Company is only able to achieve below 1% (or a loss) return on  
26 equity on a U.S. GAAP basis (the only view that matters to investors),  
27 then will the Company be able to attract additional capital?
- 28 3. Do the CAPD, City and CRMA's proposed adjustments and resulting rates  
29 provide a reasonable opportunity for the Company to achieve its  
30 authorized ROE?

1 4. If the Company's per books interest coverage ratio during the rate year is  
2 near or below the 1.5x coverage ratio prescribed in the General Mortgage  
3 Indenture, then will the Company be able to issue debt at reasonable  
4 prices, or at all?

5 5. Will the Company be able to carry out its public service obligations,  
6 including badly needed infrastructure replacement programs, if it can't  
7 attract additional capital?

8 If the Authority finds that the answer to one or more of these questions is "no," then it  
9 should have grave doubts about the propriety of the intervenors' recommendations.  
10

11 **APPROPRIATE TEST-YEAR, DISCOVERY ISSUES AND**  
12 **COMPANY'S FILING IN THIS CASE**  
13

14 Q. ARE THERE ISSUES WITH THE TEST-YEAR IN THIS CASE?

15 A. Yes. This issue is raised in the testimony of CAPD witnesses Mr. Novak and Mr.  
16 Buckner in response to my direct testimony. The Company is fully aware and takes no  
17 issue that the other parties are entitled to explore the Company's filing and recommend  
18 adjustments to the attrition year amounts, propose alternative rate making treatment or  
19 take contrary positions to the Company on the issues as they see fit. It is not the  
20 intervenors' actions of thoroughly reviewing and challenging the Company's filing that  
21 the Company finds troublesome, but instead in some cases it is the manner in which they  
22 attempt to accomplish their review.

23 Every party in the rate cases on which I work in WV, KY, VA and TN goes  
24 through this process. Every party reviews and challenges the Company's position on  
25 various elements of the cost of service, and every party requests through discovery  
26 updated actual data past the test-year on which to perform their review of the Company's  
27 revenues, expenses, rate base, capital structure and taxes. In states other than Tennessee  
28 discovery is generally issued to obtain relevant information to assess both the accuracy of  
29 the Company's filing and the rate-making methodologies employed, and normally leads  
30 to few if any discovery issues and thus is not a major component of the rate case cost.

31 In the case of the CAPD, one of their major discovery topics is not only to get  
32 more current information to assess the Company's filing and make appropriate

1 recommendations and adjustments, but instead it is essentially to generate an entirely new  
2 filing of the attrition year cost of service and revenue requirement based on a entirely  
3 different test-year. In the other states where I regularly prepare and process rate cases the  
4 parties do not perform this burdensome undertaking, nor do the Commissions vary from  
5 the use of a consistent test-year. The reasons that other Regulatory Commissions stick to  
6 a consistent test-year is that not doing so can violate the “matching principle” of rate-  
7 making. The matching principle can be violated unless all elements of the cost of service  
8 in the test-year are maintained, which is an area that can be manipulated without proper  
9 normalization of the test-year. The CAPD claims this burdensome and costly process is  
10 more accurate than simply basing their findings and recommendations on updated data.  
11 The more recent test-year data used by the CAPD can only be more accurate if it is  
12 properly normalized to include annualization for the timing of new or changed customers,  
13 contracts and expenses, and elimination of different timing and amounts of lost customers  
14 and non-recurring expenses. The determination of these normalization adjustments can  
15 only be properly determined by a detailed analysis of the data supporting each customer  
16 revenue classification, employee counts, expense account detail, and each major capital  
17 project.

18 The Company could just provide the more recent data to the CAPD and leave it to  
19 the CAPD to properly normalize the more recent test-year data, but the CAPD does not  
20 have the knowledge of the Company’s revenues and expenses to properly normalize the  
21 different test-year. The CAPD then issues significant discovery to the Company to obtain  
22 the normalizing adjustments. The Authority realized the problems with this approach in  
23 its Order in the Company’s 2006 Rate Case and issued what the Company believed was a  
24 better way forward.

25 The Company recognizes that the Authority changed its position on this area in  
26 the Order in the Company’s 2008 Rate Case. The process utilized by the CAPD does  
27 drive up the cost of the case significantly, and the CAPD’s claim of escalating cost to  
28 process a rate case is in large part due to the process they insist we follow. The impact of  
29 the CAPD’s process should be considered by the Authority in the context of the CAPD’s  
30 recommendations regarding rate case expense, which will be addressed later in this  
31 testimony.

1  
2 Q. DID ANY OF THE CAPD'S PROPOSED ADJUSTMENTS TO THE COMPANY'S  
3 ATTRITION YEAR FILING COME FROM THE DIFFERENT TEST-YEAR  
4 ANALYSIS?

5 A. The CAPD claims its adjustment to the "Insurance-Other" expense was related to the  
6 development of an entirely different test-year on which to base the attrition year for this  
7 case. I would suggest that the "insurance-other" cost adjustment proposed by the CAPD  
8 was related to updated information on the retro premium adjustments and could have  
9 easily been proposed by the CAPD based on the more recent data supplied by the  
10 Company without an entire reworking of the test period. The other adjustments proposed  
11 by the CAPD for customer accounting, rents, general office and miscellaneous expenses  
12 were very minor and resulted in a net decrease of \$31,586 to those categories of expense.  
13 The CAPD also increased group insurance costs from the Company's filing based on the  
14 latest group insurance premium statement calculation, which could also have been  
15 accomplished without an entire reworking of the test-year data. I would also note that the  
16 CAPD's major proposed adjustments for labor (employees and capitalized ratio),  
17 production costs, management fees, pension, and rate case expense were not developed  
18 from the more recent test-year data, but were based on historical data or changes in rate  
19 recovery methodology  
20

21 Q. WHAT OTHER COMMENTS DO YOU HAVE ON THE DISCOVERY PROCESS?

22 A. The Company does not contest any party's right to issue relevant discovery to assess the  
23 Company's filing and positions. The Company has no problem in responding to  
24 reasonable and relevant discovery. The Company has nothing to hide in its filing, and  
25 willingly provides the best responses it can to relevant and reasonable discovery. The  
26 Company would note that the Authority has discovery limits in its rules which can be  
27 expanded with just cause. In the case of both the CAPD and City, there was a  
28 tremendous amount of duplication of questions, particularly about management fees. The  
29 discovery also included many questions seeking information not relevant to the cost of  
30 service of TAWC, and requested information not in possession of the Company in the  
31 format requested which would result in an extraordinary burden on the Company to

1 produce in the requested format. This led to a very high number of motions to compel,  
2 which at the end of the day resulted in, I believe, the Company being required to respond  
3 to two CAPD requests (which had already been supplied to the CAPD) and the rejection  
4 of the two remaining motions of the City at that time. The other motions to compel were  
5 satisfied through discussions with the parties and supplemental responses to relevant data  
6 in a format that could be reasonably generated by the Company.

7 The Company would suggest that the Authority take into consideration the impact  
8 on the cost of this case that has resulted from the City and CAPD discovery tactics. As a  
9 point of reference, in the recent Kentucky American, West Virginia American and  
10 Virginia American rate cases in which I was involved, there was only one motion to  
11 compel filed, that being in Kentucky by the AG, and the Company's position was upheld.  
12

13 Q. DO YOU HAVE OTHER COMMENTS ON MR. BUCKNER'S TESTIMONY  
14 REGARDING THE COMPANY'S FILING?

15 A. Yes. On page 10 he references the testimony of Mr. David Foster that states that the  
16 TRA may use a historical test period, a forecasted test-period or a combination of both in  
17 setting rates for the Authority's position on the proper test-year. In addition, on page 43-  
18 44, Mr. Buckner makes a rather vague reference to the Company's rate case expense as  
19 being an indication that the Company is not "soundly managed," and goes on to indicate  
20 better documented Company workpapers would lessen discovery issues.  
21

22 Q. DOES THE COMPANY AGREE WITH THESE COMMENTS BY MR. BUCKNER?

23 A. No. The Company takes strong exception to the comment about not being "soundly  
24 managed". Mr. Buckner's claim is largely based on the amount of rate case expense  
25 charged per books during late 2008 and 2009. This expense included the write-off of a  
26 significant amount of the 2008 rate case expense disallowed by the Authority in the 2008  
27 Rate case, which was a subject recently addressed by the Court of Appeal. Secondly,  
28 these expenses also related to the Company's cost to reply to the Appeal of the 2006 Rate  
29 Case filed by the City and to process the Company's appeal of the 2008 Authority Order.  
30 I would note that none of this expense was requested for rate recovery in this case. I  
31 would also indicate that Mr. Buckner's mischaracterization of these costs to suggest



1 “unsound management” by the Company is unfounded and inflammatory. This topic will  
2 be addressed later in this testimony regarding the appropriate rate case expense in this  
3 case.  
4

5 Q. DO YOU HAVE COMMENTS ABOUT THE COMPANY’S WORK PAPERS?

6 A. The manner in which the Company filed its petition and work papers in this case was  
7 consistent with all Company filings since at least the beginning of my direct involvement  
8 in the 2003 Rate Case. I believe Mr. Buckner has been involved with most, if not all,  
9 Company rate cases since that filing. The issues with the test-year did not materialize  
10 until the CAPD changed their method in the Company’s 2006 Rate case, and this is the  
11 first I have heard of any issues with the work paper format. The Company’s accounting  
12 exhibit does reference the work paper identification contained on the Company’s  
13 expansive work papers which are provided on a CD due to the voluminous size of the  
14 material. We have also received requests from the Authority Staff to make reference to  
15 our normalizing and attrition year adjustments in discovery. Ms. Miller has gone to great  
16 lengths to provide the Staff details and back-up of each adjustment with references to the  
17 specific work paper and section of the accounting exhibit where those adjustments were  
18 reflected. This information was provided in response to TRA-02-Q92 which was also  
19 provided to all parties. Indications from the Staff were that they were appreciative of  
20 these efforts by the Company.  
21

22 Q DO YOU HAVE COMMENTS ABOUT MR. BUCKNER’S REFERENCE TO THE  
23 TESTIMONY OF MR. FOSTER?

24 A. Yes. I accept Mr. Foster’s point of view that the Authority has a great amount of  
25 discretion in determining just and reasonable rates for the utilities under its jurisdiction.  
26 However, it is important that utilities are consistently regulated. It is very difficult for a  
27 utility to properly manage its business when the regulation it is subject to is not  
28 consistent, or changes significantly from case to case. The Company is not suggesting  
29 that the Authority cannot or should not change when circumstances dictate, but  
30 uncertainty in the rate recovery process makes it difficult for the utility to plan its  
31 activities and investments to meet the regulatory expectations. In all states where I

1 regularly work there is a written and specific rate case filing process. In West Virginia  
2 the filing requirements are specifically defined in Commission Rule 42, which provides  
3 specific accounting exhibit schedules and formats for revenue requirement, rate base,  
4 expenses, taxes, and Schedule G to define the adjustments to the test-year information.  
5 Rule 42 also lists requirements for other pertinent data related to affiliate transactions,  
6 parent relationships and capital structure, mortgage indentures, etc. that are requirements  
7 of a complete change in rates petition. The same is true in Kentucky and Virginia where  
8 the accounting exhibits and other required filing information is specifically defined. I am  
9 not aware that the TRA has such a specific and defined rule and certainly don't believe  
10 the Company's filing has been ruled as incomplete or unacceptable by the Authority in  
11 any prior cases, or suggested by any party in this case.

12 The Company would support the Authority's development of specific filing  
13 requirement rules and believes such an action could simplify and lessen the cost of future  
14 filings if discovery was then limited to the Authority-approved filings.

## 15 16 **CAPITAL STRUCTURE** 17

18 Q. DO YOU HAVE GENERAL COMMENTS ABOUT THE DIFFERENCE IN THE  
19 CAPITAL STRUCTURES PROPOSED BY THE COMPANY AND THE CAPD IN  
20 THIS CASE?

21 A. Yes. The difference in capital structures proposed by the Company and CAPD is one of  
22 the largest issues in this case and it has a major impact on the difference in the proposed  
23 revenue requirements in this case.

24 On Rebuttal Exhibit MAM-3, I captured the capital structures on which current  
25 rates were established in docket number 08-00039, and both the CAPD and Company's  
26 proposed capital structure in this case. In the far right column of page 1 of this Exhibit I  
27 recalculated the CAPD's Weighted Average Cost of Capital ("WACC") using the  
28 Company's proposed 11.5% ROE. I performed this calculation in order to isolate the  
29 difference in revenue requirement solely related to capital structure. The application of  
30 the consistent ROE and debt rates resulted in a WACC based on the CAPD's proposed  
31 capital structure of 7.635%. When this WACC is compared to the 8.372% proposed by

1 the Company, it produces a difference in WACC related solely to the capital structure of  
2 0.737%. I then applied the difference in WACC from the capital structures to the  
3 Company's rate base and gross-up factor to determine the revenue requirement in this  
4 case solely related to the capital structure differences. The result of this analysis  
5 indicates that the differences in capital structure result in a difference in revenue  
6 requirement of \$1.547 million. The differences in capital structure proposed by the  
7 Company and the CAPD are therefore a major issue in this case.

8  
9 Q. HAVE YOU REVIEWED THE TESTIMONY CONCERNING CAPITAL  
10 STRUCTURE FILED BY DR. KLEIN?

11 A. Yes. As I read his testimony, Dr. Klein is proposing a capital structure based on the  
12 stand-alone TAWC capital structure proposed by the Company in this case, but adjusted  
13 to impose the cost of capital for the AWW capital structure (Parent Company only) to the  
14 total Common Equity of TAWC.

15  
16 Q. WHAT CAPITAL STRUCTURE DID THE COMPANY USE IN ITS PETITION IN  
17 THIS CASE?

18 A. The capital structure utilized by the Company reflects the capital structure that will be in  
19 place at TAWC for the attrition year in this case. That capital structure is the actual  
20 capital structure of TAWC that will be utilized to support the rate base TAWC utilizes to  
21 provide service to its customers in the Chattanooga area, and to fund its operations and  
22 capital investment programs. The Company determined the capital structure used in its  
23 filing from the books and records of the Company, along with known and measurable  
24 changes determined from the cash forecast and permanent financing activities the  
25 Company will complete through the end of the attrition year. This approach is consistent  
26 with the method utilized by the Company in past cases and properly matches the  
27 Company's capital structure with rate base the Company will have in place during the  
28 attrition year.

29  
30 Q. THE AUTHORITY HAS HISTORICALLY UTILIZED A DOUBLE LEVERAGE  
31 APPROACH IN DETERMINING THE CAPITAL STRUCTURE ON WHICH TO

1 EASTABLISH RATES FOR THE COMPANY. WHY DID THE COMPANY NOT  
2 USE THE DOUBLE LEVERAGE APPROACH IN ITS FILING?

3 A. The Company to my knowledge has never filed a rate case that included the imputation  
4 of double leverage from its parent. The reason for this is simple; the Company does not  
5 believe the use of a double leverage capital structure is appropriate for determining the  
6 cost of capital for the Company in a rate setting proceeding.

7  
8 Q. WHY DOES THE COMPANY OPPOSE THE USE OF DOUBLE LEVERAGE IN ITS  
9 CAPITAL STRUCTURE TO ESTABLISH FAIR AND JUST RATES IN THIS CASE?

10 A. Dr. Vander Weide provides considerable rebuttal testimony on why the concept of double  
11 leverage has no basis in financial theory or applicability to the “true cost” of the capital  
12 deployed in providing service by the Company. I do not wish to duplicate his arguments,  
13 but only add to the discussion the very negative impact the use of double leverage as  
14 imposed by Dr. Klein has on the Company’s ability to achieve its authorized rate of return.

15 The application of double leverage in the capital structure of TAWC deprives the  
16 Company of the opportunity to recover the true cost of the capital deployed by TAWC  
17 and to fund the rate base and cost of operations utilized by the Company in providing  
18 service to its customers. The theory behind double leverage revolves around the  
19 parent/subsidiary relationship common in the publicly traded utility sector. The  
20 Company believes one of the major components of regulation is the cost of capital for a  
21 regulated business. Where the regulated business obtains that capital should have no  
22 bearing on the determination of a fair and reasonable cost of capital used to determine  
23 just and reasonable rates for that entity. Just because the equity investor happens to be a  
24 utility holding company does not and should not have a bearing on determining the true  
25 cost of capital for setting just and reasonable rates.

26 An individual investing in a mutual fund or an institutional investor can just as  
27 easily use their borrowing power to obtain the funds to invest in equity capital as could a  
28 utility holding company, but in the case of rate-making they are handled quite differently.  
29 The cost of equity is what the market determines it to be, and should not be influenced by  
30 where the equity investor obtains the funds to make that equity investment. The  
31 application of double leverage at the subsidiary level results in determining the source of

1 funding the parent company utilizes to invest in the equity of the subsidiary. The  
2 Company does not believe it is proper or relevant to the true cost of equity at the  
3 subsidiary where the parent obtained its capital. The Company also believes the use of a  
4 double leverage in the capital structure of TAWC for establishing rates builds in  
5 automatic erosion to the authorized ROE, depriving TAWC of any reasonable  
6 opportunity to achieve that rate of return. The Company does not believe that the use of a  
7 “double leverage” capital structure in setting rates for TAWC is appropriate.

8 I have previously captured the impact of the double leveraged capital structure  
9 proposed by Dr. Klein on Rebuttal Exhibit MAM-2 which is attached to and discussed  
10 earlier in this testimony. The impact of Dr. Klein’s double leverage capital structure  
11 reduces earnings by \$924,000 and erodes the ROE authorized in this case by 171 basis  
12 points when applied to the stand-alone capital structure of TAWC.

13 If the Authority would establish rates in this case on the capital structure proposed  
14 by Dr. Klein, it would only have a fair and reasonable opportunity to achieve an ROE  
15 1.71% below what ever ROE the Authority establishes in this case.

16 Earlier in this testimony I asked the Authority to consider the positions of the  
17 CAPD and other parties in the context of the impact they produce in relationship to three  
18 primary tests of just and reasonable rates as outlined in the landmark decisions of  
19 Bluefield and Hope. The question is whether establishing rates with a built-in erosion of  
20 171 basis points from the authorized ROE (i) meets the comparable earnings test in  
21 relation to the comparable earnings of companies with similar risk, and (ii) whether the  
22 Company can attract capital under this scenario when coupled with the other drastic  
23 reductions to the Company’s cost of service proposed by the parties.

24 I would suggest the answer is no to the above questions and therefore the CAPD’s  
25 proposal is contrary to the Bluefield and Hope decisions.

26  
27 Q. CAN YOU PROVIDE A SIMPLE EXAMPLE OF WHY DOUBLE LEVERAGE IS  
28 NOT APPROPRIATE?

29 A. I believe I can. My example is based on this assumption: if someone believed they knew  
30 of a stock whose market-based return could produce 11% and they wanted to purchase  
31 that stock but didn’t have the available cash to purchase that stock they could open a line

1 of credit at the bank to support that purchase. In this example I will assume that the  
2 purchaser could borrow that money from the bank at an interest rate of 6%. The theory  
3 behind double leverage as it applies to utility rate making would indicate that regardless  
4 of the fact that the market return is 11%, the purchaser would only be allowed to receive  
5 a 6% return because they borrowed the money to purchase that stock. Obviously, the  
6 source of cash to purchase a stock has no bearing on the market return of that stock, and  
7 thus double leverage for TAWC does not reflect the true cost of the capital deployed by  
8 TAWC.  
9

10 Q. YOU INDICATED EARLIER THAT YOU HAD PROVIDED THE CAPITAL  
11 STRUCTURE AND RESULTING WEIGHTED AVERAGE COST OF CAPITAL  
12 AUTHORIZED BY THE TRA IN DOCKET NUMBER 08-00039. WHY DID YOU  
13 INCLUDE THAT INFORMATION ON REBUTTAL EXHIBIT MAM-3?

14 A. Because I thought a comparison to the capital structure on which current rates were  
15 established provided pertinent and relevant insight into the extremely harmful and  
16 inaccurate method on which Dr. Klein proposes to impose double leverage in this case.  
17

18 Q. WHAT CAPITAL STRUCTURE DID THE TRA ULTIMATELY APPROVE FOR  
19 TAWC IN ITS ORDER OF JANUARY 13, 2009?

20 A. On page 49 of its Order, the TRA used a double leveraged capital structure methodology  
21 as proposed by the CAPD and CRMA, whereby the WACC of the AWW consolidated  
22 capital structure was applied to all debt and equity capital obtained by TAWC from its  
23 parent company AWW and its affiliated subsidiary American Water Capital Corporation  
24 ("AWCC"). Based on my review of the TRA Order, it appears the TRA utilized the  
25 exact capital component ratios and cost rates as proposed in Rebuttal Exhibit MAM-2,  
26 page 2 of 2, and discussed in my rebuttal testimony, with the exception of determining  
27 the cost of equity as 10.2%.  
28

29 Q. DID DR. KLEIN UTILIZE THE SAME DOUBLE LEVERAGE METHODOLOGY  
30 PROPOSED BY THE CAPD AND USED BY THE AUTHORITY IN SETTING THE  
31 COMPANY'S RATES IN DOCKET NUMBER 08-0039?

1 A. No. He did not apply the Parent Company's consolidated capital structure to the total  
2 capital deployed at TAWC and obtained from AWW and AWCC. Instead, as stated  
3 earlier he applied the AWW (Parent Company stand-alone) capital structure to the Total  
4 Equity on the books of TAWC. This change in the CAPD methodology has resulted in a  
5 "**drastic**" change in the make-up of the debt/equity ratios proposed by the CAPD in this  
6 case from those generated under the previous methodology proposed by the CAPD and  
7 utilized by the Authority in establishing the current rates of TAWC.

8  
9 Q. PLEASE EXPLAIN WHAT YOU MEAN BY DRASTIC CHANGE IN THE CAPITAL  
10 STRUCTURE MAKE-UP.

11 A. I would again refer the Directors to Rebuttal Exhibit MAM-3. In the "light blue" shaded  
12 boxes I have indicated the Company's current rates were established on an equity ratio  
13 under double leverage of 41.517%. Dr. Klein's approach produces a total equity ratio of  
14 33.72%. This is a "drastic" reduction of 7.797% in the equity ratio on which Dr. Klein  
15 proposes to establish the WACC and rates of the Company in this proceeding. That  
16 drastic reduction in equity ratio is almost entirely driven by the change in double leverage  
17 methodology proposed by Dr. Klein in this case which accounts for the 171 basis point  
18 erosion to whatever ROE the Authority ultimately establishes in this proceeding.

19  
20 Q. WHAT HAS CHANGED IN THE MAKE-UP OF THE TAWC AND AWW CAPITAL  
21 STRUCTURES TO WARRANT SUCH A CHANGE IN THE EQUITY RATIOS  
22 FROM WHICH THE COMPANY'S CURRENT RATES WERE ESTABLISHED?

23 A. Very little in the stand-alone capital structures of AWW and TAWC, or the consolidated  
24 capital structure of AWW. **The only thing that has changed materially is the method**  
25 **of deploying double leverage proposed by the CAPD.** As Dr. Vander Weide explained  
26 in this rebuttal testimony, utilizing double leverage infuses more financial risk into the  
27 capital structure and with that additional financial risk comes a higher required cost of  
28 equity capital. In the case of Dr. Klein's recommendations at an equity ratio of 33.72%  
29 compared to the nearly 50% equity ratio of the sample group on which he relies in  
30 determining his recommended cost of equity capital, the financial risk would increase his  
31 cost of equity significantly to account for the much higher leverage and associated

1 financial risk he proposes to impute into the capital structure of TAWC. **Of course he**  
2 **does not recognize that greatly increased financial risk in his recommendation for**  
3 **the cost of equity.**  
4

5 Q. DO YOU AGREE WITH THE METHODOLOGY OF IMPOSING DOUBLE  
6 LEVERAGE PROPOSED BY DR. KLEIN?

7 A. No. As described above the impact is drastic and he provides no testimony or basis to  
8 support the Authority's adoption of this change in methodology. As I stated earlier I  
9 oppose the use of double leverage because it does not produce the true cost of capital for  
10 TAWC, erodes the authorized ROE and does not provide TAWC with a fair and  
11 reasonable opportunity to achieve the return on equity authorized by the Authority as  
12 required in the establishment of just and reasonable rates by the Bluefield and Hope  
13 decisions.  
14

15 Q. IF THE AUTHORITY ELECTS TO CONTINUE UTILIZING DOUBLE LEVERAGE  
16 IN DETERMINING JUST AND REASONABLE RATES IN THIS CASE, DO YOU  
17 AGREE WITH THE METHODOLOGY OR APPLICATION OF DOUBLE LEVERAGE  
18 AS PROPOSED BY DR. KLEIN?

19 A. No. As stated earlier I don't agree with the double leverage approach to determine the  
20 capital structure, and Dr. Vander Weide has provided significant testimony about his  
21 disagreement with the double leverage approach as well. Even though I don't agree with  
22 the so-called "double leverage" capital structure approach, I proposed to the Authority in  
23 my rebuttal testimony in docket number 08-00039 that the TRA utilize a methodology  
24 similar to that used by Dr. Klein, and that, should the Authority choose to use double  
25 leverage, only the debt/equity ratios and cost rates of the Parent (stand-alone) would be  
26 appropriate to invest in the equity of the subsidiaries. It is my belief that the double  
27 leverage theory (as objectionable as I find that concept) attempts to capture the cost of the  
28 capital structure utilized by the Parent to invest in the equity of a subsidiary. As I  
29 explained earlier in my simple example this theory does not change the true cost of  
30 capital at the subsidiary, regardless of where the Parent obtained the capital to make the  
31 investment



1           However, if one accepts the theory behind double leverage that is premised on the  
2 cost of the capital of the Parent available for investment in the subsidiary, **double**  
3 **leverage can not possibly be applied to the retained earnings portion of equity at the**  
4 **subsidiary level.** This is the one major difference I have with the methodology proposed  
5 by Dr. Klein, with which I strongly disagree.

6           The retained earnings at TAWC were generated through TAWC's dividend policy  
7 of retaining 25% of earnings for re-investment. **Therefore retained earnings were not**  
8 **generated or supplied by investment by the Parent from proceeds from the Parent's**  
9 **capital structure.** The retained earnings are a function of capital that could have been  
10 paid to the stockholders as dividends. Retained earnings should not be subject to double  
11 leverage, because they are not funded by the parent company capital structure, and **the**  
12 **Weighted Cost of the Retained Earnings portion of TAWC's capital structure**  
13 **should be determined using the full cost of equity capital the Authority determines**  
14 **is appropriate in this case.**

15  
16 Q. DO YOU HAVE OTHER ISSUES WITH THE WAY DR. KLEIN DETERMINED THE  
17 CAPITAL STRUCTURE HE PROPOSES IN THIS CASE?

18 A. Yes. Dr. Klein proposes to use the historical averages of TAWC for the years 2007-  
19 2010. His calculation of the average historical capital structure is shown in his Exhibit at  
20 page 3. His averaging of the "point in time" capital structures, December 31 in each  
21 year, does not appropriately capture the capital structure that TAWC will have in the  
22 attrition year. The bottom line is that the use of an historical average does not meet the  
23 **"known and measurable"** test for the attrition year, and violates the "matching principle".  
24

25 Q. HOW DID THE COMPANY DETERMINE ITS CAPITAL STRUCTURE?

26 A. As stated earlier in this testimony, the Company started with its historical test-year capital  
27 structure as of March 31, 2009 and included known and measurable long-term financings,  
28 changes in equity (including additional paid-in-capital and changes in retained earnings),  
29 and corresponding changes in the short-term debt balances that will occur through the  
30 attrition year. This process properly matched the CWIP expenditures and the other

1 changes to rate base elements on which the Company determined its known and  
2 measurable rate base for the attrition year.

3  
4 Q. WHY DOES DR. KLEIN'S HISTORICAL AVERAGE CAPITAL STRUCTURE NOT  
5 MEET THE KNOWN AND MEASURABLE TEST?

6 A. Because a historical, "point in time" view of the capital structure, particularly one that  
7 does not represent the 13-month average for the historical periods can, and in this case  
8 does, distort the actual capital structure due to the timing of permanent debt and equity  
9 financings. In short, Dr. Klein's approach - using an historical average capital structure -  
10 is not reflective of "known and measurable" nor is it "known and measurable" regarding  
11 the attrition year. In addition, Dr. Klein's approach does not properly "match" the capital  
12 structure and resulting WACC that will be in place to fund the rate base present in the  
13 attrition year.

14  
15 Q. WHAT IS THE IMPACT OF DR. KLEIN'S HISTOICAL AVERAGE CAPIAL  
16 STRUCTURE DETERMINATION?

17 A. In the presence of a "known and measurable" (easily verifiable) capital structure for the  
18 attrition year, there is no justifiable basis to utilize historical averages. The impact of Dr.  
19 Klein's approach is to **"artificially"** inflate Short-term Debt ratios (the lowest cost of  
20 capital) by artificially lowering the higher cost rate components of the capital structure,  
21 Long-term Debt and Equity. In fact, Dr. Klein's approach does not fully capture the  
22 impact of Long-term debt and equity financings that have already occurred in 2009 and  
23 2010. It is very easy to see the impact of Dr. Klein's "phantom" adjustment by  
24 comparing his historical average result in the right hand column of the Schedule on page  
25 3 of his Exhibit to the more current 2010 information. Dr. Klein's approach is not  
26 reflective of the current capital structure of TAWC or the "known and measurable"  
27 capital structure for the attrition year and should be rejected by the Authority.

1 **COST OF DEBT**

2

3 Q. WHAT ISSUES DO YOU HAVE WITH DR. KLEIN'S COST OF DEBT?

4 A. Only one issue. On page 5 of his testimony Dr. Klein indicates, "I find the cost of  
5 TAWC's short term debt, long term debt and preferred stock proposed by TAWC's  
6 witness Mr. Miller to be reasonable." However, looking at page 2 of his Exhibit he used  
7 a 1.2% cost rate for short-term debt instead of the 1.9% rate reflected in the Company's  
8 proposed capital structure."

9

10 **RETURN ON EQUITY**

11

12 Q. HAVE YOU REVIEWED THE TESTIMONY OF DR. KLEIN REGARDING  
13 RETURN ON EQUITY?

14 A. Yes.

15

16 Q. DO YOU HAVE ANY GENERAL COMMENTS ABOUT THAT TESTIMONY?

17 A. Yes. As I read Dr. Klein's testimony, it is his opinion and belief that his analysis fully  
18 captures investor expectations and produces an ROE of 9.00%. The Company does not  
19 believe the 9.00% recommended ROE appropriately recognizes the additional risk  
20 associated with equity when compared to current bond rates or when compared to the  
21 ROEs granted to other water companies of similar risk in regulatory jurisdictions where  
22 American Water subsidiaries have received orders, particularly when those authorized  
23 ROEs are compared to A-rate Utility Bonds at the time of those Commission Orders.  
24 The 9.00% ROE is manifestly inadequate. The end result of Dr. Klein's calculations  
25 produce a result that is significantly below the ROEs in all other U.S. regulatory  
26 jurisdictions included in my analysis for water companies of similar risk. I will address  
27 the ROEs awarded in other states in the following testimony regarding ROE and Dr.  
28 Vander Weide will address the shortcomings of the determination of a 9.00% ROE using  
29 Dr. Klein's methodologies.

30

1 Q. HAS DR. KLEIN MISSED AN IMPORTANT CONSIDERATION IN HIS  
2 RECOMMENDATION OF A 9.00% ROE?

3 A. I believe he has. An ROE authorized by a regulatory commission must pass the  
4 constitutional tests established in the landmark Bluefield and Hope cases. Those cases as  
5 decided by the U.S. Supreme Court provide the basic tests for regulatory commissions in  
6 establishing a fair and reasonable return on equity. I covered my understanding of the  
7 tests from the Bluefield and Hope decisions earlier in this rebuttal testimony. As shown  
8 on Rebuttal Exhibit MAM-2, the CAPD's overall recommendation for the revenue  
9 requirement and cost of service in this case produces an achieved ROE of only 1.12% in  
10 the attrition year when viewed from the U.S. GAAP financial statement perspective. If  
11 the CAPD's proposed revenue increase were accepted the Company would have no  
12 opportunity to achieve the inadequate ROE of 9.00% proposed by Dr. Klein. The  
13 Company believes Dr. Klein's recommendation of 9.00% when coupled with the  
14 CAPD's recommendations on other revenue, expense, tax and rate base elements of the  
15 cost of service if approved by the TRA would fail these basic tests. My rebuttal  
16 testimony will focus on the comparable earnings test by comparing the authorized equity  
17 returns of TAWC's sister companies as approved in other regulatory jurisdictions,  
18 including consideration of the additional financial risk imposed on TAWC if any form of  
19 the double leveraged capital structure is used to establish the authorized rates in this case.

20  
21 Q. WHY SHOULD THE TRA CONSIDER THE A-RATED UTILITY BONDS TO  
22 BENCHMARK THE BASIS POINTS SPREAD (RISK PREMIUM) FOR THE  
23 COMPANY'S ROE IN THIS CASE?

24 A. The utility business is a long-term business. Utility plant investments are recovered over  
25 many years, with useful depreciation lives for water mains, for instance, of upwards of 70  
26 years. Many water lines and treatment plants remain in service for over 100 years. It is  
27 also a ratemaking and financial community axiom that there is greater risk associated  
28 with the ownership of the equity in a company than with the ownership of the debt of a  
29 company, based on the simple fact that the shareholders stand "last in line" in the event  
30 of dissolution. Consequently, a comparison of current rates for long-term bonds to  
31 authorized ROEs provides a viable and meaningful benchmark of the extent of that

1 additional risk that has been authorized by regulatory commissions for companies with  
2 business risk similar to that of the Company. A-rated utility bonds provide a uniform  
3 platform on which to assess the risk associated with equity because the interest rates on  
4 those bonds are easily obtained from publication such as Value Line.

5  
6 Q. WHAT ARE THE CURRENT A-RATED UTILITY BOND RATES?

7 A. I have provided the A-Rated Utility Bond Rates for the latest 13-week period ending  
8 January 28, 2011 as published in the Value Line (publish dates indicated on exhibit), on  
9 Rebuttal Exhibit MAM-4. The average of the A-rate Utility Bonds for that 13-week  
10 period was 5.723%. I used the latest quarter's information due to the recent rise in bond  
11 rates as discussed in Dr. Vander Weide's rebuttal Testimony.

12  
13 Q. YOU INDICATED EARLIER THAT YOU DISAGREE WITH THE ROE  
14 RECOMMENDATIONS OF DR. KLEIN. WHY?

15 A. The recently authorized ROEs for other American Water operating subsidiaries, when  
16 compared to the Value Line interest rate for A-rated utility bonds at the time of the  
17 hearing in the case that established those ROEs, demonstrates just how unreasonable Dr.  
18 Klein's ROE recommendation is. This comparison is a simple method the Authority can  
19 use to benchmark the risk between A-rated utility bonds and equity recognized by  
20 Commissions in other jurisdictions in determining a fair and reasonable rate of return on  
21 equity.

22  
23 Q. WHAT ARE THE ROEs CALCULATED USING THIS APPROACH?

24 A. On Rebuttal Exhibit MAM-5, I applied the current 30-year A-rated utility bond rates of  
25 5.723% (per Rebuttal Exhibit MAM-4) and then added the average spread (risk premium)  
26 of the American Water subsidiaries' authorized return on equity to produce an ROE of  
27 10.36%.

28  
29 Q. WHY SHOULD THE TRA REVIEW THE LEVEL OF ROE AUTHORIZED BY  
30 OTHER REGULATORY JURISDICTIONS?

1 A. The Company does not obtain its equity capital in the open market, but obtains that  
2 equity from AWW. Each of the rate of return witnesses recognizes this fact and utilizes a  
3 proxy group of publicly-traded water companies to determine a market expectation of  
4 ROE. If the Company (or any company) is to be able to attract capital when needed to  
5 maintain facilities and improve service it must have the opportunity to achieve an ROE  
6 that is comparable to companies with similar risk. I believe it is appropriate, if not  
7 essential, that the TRA review all available data on ROE, including the level of ROE that  
8 other regulatory commissions are recognizing as fair and reasonable based on the most  
9 current data. All of the AWWC subsidiaries obtain their equity capital from the same  
10 parent. The AWWC subsidiaries all obtain their debt from AWCC, all have similar  
11 capital structures, and all face similar business risks. These returns can, at the very least,  
12 provide a frame of reference and comparison for the TRA to benchmark its determination  
13 of a fair and reasonable return on equity in this case.  
14

15 Q. YOU INCLUDED THE RECOMMENDED ROE OF DR. KLEIN IN THIS CASE ON  
16 THIS SCHEDULE. HOW DO HIS RECOMMENDATIONS COMPARE?

17 A. I included his recommended ROE to show how unreasonable it is. When compared to  
18 the latest quarterly average of A-rated utility bonds on Rebuttal Exhibit MAM-5, Dr.  
19 Klein's recommended 9.00% ROE produces a spread of only 328 basis points above the  
20 current average A-rated Utility Bond rates and 136 basis points below the average spread  
21 of the other AWW subsidiaries that have completed rate cases since June 2010.  
22

23 Q. IS THE COMPANY ASKING THE TRA TO USE THE METHOD JUST DESCRIBED  
24 TO DETERMINE THE ROE?

25 A. No. The Company is only asking that the Authority consider the information as a  
26 benchmark in determining the reasonableness of the ROE it establishes in this case and to  
27 point out that Dr. Klein's recommendation of a 9.00% ROE is unreasonably low. The  
28 Company believes that, when compared to the current bond market conditions, a  
29 comparison of other Commission established risk premiums (established between ROE  
30 and the A-rated utility bonds at the time the ROE was established) provides a valuable  
31 point of reference for the Authority. This is particularly true when the comparative

1 companies compete for the same equity capital, obtain their capital from the same source,  
2 and have very similar business and financial risk.

3  
4 Q. ARE THERE OTHER AREAS OF REBUTTAL EXHIBIT MAM-5 YOU WOULD  
5 LIKE TO ADDRESS?

6 A. Yes, my additional comments are addressed in the following bullet points.

- 7 • All of the AWW subsidiaries listed on Rebuttal Exhibit MAM-5 are regulated  
8 based on their stand-alone capital structure; none of those subsidiaries' rates are  
9 established using double leverage. Their ROEs are established based on the  
10 stand-alone equity ratio which would have included significantly less financial  
11 risk than the double leveraged capital structure proposed by Dr. Klein.
- 12 • The ROEs for Pennsylvania and New Jersey were established on stand-alone  
13 capital structures with approximately 50% equity. The remaining subsidiaries'  
14 ROEs were established on stand-alone Capital Structures of 43-47%.equity.
- 15 • The low authorized ROE for Ohio American, along with other disallowances of  
16 necessary cost of service elements, resulted in greatly reduced capital spending,  
17 because Ohio-American could not attract the capital necessary to carry-out  
18 needed improvements.
- 19 • The capital from AWW and AWCC are not unlimited, and like any other  
20 prudent investor, will be invested where there is a reasonable opportunity to  
21 attain the 'true' cost of capital appropriate for those investments.

22  
23 **RECOMMENDATIONS ON THE CAPITAL STRUCTURE AND**  
24 **WIEGHTED COST OF CAPITAL FOR THIS CASE**  
25

26 Q. WHAT CAPITAL STRUCTURE DO YOU RECOMMEND IN THIS CASE?

27 A. I recommend that rates in this case be established based on the TAWC (stand-alone)  
28 capital structure as proposed in Exhibit MAM-5 attached to my direct testimony. That  
29 capital structure meets the known and measurable test and matching principles that the  
30 Authority has indicated apply to the development of the attrition year filings permitted by  
31 the Authority. I would note that the method of developing an attrition year cost of  
32 service based on known and measurable changes from historical test-year data is the

1 exact methodology described in the testimony of Mr. Novak attached and identified as  
2 Attachment WHN-3. The properly developed attrition year capital structure of TAWC is  
3 the proper capital structure to develop the actual WACC that matches and will be in place  
4 to fund the rate base for the attrition year.  
5

6 Q. DO YOU HAVE A RECOMMENDATION ON THE COST OF EQUITY AND  
7 WEIGHTED AVERAGE COST OF CAPITAL THAT SHOULD BE APPLIED IF THE  
8 AUTHORITY USED THE TAWC STAND-ALONE CAPITAL STRUCTURE?

9 A. I don't have a specific number, but would suggest that the Authority will have to assess  
10 the testimony and support provided by Dr. Vander Weide and Dr. Klein, as well as the  
11 information provided earlier in this testimony to determine the fair and reasonable cost of  
12 equity. I would say that the resulting decision of the Authority should provide an ROE  
13 that is similar to the cost of equity of other companies with similar risk and similar capital  
14 structures to those of TAWC, including those of the other AWW regulated subsidiaries.  
15 From my view there is no support, based on current financial bond market and equity  
16 market information, that would support a reduction of the 10.25% ROE on which the  
17 current rates of TAWC were developed, and in fact there is significant evidence that the  
18 current cost of equity for TAWC should be increased.  
19

20 Q. DO YOU HAVE A RECOMMENDATION ON THE CAPITAL STRUCTURE FOR  
21 THIS CASE IF THE AUTHORITY ELECTS TO CONTINUE THE USE OF DOUBLE  
22 LEVERAGE?

23 A. Yes. I have prepared Rebuttal Exhibit MAM-6 to capture my recommendations. If the  
24 Authority decides to continue the double leverage approach, Dr. Klein's methodology  
25 should not be accepted, as proposed. Dr. Klein's approach should be amended to provide  
26 the full cost of equity to the retained earnings portion of the equity of TAWC as  
27 addressed earlier in this testimony. I have provided the result of this adjustment in the  
28 upper box shown on Rebuttal Exhibit MAM-6. The result of this adjustment produces an  
29 equity ratio for establishing rates in this case at 38.484% which is still 303 basis points  
30 below the equity ratio on which the current rates of TAWC were established (41.517% as  
31 shown on Rebuttal Exhibit MAM-3). This amended capital structure produces a WACC



1 of 8.070% at the 11.5% ROE recommended by the Company in its filing, a number  
2 extremely close to the 7.991% WACC on which the Authority authorized the current  
3 rates of the Company.  
4

5 Q. HAVE YOU ALSO PREPARED A CAPITAL STRUCTURE BASED ON THE  
6 METHODOLOGY RECOMMENDED BY THE CAPD IN DOCKET NUMBER 08-  
7 00039?

8 A. Yes. I have provided the result of this calculation in the lower box on Rebuttal Exhibit  
9 MAM-6. The capital structure utilizing the CAPD methodology from the 2008 Rate Case  
10 produces an equity ratio for establishing rates in this case at 40.994% which is 52 basis  
11 points below the equity ratio on which the current rates of TAWC were established. This  
12 capital structure, which was produced by utilizing the double leverage methodology  
13 consistent with the Authority's decision in the 2008 Rate Case produces a WACC of  
14 7.906% which is below the currently authorized WACC of 7.991%.  
15

16 Q. DO YOU HAVE A RECOMMENDATION ON THE PROPER ROE IF THE  
17 AUTHORITY DECIDES TO CONTINUE USING A DOUBLE LEVERAGED  
18 CAPITAL STRUCTURE?

19 A. Yes, as outlined in the rebuttal testimony of Dr. Vander Weide, the lower equity ratios  
20 produced by the double leverage approach results in increased financial risk. With  
21 increased financial risk comes a higher cost of equity capital. This is particularly true  
22 when the capital structures of the sample groups utilized by both Dr. Vander Weide and  
23 Dr. Klein are developed from the market data and capital structures of companies with  
24 much higher equity ratios, and thus lower financial risk. Any basic financial theory  
25 textbook would indicate the existence of this higher financial risk must be taken into  
26 consideration in establishing a fair and reasonable cost of equity for TAWC when its  
27 financial risk is increased due to a much lower effective equity ratio.

28 Based on my analysis of the authorized cost of equity of the other AWW  
29 regulated subsidiaries, none of which were determined using double leverage, the cost of  
30 equity for TAWC should be established at a minimum of 11.5% if double leverage is  
31 applied to the capital structure of TAWC in this case. I could not with any certainty

1 recommend what the cost of equity capital should be at the greatly increased financial  
2 risk present in the 33.720% effective equity ratio contained in Dr. Klein's proposed  
3 capital structure, other than to say I believe it would be significantly above the 11.5%  
4 level.

5  
6 Q. ON WHAT BASIS DOES DR. KLEIN SUPPORT HIS CHANGE IN METHODOLOGY  
7 FOR DOULBE LEVERAGE FROM THAT UTILIZED BY THE AUTHORITY IN  
8 SETTING THE CURRENT RATES OF THE COMPANY?

9 A. I did not see any mention of the change in methodology in his testimony. I spoke earlier  
10 in this testimony about the importance to a utility of a stable and consistent regulatory  
11 environment in order to properly plan for and carry out effective operation, maintenance  
12 and capital investment strategies. Dr. Klein proposes a reduction from the 41.517%  
13 equity embedded in the Company's current rates to 33.720%, a draconian reduction with  
14 severe and harmful ramifications on TAWC's ability to attract capital and provide  
15 adequate service. He does this with little change in the cost of debt or the capital  
16 structures of TAWC or AWW, and only through a change in methodology.

17 I would respectfully ask the Authority to carefully consider the capital structure  
18 and cost of equity capital proposed by Dr. Klein in relation to the tests outlined in the  
19 Bluefield and Hope decisions. Does the proposed capital structure and resulting WACC  
20 proposed by Dr. Klein provide any opportunity to achieve earnings commensurate with  
21 other companies of similar risk, and could the Company attract capital under that type of  
22 regulation?

23 I would suggest that the answer to those two questions is a resounding "no," and  
24 therefore the recommendations of Dr. Klein should be rejected.

25  
26 **ACCUMULATED DEFERRED INCOME TAXES AND**  
27 **ASSOCIATED IMPACT ON CURRENT INCOME TAXES**  
28

29 Q. IS THERE A DISPUTE BETWEEN THE COMPANY AND THE CAPD REGARDING  
30 ACCUMULATED DEFERRED INCOME TAXES?

31 A. Yes.  
32

1 Q. WHAT IS THE NATURE OF THAT DISPUTE?

2 A. I will start by saying income taxes are a complicated and technical subject, and I will try  
3 my best to boil the dispute down to its simplest terms. My testimony will also support  
4 the rebuttal testimony of James M. Warren. The dispute centers on two concepts related  
5 to the rate recovery of temporary/timing (“temporary or timing” are synonymous for  
6 purposes of this discussion) differences that are created by differences in the way various  
7 elements of expenses and revenues are recorded for financial statement purposes and the  
8 way they are recorded on the income tax returns. While there are many timing  
9 differences in the way revenues and expenses are recorded on financial records and tax  
10 returns, the dispute centers primarily on the timing differences related to per book  
11 depreciation (the straight line method amortized over the generally longer lives  
12 established by the Authority), and the accelerated depreciation permitted by the IRS (the  
13 shorter tax depreciation lives). The “flow through” versus “normalization” method  
14 centers on who gets the benefit of the cash generated by the timing differences and the  
15 accumulated deferred income taxes (“ADITs”) generated from those timing differences.

16 While the timing differences are recorded on the books according to the rules  
17 established by U.S. GAAP, those timing differences can be addressed under two different  
18 approaches for rate recovery: (1) the normalization approach, or (2) the flow-through  
19 approach, or a combination of the two approaches for different vintages of property  
20 driving the timing differences. To complicate the issue further, there are two different  
21 U.S. GAAP pronouncements that are applicable to financial statement presentation of the  
22 tax/book timing differences during the time in which the timing differences have  
23 occurred, with each reflecting the rate recovery of the timing differences in different  
24 ways. I will refer to these two methods later in this testimony as the “SFAS 109  
25 approach” and the “APB 11 approach.” Under either approach, the timing difference will  
26 reverse over the life of the timing difference and the tax/book impact will be the same, so  
27 therefore the rate recovery should reverse as well.

28 To completely understand this issue it is necessary to understand how the  
29 Authority has treated the various vintages of timing differences for rate recovery in past  
30 rate cases (flow-through or normalization), and whether the Authority wants to reflect the

1 impact of those timing differences using the SFAS 109 approach or the APB11 approach.  
2 If done properly the answer should be essentially the same under either approach.

3 Mr. Warren addresses these tax/book concepts in his testimony, and the proper  
4 method for rate recovery. He also addresses the FIN 48 issue regarding the proper level  
5 of ADITs surrounding the change in tax accounting for capitalized repairs. New IRS  
6 regulations on the tax deductions for Capitalized Repairs have been issued since the  
7 completion of the Company's 2008 Rate Case, and there is an issue between the  
8 Company and the CAPD on the proper rate recovery of the timing differences generated  
9 by the change in tax accounting. I will not duplicate Mr. Warren's testimony on these  
10 subjects, but will add to them the history of rate recovery of the timing differences,  
11 regarding flow-through or normalization rate recovery, and the Company's  
12 recommendation regarding the appropriate rate recovery in this proceeding.

13  
14 Q. WAS THE RATE RECOVERY OF THE TIMING DIFFERENCES AND THEIR  
15 IMPACT ON INCOME TAX EXPENSE AN ISSUE IN THE COMPANY'S 2008  
16 RATE?

17 A. Yes. The Company in docket number 08-00039 ('2008 Rate Case') proposed that its  
18 ADITs and income tax expense be determined on the SFAS 109 approach. The  
19 Company's income tax expense was determined reflecting both the permanent and  
20 temporary timing differences in arriving at taxable income on which to base the current  
21 income tax expense (payable to the IRS) for the attrition year. The Company also  
22 reflected in income tax expense the impact of the timing differences that are normalized  
23 for rate recovery, and the adjustment required to income tax expense (payable to the IRS  
24 in the attrition year) related to the timing differences on pre-1981 property that had been  
25 afforded flow-through treatment for rate recovery (the reversal of the regulatory assets  
26 created under SFAS 109 accounting). The CAPD utilized the SFAS 109 (normalization  
27 method) to determine the ADITs (no difference from Company's filing).

28 However, the CAPD used a normalized pre-tax income approach to determine  
29 income tax expense. The Company attempted to demonstrate to the Authority through  
30 my Rebuttal Testimony in the 2008 Rate Case that the CAPD method had failed to  
31 properly reflect the impact on income tax expense of the reversal on tax/book

1 depreciation timing differences related to the pre-81 property that had historically been  
2 flowed-through to the customers' benefit. The Authority nonetheless accepted the  
3 CAPD's improper exclusion from the income tax expense the adjustment that was  
4 necessary to reflect the reversal of the timing difference of the pre-1981 flow-through  
5 property. I take responsibility for the result reflected in the Authority's Order due to my  
6 testimony not effectively explaining the applicable income tax and rate recovery concepts  
7 to the Authority. However, this is a situation that needs to be corrected by the Authority  
8 in this case as explained by Mr. Warren's rebuttal testimony.  
9

10 Q. IS THE ISSUE IN THIS CASE THE SAME AS IN THE 2008 RATE CASE?

11 A. Yes. Now that Mr. Buckner has corrected the ADITs to properly reflect the regulatory  
12 assets recorded under SFAS 109 (regarding the flow-through of the timing differences on  
13 the pre-1981 property and the gross-up of AFUDC), the Company's issues with the  
14 CAPD's income tax expense are the same as those present in 2008 Rate Case as  
15 described above.  
16

17 Q. YOU MENTIONED ABOVE THAT MR. BUCKNER HAD REVISED HIS  
18 TESTIMONY AND EXHIBITS. IS THE COMPANY IN AGREEMENT WITH  
19 THOSE CHANGES?

20 A. The Company is in agreement with the revision made by Mr. Buckner to reflect the  
21 regulatory assets related to the timing differences arising from the pre-1981 flow-through  
22 property that had been afforded flow-through rate recovery and the AFUDC gross-up. In  
23 his original testimony Mr. Buckner reduced rate base by the total of the Company's  
24 ADITs (liabilities) as reflected on the Company's financial statements using the SFAS  
25 109 approach, but failed to appropriately offset that amount by the SFAS 109 (regulatory)  
26 assets for the reversal of the timing differences related to the pre-1981 flow-through  
27 property. Mr. Buckner claimed in his original testimony that he had mistakenly failed to  
28 exclude the SFAS 71 assets (related to the SFAS 109 tax assets) in the 2008 Rate Case  
29 (page 57, beginning on line 1, Bucker Original Direct). However, it now appears the  
30 error was in his original testimony and Exhibit filed in this case, and not the approach to  
31 ADITs that the CAPD utilized in the 2008 Rate Case.

1 Q. DID MR. BUCKNER CORRECT THE RATE RECOVERY ISSUE REGARDING THE  
2 IMPACT ON CURRENT INCOME TAXES AS A RESULT OF THE ADDITIONAL  
3 INCOME TAXES NOW BEING PAID TO THE IRS AS THE TIMING DIFFERENCE  
4 ON FLOW-THROUGH PROPERTY IS REVERSING?

5 A. No. It is my opinion, and that of Mr. Warren, that Mr. Buckner in his revised testimony  
6 did not properly reflect the rate recovery for the additional income taxes now being paid  
7 to the IRS due to the reversal of the timing differences on the pre-81 flow-through  
8 property. The Company believes if the Authority accepts the CAPD's proposed  
9 normalized pre-tax income approach in determining income tax expense in this case then  
10 it must correct that current tax calculation to reflect the additional taxes the Company is  
11 paying now due to the reversal of the pre-1981 property timing differences. Mr. Warren  
12 has provided in his rebuttal testimony (pages 16-21) an explanation of the errors in the  
13 CAPD's approach and why the Authority should make that modification. I will provide  
14 the Company's proposal for this required adjustment to the CAPD's income tax approach  
15 in the following testimony.  
16

17 Q. YOU HAVE REFERRED TO THE TIMING DIFFERENCES RELATED TO PRE-1981  
18 PROPERTY SEVERAL TIMES. PLEASE EXPLAIN WHY THAT IS IMPORTANT  
19 TO THIS ANALYSIS AND DISCUSSION.

20 A. Prior to 1981 the IRS permitted both normalization and flow-through accounting for  
21 depreciation timing difference for recovery in rates. It is my understanding and belief  
22 that the Authority (and its predecessor the TN PSC) recognized those timing differences  
23 using the flow-through approach for rate recovery. With the passage of the Economic  
24 Recovery Tax Act of 1981, the IRS required that timing differences generated through  
25 accelerated tax depreciation on property installed after 1980 be afforded the  
26 normalization accounting method for rate recovery. Failure to use the IRS accelerated  
27 depreciation would not be recognized for tax purposes by the IRS. It is my understanding  
28 and belief that the TRA (and its predecessor the TN PSC) adopted normalization  
29 accounting for rate recovery of the timing differences generated from accelerated  
30 depreciation on property installed after 1980 for TAWC.

1           The concepts of normalization and flow-through accounting for rate recovery are  
2 critical to the establishment of the correct income tax expense in this case. These  
3 concepts are an integral part of the issue the Company has with the normalized pre-tax  
4 income approach utilized by the CAPD. The Company's income tax expense calculation  
5 in the 2008 Rate Case utilized the SFAS 109 approach and the Company's income tax  
6 expense in this case utilized the APB 11 approach. Both calculations correctly capture  
7 the impact of the timing differences afforded by either normalization or flow-through  
8 accounting treatment for rate recovery, including the reversal of the timing difference on  
9 the pre-1981 flow-through property. The CAPD's method does not, as explained by Mr.  
10 Warren.

11  
12 Q. CAN YOU BRIEFLY DESCRIBE THE DIFFERENCES IN THE U.S. GAAP  
13 ACCOUNTING PRONOUNCEMENT REGARDING INCOME TAXES APPLICABLE  
14 TO THIS ANALYSIS AND DISCUSSION?

15 A. Until the adoption of SFAS 109 in 1992, APB 11 was the GAAP pronouncement  
16 governing financial statement presentation of income taxes. Under APB 11, only the tax  
17 consequences of timing differences subject to normalization accounting (not previously  
18 flowed through for rate recovery) were required to be reflected on the U.S. GAAP  
19 balance sheet as ADITs. The timing difference on flow-through property (pre-1981  
20 property), including the increase in current income taxes to reflect the reversal of the  
21 timing differences as they occurred, were reflected only in the income tax expense.

22           SFAS 109 required that ADITs be reflected for all temporary timing differences,  
23 including the timing differences on pre-1981 property that had been afforded flow-  
24 through treatment for rate recovery. SFAS 109 permitted the reflection of tax assets  
25 related to the timing differences previously flowed-through as current tax deductions in  
26 rate recovery under the provisions of SFAS 71. Because the Company's current taxes for  
27 rate recovery had always included the additional income tax paid to the IRS on the  
28 reversal of the pre-1981-property by the TRA (or its predecessor the TN PSC) under the  
29 APB 11 approach to rate recovery, the Company established the SFAS 109 tax assets as  
30 regulatory assets under the provisions of SFAS 71 which states that regulatory assets can  
31 be established if future rate recovery is probable.

1 Q. DID THE COMPANY USE THE SFAS 109 APPROACH TO DETERMINE ITS  
2 ADITS AND INCOME TAX EXPENSE IN THIS CASE?

3 A. No. While the revenue requirement related to income taxes and ADITs will be the same  
4 under the SFAS 109 or APB 11 approach, the Company filed this case using the APB 11  
5 approach to determine ADITs. Mr. Buckner refers to the Company's APB 11 ADITs as a  
6 "maverick" approach. I would only say that I don't agree with that assessment. The  
7 APB 11 approach was U.S. GAAP prior to the adoption of SFAS 109. U.S. GAAP is not  
8 usually referred to as a "maverick approach". As late as the Company's 1996 rate case, it  
9 was the approach on which this Company's rates were established. In fact some state  
10 regulatory commissions have not recognized the SFAS 109 approach for rate recovery  
11 and require Companies to present the determination of ADITs under the APB 11  
12 approach. Both Virginia and West Virginia, two states where I have been involved with  
13 recent rate cases, both utilize the APB 11 approach to book/tax timing differences. The  
14 other state where I regularly work on rate cases, Kentucky, has adopted the SFAS 109  
15 approach to income tax presentation for rate filings, including the amortization of the  
16 SFAS 109 regulatory assets to reflect in income tax expense the reversal of the timing  
17 differences on pre-1981 property and the gross-up of AFUDC for rate recovery.

18  
19 Q. WHY DID THE COMPANY NOT USE THE SFAS 109 APPROACH IN THIS CASE?

20 A. The Company believed the Authority's Order in docket number 08-00039 indicated that  
21 the Authority had a problem with the SFAS 109 approach utilized by the Company. The  
22 Authority did not recognize the current tax adjustment required to reflect the additional  
23 taxes being paid to the IRS on the timing differences on pre-1981 flow-through property.  
24 The Authority's Order in docket number 08-00039 references the CAPD's Corrected  
25 Post-Hearing Brief as support for its decision. As explained above, the CAPD's  
26 normalized pre-tax income approach understated the income taxes related to the reversal  
27 of the timing differences arising from the pre-1981 flow-through property, and the  
28 Company elected to utilize the APB 11 approach in this case to correct that  
29 understatement. The Company continues to believe the Authority's decision in the 2008  
30 Rate Case was not consistent with prior rate-making treatment for the income taxes now



1 being paid (returned to the IRS) on the pre-1981 timing differences, which is a situation  
2 that the Company believes the Authority should correct in this case.

3 As stated by Mr. Warren, the CAPD's proposed income tax expense calculation  
4 based on the pre-tax income at the statutory federal income tax rate does not provide for  
5 rate recovery of the tax being paid on the reversal of the timing differences on pre-1981  
6 flow-through property or the AFUDC gross-up. The CAPD's normalized pre-tax book  
7 income method of determining income taxes in this case effectively provides the benefit  
8 of the pre-1981 property timing difference to the customers twice. The CAPD does so  
9 once when the accelerated depreciation deductions are taken (flowed-through to the  
10 customer) and again by not properly reflecting the reversal of that timing difference in the  
11 CAPD's income tax expense method used in this case. Under the normalization method  
12 utilized by the CAPD to determine income tax expense there must be an adjustment to  
13 pre-tax book income to reflect the reversal of the timing difference on pre-1981 flow-  
14 through property for rate recovery and the AFUDC gross-up, both of which have (with  
15 Mr. Buckner's revised testimony) been recognized as regulatory tax assets, as discussed  
16 later in this testimony. This can be done by an adjustment to pre-tax income reflecting  
17 the pre-tax impact of the amortization of the SFAS 109 regulatory tax assets (gross-up of  
18 the \$623,832 shown on Rebuttal Exhibit MAM-7, discussed below - the amortization  
19 approach) or by utilizing a higher effective income tax rate (than the statutory income  
20 rate) to account for the reversal of the flow-through property. The CAPD's approach  
21 proposed by Mr. Buckner does neither.

22 The Authority should not perpetuate the CAPD's understatement of the  
23 appropriate income taxes.  
24

25 Q. CAN YOU PROVIDE A COMPARISON THAT SHOWS THE IMPACT OF THE  
26 CAPD'S FAILURE TO PROPERLY RECOGNIZE IN ITS INCOME TAX  
27 CALCULATION THE REVERSAL OF THE PRE-1981 FLOW-THROUGH  
28 PROPERTY?

29 A. Yes. I have attached to this testimony Rebuttal Exhibit MAM-7 to assist in this  
30 comparison. In column 1 of the Exhibit, I show the ADITs and current income tax  
31 adjustment that should be reflected in the cost of service in this case if the SFAS 109

1 approach is applied correctly to determine ADITs and ensure the current income tax  
2 expense properly reflects the reversal of the timing differences related to the pre-1981  
3 flow-through property and the AFUDC gross-up. The result is an ADIT amount of  
4 \$22,638,057 shown on line 3. This amount would be used to reduce rate base under the  
5 SFAS 109 approach as proposed by the CAPD in this case. I also include the current  
6 income tax amount related to the reversal of the SFAS 109 regulatory assets for the pre-  
7 1981 flow-through property, and the AFUDC gross-up on line 10 in the amount of  
8 \$623,832 that would be required under the proper application of SFAS 109. Rebuttal  
9 Exhibit MAM-7 also indicates a difference between the Company and the CAPD related  
10 to the FIN 48 reserve for the uncertain tax position for the capitalized repairs deduction  
11 which is addressed by Mr. Warren and later in this testimony.  
12

13 Q HAVE YOU ALSO INCLUDED THE IMPACT OF MR. BUCKNER'S SFAS 109  
14 APPROACH TO THE ADITS AND NORMALIZED PRE-TAX BOOK INCOME  
15 APPROACH TO INCOME TAX EXPENSE?

16 A. Yes. In column 2 I have shown the revenue requirement impact for the SFAS 109  
17 approach to ADITs and income tax expense as provided in Mr. Buckner's revised  
18 testimony and Exhibits.  
19

20 Q. WHAT AREAS OF MR. BUCKNERS APPROACH DO YOU WISH TO DISCUSS?

21 A. Mr. Buckner has recognized in his revised testimony and Exhibits the existence of  
22 regulatory assets related to the future rate recovery of the reversal of the timing  
23 differences related to the pre-1981 property and AFUDC gross-up. Rebuttal Exhibit  
24 MAM-7 also shows that Mr. Buckner continues to take the position that the full impact of  
25 the capitalized repairs should be recognized as an ADIT. At this point the only difference  
26 in the ADITs between the SFAS 109 approach in column 1 and the CAPD's approach  
27 shown in column 2 is the difference related to the FIN 48 reserve, which accounts for a  
28 \$2,068,329 lower rate base proposed by the CAPD.

29 However, as explained in Mr. Warren's rebuttal testimony and this testimony, Mr.  
30 Buckner's normalized pre-tax book income approach for income tax expense does not

1 properly account for the additional income tax expense that the Company is currently  
2 paying (returning) to the IRS related to the timing differences on the pre-1981 property.

3  
4 Q. NOW THAT YOU HAVE ESTABLISHED THAT MR. BUCKNER RECOGNIZES  
5 THAT REGULATORY ASSETS EXIST UNDER THE SFAS 109 APPROACH, IS IT  
6 NECESSARY FOR MR. BUCKNER TO RECOGNIZE IN CURRENT TAXES THE  
7 IMPACT OF THE REVERSAL OF THE TIMING DIFFERENCE RELATED TO THE  
8 PRE-1981 PROPERTY TIMING DIFFERENCES AND THE AFUDC GROSS-UP?

9 A. Yes. It is explicit under SFAS 71 that for there to be a regulatory asset, future rate  
10 recovery must be probable. Therefore in Mr. Buckner's SFAS 109 approach he must  
11 provide rate recovery for the regulatory asset he recognizes.

12  
13 Q. DID MR. BUCKNER INCLUDE THE ADDBACK TO CURRENT INCOME TAX  
14 EXPENSE IN ANY OTHER AREA OF HIS TAX CALCULATION RELATED TO  
15 THE REVERSAL OF THE TIMING DIFFERENCE ON PRE-1981 PROPERTY IN HIS  
16 CALCULATION?

17 A. No. I have reviewed Mr. Buckner's tax calculation (Revised Buckner testimony, Exhibit  
18 1, page 7 of 9) carefully and no other adjustment is included to account for the additional  
19 income taxes being paid (returned) to the IRS for the reversal of the timing difference  
20 related to the pre-1981 property or the gross-up of the AFUDC.

21  
22 Q. IS MR. BUCKNER'S FAILURE TO INCLUDE ANY ADDITIONAL INCOME  
23 TAXES RELATED TO THE REVERSAL OF THE TIMING DIFFERENCES ON THE  
24 PRE-1981 PROPERTY AND THE AFUDC GROSS-UP CONSISTENT WITH THE  
25 ADIT RECOMMENDATION INCLUDED IN HIS REVISED TESTIMONY?

26 A. No it is not. Mr. Buckner's inclusion of the regulatory assets as a reduction to the ADIT  
27 (liabilities) recorded on the books of the Company comes with an explicit recognition  
28 that the additional taxes paid (returned) to the IRS will be recognized for rate recovery as  
29 will the AFUDC previously included in rate base. He has failed to provide for those  
30 additional taxes in his current tax calculation as explained by Mr. Warren.

1 Q. WHAT ARE YOUR RECOMMENDATIONS REGARDING THE ADITS AND  
2 ASSOCIATED INCOME TAX EXPENSE IN THIS CASE?

3 A. Its is my firm belief and opinion that the Authority should provide for recovery of the  
4 income taxes paid (returned) to the IRS related to the timing differences on the pre-1981  
5 property. These are the same timing benefits on the pre-1981 property that have flowed-  
6 through the current income tax calculation in prior rate cases when the accelerated tax  
7 deductions were reflected on the tax returns of the Company. My recommendation,  
8 based on the rebuttal testimony above and that of Mr. Warren, would also include:

- 9 1. The Authority should recognize the SFAS 109 approach for rate recovery as a  
10 matter of policy for future TAWC rate cases. This method of rate recovery for  
11 income taxes would be simpler for the parties to utilize in developing their tax  
12 calculations for rate filings and can be easily verified to the Company's books  
13 which are also recorded using the SFAS 109 approach as required by U.S.  
14 GAAP. The SFAS approach would include both the determination of the  
15 appropriate rate reduction for ADITs and the income tax expense. (This is  
16 exactly the approach proposed by the Company in its 2008 rate case, as well as  
17 its 2000, 2003, 2004 and 2006 rate cases).
- 18 2. If the Authority should continue to utilize the normalized pre-tax book income  
19 method for income tax expense as proposed by the CAPD, it should be amended  
20 to either: (i) reflect the additional \$623,832 of current income tax expense related  
21 to the reversal of the timing differences on pre-1981 flow-through property and  
22 the AFUDC gross-up reflected as regulatory assets under the SFAS 109  
23 approach, as shown on Rebuttal Exhibit MAM-7, column 1, line 10; or (ii)  
24 amend the CAPD's income tax expense calculation to reflect the appropriate  
25 effective income tax rates to account for the reversal of the timing differences on  
26 the pre-1981 flow-through property and the AFUDC gross-up. Under either  
27 method the CAPD's taxes should be \$623,832 higher than currently determined  
28 by the CAPD's normalized pre-tax book income approach.
- 29 3. The Company would accept the normalized pre-tax income approach for  
30 determining income tax expense in future rate cases if, and only if, the Authority  
31 makes it clear in its Order in this case that the normalized pre-tax book income

1 method must properly include payments to the IRS related to the reversal of  
2 flow-through property and the gross-up of AFUDC through either the appropriate  
3 effective FIT rate method described in Mr. Warren's testimony or by  
4 amortization of the regulatory assets created under SFAS 109 that are not  
5 included in the CAPD's income tax expense calculation proposed in this case.  
6 The normalized pre-tax income method properly adjusted to reflect the reversal  
7 of the timing differences on the pre-1981 property and the AFUDC gross-up will  
8 produce the same answer as the full SFAS 109 approach.

9 4. The Company would recommend either of the approaches indicated under  
10 paragraph 2 above in this case.

11 5. The Authority should accept the proper SFAS 109 approach for determining  
12 ADITs as shown on Rebuttal Exhibit MAM-7, columns 1, line 3, which would  
13 include the ADIT amount of \$22,638,057. This ADIT rate base reduction should  
14 be used under either the SFAS 109 approach to income tax expense or the  
15 normalized pre-tax book income approach indicated in paragraph numbers 1 and  
16 2 above. (This amount does not include the liability for the FIN 48 reserve as  
17 ADITs for the reasons outlined in the rebuttal testimony of Mr. Warren and the  
18 following section of this testimony.)

19 6. If the Authority elects not to utilize the SFAS 109 approach for ADITs as  
20 proposed by the CAPD in Mr. Buckner's revised testimony (except for the  
21 inclusion of the FIN 48 reserve), the Authority should utilize the ADITs of  
22 \$17,153,815 determined under the APB 11 approach included in the Company's  
23 filing, and the income tax calculation proposed by the Company on Exhibit 2,  
24 Schedule 6, page 2 of 2 included in the Company's petition.

## 25 **FIN 48**

26  
27  
28 Q. WHAT EXACTLY IS FIN 48?

29 A. Mr. Warren explains FIN 48 thoroughly in his rebuttal testimony and I do not want to  
30 repeat his testimony. In short FIN 48 is an accounting pronouncement related to the  
31 income tax financial presentation required by SFAS 109. FIN 48 requires a company to

1 perform a detailed analysis of all of its income tax positions. To the extent any of its  
2 income tax positions and deductions are determined to be uncertain, a detailed analysis is  
3 required to determine and quantify the level of tax positions and deductions that are  
4 uncertain under the guidelines. The analysis should determine whether any tax deduction  
5 is “more likely than not” to be rejected by the IRS or other taxing authority.  
6

7 Q. HOW DID MR. BUCKNER ADDRESS THE CHANGE IN TAX ACCOUNTING  
8 METHOD RELATED TO THE CAPITALIZED REPAIRS DEDUCTIONS?

9 A. Mr. Buckner proposes to normalize the impact of the temporary timing differences  
10 created by the change in the tax accounting method related to the capitalized repairs in a  
11 way that is consistent with the overall normalization approach he utilizes in his income  
12 tax calculation, just as he does for all other current year temporary timing differences  
13 between book and tax accounting. The Company agrees with Mr. Buckner’s approach to  
14 normalize the timing differences related to capitalized repairs for rate recovery and is the  
15 same normalization approach proposed by the Company in its filing regarding the  
16 capitalized repairs deduction (See Exhibit MAM-14 attached to Mr. Miller’s Direct  
17 Testimony). To be perfectly clear, Mr. Buckner’s normalization approach for temporary  
18 timing differences that occurred in the current year however does not properly account  
19 for the reversal of the timing differences related to the pre-1981 property as explained  
20 previously.  
21

22 Q. DID MR. BUCKNER INCLUDE THE ENTIRE AMOUNT OF THE CAPITALIZED  
23 REPAIRS DEDUCTION IN HIS DETERMINATION OF THE ACCUMULATED  
24 DEFERRED INCOME TAX TO BE DEDUCTED FROM RATE BASE?

25 A. Yes. He did not reflect the fact that the uncertain tax position (approximately 30% of the  
26 total deduction) related to the capitalized repairs deduction is not in fact an ADIT  
27 (interest free capital as defined by the IRS). The uncertain amount of the capitalized  
28 repairs deduction is currently recorded as a deferred liability accruing interest until such  
29 time that the IRS, (i) issues additional guidelines concerning the definition of the unit of  
30 property applicable for the capitalized repairs, (ii) eliminates the uncertainty of the  
31 Company’s aggressive tax position by IRS audit of the 2008 federal income tax return

1 where the capitalized repairs were first recorded (including the catch-up portion from  
2 2001-2007), or (iii) the statute of limitations expires on the audit of the 2008 Federal  
3 income tax return. Mr. Warren has covered the reasons that the uncertain tax position  
4 recorded under FIN 48 should not be reflected as ADITs (rate base reduction) until the  
5 uncertainty is removed by IRS ruling, IRS audit, or the statute of limitations and I will  
6 not repeat his testimony here.

7  
8 Q. DID MR. BUCKNER ADDRESS THE “MORE LIKELY THAN NOT” STANDARD  
9 UTILIZED IN DETERMING UNCERTAIN TAX POSITIONS UNDER FIN 48?

10 A. Yes. On page 56 of Mr. Buckner’s testimony he indicates the Company’s experts have  
11 determined the risk is not high for the IRS to reverse the aggressive deduction taken by  
12 the Company. Mr. Buckner grossly mischaracterizes the Company’s response to  
13 discovery request TRA-02-134 in making this statement. In fact, the Company’s tax  
14 experts have determined there is a high likelihood that approximately 30% of the  
15 capitalized repairs deduction taken by the Company will **not** be recognized by the IRS.  
16 As explained in Mr. Warren’s testimony the Authority should not reflect a rate base  
17 reduction for the uncertain tax position which would only discourage the Company from  
18 taking aggressive positions before the IRS. I concur with Mr. Warren that it is in the  
19 customers’ best interest for the Company to take aggressive tax positions when  
20 appropriate. If the Company eventually wins the issue at the IRS the customers benefit,  
21 and if the Company losses then the customers are no worse off.

22  
23 Q. MR BUCKNER INDICATES THAT THE STATUTE OF LIMITATIONS WILL  
24 EXPIRE ON PART OF THE CAPITALIZED REPAIRS DEDUCTION IN 2010. IS HE  
25 CORRECT?

26 A. No, Mr. Buckner is not correct on this point which is made in support of his proposal for  
27 including the uncertain portion of the capitalized repairs deduction as ADITs in this case.  
28 Mr. Buckner references the 2009 Annual Report of TAWC that contained in Footnote 9-  
29 Income Taxes (at page 21 of 26 in attachment 3 provided with the response to discovery  
30 request TN-TRA-01-Q5) as support for this position. The 2009 Annual Report language  
31 referenced states in which the statute of limitations expires in 2010 for 2006 federal

1 income tax returns. In fact, the capitalized repairs deduction (including the 2001-2007  
2 catch-up deduction) was recorded on the 2008 federal income tax return and that statute  
3 of limitation will not expire until 2012, which is after the end of the attrition year in this  
4 case.

5  
6 Q. MR. BUCKNER INDICATES THAT THE COMPANY IS NOT RECORDING  
7 INTEREST ON THE UNCERTAIN TAX LIABILITY RECORDED IN  
8 ACCORDANCE WITH FIN 48. IS HE CORRECT ABOUT THAT?

9 A. No. Mr. Buckner again relies on the TAWC 2009 Annual Report (same reference as in  
10 the preceding answer) in support of this statement. The 2008 federal income tax return  
11 was not filed until August 2009, and as the 2009 Annual Report states no interest for  
12 uncertain tax liability was recorded in 2009. However, this was an error by the Company  
13 which was corrected in the January 2010 accounting close, and the full applicable interest  
14 related to the uncertain tax position on the capitalized repairs deduction continues to be  
15 recorded on the financial statements of TAWC. This fact clearly shows that the uncertain  
16 tax position regarding the full capitalized repairs deduction is not an ADIT at this time,  
17 because it is not interest free capital as Mr. Buckner incorrectly asserts.

18  
19 Q. ARE THERE OTHER AREAS OF MR. BUCKNER'S TESTIMONY ON THE  
20 CAPITALIZED REPAIRS DEDUCTION AND FIN 48 ISSUE WITH WHICH YOU  
21 DISAGREE?

22 A. Yes. I disagree with his assertion on page 55 of his testimony (beginning on line 11), that  
23 the Authority will have the opportunity in a future rate case to correct the impact in this  
24 case of providing the customers the benefit of the uncertain tax position under FIN 48,  
25 He makes this claim based on his reference to the "Company's propensity to file bi-  
26 annual rate filings". It seems that the CAPD and Mr. Buckner's notion of the regulatory  
27 compact as discussed earlier in this testimony is that the Company's rates should be set at  
28 levels that produce an ROE of approximately 1% on a U.S. GAAP basis (see rebuttal  
29 exhibit MAM-2 discussed earlier in this testimony) and not file another rate case for  
30 some period longer than two years from the completion of this case. That is a "far



1        fetched” understanding of the standards of U.S. utility regulation as contained in the  
2        context of the Bluefield and Hope decisions.

3  
4        Q.     WHY DO YOU DISAGREE WITH MR. BUCKNER’S SUGGESTION THAT THE  
5        AUTHORITY CAN JUST CORRECT ANY IRS DISALLOWANCE OF THE  
6        UNCERTAIN TAX POSITION IN A FUTURE RATE CASE?

7        A.     Under the approach proposed by Mr. Buckner, the Company could never recover in rates  
8        the benefit from the uncertain tax deduction portion of the capitalized repairs provided to  
9        the customer in this case in the event the IRS does not allow the entire aggressive  
10       capitalized repairs deduction. Approximately 30% of the capitalized repairs deduction  
11       has been determined to be “more likely than not” to not be recognized by the IRS. The  
12       uncertainty of the tax position is based on a thorough examination and determination by  
13       the Company’s tax experts and the Company’s independent outside auditors. If the IRS  
14       rules as the Company’s tax experts have determined, that a portion of the capitalized  
15       repairs is not deductible, I have no doubt that the CAPD would noisily object that it  
16       would be retroactive rate making if the Company were to attempt to recover lost revenue  
17       from the customers from a prior case.

18       Under the Company’s approach the customer would get the full benefit of the  
19       uncertain tax position in future rate cases if the IRS determines the full capitalized repairs  
20       deduction is appropriate through a generic ruling, tax return audit or the statute of  
21       limitations expires. This would occur because the FIN 48 liability would then be  
22       reflected as ADITs and the customers would get the full benefit of the normalized  
23       capitalized repairs over the remaining life of the timing difference. In addition, the  
24       Company would not be harmed by providing the benefit of the uncertain tax position in  
25       this case to the customer in the event the uncertain portion of the capitalized repairs  
26       deduction (approximately 30% of the total deduction) will be disallowed by the IRS as  
27       the tax experts have determined.

28       The Company’s proposal in this case regarding the uncertain tax position on the  
29       capitalized repairs is the only way to treat both the customers and the Company fairly  
30       until the uncertainty of this tax position is eliminated. In other words, the Company’s  
31       approach is a “two way” street.

1  
2 Q. HAVE OTHER REGULATORY COMMISSIONS ISSUED ORDERS IN  
3 CONTESTED RATE CASES ON THE FIN 48 ISSUE?

4 A. Yes. As indicated in my Direct Testimony, both the Missouri and Washington state<sup>1</sup>  
5 utility regulatory commissions have determined that the FIN 48 reserve for the uncertain  
6 tax position surrounding the accounting change for capitalized repairs should not be  
7 treated as an ADIT (rate base reduction) until the uncertainty surrounding the IRS  
8 position is eliminated.

9 In the recent Kentucky American rate case<sup>2</sup> both Mr. Warren and I provided  
10 similar testimony on the FIN 48 issue and the Kentucky PSC agreed with the Company's  
11 position not to reflect the FIN 48 reserve as ADITs until the uncertainty of the level of  
12 capitalized repairs deduction had been eliminated.

13  
14 Q. WHAT IS YOUR RECOMMENDATION ABOUT THE RECOGNITION OF THE  
15 UNCERTAIN TAX POSITION REGARDING THE CHANGE IN TAX  
16 ACCOUNTING FOR CAPITALIZED REPAIRS?

17 A. The position of the CAPD should be rejected for all the reasons addressed in this  
18 testimony and that of Mr. Warren. The CAPD's position is not fair to either the customer  
19 or the Company. The Company's approach is the only way that both the customers and  
20 the Company can be treated fairly until the uncertainty of the aggressive tax position  
21 taken by the Company is eliminated.

22  
23 **WORKING CAPITAL**  
24

25 Q. DID BOTH THE CRMA AND CAPD WITNESSES ADDRESS WORKING  
26 CAPITAL?

27 A. Yes.  
28

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1 In the Matter of Union Electric Company, d/b/a AmerenUE's Tariffs to Increase Its Annual Revenues for Electric Service, Case No. ER-2008-0318, slip. op. at 55 (Mo. PSC Jan. 6, 2009); Washington Utilities and Transportation Commission v. Puget Sound Energy, Inc., Case No. 2010-00036, slip op. at 70 (Wash. UTC April 2, 2010).

<sup>2</sup> Final order of the Kentucky PSC in case # 2010-00036, regarding petition to increase rates by Kentucky American Water Co., pages 17-20.

1 Q. HOW DID THE COMPANY CALCULATE WORKING CAPITAL?

2 A. The Company's Working Capital calculation of \$1,011,256 was provided in the response  
3 to TN-TRA-01-Q013 (the Company's working papers) at the tab WORKING CAPITAL  
4 (pages 1-56). The Working Capital was supported by a lead/lag study prepared by the  
5 Company based on the 12-month period ending March 2010, the historical test-year used  
6 by the Company. The lead/lag study was provided in the working paper referenced  
7 above at the tab LEAD LAG STUDY (pages 1-35). The Company's working capital  
8 methodology and the categories of working capital are exactly the same as were  
9 recognized for inclusion as working capital by the Authority in docket number 08-00039.  
10 The Company included average attrition year balances for prepaid taxes, materials and  
11 supplies, deferred regulatory expense, unamortized debt, and other deferred debits. For  
12 all other revenue and expense items the Company used the lead/lag method to determine  
13 the working cash requirement related to those items, based on the lead/lag study prepared  
14 for this case.

15 The Company did not include cash, prepaid taxes or the 2006 management audit  
16 based on the Authority's decision in the 2008 Rate Case.

17  
18 Q. PLEASE ADDRESS YOUR CONCERNS WITH CAPD'S ADJUSTMENTS TO  
19 WORKING CAPITAL AS DISCUSSED IN THE TESTIMONY OF MR. BUCKNER.

20 A. Mr. Buckner adjusted two areas of the Company's proposed working capital:

- 21 • Deferred Rate Case Expense, and
- 22 • The lead days associated with federal and state income taxes.

23  
24 Q. DO YOU AGREE WITH THE CAPD'S ADJUSTMENT TO DEFERRED RATE CASE  
25 EXPENSE?

26 A. No. Mr. Buckner reduces the Company's requested deferred rate case expense request of  
27 \$630,897 by \$320,163. Mr. Buckner supports his claim based on the rate case expense  
28 disallowed by the Authority in the Company's 2008 Rate Case. I would only comment  
29 on his claims of excessive regulatory expenses as being unfounded. As stated in the  
30 opening sections of this testimony, this case includes the discovery of the CAPD and City  
31 which requested excessive discovery of information not relevant to this proceeding and

1 information that is burdensome or not available. In addition, this case features  
2 unprecedented motions to compel (most of which were settled); motions for moving the  
3 hearing from the Authority's hearing room at great cost to the Company, other parties  
4 and the Authority; six intervenors (including the CAPD, City, CRMA, and UWUA's  
5 active intervention); and major adjustments to nearly every category of the cost of  
6 service, requiring nine Company witnesses. The Company does not believe its cost to  
7 process a rate increase request with this level of atypical elements is excessive.

8 The Company agrees it costs more to process rate cases in Tennessee than other  
9 states, at least in the ones where I regularly appear. However, in other states there are  
10 fewer active intervenors, the discovery is carried out vigorously but in a much less costly  
11 manner, the issues are more focused, the number of required witnesses is less, there is no  
12 added cost for moving the hearing, and in many cases the entire case or significant  
13 portions of the case are settled without a full evidentiary hearing. It should not surprise  
14 anyone that considering the issues mentioned above the cost to process a rate case in  
15 Tennessee is more than in other states, at least the ones where I regularly prepare and  
16 process rate cases. Earlier in this testimony I made recommendations to the Authority  
17 about how the rate case process for TAWC could be streamlined and made less costly. I  
18 am hopeful that could happen in the future.

19  
20 Q. WHAT IS YOUR RECOMMENDATION REGARDING THE CAPD'S PROPOSED  
21 ADJUSTMENT TO REDUCE DEFERRED RATE CASE EXPENSE?

22 A. Mr. Buckner's adjustment should be rejected. The Tennessee Court of Appeals' opinion  
23 in the 2008 rate case reversed the Authority's decision to disallow one-half of the rate  
24 case expense,<sup>3</sup> which contradicts the very basis on which Mr. Buckner proposed his  
25 adjustment. In the discussion on rate case expense later in this testimony, the Company  
26 is amending its requested rate case expense recovery to reflect full recovery of the  
27 \$275,000 in the attrition year based on the Court of Appeals decision.

28  

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<sup>3</sup> Tennessee American Water Company v. Tennessee Regulatory Authority, Case No. M2009-00553-COA-R12-CV, Filed January 28, 2011, at page 30.

1 Q. DO YOU AGREE WITH THE CAPD'S ADJUSTMENT TO LEAD DAYS IN THE  
2 COMPANY'S LEAD/LAG STUDY FOR INCOME TAXES?

3 A. No. Mr. Buckner used the tax payment dates from a text book as support for this  
4 proposed change for the lead days on income taxes. His only reference is to a set of dates  
5 based on when the taxes are paid as referenced in footnote 137 on page 52 of his  
6 testimony.

7 Unless I have missed something in the CAPD's pre-filed testimony Mr. Hahne  
8 and Mr. Aliff have not prepared a lead/lag study in this case, and Mr. Buckner has not  
9 either. The Company's lead/lag study used the actual payment dates for income taxes  
10 through March 2009 and those dates correspond to the current IRS payment guidelines.  
11 The payment dates referenced by MR. Buckner do not.

12 Mr. Buckner's reference to a text book that does not reflect the current IRS  
13 schedule for estimated payments should not and can not supplant the actual payment  
14 dates of the Company in establishing the working capital in this case. Mr. Buckner's  
15 proposed adjustment to the lead/lag study lead days for income taxes should be rejected.

16  
17 Q. DO YOU AGREE WITH CRMA WITNESS GORMAN'S RECOMMENDATION TO  
18 ELIMINATE UNAMORTIZED DEBT EXPENSE FROM THE WORKING CAPITAL  
19 CALUCLATION?

20 A. The Company does not disagree with Mr. Gorman that unamortized debt expense should  
21 be eliminated from working capital if the Company' stand-alone capital structure is used  
22 in the establishment of the rates authorized in this case. However, if the Double  
23 Leverage capital structure approach is utilized by the Authority to establish rates in this  
24 case, then all of the debt (and unamortized debt expense) issued by TAWC may not be  
25 embedded in the capital structure used for rate recovery. Mr. Gorman's approach is  
26 inconsistent with the approach proposed by the CAPD in this case regarding unamortized  
27 debt expense.

28  
29 Q. DO YOU AGREE WITH THE OTHER ADJUSTMENTS PROPOSED BY MR.  
30 GORMAN TO THE COMPANY'S LEAD/LAG PORTION OF THE WORKING  
31 CAPITAL?

1 A. No. The following is a list of changes made to the Company's Working Capital  
2 calculations proposed by Mr. Gorman that will be addressed is rebuttal testimony.

3 • Lead/lag items related to:

4 A. Lead days for management fees

5 B. Lead days for uncollectible expense

6 C. Lead days for depreciation and amortization expense

7 D. Lead days for deferred income tax expense

8 E. Lead days for gross receipts taxes  
9

10 Q. DO YOU AREE THAT WITH MR. GORMAN'S ADJUSTMENT TO THE LEAD/LAG  
11 DAYS ASSIGNED TO AWWSC COSTS IN THE COMPANY'S LEAD LAG STUDY?

12 A. No. Mr. Gorman changed the lead/lag days for AWWSC costs to 25.24 days from the  
13 -11.97 days determined by the Company's lead/lag study provided in this proceeding  
14 based on the actual payments made during the historical test-year ending March 31, 2010.  
15 As outlined in the Service Company Agreement between TAWC and AWWSC,<sup>4</sup> the  
16 Company makes an advance payment to AWWSC of one-half of the prior month's bill at  
17 mid month and pays the balance of the monthly bill once received. The contract included  
18 this pre-payment arrangement because the services from AWWSC include payroll and  
19 payroll benefits of AWWSC employees, and it is reasonable for TAWC to pay for those  
20 services in line with the payroll dates on which those costs are incurred by AWWSC, the  
21 vast majority of which are the AWWSC costs for payroll, payroll taxes and employee  
22 benefit costs. If TAWC did not pay for the AWWSC services in the current manner,  
23 AWWSC would have to incur the working capital costs to meet its payroll and other  
24 expense as incurred but not receive full payment for those services until well past when  
25 the expenses were incurred. This would lead to additional working cash requirements at  
26 AWWSC which AWWSC would pass along to TAWC and the other AWW subsidiaries  
27 in AWWSC's bill.

28 Mr. Gorman proposes to establish the lead/lag days for AWWSC costs by  
29 applying the TAWC's lead/lag days to the various costs of AWWSC. This analysis is

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<sup>4</sup> See response to discovery request TN-TRA-01-Q032-ATTACHMENT, page 11 of 15. (Service Company Agreement, at Article IV, 4.1).

1 faulty for several reasons. First he is calculating the working capital of AWWSC and not  
2 the working capital of TAWC. Secondly, the lead/lag days of TAWC are not a proxy for  
3 when AWWSC receives its revenues and pays its expenses. Third, it is not clear, but it  
4 appears Mr. Gorman did not take into account the revenue lag at AWWSC in his  
5 calculation.

6 Mr. Gorman's approach only considers "**one side**" of the equation. The proposed  
7 adjustment inappropriately reduces the working cash of TAWC through his adjustment,  
8 but he does not propose to add back to the AWWSC management fees the impact of the  
9 working cash requirement he will create at AWWSC. If both side of the equation were  
10 considered under Mr. Gorman's approach, the answer would have little, if any, impact on  
11 the cost of service in this case. Since Mr. Gorman's approach does not consider both  
12 sides of the equation and it is not reflective of the actual lead/lag days of TAWC as  
13 shown in the Company's lead/lag study filed in this case, his proposed adjustment should  
14 be rejected. As he did in the Company's 2008 rate case, Mr. Gorman attempts to  
15 manufacture an argument to lower the actual lead/lag days for AWWSC costs to TAWC,  
16 and the lead/lag days determined by the actual lead/lag study performed on the actual  
17 historical test-year for this case. Mr. Gorman provides no justifiable reason for changing  
18 the expense lead/lag days for this category of expense from that determined in the  
19 lead/lag study supplied by the Company in this case.

20  
21 Q. DO YOU AGREE WITH MR. GORMAN'S ADJUSTMENT TO THE LEAD/LAG  
22 DAYS FOR UNCOLLECTIBLE EXPENSES?

23 A, No. Mr. Gorman claims that uncollectible expense is a non cash expense and therefore  
24 the post-payment lag days should be set to equal the revenue lag, effectively eliminating  
25 any working cash requirements related to this expense. Mr. Gorman is incorrect to say  
26 uncollectible expense is non-cash. The revenue of the Company is recorded on gross  
27 billing. Uncollectible expense is the amount of cash that the company never collects  
28 from the billed revenues recorded on the books. Quite obviously uncollectible expense is  
29 a cash item, but Mr. Gorman provides no justifiable reason for changing the expense lag  
30 days for this category of expense. Mr. Gorman proposed this very same adjustment and  
31 the Authority did not accept his position in the 2008 Rate Case, and he has provided no

1 additional information to support a change to the manner in which rates were established  
2 in the Authority's Order in the 2008 Rate Case.

3  
4 Q. DO YOU AGREE WITH MR. GORMAN'S ADJUSTMENT TO THE LEAD/LAG  
5 DAYS FOR DEPRECIATION, AMORTIZATION EXPENSE AND DEFERRED  
6 INCOME TAXES?

7 A. No. Mr. Gorman also adjusted the post payment days for depreciation expense,  
8 amortization expense and deferred income tax expense, effectively eliminating any  
9 working cash requirements related to these expenses. Mr. Gorman claims because these  
10 expenses are non-cash items, no working capital requirement should be permitted. Mr.  
11 Gorman is incorrect in stating that there is no working cash associated with depreciation,  
12 amortization and deferred income tax expense. Depreciation expense does not require a  
13 cash payment, although the cash was expended at the time the property was installed.  
14 The depreciation is the return of the Company's original investment. The depreciation  
15 expense is recorded to return the investment in property each month, but the Company  
16 does not receive the cash for that return of capital (depreciation expense) until the  
17 revenue from the month that expense is recorded is collected. Therefore, there is a  
18 working capital requirement associated with depreciation expense equal to the revenue  
19 lag days.

20 The same principles apply to amortization and deferred income taxes. Mr.  
21 Gorman proposed the same adjustments to lead/lag days for depreciation, amortization  
22 and deferred income tax expenses in the Company's 2008 Rate Case and they were not  
23 accepted by the Authority in the Company's 2008 Rate Case Order. Mr. Gorman  
24 provides no justifiable reason for changing the post payment days for depreciation and  
25 deferred income tax expense. The CAPD did not make an adjustment to this category of  
26 expense from the Company's working capital calculation. A similar adjustment was  
27 suggested by the Kentucky AG in the 2004 rate case of Kentucky American Water Co.  
28 and the Kentucky Public Service Commission upheld the Company's position in its order  
29 from that case.<sup>5</sup>

30  

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<sup>5</sup> Order in Kentucky American Water Co. Case No. 2004-00103 at page 17-18.



1 Q. DO YOU AGREE WITH MR. GORMAN'S ADJUSTMENT TO THE LEAD/LAG  
2 DAY FOR GROSS RECEIPTS TAX?

3 A. No. Mr. Gorman quotes Tenn. Code Ann. § 67-4-306 to support his claim for a reduction  
4 in working cash related to gross receipts of \$328,178. The Company believes his  
5 interpretation of the code is incorrect. Mr. Gorman appears to use the prior year's  
6 revenues on which the current year's taxes will be based to incorrectly assume the  
7 Company has received those gross receipts tax equivalents in revenue. While each rate  
8 case builds into rates an element for gross receipts and all other taxes, the rates are  
9 established for the gross receipts taxes paid in the attrition year. Mr. Gorman's assertion  
10 that this situation should set the revenue lag days to zero for gross receipts tax is  
11 unfounded. The assessment date for the tax (for the taxes used in the lead/lag study) does  
12 not equate to the service period as Mr. Gorman claims any more than property taxes for  
13 the current year (service period) is based on the assessment of property for some prior  
14 period. His claim that the overall revenue lag days should not apply to gross receipts  
15 taxes is not correct.

16 Mr. Gorman is correct that the service period shown on the Company's lead/lag  
17 study for gross receipts is incorrect. I have prepared information identified as Rebuttal  
18 Exhibit MAM-9, that supports the correct service period for gross receipts taxes, and I  
19 have provided corrected working papers that calculate the correct impact on Working  
20 Capital once this error is corrected.

21 Page 1 of 5 of Rebuttal Exhibit MAM-9 is the actual gross receipts tax invoice for  
22 TAWC for the historical test-year ended March 2010 which shows the taxable period to  
23 which the tax applies. I have highlighted that area to show the taxable period (the service  
24 period is 7-1-09 to 6-30-2010, payable by August 1, 2009). The Company incorrectly  
25 showed the service period as 7-1-09 to 6-30-09.

26 Page 2 of 5 shows the corrected lead/lag study page for gross receipts tax –  
27 updated working paper TRA-01-Q013-REVISED LEAD/LAG STUDY, page 32 of 35.  
28 The result of using the corrected service period determines a lead/lag days of (134.76).

29 Pages 3-5 of 5 of Rebuttal Exhibit MAM-9 incorporates the (134.76) days for  
30 gross receipts tax into the working capital working papers – TRA-01-Q13-REVISED  
31 WORKING CAPITAL, pages 1-3.

1 As shown on Rebuttal Exhibit-9, page 4 of 5, is that the resulting lead/lag working  
2 capital is \$927,000. Rebuttal Exhibit-9, page 3 of 5 is then revised to show a total  
3 Working Capital of \$1,275,258.  
4

5 Q. WHAT IS THE IMPACT OF THE CORRECTION TO THE SERVICE PERIOD FOR  
6 GROSS RECEIPTS TAX ON THE WORKING CAPITAL REQUESTED IN THE  
7 COMPANY'S FILING?

8 A. The result of this correction increases the Company's working capital by \$264,000 and  
9 not a reduction of \$328,178 as suggested by Mr. Gorman.  
10

11 Q. WHAT IS YOUR RECOMMENDATION FOR WORKING CAPITAL IN THIS CASE?

12 A. The Company's lead/lag study should be accepted in this proceeding for use in  
13 developing the lead/lag portion of the Working Capital. As discussed above, neither Mr.  
14 Buckner nor Mr. Gorman have provided any justifiable reasoning or have made a  
15 credible argument to support a change in the lead/lag days included in the lead/lag study.  
16 Mr. Gorman's proposal to eliminate the unamortized debt expense should not be accepted  
17 if double leverage is utilized in the capital structure on which rates are established in this  
18 proceeding. As shown above, Mr. Buckner's proposal to reduce deferred rate case  
19 expense is not supported by the recent Court of appeals decision. My recommendation is  
20 that working capital for this case should be \$1,275,258 as amended by this testimony.  
21

## 22 RATE BASE

23  
24 Q. WHAT RATE BASE IS THE COMPANY RECOMMENDING BASED ON ITS  
25 REBUTTAL TESTIMONY?

26 A. The Company is recommending a rate base of \$124,799,780 as shown on Rebuttal  
27 Exhibit MAM-9. This level of rate base is predicated on the assumption that the  
28 Authority will accept the ADIT balance of \$22,638,057 as determined on Rebuttal  
29 Exhibit MAM-7, line 3 under the SFAS 109 approach and not increase the ADITs for the  
30 FIN 48 amount related to the uncertain tax position resulting from the tax accounting  
31 change for capitalized repairs. This recommendation is also predicated on the

1 assumption that the Authority will utilize the normalized pre-tax book income approach  
2 in this case as proposed on Exhibit 1, page 7 of 9 attached to the revised testimony of Mr.  
3 Buckner. This approach will determine the level of income taxes as amended to increase  
4 the income tax expense to properly account for the reversal of the timing difference  
5 related to pre-1981 flow-through property and the AFUDC gross-up, in the amount of  
6 \$623,832 as shown on Rebuttal Exhibit MAM-7. This rate base recommendation of  
7 \$119,579,338 was developed from the rate base of \$114,967,598 as proposed in the  
8 amended testimony of Mr. Buckner, with the insertion of the ADIT balance of  
9 \$22,638,057 shown above, the Company's working capital addressed in the previous  
10 section of this testimony of \$1,275,258, and the Company's CWIP balance of \$4,201,421  
11 based on the rebuttal testimony of Ms. Sheila Miller.

12 In the alternative, if the Authority does not recognize the \$623,832 adjustment  
13 increasing income taxes under the CAPD's approach referenced above, the Company  
14 would recommend the Authority insert an ADIT balance of \$17,153,815 into to the ADIT  
15 line on Rebuttal Exhibit MAM-8 which produces a rate base of \$125,063,580.

## 16 REVENUES

17  
18  
19 Q. PLEASE DESCRIBE THE METHOD THAT THE COMPANY UTILIZED IN  
20 DEVELOPING THE ATTRITION YEAR BILLING DETERMINATES AND GOING-  
21 LEVEL REVENUES IN THIS CASE.

22 A. The Company requested that a bill analysis report be generated that breaks the various  
23 billing determinates down by customer class, meter size, and customer usage for each  
24 tariff block. The Company then analyzes this data to determine the required  
25 normalization adjustments. The historical test-year data is normalized for such items as:

- 26 • Billing routes that were billed more or less than 12 times in the year and  
27 normalizing those to properly reflect the billing determinates for a 365 day period.
- 28 • Customer growth is determined by month and then annualized so that all  
29 customers at the end of the historical test-year reflect a full years billing.

- Large industrial customer usage is reviewed to determine any abnormal billing during the year, adjusted if necessary, and any addition or loss of a large customer during the year is normalized.

The Company also asked Dr. Spitznagel to determine the weather and customer usage trends to determine the normalization factors specific to the historical test-year and apply those factors to arrive at the normalized attrition year billing determinates. Once this is done, the Company adds organic customer growth based on historical average growth rates to arrive at the normalized billing determinates appropriate for the selected attrition year. Finally, the Company applies the currently authorized tariffs to the attrition year billing determinates to calculate going-level revenue for the attrition year.

Calculating attrition year billing determinates and going-level revenues is an extremely time consuming process. Because of the magnitude of data required, the annual bill analysis is only requested in preparation of rate cases. It usually takes two to three weeks to reconcile that data to the per-books revenue, a process that assures that the billing determinates for the historical test-year are correct. It is also very time intensive to then review the raw data to determine the known and measurable normalization adjustments. It takes approximately 45 days from start to finish to complete this area of the case and is the most time-consuming part.

Q. WHAT ARE YOUR COMMENTS ABOUT THE TESTIMONY OF DR. KLEIN REGARDING WEATHER NORMALIZATION?

A. Dr. Klein did not indicate that he performed any analysis or study of the Company's proposal or that of the CAPD or CRMA. As stated in Dr. Spitznagel's rebuttal testimony, he simply references publications that are not relevant to the normalized water sales and revenues for the attrition year in this case.

Q. WHAT ARE YOUR COMMENTS ABOUT THE TESTIMONY OF MR. NOVAK REGARDING WEATHER NORMALIZATION?

A. Dr. Spitznagel has provided rebuttal testimony regarding the shortcomings and inaccuracies of Mr. Novak's claim that there is a lack of statistical correlation of water sales to weather, and I will not attempt to address or repeat Dr. Spitznagel's rebuttal on

1 that topic. I do very much disagree with Mr. Novak's conclusion, however, as stated  
2 later in this testimony.

3 I would also say that Mr. Novak confirms the WNA approach utilized for rate  
4 cases by TAWC did originate from his work as the Company has previously stated. Mr.  
5 Novak indicates that the Staff never accepted the WNA approach used by TAWC,  
6 however, I can find no testimony in the records of the TAWC rate cases through the 2004  
7 rate case where any party took exception with the Company's revenue projections for the  
8 attrition year.

9 It appears to me that, to some extent, the differences of the parties about whether  
10 the WNA approach was or was not used or implicitly accepted by the Authority in setting  
11 the Company's rates has detracted from the real issue in this case. The **critical issues**  
12 should be how best to determine just and reasonable rates for the attrition year and which  
13 method of determining the going-level revenues at present rates best accomplishes that  
14 goal in this case.

15  
16 Q. DID ANY PARTY TO THIS CASE NOT UTILIZE SOME FORM OF  
17 NORMALIZATION TO ARRIVE AT THE SALES FOR THE ATTRITON YEAR?

18 A. Each party to this case which addressed attrition year sales used some form of  
19 normalization to determine the attrition year water sales levels on which to base attrition  
20 year revenues at present rates (the Company, the CAPD and the CRMA). The question  
21 in this case is then not whether some form of normalization of sales should be used but  
22 which method recommended by the parties will be the most accurate for setting just and  
23 reasonable rates.

24  
25 Q. IS ANY FORM OR NORMALIZATION GOING TO PRODUCE THE EXACT  
26 FUTURE ATTRITION YEAR SALES LEVELS?

27 A. No. No party knows with absolute certainty what the weather is going to be next July or  
28 August, what the state of the economy is going to do be, if a large customer is going to  
29 leave or connect to the TAWC system or any other number of variables that could impact  
30 water sales. Each party has to look at some period in the past to establish a basis to  
31 provide appropriate normalized sales levels in the future. Some factors we know are

1 highly likely to occur, such as, the weather is going to be hotter/colder or drier/wetter  
2 than average, or that ongoing trends of declining usage will very likely continue as family  
3 sizes continue to decline and low-flow plumbing devices and household appliances are  
4 retro fitted in existing homes and installed in new homes, or that customer growth  
5 (although very small at TAWC) will likely occur. Because of the inherent uncertainty in  
6 predicting future revenues, the ultimate question to be addressed by the Authority is  
7 which method proposed in this case is the most accurate?

8 As explained later in this testimony, I believe the Authority will realize that the  
9 method proposed by the Company (as supported by the Dr. Spitznagel through a  
10 statistically solid trended usage per customer per day study) is the most accurate of the  
11 sales normalization methods proposed in this case (based on historical data) and thus is  
12 the best method to forecast sales levels in the attrition year for residential and commercial  
13 sales.

14  
15 Q. WHAT WATER SALES NORMALIZATION METHODS ARE PROPOSED BY THE  
16 CAPD AND THE CRMA?

17 A. The CAPD does not use a consistent approach to normalize sales for the test-year. For  
18 some customer classifications, the CAPD uses a seven year average usage trend to arrive  
19 at the normalization adjustments, although this is not consistent for each tariff area within  
20 each customer classification. In other instances they only use the information for the  
21 twelve months ended September 2010.

22 The CRMA, through its witness Mr. Gorman, recommends that a five year  
23 historical average of the years through 2009 be used. Mr. Gorman did not include the  
24 more recent information supplied by the Company through September 2010 in its  
25 analysis.

26  
27 Q. DO YOU AGREE WITH THE CAPD'S NORMALIZATION APPROACH?

28 A. No, for the following reasons:

- 29 • As addressed more fully in Sheila Miller's testimony, the CAPD does not use a  
30 consistent approach and the information provided with Mr. Hughes' testimony  
31 that the CAPD relies on to base its recommendation for attrition year sales levels

contains many errors. The impact of those errors increases the CAPD's attrition year revenues by \$227,903. The lack of a consistent methodology leaves open the possibility for inaccuracies and manipulation of the method in arriving at the attrition year normalized sales levels.

- The CAPD did not properly normalize each historical year used in the trending analysis for the actual customers at the end of each year, the changes in customer usage patterns, routes billed more or less than 12 times in the test-year, or the variances in actual billed days generated through each year's meter reading schedule, to name a few.
- By not isolating the impact of weather in their trending they do not properly incorporate the on-going trend of declining usage that is being caused by such known items as smaller family size and the more prevalent use of low flow plumbing and household appliances.

Q. DID DR. SPITZNAGEL DEVELOP A TRENDING ANALYSIS THAT ISOLATES USAGE TREND AFTER THE PROPER WEATHER IMPACTS WERE DETERMINED FOR EACH YEAR?

A. Yes. That trend for the residential and commercial customer classifications is shown on Rebuttal Exhibits ELS-1 and 2. Those trending graphs show a steady decline in the per customer usage for the residential and commercial classification. This information is consistent with the Company's internal analysis of declining trends, which it uses in developing budgets and forecasts.

Q. DID THE TRA ADDRESS THE CAPD'S METHODOLOGY FOR FORECASTING RESIDENTIAL AND COMMERCIAL AVERAGE USAGE PER CUSTOMER PER DAY IN ITS ORDER IN THE 2008 RATE CASE?

A. Yes. The TRA stated in the 2008 rate case Order that "the panel found neither the Company's nor the Consumer Advocate's methodology for forecasting residential and commercial average usage persuasive." The Company would suggest the CAPD has not changed its method of forecasting attrition year residential and customer usage from that proposed in the 2008 TAWC Rate Case, and will show the CAPD's methodology is not

1 the most accurate method for forecasting the attrition year sales levels later in this  
2 testimony.

3  
4 Q. DO YOU AGREE WITH MR. GORMAN'S NORMALIZATION APPROACH?

5 A. Mr. Gorman based his recommendation for residential and commercial attrition year  
6 customer usage on a simple average of the years 2005-2009. This recommendation is  
7 flawed for the following reasons:

- 8 • Mr. Gorman's five year average is of such short duration that it does not properly  
9 normalize for weather.
- 10 • Mr. Gorman's five year average does not account for the declines in average  
11 usage, such as, declining family size and the impacts from the more prevalent use  
12 of low-flow plumbing and household appliances which tend to overstate his  
13 normalization results.
- 14 • Mr. Gorman did not properly normalize each historical year used in the historical  
15 average for the actual customers at the end each year, changes in customer usage  
16 patterns, routes billed more or less than 12 times in the test-year, or the variances  
17 in actual billed days generated through each year's meter reading schedule, to  
18 name a few.

19  
20 Q. WHAT OTHER COMMENTS DO YOU HAVE ABOUT MR. GORMAN'S  
21 PROPOSAL?

22 A. In reviewing Mr. Gorman's testimony in this case and in the Company's 2008 Rate Case  
23 I noticed that he proposed a three-year historical average in the previous case. It struck  
24 me as odd that he did not include the latest historical period for the 12-months ending  
25 September 2010, which was provided to the parties in this case, in his analysis of  
26 historical usage. I calculated what the three year average for the years ending September  
27 2010, December 2008 and December 2009, and arrived at an average usage per  
28 residential customer per day of 141.4 and an average usage per commercial customer per  
29 day usage of 1,008.3. Notably, the three year average based on the latest available data is  
30 significantly lower than his recommendation of 144.2 gallons per residential customer per



1 day and 1,033.6 gallons per commercial customer per day he is recommending in this  
2 case.

3  
4 Q. DID THE TRA ADOPT MR. GORMAN'S UNADJUSTED THREE YEAR AVERAGE  
5 HISTORICAL USAGE AVERAGE METHODOLOGY IN ITS ORDER IN THE 2008  
6 TAWC RATE CASE?

7 A. No.

8  
9 Q. YOU STATED EARLIER IN THIS TESTIMONY THAT YOU WOULD ADDRESS  
10 THE ACCURACY OF THE PARTIES' VARIOUS METHODOLOGIES OF  
11 CALCULATING CUSTOMER USAGE AND REVENUES BY COMPARING THESE  
12 METHODOLOGIES TO ACTUAL HISTORICAL DATA TO DETERMINE WHICH  
13 METHODOLOGY BEST PREDICTS ATTRITION YEAR RATES. HAVE YOU  
14 PERFORMED SUCH AN ANALYSIS?

15 A. Yes. I have developed and attached the results of that analysis to this testimony, which  
16 identified as Rebuttal Exhibit MAM-10.

17  
18 **Residential Customer Analysis (pages 1 and 2 of Rebuttal Exhibit MAM-10)**

19  
20 Q. WHAT INFORMATION IS CONTAINED ON REBUTTAL EXHIBIT MAM-10,  
21 PAGES 1 AND 2?

22 A. I have provided graphs that show the actual residential sales levels for both the "average  
23 usage per customer per day" and total residential sales for the calendar years 2004-2009  
24 and the twelve month period ending September 30, 2010 (the graph shows the actual  
25 number in the color blue). I have also provided the level of sales on which the  
26 Company's rates have been established for each period (shown in the color yellow). I  
27 have also provided the attrition year projections of the CAPD and CRMA for the periods  
28 available to me (the CAPD projections are shown in the color green and the CRMA  
29 projections shown in the color light blue). I have also shown the projections used by the  
30 Company based on Dr. Spitznagel's weather and customer usage studies to forecast  
31 future water sales levels (shown in the color pink).

1  
2 Q. HOW DID THE PROJECTIONS OF THE CAPD, THE CRMA, THE COMPANY,  
3 AND THE TRA (BASED ON THEIR FOUR YEAR AVERAGE ADOPTED IN THE  
4 2008 RATE CASE) COMPARE TO ACTUAL RESULTS?

5 A. I will focus my response on the information on Rebuttal Exhibit MAM-10, page 1 of 4  
6 since it is the average usage per customer per day which has been used to determine the  
7 attrition year residential sales levels on which to base revenues at current rates in prior  
8 Company rate cases. The results of the comparison are as follows:

- 9 • The graph on Rebuttal Exhibit MAM-10, page 1 of 4, shows the CAPD's  
10 projections (green) beginning in 2007. The actual results on an average usage  
11 per customer per day basis only exceed the CAPD's forecast in 2007, one of the  
12 hottest/driest years on record for the Chattanooga area. The projections of the  
13 CAPD are significantly higher than the actual results for 2008, 2009 and the 12  
14 months ending September 2010 – the historical test-year proposed by the CAPD  
15 in this case. The projections by the CAPD, if accepted by the TRA, would not  
16 provide a 50/50 change that the revenues in a given year would have been higher  
17 or lower than the level on which rates were established, and would not have  
18 provided the Company a fair and reasonable opportunity to achieve its authorized  
19 cost of capital.
- 20 • The same graph shows the CRMA's projections (light blue) for 2009 and 2010 as  
21 recommended by Mr. Gorman in the 2008 Rate Case based on his simple three-  
22 year historical average. Again, these projections were well above the actual  
23 levels for 2009 and the 12-months ended September 30, 2010 (as well as being  
24 higher than the CAPD and TRA's projections). As stated earlier, the use of a  
25 simple unadjusted average to determine attrition year sales is not an accurate  
26 method as the historical data on Rebuttal Exhibit MAM-10, page 1 demonstrates.
- 27 • I have also provided on the graph (in yellow) the residential sales levels on which  
28 the Company's rates were established. The yellow line and Dr. Spitznagel's  
29 projections are the same for the period 2004-2008 because the Company believes  
30 that level represents the level on which rates were established. I am not showing  
31 this information to again raise a dispute about where the WNA was used or not,

1 but only to show the actual data compared to the level on which rates were  
2 established. In only one year of that five year period did actual sales per  
3 residential customer per day exceed the level on which rates were established,  
4 that being the heavy drought year of 2007. However, the actual sales levels were  
5 very close in both 2006 and 2008. Thus, history tells us the sales during the  
6 period of 2004-2008 have a near equal chance of being higher or lower than  
7 normal using that methodology. However, the graph shows that the same is not  
8 true for the period of 2009-2010. For that period the graph demonstrates that the  
9 TRA's short-term historical average was not an accurate predictor of future  
10 attrition year water sales levels.

- 11 • I have shown the Company's projections using Dr. Spitznagel's statistical WNA  
12 and other customer trend study on the graph (pink). Over the seven yearly  
13 periods from 2004 through September 2010, actual sales levels exceeded the  
14 forecast in two years (2007 and 2010) and the overage for 2010 was very minor.  
15 Actual sales levels were under the forecast in five of the seven historical periods,  
16 although the actual results were very close in 2006, 2008 and 2009.

17  
18 Q. WHAT IS YOUR CONCLUSION FROM THE DATA PROVIDED ON REBUTTAL  
19 EXHIBIT MAM-10, PAGE 1?

20 A. It is clear to me that the Company's forecasts using Dr. Spitznagel's studies have been  
21 the **most** accurate when compared to the actual usage data that came after the projections  
22 were made. The trending method utilized by the CAPD and the simple historical average  
23 method utilized by Mr. Gorman have been proven **not to be the most accurate**  
24 predictors of the future sales levels for all the reasons provided earlier in this testimony  
25 and as shown on the exhibit.

26  
27 **Commercial Customer Analysis (pages 3 and 4 of Rebuttal Exhibit MAM-10)**

28  
29 Q. WHAT INFORMATION IS CONTAINED ON EXHIBIT MAM-10, PAGES 3 OF 4?

30 A. Exhibit MAM-10 pages 3 of 4 is a graph that shows the actual commercial sales levels  
31 for both the "average usage per customer per day" and total commercial sales for the

1 calendar years 2004-2009 and the twelve month period ending September 30, 2010 (the  
2 graph shows the actual number in the color blue). I have also provided the level of sales  
3 on which the Company's rates have been established for each period (shown in the color  
4 yellow). I have also provided the attrition year projections of the CAPD and CRMA for  
5 the periods available to me (the CAPD projections are shown in the color green and the  
6 CRMA projections shown in the color light blue). I have also shown the projections  
7 used by the Company based on Dr. Spitznagel's weather and customer usage studies to  
8 forecast future water sales levels (shown in the color pink).

9  
10 Q. HOW DID THE PROJECTIONS OF THE CAPD, THE CRMA, THE COMPANY,  
11 AND THE TRA COMPARE TO ACTUAL RESULTS?

12 A. I will focus my response on the information on Rebuttal Exhibit MAM-10, page 3 of 4  
13 since it is the average usage per customer per day which has been used to determine the  
14 attrition year commercial sales levels on which to base revenues at current rates in prior  
15 Company rate cases.

- 16 • The graph on Rebuttal Exhibit MAM-10, page 3 of 4, shows the CAPD's  
17 projections (green) beginning in 2007. The actual results on an average usage  
18 per customer per day basis exceed the CAPD's forecast in 2007 and 2008, with  
19 2007 being one of the hottest/driest years on record for the Chattanooga area.  
20 The projections of the CAPD are significantly higher than the actual results for  
21 2009 and the 12 months ending September 2010, the historical test-year proposed  
22 by the CAPD in this case. Also, there is a wide fluctuation in the CAPD's  
23 projections for commercial usage, a variance level that would be of concern to  
24 the Company if it were utilized in setting rates.

- 25 • The same graph shows the CRMA's projections (light blue) for 2009 and 2010 as  
26 recommended by Mr. Gorman in the 2008 Rate Case based on his simple three-  
27 year historical average. Again, these projections were well above the actual  
28 levels for 2009 and the 12-months ended September 30, 2010. As stated earlier,  
29 the use of a simple unadjusted average to determine attrition year sales is not an  
30 accurate method on which to project a future attrition year usage level, as proven  
31 by reviewing the historical data on Rebuttal Exhibit MAM-10, page 3.

- I have also provided on the graph (in yellow) the commercial sales levels on which the Company's rates were established. The yellow line and Dr. Spitznagel's are the essentially the same for the period 2004-September 2010 because the Company believes that level represents the level on which rates were established. In three years actual sales exceed the projection, three years actual sales were below the projection, and one year was essentially the same. I would say history tells us the actual sales during that seven year period had a near equal chance of being higher or lower than normal based on this methodology. I would note that the TRA established rates in the 2008 Rate Case using the Company's projections (not methodology) and that has proven to be very accurate compared to the four year historical average used in establishing the residential sales levels in the 2008 Rate Case
- I have shown the Company's projections using Dr. Spitznagel's statistical WNA and other customer trend study on the graph (pink). Over the seven yearly periods from 2004 through September 2010 actual sales levels exceeded the forecast in three years (2005-2007). Actual sales levels were under the forecast in two of the seven historical periods, and for two years the actual sales and projections were nearly the same.

Q. WHAT IS YOUR CONCLUSION FROM THE DATA PROVIDED ON REBUTTAL EXHIBIT MAM-10, PAGE 3?

A. It is clear to me that the Company's forecasts using Dr. Spitznagel's studies have been the **most** accurate when compared to the actual usage data that came after the projections were made. The trending method utilized by the CAPD and the simple historical average method utilized by Mr. Gorman have been proven **not to be the most accurate** predictors of the future sales levels for all the reasons provided earlier in this testimony.

Q. WHAT ARE YOUR RECOMMENDATIONS REGARDING WHICH PROJECTIONS ARE THE MOST ACCURATE FOR DETERMINING THE RESIDENTIAL AND COMMERCIAL CLASSIFICATIONS SALES LEVELS AND CORRESPONDING REVENUES FOR THE ATTRITION YEAR IN THIS CASE?

1 A. Based on the analysis provided in Rebuttal Exhibit MAM-10, it is clear to me that the  
2 Company's projections of the residential and commercial water sales levels for the  
3 attrition year have proven to be the most accurate method when compared to actual sales  
4 levels. Both the trending method used by the CAPD and the simple historical average  
5 methodologies used by the CRMA have been proven to be for less accurate when  
6 compared to actual results. It is my recommendation that based on this analysis the  
7 Authority adopt the Company attrition year water sales projections and corresponding  
8 revenues for use in establishing fair and reasonable rates in this proceeding. This  
9 recommendation would provide an equal opportunity for the actual sales in the attrition  
10 year to be either higher or lower than the projection, which is fair to both the customers  
11 and the Company.  
12

13 **Revenue True-up Mechanism**  
14

15 Q. DO YOU AGREE WITH MR. BUCKNER'S COMMENTS REGARDING A  
16 DECOUPLING MECHANISM?

17 A. No. Mr. Buckner obviously does not like the idea of a revenue true-up mechanism.  
18 Based on the discussion above about the accuracy of the CAPD's revenue projections in  
19 past Company rate cases, I can understand why. It is obvious that the CAPD's revenue  
20 projections would have overstated going-level revenues. As I said in my Direct  
21 Testimony, the Company's lower revenues since the 2008 Rate Case order compared to  
22 the level on which current rates were established is a major driver of the level of rate  
23 increase requested in this rate case.

24 It appears that the CAPD desires to set rates on going-level attrition year revenues  
25 at a level where the odds are not evenly balanced for the Company and the customer in a  
26 given year. Under the CAPD's position, the Company would never have a 50/50 chance  
27 that revenues in any given year would be higher or lower than in a normal weather year.  
28 Rather, the Company's revenues would have a much higher change of being lower than  
29 the level embedded in current rates. This is exactly the situation the Company has been  
30 expected to operate under in 2009 and 2010, lower revenues than the true cost of service.  
31 The Company then has little choice but to operate with less employees than it needs and

1 curtail and cut back on needed capital improvements. Of course the CAPD then latches  
2 on to the vacancy rates and lower capital spending as their justification to hold down  
3 costs in this case.

4 In the Company's opinion this is a vicious cycle that is not in the best long-term  
5 interest of the customers or the Company. This cycle the CAPD seems to want to impose  
6 on the Company shows up clearly in the overall financial positions of the Company as  
7 discussed earlier in this testimony and demonstrated on Rebuttal Exhibits MAM-1 and 2.

8  
9 Q. HOW DOES MR. BUCKNER DESCRIBE THE REVENUE TRUE-UP MECHANISM  
10 IN HIS TESTIMONY?

11 A. On page 61, he appropriately indicates that regulation affords an "opportunity" to earn a  
12 just and reasonable rate of return. Mr. Buckner then goes on to indicate that "a revenue  
13 true-up mechanism guarantees a utility a fixed level of revenue with the ratepayers acting  
14 as the insurer for a substantial amount of the business risk". On the following page, Mr.  
15 Buckner goes on to say that "TAWC would be immune to all manner of economic risks  
16 that formally effected revenues", and that "in his opinion, a decoupling mechanism can  
17 further erode the incentive for a utility to control operating costs."

18  
19 Q. DO YOU AGREE WITH THE VIEWS EXPRESSED BY MR. BUCKNER?

20 A. No. Mr. Buckner seems to believe that a utility has an incentive to increase costs and that  
21 can be controlled by setting their rates on revenues so that they do not have a likely  
22 chance of receiving rates that are effective.

23 This is a strange view of the concept of "a fair opportunity to achieve the cost of  
24 capital of companies with similar risk" as established under *Bluefield* and *Hope*.  
25 Unfortunately, to some extent the Company has found itself in exactly this position over  
26 the last two years. Its revenues can not support the costs it needs to maintain proper  
27 service and investment levels, and the Company had little choice but to take actions not  
28 in the best long-term benefit of the customers or the Company. Even with those actions  
29 taken by the Company to cut-back on needed operating expenses and capital investment,  
30 the Company was only able to achieve an ROE of 2.8% in 2009 and 2.66% in 2010.

1 Q. WHAT IS YOUR RECOMMENDATION ABOUT A REVENUE TRUE-UP  
2 MECHANISM?

3 A. The Company believes that a revenue true-up mechanism would be an innovative and  
4 proper approach for the Authority to adopt in this case. There always seems to be  
5 concern by the Authority that the Company is going to over-earn, particularly in setting  
6 rates under the Company's proposed methodology.

7 As stated earlier, the Company believes its projections for the attrition year in this  
8 case would provide a balanced risk that actual revenues in the attrition year would be  
9 higher or lower than the level on which rates will be established in this case. Likewise, a  
10 revenue true-up mechanism would provide an equal risk that the Company would return  
11 higher revenues than the level established as the risk that the customers would have to  
12 repay a shortfall. I understand it's the CAPD's mission to protect the customer, but it's  
13 the Authority's mission to balance the interests of the customer and the Company within  
14 the guidelines established in *Bluefield* and *Hope*. The Company believes that the  
15 Authority can do so by adopting a revenue true-up mechanism.

16 Any required true-up could be handled by filing with the Authority to handle the  
17 true-up, or the Authority could permit the Company a balancing account treated as a  
18 regulatory asset/liability for the over/under collection of revenue to be trued-up in the  
19 next general rate filing. Either method is acceptable to the Company.

20  
21 **UNACCOUNTED FOR WATER**  
22

23 Q. DID THE CAPD AND MR. GORMAN MAKE ADJUSTMENTS TO PRODUCTION  
24 COSTS BASED ON ADJUSTMENTS TO SYSTEM DELIVERY FOR  
25 UNACCOUNTED FOR WATER?

26 A. Yes. Both the CAPD and CRMA proposed to reduce the system delivery on which the  
27 Company based its production costs for the attrition year by capping unaccounted for  
28 water ("UFW") at 15%.

29  
30 Q. DID THE AUTHORITY ESTABLISH CURRENT RATES ON A 15% LIMIT FOR  
31 UNACCOUNTED WATER IN THE COMPANY'S 2008 RATE CASE?



1 A. Yes. However, I would respectfully ask that the Authority reconsider its limit in this  
2 case.

3  
4 Q. WHY SHOULD THE AUTHORITY RECONSIDER ITS DECISION TO IMPOSE A  
5 HARD LIMIT ON UNACCOUNTED FOR WATER IN ESTABLISHING RATES IN  
6 THIS CASE?

7 A. The Company does not disagree that it should strive to meet a target of 15% for UFW.  
8 However, the Company's production expense for recovery should not be limited to a  
9 target the Company can not meet at this time without a major increase in its investment in  
10 main replacements. While the Company's UFW is currently above the 15% target, the  
11 Company's actual UFW is not out of line with other water providers in the state of  
12 Tennessee as outlined in the rebuttal testimony of Mr. Watson. In order to determine if  
13 the Company's UFW is excessive, a study must and should be done which takes into  
14 consideration the variances in operating conditions of the Company for items such as:  
15 terrain, operating pressures, age of mains and service lines, customer density and other  
16 factors, and then compare or benchmark those statistics to those of other water systems in  
17 Tennessee with similar operating conditions. Neither the CAPD nor Mr. Gorman has  
18 provided any basis for the limit of 15% UFW for rate recovery. Rather, they have just  
19 arbitrarily set the standard for rate making without any consideration of the Company's  
20 targeted UFW or of how TAWC compares to other Tennessee water providers. They  
21 have also ignored the impact on rates of the capital cost that will be needed to lower  
22 TAWC's UFW ratio.

23  
24 Q. HAVE OTHER REGULATORY AGENCIES ESTABLISHED TARGETS WHEREBY  
25 UNACCOUNTED FOR WATER RATIOS WOULD BE EXCESSIVE?

26 A. Yes. The Tennessee Utility Management Review Board has determined that UFW in  
27 excess of 35% is excessive.<sup>6</sup> It is my understanding that this organization has jurisdiction  
28 over the publicly held water and wastewater districts in Tennessee.

29  

---

<sup>6</sup> See the response to discovery request TN-CMA-01-Q6, and TN-TRA-02-Q133.

1 Q. DOES THE COMPANY AGREE WITH LIMITING RATE RECOVERY TO THE 15%  
2 CAP ON UFW FOR SETTING RATES IN THIS CASE?

3 A. No. Setting rates on a UFW ratio that is not been demonstrated to be excessive or out of  
4 line with other Tennessee water providers is not reasonable. This is particularly true  
5 when no consideration is given to the impact on the customers' rates that will occur due  
6 to the capital costs that would have to be deployed to remediate the UFW ratio to the  
7 15% target. I have been involved with several studies regarding UFW in other states and  
8 each of those studies has indicated that the cost to the ratepayers to remediate the UFW  
9 ratio will far exceed the savings in production costs.

10 In fact, the arbitrary cap of 15% on UFW in this case would be counter-  
11 productive. It only results in an erosion of the Company's earnings which perpetuates the  
12 Company's inability to attract the capital needed to address the UFW remediation plan, as  
13 demonstrated earlier in this testimony (See Rebuttal Exhibit MAM-2)

14  
15 Q. HAS THE LEVEL OF UNACCOUNTED FOR WATER BEEN AN ISSUE IN OTHER  
16 RATE CASES IN WHICH YOU HAVE BEEN INVOLVED?

17 A. Yes. The Consumer Advocate Division of the West Virginia PSC advocated a 15% cap  
18 on UFW for rate recovery in case number 07-0998-W-42T. There was a significant  
19 amount of testimony from the parties on this subject. The case ended in a settlement.  
20 However, the rates of WVAVC did include its full production costs under the Settlement  
21 Agreement. The Settlement Agreement specifically addressed the issue of UFW. The  
22 parties to the Stipulation agreed that the Company shall engage an independent consultant  
23 to study and submit a written report with recommendations for a comprehensive plan to  
24 reduce unaccounted for water and that the report shall include estimates of capital  
25 expenditures necessary to achieve quantifiable improvement. The engagement by the  
26 Company of the consultant was subject to several conditions, such as: (i) the submittal to  
27 the parties of an RFP with a list of potential consultants, (ii) intervenor participation and  
28 comments on the RFP and the list of consultants, (iii) concurrence from the intervening  
29 parties before the RFP would be issued, (iv) a review by the parties to the RFP and

1 consultant selection, (v) a due date for the report, (vi) recovery of the Study cost in  
2 subsequent rate cases of WVAWC, and (vii) other minor conditions.<sup>7</sup>

3  
4 Q. WAS THE REPORT REGARDING THE REMEDIATION PLAN FOR WEST  
5 VIRGINIA AMERICAN WATER COMPANY UFW PERFORMED?

6 A. Yes. The Report was issued in May 2008. The report indicated that WVAWC's current  
7 rate of main replacement was approximately 600 years and should be replaced on a 100  
8 year cycle. The Report identified the cost to undertake the escalation of main, service  
9 line and meter replacements identified the resulting cost savings in production costs from  
10 remediating the UFW level.

11  
12 Q. WHAT ACTIONS DID THE COMPANY TAKE AFTER COMPLETION OF THE  
13 WATER LOSS REPORT?

14 A. In its 2008 WVAWC Rate Case<sup>8</sup>, the Company proposed increased capital costs to  
15 address the remediation of its UFW level in a reasonable manner that would balance the  
16 Company's need for additional capital investment and the rate impact (net of production  
17 cost savings). WVAWC demonstrated the additional costs to the rate payers that would  
18 occur from the UFW remediation plan, but did so in a manner that would not be  
19 burdensome on the customers. The rate recovery issues surrounding the  
20 recommendations of the WVAWC Water Loss Study have now moved to the next stage –  
21 the proposal for a Distribution System Improvement Surcharge in the current WVAWC  
22 2010 Rate Case<sup>9</sup> of the WVAWC. The 2010 WVAWC rate case is still pending a final  
23 order.

24  
25 Q. BASED ON YOUR DISCUSSION ABOVE REGARDING UFW, WHAT IS YOUR  
26 CONCLUSION AND RECOMEMNNATION?

27 A. I do not believe the Authority should set a hard cap of 15% for UFW in setting rates, a  
28 target that TAWC can not currently meet without significant additional capital costs and  
29 additional costs to its customers. The Company does not object to the TRA's

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<sup>7</sup> Final Order of the WV PSC in case number 07-0998-W-42T, attached Stipulation of Settlement, pages 6-8)

<sup>8</sup> Case number 08-0900-W-42T, Petition of West Virginia American to increase rates before the WV PSC.

<sup>9</sup> Case number 10-0920-W-42T, Petition of West Virginia Ameican to increase rates before the WV PSC.

1 establishment of 15% UFW as a reasonable target for TAWC to strive to meet in a  
2 reasonable and responsible matter, with the impact on customer rates taken into account.

3 I recommend that the Authority instruct TAWC to undertake a Water Loss Study  
4 similar to that undertaken by WVAWC in 2008 that addresses the level of UFW and the  
5 additional capital investment required to remediate the level of UFW I recommend that  
6 the Authority permit the Company to record the cost of that Study as a regulatory asset,  
7 in order to address the cost of that Study in its next general rate case. I recommend that  
8 the Authority instruct the Company to include the costs of a reasonable remediation plan  
9 for the level of UFW in order to address the impact on customer rates. I believe this  
10 recommendation will put into place a process to improve the UFW ratio at TAWC in a  
11 manner fair to the customers future rates and in a manner that does not punitively deprive  
12 the Company of production costs.

#### 13 14 **RATE CASE EXPENSE** 15

16 Q. WHAT LEVEL OF RATE CASE EXPENSE DID THE COMPANY REQUEST IN  
17 THIS CASE?

18 A. The calculation of the Company's rate case expense was provided in the Company's  
19 workpapers attached to its response to discovery request TRA-01-Q13 – REGULATORY  
20 EXPENSE, Page 1 of 1. The Company included an estimate for the cost of this case of  
21 \$645,000, and requested a 3 year amortization. The Company included the unamortized  
22 balance of the cost of its 2006 rate case<sup>10</sup> at the beginning of the attrition year of \$65,579  
23 (amortization of the 2006 Rate Case costs will end in September 2011. The Company  
24 included the unamortized balance of the of its 2008 Rate Case<sup>11</sup> costs at the beginning of  
25 the attrition year of \$68,750 (amortization of the 2008 costs will end in September 2011).  
26 The Company included an estimate of the cost of service study for this case of \$42,500 to  
27 be amortized over 3 years. The Company included the unamortized balance of the 2008  
28 cost of service study<sup>12</sup> at the beginning of the attrition year of \$8,596 (amortization of the

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<sup>10</sup> TRA Order in docket number 08-00039, at page 25. The TRA instructed TAWC to amortize the remaining balance for the 2006 Rate Case costs over a new three year period in that Order.

<sup>11</sup> Id.

<sup>12</sup> TRA Order in docket number 08-00039, at page 25. The TRA instructed TAWC to amortize the cost for the

1 2008 cost of service study costs will end in September 2011). The Company included the  
2 unamortized balance of the 2008 depreciation study<sup>13</sup> at the beginning of the attrition  
3 year of \$7,826 (amortization of the 2008 depreciation study costs will end in September  
4 2011). The total of the amortization of these costs in the attrition year is \$379,918 for the  
5 attrition year per the Company's original filing in this case.  
6

7 Q. WHAT DID THE CAPD WITNESSES RECOMMEND?

8 A. Mr. Buckner recommends that rate case cost in this case should be set at \$195,284. He  
9 makes adjustments to reduce the Company's request for the amortization of the 2006 rate  
10 case cost, eliminate the cost for the Cost of Service Study for TAWC performed by Mr.  
11 Hebert in this case, and permit only the amortization of one-half of the Company's  
12 estimate of the cost of the current 2010 Rate Cost. I would note as provided in the  
13 testimony in the Q&A above, the Authority instructed the Company to amortize the cost  
14 of the 2006 Rate Case over a new three year period beginning with the effective date of  
15 the rates authorized in the 2008 Rate Case. The CAPD's position concerning the cost of  
16 the Cost of Service Study and the cost of this proceeding will be addressed later in this  
17 testimony.  
18

19 Q. DO YOU HAVE A RESPONSE TO THE COMMENTS MADE IN MR. BUCKNER'S  
20 TESTIMONY ABOUT RATE CASE EXPENSE?

21 A. I addressed some of those comments earlier in this testimony, particularly the comments  
22 of Mr. Buckner indicating "the Company's level of rate case expense indicating the  
23 Company is not soundly managed." He appears to base this comment on the \$2,766,525  
24 of regulatory expense provided in response to TN-CAPD-01-Part III-Q70. This amount  
25 included the amount of rate case expense the Company had to write-off to expense in  
26 September 2008 after the Authority's decision in the 2008 Rate Case<sup>14</sup> and the  
27 Company's expenses related to the appeal of the 2006 Rate Case Order by the City of  
28 Chattanooga and the Company's appeal of the 2008 Rate Case Order, costs which the

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2008 cost of service over a three year period in that Order.

<sup>13</sup> TRA Order in docket number 08-00039, at page 25. The TRA instructed TAWC to amortize the cost for the 2008 depreciation study over a three year period in that Order.

<sup>14</sup> The ruling of the Tennessee Court of Appeals in case number M2009-00553-COA-R12-CV of January 28, 2011, at page 28, awarded TAWC the portion of the 2008 Rate Case Expense disallowed by the TRA.

1 Company did not include in its original filing in this case. The Company takes exception  
2 to Mr. Buckner's portrayal of the Company's actions to defend its right for fair and  
3 reasonable rates as an "unsound management" practice.

4 Mr. Buckner goes on to assert that the Company's rate case costs are for the  
5 shareholders' interest to the detriment of the customers. Again, TAWC strongly  
6 disagrees with this portrayal of the rate case process that TAWC must undergo as a  
7 regulated utility. It appears that Mr. Buckner does not fully appreciate the Regulatory  
8 Compact contained in the Bluefield and Hope decisions. When the Company's (or for  
9 that matter any utility's) revenues do not adequately meet the reasonable cost of  
10 providing the service (after efforts to reduce costs where possible) then the Company has  
11 no other option but to seek rate relief before the Authority. It is this part of the  
12 Regulatory Compact that Mr. Buckner appears to have missed. I have covered earlier in  
13 this testimony the Company's perspective regarding why the cost of this case and prior  
14 Company rate cases are higher than in other states, and how the process for a rate case in  
15 Tennessee is different than in other states. The CAPD and the other parties to this case  
16 do in fact play a large role in driving up the cost of a rate case for TAWC.

17 A rate case, contrary to Mr. Buckner's assertion, does not inappropriately benefit  
18 the Company's shareholders. A rate case only establishes rates to provide the Company a  
19 reasonable opportunity (not a guarantee) to earn its cost of capital (a legitimate cost of  
20 providing service). A rate case or rate increase does not provide a benefit to the  
21 shareholders other than their right to an opportunity to achieve a fair return on their  
22 significant investment.

23 The Company also believes setting rates at an appropriate cost of providing the  
24 service is not in the best long-term interest of the customer. It is not in the best long-term  
25 interest of the customer to place this Company in the unenviable financial position as  
26 shown in Rebuttal Exhibits MAM-1 and 2. Setting rates artificially low will only lead to  
27 the Company's inability to attract capital at reasonable rates and will eventually lead to  
28 inadequate service, which is a result I am sure neither the Company's customers nor the  
29 CAPD would accept.  
30

1 Q. DOES THE COMPANY HAVE A BETTER COST OF THIS RATE CASE BASED ON  
2 THE TRAVEL OF THIS CASE TO DATE?

3 A. Yes. I have provided that update as Rebuttal Exhibit MAM-11. Based on the decision of  
4 the Tennessee Court of Appeals the Company is proposing that the \$275,000 of rate case  
5 expense disallowed by the Authority in docket number 08-00039 be included in the  
6 attrition year as a period cost. The Company has absorbed that cost since September  
7 2008 and recovery of that amount in the attrition year would, in the Company's opinion,  
8 satisfy the decision of the Tennessee Court of Appeals.

9 I have also updated the Company's expected cost of this case from the \$645,000  
10 estimate provided in the Company's original filing to a cost of \$1,240,492. Rebuttal  
11 Exhibit MAM-11 updates the estimate of the cost of this case by starting with the actual  
12 costs as of January 31, 2011 and including the additional legal cost in anticipation of a  
13 full evidentiary hearing in Chattanooga, the additions of costs for the witnesses' rebuttal  
14 testimony, including new rebuttal witnesses that were not anticipated but are now  
15 necessary based on the issues raised by the CAPD and the City in their testimony. The  
16 Company believes this updated estimate reflects the Company's required and reasonable  
17 costs to process this case based on the level of discovery raised by the intervenors, the  
18 number of discovery disputes, the increase in the number of intervenors, the number of  
19 issues raised and addressed in the testimony of the intervenors, and moving the  
20 evidentiary hearing to Chattanooga.

21  
22 Q. DOES THE COMPANY AGREE WITH THE CAPD'S PROPOSAL TO ELIMINATE  
23 THE COST OF THE COMPANY'S COST OF SERVICE PREPARED AND FILED IN  
24 THIS CASE?

25 A. No. The Company certainly understands that the CAPD disagrees with the results of the  
26 Cost of Service Study ("COSS"). The COSS shows that the residential customers are  
27 paying significantly less than their "true" cost of service. It is also obvious that the  
28 CAPD would not oppose an across the board increase (at whatever level the Authority  
29 determines appropriate in this case) because that is in the best interest of the residential  
30 customers the CAPD represents. However, while Mr. Gorman and Mr. Herbert have  
31 slight differences in their methodologies (as addressed in the rebuttal testimony of Mr.

Herbert), the CRMA has a competing interest to the CAPD regarding how the cost of service is allocated. The CRMA obviously wants to protect the interest of the commercial and industrial customers they represent. The Company believes providing a COSS that demonstrates how current and proposed rates compare to the “true” cost of service is information that the Authority should have in making its decision about fair and reasonable rates in this case and how they will allocate the cost of service.

Mr. Herbert’s work is not limited to the cost of service study, but it also includes the generation and testing of those tariffs to assure they produce the revenue requirement as intended. While the CAPD may not agree with the results of the COSS in this case, I am confident that the CRMA is concerned that the rates for the customers they represent move towards the true cost of service. The fact the CAPD does not agree with the COSS result is not a justification for denying the cost of the Study. The Authority, however, should be aware of the disparity between current and proposed revenues and the true cost of providing that service as they undertake their deliberations in this case.

Q. WHAT IS THE AMOUNT OF RATE CASE EXPENSE THE COMPANY IS REQUESTING IN THIS CASE BASED ON THE REVISED ESTIMATE OF THE COST OF THIS CASE AND THE RECOVERY OF THE DISALLOWED COST OF THE COMPANY’S 2008 RATE CASE?

A. The Company’s is requesting that its rate case cost in this case be established at \$847,368 as shown on Rebuttal Exhibit MAM-11.

#### **ANNUAL INCENTIVE PLAN**

Q. WHAT ADJUSTMENTS TO THE COMPANY’S FILING DID THE CAPD MAKE RELATED TO ANNUAL INCENTIVE PLAN COSTS?

A. The CAPD witness eliminated all Annual Incentive Plan (“AIP”) for employees of TAWC in the amount of \$102,646. Mr. Buckner does not specifically eliminate the AIP costs related to AWWSC employee time changed to TAWC in his recommendation to base AWWSC charges (management fees) on the year 2004 plus inflation. However, in his testimony he provides a more surgical approach to the AWWSC costs in an attempt to



1 support his AWWSC cost recommendation in this case. The AWWSC costs and  
2 allocation issues raised in Mr. Buckner's testimony will be addressed later in this  
3 testimony. The AIP is a national plan that applies to all AWW non-hourly employees of  
4 AWW, and the rebuttal testimony on the AIP plan applies to both TAWC costs and  
5 AWWSC costs.

6  
7 Q. DO YOU HAVE COMMENTS ON THE REASONING MR. BUCKNER APPLIES TO  
8 HIS PROPOSED ADJUSTMENT?

9 A. Yes. He makes a number of assertions that will be shown to be incorrect later in this  
10 testimony. Essentially he ties his justification to the following items: (i) the AIP awards  
11 the employees for increasing regulated earnings, (ii) the rate payers have no mechanism  
12 to share in the increased earnings, (iii) the employees and shareholders (only) reap the  
13 benefits, and (iv) TRA precedent. Mr. Buckner goes as far as to say the Company's  
14 efforts to meet the AIP targets bring into play "over earnings". I would note that given  
15 the financial track record of TAWC shown on Rebuttal Exhibit MAM-1, the Company  
16 has not overearned its authorized ROE in any year since 2001, and has been hundreds of  
17 basis points below the authorized ROE since 2006. If the CAPD's recommended rate  
18 increase is adopted in this case Rebuttal Exhibit MAM-1 shows an achieved ROE of  
19 0.23% (less than 1%). Any concern Mr. Buckner has about the Company earning more  
20 than authorized is not founded in reality. The Company will demonstrate in its testimony  
21 that the four assertions above made by Mr. Buckner are also not accurate.

22  
23 Q. WHY IS MR. BUCKNER'S CLAIM THAT PAST TRA ORDERS ARE PRECEDENT-  
24 SETTING REGARDING THE CURRENT TAWC INCENTIVE PLAN?

25 A. The Company's AIP plan was changed in 2009 to make the entirety of the individual  
26 employee AIP award applicable to each eligible employee's individual goals, which are  
27 not tied to the financial performance of TAWC or AWW. The 70% financial target ratio  
28 referred to by Mr. Buckner is only applicable to establishing the overall amount of AIP  
29 payable in any given year. After the AIP pool is determined based on the 70%  
30 financial targets and 30% operational, environmental, customer satisfaction and safety

1 goals of AWW, the individual employee AIP awards are no longer tied to the overall  
2 AWW goals used to establish the AIP pool.

3 This is a significant change from the AIP that was in place through 2008 where  
4 30% of each individual's AIP was tied to the overall financial goals of TAWC. I would  
5 note that based on the prior plan the CAPD proposed a 30% reduction in prior cases. The  
6 Company believes to the extent that prior Authority orders are precedent-setting, the  
7 TRA should consider the change in the AIP beginning in 2009 along with the following  
8 testimony before determining what level, if any, of the AIP that should be recovered in  
9 rates in this case.

10  
11 Q. WHY IS MR. BUCKNER'S CLAIM THAT THE AIP AWARDS THE EMPLOYEES  
12 FOR INCREASING REGULATED EARNINGS NOT ACCURATE?

13 A. Mr. Buckner seems to imply that the employee goals are only related to regulated  
14 earnings growth. This assertion by Mr. Buckner is not based in fact. As stated earlier the  
15 individual goals are structured to improve efficiency and improve service, and are not  
16 tied directly to earnings. To the extent those individual employee goals are met, the rate  
17 payers do receive the benefit of improved service immediately and they receive the  
18 financial benefit in the rate case. This area will be addressed in more detail in the  
19 following testimony.

20  
21 Q. WHY ARE MR. BUCKER'S CLAIMS THAT THERE ARE NO MECHANISMS FOR  
22 THE CUSTOMERS TO SHARE IN THE BENEFITS OF THE AIP AND THAT ONLY  
23 THE SHAREHOLDERS AND THE EMPLOYEES BENEFIT INACCURATE?

24 A. These claims are inaccurate because Mr. Buckner only drives on "one way" streets. Mr.  
25 Buckner fails to recognize or admit that the Company's incentive compensation is part of  
26 the overall compensation plan, that the overall compensation plan is established to drive  
27 employee performance, that the overall compensation plan, including the incentive  
28 compensation, is market-driven, and most importantly that the performance-driven  
29 culture and compensation plans result in benefits to TAWC's customers. The Company  
30 believes a "performance based culture does benefit the customer, the employee (who  
31 meets high performance goals) and the shareholder," contrary to Mr. Buckner's

1        assertions otherwise. Achieving the overall financial, operational, environmental, and  
2        customer satisfaction goals of AWW only determines the amount of AIP available in any  
3        given year, but it is the performance of each individual employee that determines his/her  
4        incentive compensation, if any. The performance goals of each employee are related to  
5        matters that are specific to that job function, and not to the financial parameters that  
6        determine the overall amount of AIP available.

7  
8        Q.    MR. BUCKNER PROVIDES REFERENCE TO DECISIONS OF OTHER STATE  
9        REGULATORY COMMISSIONS. WHAT IS YOUR POSITION ON THAT?

10      A.    I was not surprised by Mr. Buckner's list and would point out that he only listed states  
11      that have not approved incentive compensation or parts of incentive compensation. His  
12      list obviously does not list the states that do recognize states that have authorized  
13      incentive compensation or parts of incentive compensation plans. Different state  
14      commissions handle things differently regarding test-years, filing requirements, and a  
15      myriad of other areas which must be considered in looking at the overall revenue  
16      requirement and the impact of rate orders to provide proper context and meaning.

17  
18      Q.    YOU DO REGULATORY WORK IN A NUMBER OF JURISDICTIONS, SO CAN  
19      YOU TELL US HOW THOSE JURISDICTIONS TREAT INCENTIVE  
20      COMPENSATION?

21      A.    Yes. Virginia recognized the incentive compensation for rate recovery. West Virginia  
22      also recognizes incentive compensation for rate recovery. In addition, based on the pre-  
23      2009 AWW/TAWC incentive compensation plan, Tennessee recognized both the  
24      operation and customer portions (about 60%) of the total incentive compensation. The  
25      Kentucky Commission has not recognized the incentive compensation pay for rate  
26      recovery. I believe a section of an Order from the West Virginia Commission provides a  
27      perspective about incentive compensation that is worth mentioning.

28  
29                    "The Commission does not find the position of the CAD and the  
30                    Cities to be persuasive. Indeed, incentive compensation is a  
31                    known and measurable expense in this case. It was contained in  
32                    the test year and shall be allowed for ratemaking purposes. The

Commission understands the arguments made by the Cities that bonuses awarded to executives for putting more money in the shareholder pockets should be borne by shareholders, not by ratepayers. Looking at the situation from a slightly different perspective, however, it appears that it is the “incentive” and not the compensation that draws the ire of the Cities and the CAD. The Commission realizes that the Company could very well do away with its long-term incentive plan and instead spread the money in the form of salaries. In the present case, no party objected to the overall salary expense and it is unlikely that the addition of an additional \$139,070 to the current salary expense would have triggered any outrage among the parties. Furthermore, at the bottom line, the Commission realizes that all employees of the Company are working not only to provide clean, safe, and potable water to the citizens of West Virginia but are also working as employees of the stockholders with an end towards maximizing stockholder wealth. The incentive compensation is merely a different means of providing such motivation. To the extent employee incentives result in efficiencies and/or increased productivity stockholders are benefited, but eventually such benefits will be reflected in lower revenue requirements and lower rates. Thus, both stockholders and ratepayers benefit from increased productivity and operating efficiencies.

The Commission rejects the Cities and CAD arguments and will allow the inclusion of the costs of the Long-Term Incentive Plan in the revenue requirements in this case.”<sup>15</sup>

Q DOES MR. BUCKNER ASSESS THE 2009/2010 PLAN AS IT COMPARES TO THE PRIOR AIP PLAN?

A. No. He makes no mention of the fact the AIP plan has been changed since the Company’s 2008 Rate Case. Instead, Mr. Buckner simply proposes to eliminate 70% of AIP now instead of the 30% he proposed to eliminate under the pre-2009 Plan in the Company’s 2008 Rate Case. In the AIP plan prior to 2009, there was a corporate financial threshold that had to be met for the incentive plan awards to be applicable. In addition, each individual’s incentive plan compensation was determined in large part (30%-40% depending on the employees’ functional area) on those same financial results

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<sup>15</sup> Case #03-0353, Final Order of WV PSC, in general rate proceeding regarding West Virginia American Water Co., at page 39.

1 for AWW (corporate AWWSC employees), or each regulated subsidiary (i.e. TAWC), or  
2 group of regulated subsidiaries (i.e. Eastern Division). However, in 2009/2010 the AIP  
3 Plan changed in that AWW, Region/Division or regulated subsidiary financial results do  
4 not determine any portion of each individual's incentive compensation award. Contrary  
5 to the assertions of Mr. Buckner, the overall financial, operational, customer satisfaction,  
6 environmental, business transformation and diversity targets of AWW only determine the  
7 "pool" of AIP compensation each year, but once the AIP "pool" of compensation  
8 available is determined, it is each individual employee's performance that drives the  
9 employee's incentive compensation payment. This is a significant change from the pre-  
10 2009 AIP plans in effect.

11  
12 Q. WHY WOULD THE INCENTIVE COMPENSATION "POOL" AVAILABLE IN ANY  
13 YEAR BE AT LEAST PARTIALLY DRIVEN BY FINANCIAL RESULTS?

14 A. Certainly the overall financial performance of AWW and TAWC are important to  
15 management, shareholders and other investors. However, Mr. Buckner is wrong to  
16 indicate that TAWC's customers don't share in those benefits, or that the Authority  
17 should not be concerned about the overall AWW financial position. I do not personally  
18 know of any incentive compensation plan where financial results are not part of the  
19 equation and cannot imagine that any reasonable incentive compensation plan would not  
20 at some level be based on overall financial goals. It would be unreasonable to expect  
21 incentive compensation be awarded in a year in which financial results did not allow for  
22 incentive compensation.

23  
24 Q. WHAT ARE SOME OF THE BENEFITS THAT THE CUSTOMERS SHARE AS A  
25 RESULT OF A FINANCIALLY HEALTHY, EFFICIENT AND PRODUCTIVE  
26 COMPANY?

27 A. The overall financial performance of AWW can and does directly impact TAWC's  
28 customers. TAWC obtains its capital through AWCC for debt and AWW for equity.  
29 The financial benefits to TAWC and its customers through the use of AWCC have been  
30 substantial. The debt issued by AWCC is only secured by the overall financial strength  
31 of AWW. Both AWCC and AWW's credit ratings are tied to overall AWW financial

1 strength, interest coverage, debt/equity ratio, free cash flow and various other financial  
2 criteria. These financial benchmarks directly impact the investment-grade bond rating for  
3 AWCC and AWW, which drive the financial benefits for TAWC's customers. It should  
4 be obvious that based on the financial results for TAWC shown on Rebuttal Exhibit  
5 MAM-1 that TAWC could not obtain a bond rating of BBB+ plus if it obtained debt  
6 financing on a stand-alone basis. Mr. Buckner believes that only TAWC's shareholders  
7 benefit from strong financial performance, but he is mistaken.

8  
9 Q. DOES MR. BUCKNER ACKNOWLEDGE THAT THE OVERALL EMPLOYEE  
10 COMPENSATION IS BASED ON MARKET STUDIES PERFORMED BY AWW  
11 AND TAWC?

12 A. No. Mr. Buckner does not mention that the AIP is part of the overall compensation plan  
13 for TAWC employees, which in total is targeted to compensate the employees at the 50<sup>th</sup>  
14 percentile of the wage band for each position. The 50<sup>th</sup> percentile means the mid-point or  
15 average and in that context some employees will be higher and some lower than the mid-  
16 point. What Mr. Buckner fails to mention or acknowledge is that under the current  
17 performance-based culture and overall compensation plan, it is the high performers who  
18 are recognized in overall compensation and it is the lower performing employees or  
19 employees needing to improve performance that receive less compensation. The  
20 Company does not agree with Mr. Buckner's portrayal of the AIP and believes Mr.  
21 Buckner's approach, if accepted, would discourage high performance to the detriment of  
22 the customers.

23  
24 Q. IS THE INCENTIVE COMPENSATION A DISCRETIONARY EXPENSE FOR THE  
25 COMPANY?

26 A. No. The incentive compensation plans are not discretionary. Those plans, as stated  
27 numerous times in this testimony, are and should be viewed as an integral part of the  
28 overall compensation policy of AWW, AWWSC and TAWC.

29  
30 Q CAN YOU PROVIDE INFORMATION THAT CONTRADICTS THE CAPD'S  
31 ASSERTION THAT THE CUSTOMERS DO NOT SHARE IN THE BENEFITS

1 GENERATED FROM A PERFORMANCE-BASED CULTURE AND  
2 PERFORMANCE-BASED COMPENSATION PLAN?

3 A. Yes. To demonstrate the benefits I am attaching schedules identified as Rebuttal Exhibit  
4 MAM-12. On page 3 of 3 of the Exhibit the Company has shown its O&M costs on a per  
5 customer basis from 2004-2010, and as projected for the 2011 attrition year. Those costs  
6 have been adjusted (as shown in Note 1 of the Schedule) to reflect only those costs that  
7 are primarily impacted by inflationary trends. The schedule also shows the rate of  
8 inflation for the same five year period. Page 2 of 3 of Rebuttal Exhibit MAM-12 shows  
9 the results graphically. The result of this analysis shows that for the actual period from  
10 2004-2011 the Company's O&M expenses on a per customer basis were below the  
11 cumulative rate of inflation. This information indicates the Company has operated at a  
12 high rate of efficiency even though the Company experienced dramatic increases in: (i)  
13 its electricity costs from the electric providers (55.56%), (ii) increased chemical costs and  
14 chemical delivery costs driven by the relationship to the petroleum markets (50.16%),  
15 and (iii) a 109.68% increase in maintenance costs largely driven by the cost of paving  
16 based on the City of Chattanooga, the cost of gasoline and higher delivery costs also  
17 driven by the cost of fuel. The Company believes keeping its O&M costs per customer  
18 near the rate of inflation during the troubled financial conditions experienced and  
19 identified above is a direct customer benefit that resulted in large part due to the  
20 performance based culture (of which the incentive compensation plans are a large part at  
21 TAWC and AWWSC).

22  
23 Q. REBUTTAL EXHIBIT MAM-12 HAS THREE PAGES. WHAT INFORMATION  
24 WAS INCLUDED ON PAGE 1?

25 A. Page 1 of Rebuttal Exhibit MAM-12 captures the Company's performance on a number  
26 of Key Performance Indicators (KPIs), which are specifically identified in the incentive  
27 compensation plans and are incorporated into each employee's performance goals. These  
28 KPIs are regularly reviewed to track progress and improvement in customer satisfaction,  
29 operational integrity, meter reading accuracy, customer service order execution, effective  
30 collections, and safety. Some of the metrics are shown, but information was not readily  
31 available for all four years. The schedule shows the trends, with green indicating

1 improvement, yellow indicating neutral, and red indicating needs improvement. The  
2 schedule shows improvement for the majority of the KPIs and only two show  
3 improvement needed: non-pay orders worked and hydrant inspections. Again the  
4 improvements shown in those ratios are driven by the performance-based culture of  
5 TAWC and AWWSC, which in turn is driven by the meaningful and challenging  
6 employee performance goals. While it is difficult to quantify the impact of those  
7 improvements in dollars, a more productive, safer and improved environmentally  
8 compliant workforce benefits the customers in the form of lower costs and improved  
9 service.

10  
11 Q. CAN YOU SUMMARIZE THE COMPANY'S POSITION ON INCENTIVE  
12 COMPENSATION?

13 A. Yes. The incentive compensation costs should be included in the cost of service  
14 because they are part of the overall market-based compensation package offered by the  
15 Company. The overall compensation package, including the incentive compensation, is  
16 designed to pay employees at the market-based salary range with a significant portion of  
17 that compensation directly tied to performance-driven goals and objectives. It is entirely  
18 up to the employee and supervisor to meet or exceed those goals that are structured to  
19 benefit both the Company and its customers, with the understanding that strong  
20 performance will be rewarded appropriately and lacking performance will not. It is a fact  
21 of being a regulated utility that the enhanced performance of Company employees will  
22 result in better service and lower costs, which directly flow to the benefit of the  
23 Company's customers each time the Company files a rate case. A utility company can  
24 only retain cost savings as long as it doesn't file a rate case. When other factors drive the  
25 need to file a case, such as capital investment and inflation, any gains in efficiency and  
26 cost savings then flow directly to the benefit of the customers. Obviously service  
27 improvements driven by the performance-based culture flow to the benefit of the  
28 Company's customers immediately.

29 In addition, because the Company's overall employee compensation package is  
30 market-based, including the at-risk portion of employee compensation in the incentive  
31 compensation plans, the elimination of the incentive compensation costs would require



1 the Company to increase the base salary to remain competitive in the employee  
2 marketplace if the Company is to attract and retain qualified employees. If this  
3 hypothetical situation were to become a reality, presumably the Authority would permit  
4 the recovery of that compensation if it were base salary/wages instead of the incentive  
5 compensation. The Company believes under that scenario the Company's customers  
6 would lose. An increase in base pay would make it much more difficult to encourage a  
7 performance-based culture, and would result in compensating low performing employees  
8 at a higher level than the current at-risk incentive-based performance compensation plan.  
9 The Company does not believe customers would be better off under this type of  
10 compensation plan. According to Mr. Buckner's recommendation in this proceeding, he  
11 is attempting to tell the Authority that it should provide the obvious benefits of the  
12 performance based-compensation plan that accrue to the customers in this case for **free**.  
13 Obviously, that would be an inappropriate result and a message the Authority should not  
14 want to convey to any utility with respect to efforts to work more efficiently and provide  
15 a high level of service to its customers.

16  
17 **PENSION EXPENSE**  
18

19 Q. DID THE CAPD WITNESS MR. BUCKNER MAKE ADJUSTMENTS TO THE  
20 COMPANY'S PROPOSED PENSION EXPENSE?

21 A. Yes. Mr. Buckner used a capitalized payroll rate of 20.57% which was the 2008 actual  
22 payroll capitalization rate compared to the Company's proposed payroll capitalization  
23 rate of 15.83%. Mr. Buckner's higher capitalized payroll rate reduced the Company's  
24 requested pension expense by \$92,701.

25  
26 Q. DOES THE COMPANY AGREE WITH THE CHANGE IN PAYROLL  
27 CAPITALIZATION RATE PROPOSED BY MR. BUCKNER?

28 A. No. The rebuttal testimony of Ms. Sheila Miller provides the Company's position about  
29 the change in payroll capitalization rate proposed by Mr. Buckner. Mr. Buckner based  
30 his adjustment on the relationship of capital payroll to the amount of plant placed in  
31 service. I absolutely agree with Ms. Miller that there is no correlation between the level

1 of capital payroll and the amount of plant in service for a year. There can be a correlation  
2 between capital payroll and the capital expended in a year, but only if an analysis is  
3 performed to determine the amount of capital expenditures that are performed in a year  
4 by internal labor compared with contract labor. Mrs. Miller has provided that analysis  
5 with her rebuttal testimony and the facts clearly show that there is no basis for the  
6 adjustment of the Company's capital payroll ratio of 15.83% for the level of internal  
7 capital spending that Company employees will be performing in the test-year.

8 The adjustment proposed by Mr. Buckner to lower pension expense for a higher  
9 capitalized payroll ratio for the attrition year is without merit and should be rejected.

10  
11 Q. IS THERE ANOTHER AREA OF MR. BUCKNER'S TESTIMONY CONCERNING  
12 PENSION EXPENSE WITH WHICH YOU DISAGREE?

13 A. Yes. In his testimony Mr. Buckner indicated the Company had provided updated  
14 information from the Company's actuary Towers/Watson which indicated a higher  
15 ERISA pension expense for 2011 than included in the Company's original filing.  
16 However, Mr. Buckner claimed the latest Pension Evaluation Report information or 2011  
17 should not be used to establish the rates in this case because the information indicated the  
18 September 2011 payment was subject to change once a new Pension Evaluation Report  
19 was issued in August 2011.

20  
21 Q. HAS THE COMPANY PROVIDED THE LATEST ACTUARIAL INFORMATION ON  
22 PENSION EXPENSE TO THE PARTIES IN THIS CASE?

23 A. Yes. The Company provided the most recent pension expense for 2011 as provided by  
24 Towers/Watson in a letter to the Company dated July 21, 2010. This information was  
25 provided in the response to discovery request TN-CAPD-Part III-Q48-CONFIDENTIAL  
26 ATTACHMENT filed on November 15, 2010.

27  
28 Q. SHOULD THE LATEST PENSION PROJECTION FOR THE ATTRITION YEAR  
29 FROM THE COMPANY'S PROFESSIONAL ACTUARIAL FIRM BE USED FOR  
30 ESTABLISHING THE JUST AND REASONABLE RATES IN THIS CASE?

1 A. Certainly. This is an astounding position taken by Mr. Buckner, since it was he who in  
2 the Company's 2006 Rate Case argued that only the latest Pension Valuation Report  
3 should be used in establishing the pension expense in that Case, a position the Authority  
4 upheld.<sup>16</sup>

5  
6 Q. IS THE POSITION TAKEN BY MR. BUCKNER REGARDING USING THE LATEST  
7 PENSION EVALUATION INFORMATION IN THIS CASE CONSISTENT WITH  
8 THE POSTION HE TOOK IN THE 2006 RATE CASE?

9 A. No it is not. Mr. Buckner claims the latest Pension Evaluation information for the  
10 attrition year should not be used because it could change with the issuance of a new  
11 Pension Evaluation Report in August 2011. Of course the pension costs could change  
12 when the new Report issued in August 2011 if the actuarial assumptions change to reflect  
13 a change in the economy for the good or bad, interest rates rise or fall, or medical cost  
14 trends go up or down.

15  
16 Q ARE THE COMPANY'S PAYMENTS IN THE ATTRITON YEAR CONSISTENT  
17 WITH THE UPDATE PENSION PAYMENTS REFERENCED IN THE DISCOVERY  
18 RESPONSE TO THE CAPD?

19 A. Yes. On January 14, 2011 TAWC made a payment consistent with the information  
20 provided in the latest Pension Evaluation Report referenced above.

21  
22 Q. WHAT IS YOUR RECOMMENDATION ON PENSION EXPENSE FOR THE  
23 ATTRITON YEAR?

24 A. I have attached Rebuttal Exhibit MAM-13 which provides the correct 2011 pension  
25 expense based on the latest Pension Evaluation Report of Towers/Watson compared to  
26 the pension expense included in the Company's original filing. The result is a pension  
27 expense of \$2,062,140 which is \$417,027 above the level requested by the Company in  
28 its original filing.

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<sup>16</sup> TRA order in docket number 06-00290, at page 28.

1 Consistent with Mr. Buckner's testimony in the TAWC 2006 Rate Case and the  
2 Authority's Order in that case, the Authority should utilize the latest Pension Evaluation  
3 Report ERISA pension expense to set the rates of TAWC in this proceeding.  
4

5 **OTHER POST RETIREMENT EMPLOYEE BENEFIT COST (OPEBS)**  
6

7 Q. WHAT ARE OPEBS?

8 A. OPEBs are group insurance costs promised to certain employees of TAWC that were  
9 hired prior to January 1, 2006 when they retire.  
10

11 Q. DO YOU AGREE WITH THE CAPD WITNESS BUCKNER'S OPEB EXPENSE?

12 A. No. Mr. Buckner again ignored the latest OPEB Evaluation Report information  
13 regarding OPEB expense for the attrition year 2011. Instead he took the level of OPEB  
14 expense as of September 2010 and increased it by an inflation factor.  
15

16 The Authority should not recognize an inflation/growth factor applied to the  
17 historical test-year numbers in substitution for a known and measurable OPEB  
18 Evaluation Report prepared by a reputable actuary firm such as Towers/Watson.

19 I will not repeat the Company's position about the pension expense above but the  
20 arguments about Mr. Buckner's position and the correct OPEB level for the 2011 attrition  
21 year are the same.

22 Q. WHAT IS YOUR RECOMMENDATION FOR THE CORRECT OPEB EXPENSE ON  
23 WHICH TO ESTABLISH RATES FOR THE ATTRITION YEAR IN THIS CASE.

24 A. I have attached Rebuttal Exhibit MAM-13 which provides the correct 2011 OPEB  
25 expense based on the latest OPEB Evaluation Report of Towers/Watson compared to the  
26 OPEB expense included in the Company's original filing. The result is an OPEB  
27 expense of \$1,174,215 which is \$214,641 above the level requested by the Company in  
28 its original filing.

29 Consistent with the Authority's stated position on pension expense, the use of an  
30 inflated OPEB number as proposed by Mr. Buckner is not the best available information  
31 for the OPEB cost for the 2011 attrition year and should not be used in the presence of

1 the most current information for the attrition year as provided by the Company's actuary,  
2 a cost which the Company is currently paying to the OPEB VEBA trustee and recording  
3 on its books in January 2011.  
4

5 **EMPLOYEE LEVELS FOR THE ATTRITION YEAR**  
6

7 Q. WHAT LEVEL OF EMPLOYEES DID THE CAPD INCLUDE IN THE ATTRITION  
8 YEAR?

9 A. The CAPD proposes an employee level of 104 employees for the attrition year, which is  
10 six less than the level requested by the Company in its filing. Mr. Watson covers  
11 TAWC's concerns about the CAPD at length in his testimony, including why TAWC  
12 needs the 110 employees to maintain adequate service, why the recent vacancies have  
13 occurred and the Company's efforts to fill the ten job vacancies. It is appropriate for Mr.  
14 Watson to be the primary witness in this area because he is President of TAWC and he is  
15 in the best position to know what is needed to operate the day to day service levels  
16 required at TAWC and what is getting done adequately and what is not getting done  
17 adequately over the last year.  
18

19 Q. WHAT IS THE PRIMARY REASON GIVEN BY MR. BUCKNER FOR THE LOWER  
20 LEVEL OF EMPLOYEES HE RECOMMENDS?

21 A. The primary reason relates to the historical vacancy rates. This is an area of Mr.  
22 Buckner's testimony I will address because it is very relevant to the discussion on  
23 AWWSC costs that will follow in this testimony.  
24

25 Q. WHY IS THE HISTORICAL VACANCY RATE RELEVANT TO THE  
26 DISCUSSION ABOUT AWWSC COSTS?

27 A. At page 22 and 23 of Mr. Buckner's testimony he claims that there is no offset that exists  
28 to the increase in management fees and that the shift to AWWSC for many services did  
29 not result in more efficient operations. Mr. Buckner forms his opinion about historical  
30 vacancy rates from the information provided in his working papers at page 8 (workpaper  
31 E-PAY-5). He compares the actual employee numbers to the number of employees

1 approved in the Company's rate cases. This is a very misleading comparison because his  
2 employee counts for the various docket numbers appear to be the number of employees  
3 the Company requested for the attrition year not the number of employees the TRA  
4 approved. For example, Mr. Buckner lists 114 employees for docket number 08-00039,  
5 but the Authority approved only 109 employees.<sup>17</sup> Obviously Mr. Buckner's numbers are  
6 wrong and they overstate the vacancy rates.

7  
8 Q. PLEASE ADDRESS THE VACANCY RATE IN 2004 COMPARED TO THE  
9 AUTHORIZED LEVEL OF EMPLOYEES AUTHORIZED IN DOCKET NO. 03-  
10 00118.

11 A. In docket number 03-00118, Mr. Buckner lists 119 employees for the attrition year,  
12 which is a number substantially greater than the Company's actual number for the  
13 attrition year in that docket. The reason for that variance is because at the time of  
14 processing the 2003 Rate Case the Company did not include the unknown impact of the  
15 transition to the National Shared Service Center ("SSC") and the Customer Call Center  
16 ("CCC"). Obviously when those reorganization started occurring in 2004 the Company  
17 had lower employee accounts, but the decrease in employee cost at TAWC resulted in a  
18 corresponding increase in AWWSC costs.

19  
20 Q. WHAT ABOUT THE VACANIES MR. BUCKNER SHOWS RELATED TO THE  
21 DOCKET NUMBER 04-00288?

22 A. In docket 04-00288, the Company requested an employee count of 106 employees. At  
23 that time the Company did not know a reorganization would happen in the attrition year  
24 to move finance and accounting functions previously performed at TAWC to the new  
25 Regional AWWSC office located in Hershey, PA. Again, the employee count in the  
26 attrition year was lower than approved in that docket.

27 The shift of accounting and finance functions to the regional office in 2005 has  
28 continued to be an area that has been a point of contention between the Company and the  
29 CAPD, especially regarding the increase in AWWSC costs. Mr. Buckner continues to  
30 use the AWWSC costs authorized in 2004 as his basis on which to base his proposals for

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<sup>17</sup> TRA order in docket number 08-00039, at page 12.

1 rate recovery of management fees, and continues to misrepresent the basis for the  
2 increase in management fees authorized by the TRA in the 2004 Rate Case. He has  
3 continually misrepresented the reasons that 2005 AWWSC costs exceeded the level  
4 approved in the 2004 Rate Case, when this increase was obviously driven by a shift in  
5 functions to the Regional AWWSC cost in Hershey, PA and Charleston WV in order to  
6 drive more efficient operations and costs.

7  
8 Q. WHAT IS YOUR CONCLUSION ABOUT THE INFORMATION SHOWN ON CAPD  
9 WORKING PAPER E-PAY5 PROVIDED IN THE EXHIBIT ATTACHED TO MR.  
10 BUCKNER'S TESTIMONY AT PAGE 8?

11 A. It is obvious to me that Mr. Buckner's portrayal of the vacancy rates on this working  
12 paper are misleading at best, and they do not form any reasonable basis for the vacancy  
13 rates Mr. Buckner portrays. Second, the reasons for these vacancies provide the basis for  
14 the shift in costs from TAWC to AWWSC as shown on Exhibit MAM-11 attached to my  
15 direct testimony.

16 Mr. Buckner claims these shifts in costs do not exist. When the facts regarding  
17 the vacancy rates shown on Mr. Buckner's work paper referenced above are considered,  
18 however, they do not support those vacancy rates Mr. Buckner is using to artificially  
19 lower the employees Mr. Watson demonstrates he needs to carry out the day to day  
20 operations of TAWC. In addition, the vacancy rates on Mr. Buckner's working paper  
21 fully support the fact that there has been a shift of functions and cost from TAWC to  
22 AWWSC, contrary to Mr. Buckner's claims otherwise. I will re-emphasized later in this  
23 testimony that this shifts has resulted in a lower cost to the customers of TAWC.

24  
25  
26 **THE RELATIONSHIP BETWEEN TAWC AND AMERICAN WATER RESOURCES**

27  
28 Q. DID MS. DISMUKES RECOMMEND AN ADJUSTMENT TO TAWC'S REVNUES  
29 RELATED TO THE REVENUES GENERATED BY AWR IN TENNESSEE?

1 A. Yes. She proposes to increase the going-level revenues of TAWC by \$1,071,281<sup>18</sup> which  
2 represents her estimate of the total revenue generated by AWR in Tennessee.

3  
4 Q. DOES TAWC AGREE WITH HER PROPSAL?

5 A. No. The adjustment proposed by Ms. Dismukes is without merit as will be explained in  
6 this testimony and should be rejected by the Authority.

7  
8 Q. PLEASE DESCRIBE AMERICAN WATER RESOURCES, A NON-REGULATED  
9 AFFILIATE OF AWW, AND EXPLAIN WHAT SERVICES ARE PROVIDED BY  
10 AWR TO TAWC.

11 A. American Water Resources, Inc. (AWR) is a non-regulated affiliate of AWW that offers  
12 services to households across the country, including water customers of TAWC, that have  
13 of their own accord chosen to contract with AWR for customer protection plans. These  
14 plans include protection and service for repair of water customer service lines,  
15 wastewater customer sewer laterals, and indoor plumbing repair plans. These lines are  
16 owned by the customer and repairs to the service lines are the responsibility of the  
17 customer.

18  
19 Q. WHAT RELATIONSHIP EXISTS BETWEEN AWR AND TAWC?

20 A. AWR and TAWC have an affiliate agreement<sup>19</sup> whereby TAWC will provide billing  
21 services for billing to customers of AWR who are also customers of TAWC. As stated in  
22 the agreement, TAWC will be provided 40.5¢ for each bill rendered on behalf of AWR.  
23 The 40.5¢ is the cost of the tariffs of TAWC for providing billing services to a number of  
24 sewer authorities for which TAWC also provides billing services, including the City of  
25 Chattanooga Sanitary Board. The Agreement indicates that TAWC will also bill AWR  
26 for any costs not covered by the billing fee at 115% of cost (Article 3.3.2 of the Affiliated  
27 Agreement). The Agreement also indicates that TAWC will distribute, upon the request  
28 of AWR, informational and promotional materials regarding the AWR programs to its  
29 customers though inserts in its billing envelopes, which is the same service TAWC would

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<sup>18</sup> Dismukes testimony, Schedule KHD-4.

<sup>19</sup> See the response to TN-COC-01-Q39-Attachment 1.



1 provide to its contract sewer billing customers upon request.

2  
3 Q. DOES TAWC INCUR ANY ADDITIONAL COST IN PROVIDING THE BILLING  
4 SERVICES TO AWR?

5 A. Other than incremental cost to print additional information on the bill and collect the fees  
6 there is little, if any, additional costs incurred by TAWC. In fact, the cost TAWC incurs  
7 for billing AWR customers is less than the cost of providing billing services to other  
8 contract billing customers, such as the City of Chattanooga Sanitary Board.

9  
10 Q. WHY WOULD THE COST OF TAWC BE LESS FOR SANITARY BILLING  
11 CUSTOMERS THAN FOR AWR BILLING?

12 A. AWWSC allocates additional charges from its customer service center to TAWC to  
13 provide for the billing and collecting services it provides for the billing of the local  
14 sanitary boards, but there are no additional charges allocated to TAWC by AWWSC for  
15 billing AWR customers. The AWWSC billing costs are allocated directly to AWR  
16 through the Tier 1 allocations that have been established to appropriately allocate  
17 AWWSC costs to the non-regulated subsidiaries of AWW. TAWC's bill includes a  
18 separate phone number for service issues or requests for service related to services  
19 provided by AWR, while calls related to local TAWC sanitary billing are routed to the  
20 same customer service representatives that handle TAWC water customer calls.

21  
22 Q. ARE THE CONTRACT BILLING ARRANGEMENTS A BENEFIT TO  
23 CUSTOMERS?

24 A. The revenue generated from contract billing, including the billing arrangement with  
25 AWR, is treated as regulated revenues for establishing the rates of TAWC. This is  
26 because TAWC is already billing its customers for water service (including IT billing  
27 services, postage, envelopes and bill forms), so there is little incremental cost associated  
28 with providing contract billing. The net revenue generated from the 40.5¢ per bill fee  
29 goes directly to the benefit of the customers in the rate setting process. If TAWC were to  
30 stop contract billing for all contract billing customers, including AWR, the rates TAWC's  
31 customers pay for water service would increase. In addition, the Company can provide

1 this contract billing service to all contract billing entities, including the City of  
2 Chattanooga, at a cost lower than they can obtain that service elsewhere. This also  
3 provides the wastewater customers served by these contract billing arrangement with  
4 lower wastewater bills as well.

5  
6 Q DOES TAWC BELIEVE THAT THE SERVICE LINE PROTECTION PLANS  
7 OFFERED BY AWR ARE BENEFICIAL TO ITS CUSTOMERS?

8 A. Yes. As has been noted in AWR literature, customers are responsible for the costs of  
9 maintenance and repair of the water service line, sewer laterals, and their in-home  
10 plumbing systems. These costs to repair a service line or a sewer lateral can be  
11 significant. The AWR programs are relatively low cost and can assist customers with the  
12 cost of a repair. Since AWR is an affiliate, TAWC is aware that AWR is a reputable  
13 company that can be relied upon to perform promised services at the time of a problem.  
14 Therefore, the endorsement of the AWR programs by TAWC's President is not an  
15 unreasonable thing to do, and in fact the Company believes it is providing a service to its  
16 customers by educating them that the service line and sewer line laterals are their  
17 responsibility.

18 The Company is aware that many customers do not realize this fact, and are  
19 shocked at the cost when repairs are needed on the service lines and sewer laterals when  
20 they have problems, such as leaks and blockages. At no time does TAWC state that the  
21 plan confers special status as a water customer, and clearly indicates acceptance of  
22 service from AWR is strictly voluntary and entirely the decision of the customer.

23  
24 Q. WHY ARE THERE NO ADDITIONAL CHARGES FROM AWWSC TO TAWC FOR  
25 THE AWR BILLING AND COLLECTING?

26 A. AWR maintains its own call center, and the AWWSC call center does not handle billing  
27 calls for AWR. The incremental cost of billing and collecting is very small because the  
28 process is fully automated, so no measurable additional costs are incurred.

29  
30 Q. DOES TAWC PROVIDE REPAIR SERVICES FOR AWR?

31 A. No. AWR engages local contractors to perform repairs when an AWR customer makes a

1 claim, and the full cost of the repair up to the limit established in the contract between  
2 AWR and the customer is borne entirely by AWR.

3  
4 Q. DO TAWC EMPLOYEES IDENTIFY CUSTOMER SERVICE LINE LEAKS?

5 A. When any customer calls with a concern about a leak, TAWC employees respond  
6 initially. If the leak is identified on the customer's service line, they are so advised. If  
7 they are an AWR customer, they have a separate toll free number to call to receive  
8 services from AWR. Because the Company's personnel always respond to a customer's  
9 service issue regarding a high bill or leak, TAWC does not incur any additional costs  
10 when it instructs the customer that the leak appears to be on the customer owned line and  
11 they need to call AWR if they have the a service line protection with AWR.

12  
13 Q. MS. DISMUKES ASSERTS AT PAGE 15 OF HER TESTIMONY THAT THERE ARE  
14 "SUBSTANTIAL BENEFITS TO AWR FOR ITS AFFILIATION WITH TAWC.  
15 THESE BENEFITS INCLUDE THE USE OF TAWC'S NAME AND PRESIDENT'S  
16 SIGNATURE, LOGO, REPUTATION, GOODWILL, AND CORPORATE." WHAT  
17 COST RECOVERY IS TAWC RECEIVING FROM CUSTOMERS FOR THESE  
18 INTANGIBLE ASSETS OF TAWC?

19 A. As described above, TAWC believes making the customers aware of the service line  
20 protection programs and the fact that the customer is responsible for the cost of repairs to  
21 those lines is information that many customers do not realize until they face substantial  
22 costs when repairs are needed.

23 The Company is not compensated for signing the letters sent to the customers,<sup>20</sup>  
24 unless that results in additional cost to TAWC, which it has not. AWR has borne the full  
25 cost of producing the customer information about the service line, sewer lateral and in-  
26 home protection programs. TAWC has borne no cost for producing or sending that  
27 information to its customers.

28  
29 Q DO THE RATES OF TAWC INCLUDE RECOGNITION OF THE VALUE OF THE  
30 INTANGIBLE ASSETS OF TAWC LISTED ON PAGE 15 OF MS. DISMUKES

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<sup>20</sup> Information contained in Schedule KHD-3 attached to the testimony of Ms. Dismukes.

1 TESTIMONY?

2 A. No. The regulatory process is a cost-based process. While Ms. Dismukes perceives value  
3 for these attributes, there is no rate base value or expense recognition allowed by the  
4 TRA for them. Thus, TAWC recovers nothing from its regulated customers for these  
5 attributes or intangible assets. Therefore, there is no value for those intangible assets  
6 recovered from the rate payers, and they should not, and are not entitled to a lower rate  
7 from assets to which they do not contribute.

8  
9 Q. IS ANY COST INCURRED BY TAWC FOR PROVIDING THE SIGNED LETTER?

10 A. No. AWR pays for the letterhead and all other material sent to the customers about the  
11 programs.

12  
13 Q. HAVE OTHER PARTIES UNAFFILIATED WITH AWW REGULATED SERVICE  
14 AREAS PROVIDED SIMILAR LETTERS TO THEIR CUSTOMERS ABOUT THE  
15 SERVICES PROVIDED BY AWR?

16 A. Yes. The Mayor of Burlington Iowa signed a letter informing the water and sewer  
17 customers of the City about the services provided by AWR at no cost to AWR.

18  
19 Q. ON PAGE 15 OF MS. DISMUKES TESTIMONY SHE MAKES REFERENCES TO  
20 THE VALUE OF THE COMPANY'S CUSTOMER LIST AND ADDRESSES. DO  
21 YOU HAVE COMMENTS ABOUT THIS AREA OF HER TESTIMONY?

22 A. The mailing addresses of TAWC customers can be obtained at very little cost. The cost  
23 of obtaining names and mailing addresses of homes in the TAWC footprint can be  
24 obtained at a cost of less than \$3,000. While Ms. Dismukes places great value on such  
25 items, in reality they have little or no value to TAWC.

26  
27 Q. ON PAGE 13 MS. DISMUKES CLAIMS THAT TAWC REFUSED TO PROVIDE  
28 THE EXPENSES AND REVENUES OF AWR. IS HER STATEMENT CORRECT?

29 A. No. Ms. Dismukes is apparently confused by the Company's legitimate discovery  
30 objections concerning the relevance and overly broad nature of the discovery request.  
31 Ms. Dismukes references a discovery response to which the Company objected, the City

1 moved to compel, and the hearing officer in this case ruled in favor of the objection. The  
2 Authority should not be misled by this type of inaccurate portrayal of the facts by Ms.  
3 Dismukes.

4  
5 Q. HAVE THE CUSTOMERS OF TAWC COMPLAINED ABOUT BEING MADE  
6 AWARE OF THE SERVICES PROVIDED BY AWR?

7 A. The Company is not aware of any customer complaints about the information provided  
8 about AWR services and the Company is not aware of any complaints filed at the TRA  
9 about the subject.

10  
11 Q. MS DISMUKES PROPOSES THAT TAWC'S PRESENT RATE REVENUE SHOULD  
12 BE INCREASED BY \$1,071,281 PER YEAR TO ACCOUNT FOR THE "BENEFIT"  
13 OF SERVICES PROVIDED TO AWR BY TAWC. IS THIS A REASONABLE  
14 PROPOSAL?

15 A. No. If this recommendation is adopted, it will reduce TAWC's rate revenues by an equal  
16 amount. It represents a blatant attempt on her part to "appropriate" revenues of a non-  
17 regulated affiliate for the benefit of ratepayers. The Company has responded to a number  
18 of discovery requests regarding this issue and it is clear that TAWC provides no services  
19 to AWR that are not covered by the contract billing fee or the provisions of the agreement  
20 to bill AWR for other services at cost plus 15%.

21 TAWC does not bear any risk or costs associated with the services provided to  
22 AWR customers, and does not bear any risk for the cost to repair the service lines, sewer  
23 laterals or in-house plumbing on the facilities owned by the customers. Therefore,  
24 because the customers bear no risk for the costs of AWR in the rates of TAWC they are  
25 not entitled to any portion of the revenue generated by the contracts between AWR and  
26 the customers who elect to accept AWR services. Such an amount is approximately \$53  
27 per AWR customer. As described above, the fees paid by AWR to TAWC more than  
28 adequately compensate TAWC for the services it provides to AWR, which currently and  
29 in the future go directly to the benefit of TAWC's customers. Ms. Dismukes'  
30 recommendation to pass her estimate of \$1,071,281 of revenue generated in Tennessee by  
31 AWR is without merit and clearly inappropriate.

1  
2 Q. WHAT WOULD TAWC BE FORCED TO DO IF THE PROPOSAL OF MS.  
3 DISMUKES WERE USED IN SETTING THE RATES OF TAWC IN THIS CASE?

4 A. As demonstrated in Rebuttal Exhibit MAM-1, TAWC could ill afford the loss of over  
5 \$1.0 million of its demonstrated revenue requirement by imposing the confiscatory and  
6 unconscionable proposal of Ms. Dismukes. The Company would be forced to terminate  
7 its agreement with AWR, which would then deprive the customers of the benefit they  
8 now receive from the additional revenue from the billing contract with AWR. TAWC  
9 would then have no choice but to file another rate case to recoup the lost revenue.  
10

11 Q. ON PAGE 16 OF HER TESTIMONY MS. DISMUKES RECOMMENDS A  
12 THOROUGH EXAMINAATION OF THE RELATIONSHIP BETWEEN TAWC AND  
13 AWR. DO YOU AGREE?

14 A. It is my opinion that Ms. Dismukes puts the cart before the horse with her unconscionable  
15 recommendation regarding the relationship between AWR and TAWC. The Schumaker  
16 Management Audit looked at this relationship as indicated on the Schumaker Report  
17 provided as Exhibit MAM-8 with my direct testimony at pages 26, 35, and 43 of 143. On  
18 page 54 of 143, the Schumaker Reports says, "Schumaker and Company also considers  
19 TAWC's methodology for charge AWR for billing of its home protection programs to  
20 TAWC customers to be a reasonable methodology."

21 I submit that Ms. Dismukes clearly should have read the Schumaker Report  
22 before deciding to include her outrageous recommendation to increase revenue by  
23 \$1,071,281. The Authority already ordered that a Management Audit be performed, set  
24 the scope for the Audit, approved the contractor and contract for the Audit, and is now  
25 considering the results of the Audit. If the Authority truly believes that it needs to order  
26 another audit to again address an issue that was already addressed in the Schumaker  
27 Management Audit, the Company would not be opposed to such a decision. However,  
28 the Company believes the Authority should take that step before imposing any impact on  
29 the Company's rates in this case from its relationship with AWR.  
30

1       **MANAGEMENT FEES, AWWSC ALLOCATION METHODOLOGIES AND THE**  
2       **SCHUMAKER MANAGEMENT AUDIT**  
3

4       Q.     WHAT ISSUES REGARDING MANAGEMENT FEES, AWWSC ALLOCATION  
5             METHODOLOGIES AND THE SCHUMAKER MANAGEMENT WILL YOU  
6             ADDRESS IN THIS REBUTTAL TESTIMONY?

7       A.     Both Mr. Buckner and Ms. Dismukes cover a wide range of issues surrounding the  
8             management fees, AWWSC allocation methodologies and the Schumaker Management  
9             audit. Both Mr. Baryenbruch and Mr. Uffelman provide rebuttal to a large portion of  
10            these comments, issues and recommendations in their rebuttal testimony. I will attempt  
11            to limit my rebuttal to areas not addressed in their testimony. Since the issues  
12            surrounding the testimony of Ms. Dismukes and Mr. Buckner are different in nature and  
13            scope, I will address each of those witnesses testimony separately.

14            Mr. Gorman makes a comment that the management fees requested by the  
15            Company in this case are significantly higher than the Authority awarded in the  
16            Company's 2008 Rate Case. I will address the ruling of the Authority in the 2008 Rate  
17            Case in rebuttal to comments made by Mr. Buckner and my comments will be equally  
18            applicable to the comments of Mr. Gorman. I would indicate that in response to Mr.  
19            Gorman's claim on page 23 of his testimony that TAWC has not supported their claim  
20            for management fees, Mr. Gorman does not provide any support for this claim, nor does  
21            he refute or even address my substantial testimony or the Schumaker Management Audit  
22            Report.

23  
24                               **Rebuttal of Ms. Dismukes**  
25

26       Q.     WHAT IS YOUR PRIMARLY CONCERN WITH THE TESTIMONY OF MS.  
27             DISMUKES REGARDING HER RECOMMENDATION ON THE LEVEL OF  
28             MANAGEMENT FEES?

29       A.     My primary concern is the impact of her recommendation and the inadequate evidence  
30             she put forth to support her positions.  
31

1 Q. WHAT IS MS. DISMUKES' OVERALL RECOMMENDATION REGARDING THE  
2 LEVEL OF MANAGEMENT FEES FOR RATE RECOVERY IN THIS CASE?

3 A. On page 43 of her testimony, Ms. Dismukes indicates that she recommends a reduction of  
4 \$4,089,360 in attrition year service company A&G costs, and on page 45 she  
5 recommends a reduction in service company customer accounting charges of \$676,655.  
6 On page 5 of her testimony, Ms. Dismukes recommends that management fees be  
7 reduced an additional \$94,658 for Business Development and Corporate Government  
8 Affairs functions.

9  
10 Q. WHAT IS HER SUPPORT FOR THESE ADJUSTMENTS?

11 A. The primary support is provided from the information provided on Schedules KHD-15  
12 and KHD-16. These schedules are reportedly developed from information filed for  
13 various water utilities in the Southeastern region of the U.S.

14  
15 Q. DO YOU AGREE WITH THE INFORMATION OR THE RESULTS ON SCHEDULES  
16 KHD-15 AND KHD-16?

17 A. No I do not agree with her results or that those schedules are based on accurate data.  
18 Even a casual review of Schedules KHD-15 and KHD-16 would indicate the information  
19 for some of the water utilities could not be correct. Mr. Baryenbruch has provided an  
20 analysis and schedules eliminating several of the water utilities' information from the  
21 schedules because it is obvious that the information could not possibly be correct. While  
22 Mr. Baryenbruch's schedules correct for the obvious errors, they do not account for all  
23 the inconsistencies that could, and I am sure are, embedded in the way various utilities  
24 report their financial information on their Annual Commission Reports.

25 Ms. Dismukes appears to have done no screening or analysis of the information  
26 utilized in her Schedules KHD-15 and KHD-16 to determine if the reported information  
27 was consistent or even accurate. The first thing that struck me was that for TAWC she  
28 showed A&G labor being less than the employee benefit costs, which is something I  
29 knew could not be correct. In fact, while TAWC shows employee benefits in total in the  
30 900 series of accounts she includes them as A&G costs, instead of allocating them back  
31 pro-rata to the A&G labor. I also quickly pick-up on the fact that her management fee



1 costs were the total AWWSC costs less customer accounting. I know the remaining  
2 AWWSC costs are not A&G costs because the charges from AWWSC includes charges  
3 for water quality testing, engineering, maintenance services, and operations support, none  
4 of which are A&G.

5 I worked with Mr. Baryenbruch to adjust the TAWC costs to reflect only the  
6 A&G costs and amazingly TAWC's costs went from \$132 per customer as shown on  
7 Schedule KHD-15 to \$74 dollars as shown on Mr. Baryenbruch's PLB-15. I also found  
8 surprising the fact that Carolina Water Services could operate with a negative \$110,000  
9 of A&G labor costs. It is certainly not credible to believe the employees would pay the  
10 Company to work there.

11 These few examples show the striking lack of analysis of the information  
12 contained on Schedules KHD-15 and KHD-16. Ms. Dismukes' use of and the portrayal  
13 of the information contained on Schedules KHD-15 and KHD-16 lead me to the  
14 conclusion that her work was inadequate at best, provided no usable information on  
15 which to access whether the A&G management fee costs were reasonable, and her  
16 recommendation should be rejected.

17  
18 Q. HAVE YOU HAD EXPERIENCE IN ACCESSING THE ANNUAL COMMISSION  
19 REPORTS OF WATER UTILITIES IN YOUR EXPERIENCE WITH AWW?

20 A. I have been involved with the acquisition of dozens of small public and private water  
21 systems in West Virginia, Kentucky and Tennessee. The starting point for accessing  
22 those companies were the Annual Commission Reports. In my experience I found in  
23 most cases the information on those reports was not accurate or consistent and a great  
24 deal of analysis was required to get accurate numbers. Many small systems simply do  
25 not have the financial capabilities to hire accountants or employees that maintain proper  
26 records and they simply fill out the report in the easiest and cheapest manner possible, but  
27 seldom in an accurate manner. I suspect that would be true for many of the small systems  
28 shown on Ms. Dismukes' Schedules KHD-15 and KHD-16 as well.

29 Q. HAVE YOU LOOKED AT OTHER DATA THAT WOULD TEST THE VALIDITY  
30 OF THE APPLICABILITY OF SCHEDULES KHD-15 AND KHD-16?

1 A. Yes. I obtained the current tariffs for most of the water utilities shown on Schedules  
2 KHD-15 and KHD-16. I have attached Rebuttal Exhibit MAM-14 which shows the rates  
3 of those utilities compared to TAWC, all at the average usage per customer of TAWC's  
4 customers. As can be seen on the Exhibit, most of the utilities on Ms. Dismukes'  
5 Schedules KHD-15 and KHD-16 have rates significantly higher than the current rates of  
6 TAWC's \$16.62 per the average residential customer. Only six have lower rates than  
7 TAWC, and twenty-five have higher rates than TAWC for residential customers, several  
8 of which are substantially higher. In fact, twelve of those systems have rates twice as  
9 high as TAWC.

10 This information would lead most people to ask if the utilities used in Schedules  
11 KHD-15 and KHD-16 are so much more efficient than TAWC, then why would those  
12 utilities have rates so much higher than TAWC? The answer to that question obviously is  
13 that the information provided by Ms. Dismukes is not accurate and is not consistent in the  
14 accounting presentation, so therefore the utilities are not comparable to the management  
15 fee A&G costs of TAWC.

16  
17 Q. CAN YOU PUT INTO CONTEXT THE RECOMMENDATION OF MS. DISMUKES  
18 AS TO THE TOTAL O&M COSTS AND TOTAL MANAGEMENT FEES COSTS OF  
19 TAWC?

20 A. Yes. The total O&M costs of TAWC that were requested in the Company's original  
21 filing in this case was \$23,884,779. Ms. Dismukes proposes to reduce management fee  
22 expenses by \$4,860,673, which equates to a reduction in O&M costs of 20.35%. The  
23 Company's management fees request in the original filing in this case is \$5,226,034. Ms.  
24 Dismukes proposed adjustment would equate to a disallowance of 93.08% of the total  
25 management fees.

26 In the opinion and recommendation of Ms. Dismukes, the Company would have  
27 available \$365,361 on which to provide the essential services performed by AWWSC for  
28 TAWC; such as, customer contact, customer billing, collections activities, water quality  
29 testing, accounting, financings, procurement, IT services, engineering, HR functions, and  
30 legal services just to name a few.

1 Q. IN YOUR OPINION, IS THE RECOMMENDATION OF MS. DISMUKES TO  
2 REDUCE THE A&G AND CUSTOMER ACCOUNTING SERVICES PROVIDED BY  
3 AWWSC BY \$4,860,673 REASONABLE?

4 A. No, in my opinion her recommendation is outrageous, not supported by any credible  
5 analysis, is without merit and should be rejected entirely.  
6

7 Q. ON PAGE 5 MS. DISMUKES ADDRESSES THE SCHUMAKER REPORT, WHAT  
8 ARE YOUR COMMENTS CONCERNING HER ASSESSMENT OF THE  
9 SCHUMAKER REPORT?

10 A. Ms. Dismukes indicates that the Schumaker Report analysis and conclusions regarding  
11 the reasonableness of the AWWSC costs to TAWC should be rejected. She limits her  
12 area of dispute to a portion of the Schumaker Report supporting finding IV-1. In this  
13 finding Schumaker used a series of benchmarking comparisons of the costs of AWWSC  
14 to those of electric service companies to assess the reasonableness of the AWWSC costs.  
15 Putting aside the merits of Ms. Dismukes' criticism of finding IV-1, Ms. Dismukes fails  
16 to mention the significant other data contained in the Schumaker report used by  
17 Schumaker to arrive at her conclusions about the AWWSC costs and services provided to  
18 TAWC as outlined in the Management Audit scope approved by the Authority.  
19

20 Q. DO YOU HAVE ANY COMMENTS REGARDING PAGE 5 OF MS. DISMUKES'  
21 TESTIMONY ADDRESSING THE RELATIONSHIP OF AWWSC COSTS TO  
22 TOTAL O&M COSTS, A&G/CUSTOMER ACCOUNTING COSTS OF TAWC?

23 A. Yes. Ms. Dismukes seems to fall into the same trap as Mr. Buckner in that she only  
24 focuses on the increase in management fee costs and not the offsets in labor and benefit  
25 costs at TAWC or the service improvements and efficiencies gained from centralization  
26 and standardization of those functions. She is right that management fees have increased  
27 when only looking at the total numbers in a vacuum, but she ignores the offsetting costs  
28 in other areas of the TAWC cost of service. Ms. Dismukes makes no mention of the  
29 savings generated from those centralization efforts as identified in Exhibit MAM-11  
30 attached to my direct testimony or the explanations of the increase in management fees  
31 provided in Exhibit MAM-10 of my direct testimony. I would also note that when the

1 total O&M costs for TAWC as adjusted for pensions and OPEB costs (which are not  
2 inflation driven) and capital cost billed through AWWSC to make the comparison to  
3 TAWC “apples to apples” are removed the remaining O&M costs of TAWC have  
4 remained below the rate of inflation for the period 2005-2011, as shown on Exhibit  
5 MAM-4 of my direct testimony.

6 When Ms. Dismukes and Mr. Buckner solely focus on the increase total in  
7 management fees they miss the facts concerning the overall increase in O&M costs at  
8 TAWC. The Schumaker Report did look at the bigger picture of the reasons behind the  
9 increase in management fees. At page 124 of Exhibit MAM-8 (the Schumaker Report),  
10 the report says, “Consolidation and centralization of governance, strategy, policy  
11 development, and support functions is generally considered at cost effective way to  
12 provide such services. Schumaker & Company found no evidence to the contrary within  
13 the American Water organization.”  
14

15 Q. ON PAGE 20 OF MS. DISMUKES’ TESTIMONY SHE INDICATES THAT THE  
16 PERCENTAGE OF AWWSC COSTS TO THE NON-REGULATED SUBSIDIARIES  
17 HAS DECLINED FROM 2005-2009. IS SHE CORRECT?

18 A. She accurately reflects the numbers, but she is not correct in her conclusion because of  
19 the lack of analysis to support her conclusion. The fact is the non-regulated subsidiaries  
20 were charged over \$8.0 million in 2005 for the costs of project STAR, a business  
21 development tool geared for the non-regulated business. The fact is that the allocation of  
22 AWWSC costs to the non-regulated subsidiaries has increased since the introduction of  
23 the Tier 1 allocation factors in 2006.  
24

25 Q. DO YOU HAVE COMMENTS ABOUT THE CLAIM OF MS. DISMUKES ON PAGE  
26 42 OF HER TESTIMONY THAT INDICATES THERE ARE NO ECONOMIES OF  
27 SCALE TO TAWC FOR BEING PART OF THE LARGER ORGANIZATIONS?

28 A. Yes. She bases this conclusion on the results shown on Schedule KHD-15. Both in Mr.  
29 Baryenbruch’s rebuttal testimony and earlier in this testimony the Company has  
30 demonstrated Schedule KHD-15 was developed based on inaccurate, inconsistent and  
31 unreliable information, so therefore her conclusion is not based on a reasonable analysis.

1 Her conclusion is not supported by the information referenced above and shown on  
2 Exhibits MAM-4, MAM-10 and MAM-11 attached to my direct testimony.

3  
4 Q. DO YOU HAVE COMMENTS ON MS. DISMUKES ON PAGE 48 OF HER  
5 TESTIMONY THAT MR. BARYENBRUCH AND THE COMPANY HAVE NOT  
6 DEMONSTRATED THAT THE LEVEL OF SERVICES PROVIDED BY AWWSC  
7 WOULD BE REQUIRED IF TAWC WERE A STAND-ALONE COMPANY?

8 A. Yes. It appears that Ms. Dismukes may have failed to read the Schumaker Report, but  
9 her conclusion in this regard is in direct conflict of Finding IV-1 as shown on Exhibit  
10 MAM-8 of my direct testimony, at page 118 of 143, which states, "The Composition and  
11 mix of responsibilities as identified by functions and associated services provided by the  
12 AWWSC and utility company organizations, such as TAWC, is reasonable."

13  
14 **Rebuttal of Mr. Buckner**

15  
16 Q. WHAT LEVEL OF MANAGEMENT FEES DOES MR. BUCKNER RECOMMEND  
17 FOR THE ATTRITION YEAR?

18 A. Mr. Buckner recommends rates for the attrition year should be \$3,670,849<sup>21</sup>, a reduction  
19 of \$1,555,185 below the \$5,226,034 requested by the Company.

20  
21 Q. WHAT METHOD DID MR. BUCKNER USE IN ARRIVING AT THIS  
22 RECOMMENDED MANGEMENT FEE AMOUNT?

23 A. Mr. Buckner started with the level of management fees authorized in docket number 04-  
24 00288 and increased that number by an inflationary trend through the 2011 attrition year.

25  
26 Q. WHAT SUPPORT DOES MR. BUCKNER GIVE FOR THAT METHODOLOGY?

27 A. On page 12 of his testimony, Mr. Buckner indicates his method is based on TRA  
28 precedent and history of O&M expense for TAWC.

29  

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<sup>21</sup> Buckner Revised Testimony, at Exhibit 1, page 5 of 9.

1 Q. DO YOU AGREE WITH MR. BUCKNER'S STATEMENT THAT THE  
2 METHODOLOGY HE UTILIZED IS BASED ON TRA PRECEDENT?

3 A. No. The TRA did adopt the method proposed by the CAPD in the 2008 Rate Case. In  
4 the motion of Director Roberson, he made it clear that his motion required a new  
5 management audit to address whether the management fees and allocations of the  
6 Company's AWWSC costs were reasonable and prudent, and the management audit was  
7 to be conducted by a certified public accountant. The motion went on to indicate that  
8 based on the management audit the TRA or a party could request reinstatement of the  
9 disallowed management fees from the 2008 Rate Case. The Company does not believe  
10 the Order of the Authority in the 2008 Rate Case was precedent setting as to adopting the  
11 methodology proposed by the CAPD in that case. To the contrary, the 2008 Rate Case  
12 docket was left open to address the development of the management audit RFP. The  
13 management audit was subsequently transferred to docket number 09-00086. Clearly  
14 the Authority did not adopt the CAPD's methodology as a precedent for future rates  
15 cases, but could revisit their decision from the 2008 Rate Case once the management  
16 audit was completed.

17  
18 Q. DID THE TENNESSEE COURT OF APPEALS ADDRESS THE ESTABLISHMENT  
19 OF MANAGEMENT FEES IN THE APPEAL OF THE 2008 RATE CASE?

20 A. Yes. Indicating that, "The management fees set by the TRA were to be revisited within  
21 six months upon the filing of an appropriate management audit by TAWC. Using the  
22 fees from 2005 was a reasonable, temporary solution to the dilemma until TAWC could  
23 submit a proper management audit."<sup>22</sup> Obviously the Court of Appeal did not indicate  
24 that the TRA has set a precedent based on the CAPD methodology used to set the level of  
25 management fees in the 2008 Rate Case.

26  
27 Q. DID THE CAPD DEVELOP A DIFFERENT APPROACH TO MANAGEMENT FEES  
28 IN THE TESTIMONY OF MR. BUCKNER?

---

<sup>22</sup> Decision of the Court of Appeals of Tennessee, No. M2009-00553-COA-RV-CV, dated January 28, 2011, at page 23.

1 A. Beginning on page 30 of his testimony Mr. Buckner, describes a number of adjustments  
2 to the Company's requested management fees, including (i) the use of the Atmos Energy  
3 allocation factors to reallocate AWWSC costs, (ii) elimination of external affairs costs,  
4 (iii) elimination of 70% of the AIP, (iv) elimination of Business Development costs, (v)  
5 elimination of accounting expenses, (vi) normalized payroll, (vii) adjusted payroll  
6 growth, (viii) elimination of stock based compensation, and (ix) applied a GDP deflator  
7 factor. The result of these adjustments are shown on Mr. Buckner's Exhibit, page p23,  
8 and produced a management fee number for the attrition year of \$3,515,578. Mr.  
9 Buckner did not use this management fee number in his cost of service, but indicates this  
10 only confirms the 2004 docket amount plus inflationary and growth trends provides a  
11 reasonable level of management fees.  
12

13 Q. DID MR. BUCKNER DESCRIBE HIS OPINION OF THE COMPANY'S  
14 MANAGEMENT FEES REQUESTED FOR THE ATTRITION YEAR?

15 A. Yes. On page 5 of this testimony Mr. Buckner states, "TAWC's growth in management  
16 fees exceeds any economic justification, and has far outstripped inflation."  
17

18 Q. DO YOU AGREE WITH THIS PORTRAYAL OF THE COMPANY'S  
19 MANAGEMENT FEES INCREASE?

20 A. No. Mr. Buckner seems to cling to the notion that the only acceptable level of  
21 management fees was established in the 2004 Rate Case, and should never change except  
22 for inflation. Mr. Buckner ignores that the way TAWC and AWWSC provides service to  
23 our customers has changed. He states on page 23 of his testimony that TAWC's other  
24 expenses continue to rise and there is no offset anywhere in TAWC's forecast to account  
25 for that rise, and goes on to say that the TAWC forecasted management fees do not show  
26 a more cost effective operation. The Employee Count section of this testimony and the  
27 employee vacancy rate shown on his Exhibit at page 8 show that many of the vacancies  
28 he claims as justification for his proposed reduction in the number of employees  
29 requested by TAWC show there have been offsets to the increase in management fees.  
30

1 Q. DID YOU ADDRESS THE OFFSETS AND SAVINGS THAT HAVE BEEN  
2 CREATED THROUGH THE MOVE TO A MORE CENTRAL APPROACH TO THE  
3 MAJOR FUNCTIONS NOW PROVIDED BY AWWSC IN YOUR DIRECT  
4 TESTIMONY?

5 A. Yes. I provided that analysis on Exhibit-11 to my direct testimony. That exhibit starts  
6 with the TAWC labor and benefits approved in docket number 03-00118, a period prior  
7 to the major reorganizations that created national call centers; shared service centers for  
8 benefits, procurement and general accounting; and a regional approach to finance,  
9 planning and the field service operations. I then developed inflation factors from actual  
10 TAWC data (page 2 of 2) to determine a reasonable estimate of what the combined costs  
11 of TAWC labor, employee benefits and AWWSC costs would have been if none of the  
12 reorganizations had occurred to provide more cost effective centralized functions when it  
13 made sense to do so. I then compare those results to the combined TAWC labor,  
14 employee benefit costs and AWWSC costs for the attrition year.

15  
16 Q. HAS THE PURPOSE OF THE LABOR AND MANAGEMENT FEES ANALYSIS IN  
17 PAST COMPANY RATE CASES BEEN TO IDENTIFY ALL SAVINGS  
18 GENERATED BY THE REORGANIZATIONS?

19 A. No. My purpose was to show that there have been offsets to the increase in management  
20 fees contrary to the assertions of the CAPD, Mr. Buckner and the City otherwise. In past  
21 cases this analysis has shown that the overall impact has been a savings to the customers  
22 of TAWC.

23  
24 Q. DID DIRECTOR ROBERSON ADDRESS THE LABOR AND MANAGEMENT FEE  
25 ANALYSIS WITH YOU IN THE LAST CASE?

26 A. Yes. If I recall correctly he indicated that he expected the savings to be bigger. As I  
27 stated my purpose was to demonstrate offsets existed to the management fee increase not  
28 to identify all savings.

29  
30 Q. DID YOU PROVIDE OTHER SUPPORT FOR THE REASONS FOR THE INCREASE  
31 IN MANAGEMENT FEES IN YOUR TESTIMONY?



1 A. Yes. That information was provided on Exhibit MAM-10 with my Direct Testimony in  
2 this case that demonstrated the increase in management fees from 2005 through the 2011  
3 attrition year had primarily increased due a shift in employees and functions from TAWC  
4 to AWWSC, significant increases in pension and group insurance costs largely driven by  
5 market returns on the pension and OPEB trustee fund investments due to the major  
6 recession that began in 2008. The Exhibit also identified a substantial increase in the  
7 depreciation, interest cost and maintenance of IT assets purchased and now owned by  
8 AWWSC that had previously been capitalized at TAWC. The other categories of  
9 expenses for AWWSC had actually decreased from 2005 through the attrition year.

10  
11 Q. DID EITHER MR. BUCKNER OR MS. DISMUKES ADDRESS THE ANALYSIS OF  
12 INCREASED EXPENSES AT AWWSC FROM 2005 THROUGH THE 2011  
13 ATTRITION YEAR?

14 A. No. Neither Mr. Buckner nor Ms. Dismukes mentioned the information on Exhibit  
15 MAM-10. Mr Buckner's only response to the management fees is that there is no  
16 justification for the level of increase in management fees and no offsets of gains in  
17 productivity have occurred.

18  
19 Q. YOU MENTIONED THAT A LARGE PART OF THE INCREASE IN  
20 MANAGEMENT FEES HAS OCCURRED DUE TO CAPITALIZING  
21 INFORMATION TECHNOLOGY ASSETS AT THE SERVICE COMPANY? WHY IS  
22 THAT CHANGE IMPORTANT TO ANY FAIR REVIEW AND ANALYSIS OF THE  
23 INCREASE IN MANAGEMENT FEES?

24 A. In the past major IT equipment and software purchases were capitalized at the subsidiary  
25 level as shared assets. Those assets were reflected as rate base at TAWC which were  
26 covered in rates at the WACC which included a return to equity component. The costs to  
27 TAWC were all reflected as capital costs; depreciation, interest expense and a return  
28 component. They are now capitalized at AWWSC which are passed to TAWC at cost  
29 which includes depreciation, interest expense and property taxes, but no return cost since  
30 AWWSC bills at cost.

1 Q BY CAPITALIZING THE MAJOR INFORMATION TECHNOLOGY ASSETS AT  
2 AWWSC DOES THAT PROVIDE A LOWER COST TO TAWC'S CUSTOMERS  
3 THAN CAPITALIZING THOSE COSTS AT TAWC ON A SHARED BASIS?

4 A. Yes. Because AWWSC bills at cost with no return component, the cost to the  
5 Company's customers is lower than if TAWC capitalized those assets on its book.  
6

7 Q. WHY IS IT NECESSARY TO RECOGNIZE THE DEPRECIATION, INTEREST  
8 EXPENSE AND PROPERTY TAXES PAID NOW INCLUDED IN MANAGEMENT  
9 FEES IN THE ANALYSIS SHOWN ON EXHIBIT MAM-11 OF YOUR DIRECT  
10 TESTIMONY?

11 A. Because in 2003, the starting point for the analysis shown on Exhibit MAM-11, AWWSC  
12 had very little capital costs, not taking consideration the shift of capital cost from TAWC  
13 to O&M expense at TAWC when billed as management fees would render any  
14 comparison "apples to oranges". In Exhibit MAM-11, I properly accounted for the shift  
15 in capital costs to O&M and the savings from the reorganization total \$1.229 million to  
16 the benefit of TAWC's customers, a fact that Mr. Buckner ignores or refuses to view  
17 objectively.  
18

19 Q. DID MR. BUCKNER ADDRESS EXHIBIT MAM-11 IN HIS TESTIMONY?

20 A. Yes. Page 28 of his testimony Mr. Buckner refers to Exhibit MAM-11 as "mathematical  
21 gymnastics in an attempt to show the increased management fee increases resulting from  
22 reorganization provided savings to the customers." He goes on to say, "With each  
23 numeric invention the numbers and the assumptions used by the Company in their fruit  
24 basket comparisons cast doubt as to their veracity."  
25

26 Q. DOES THE COMPANY AGREE WITH MR. BUCKNER'S PORTRAYAL OF THE  
27 COMPANY'S EFFORTS TO DEMONSTRATE TO THE AUTHORITY THE  
28 IMPACTS OF ITS EFFORTS TO WORK IN A MORE EFFICIENT AND COST  
29 EFFECTIVE WAY?

1 A. Obviously the Company takes exception to this commentary by Mr. Buckner. The  
2 Company's testimony shows the successful impacts of the Company's efforts, which are  
3 facts that Mr. Buckner fails to objectively consider or simply ignores.  
4

5 Q. DO YOU HAVE ANY COMMENTS ABOUT THE ASSERTION BY MR. BUCKNER  
6 ON PAGE 23 OF HIS TESTIMONY THAT THE COMPANY CONCEDES THE  
7 REORGANIZATIONS HAVE NOT RESULTED IN MORE COST EFFICIENT  
8 OPERATIONS?

9 A. We disagree with Mr. Buckner's assertions. The Company has never conceded and does  
10 not in this case concede that the reorganizations leading to a more centralized approach  
11 have not led to more efficient operations. The reason the Company has never done this is  
12 because it is simply not true as demonstrated by Exhibit MAM-11.  
13

14 Q. DO YOU HAVE COMMENTS ABOUT THE ASSERTION ON PAGE 24 OF MR.  
15 BUCKNER'S TESTIMONY THAT THE SCHUMAKER & COMPANY REPORT IS  
16 SOMEWHAT LIMITED IN SCOPE?

17 A. Yes. Mr. Buckner's comments are misplaced. The Company brought before the TRA  
18 and its staff the RFP for the management audit which was modified and approved by the  
19 Authority. The TRA reviewed the recommendations about the selection of the auditor  
20 and approved the team of Schumaker & Company and Work & Greer CPAs as the  
21 successful bidder. In addition the Authority approved the contract with Schumaker &  
22 Company including an exhibit attached to the contract that clearly identified each area of  
23 the AWWSC/TAWC relationship that was to be addressed in the management audit.  
24 The scope of the management audit was set by the Authority, and the audit was  
25 conducted in accordance with the scope set by the Authority.  
26

27 Q. DO YOU HAVE COMMENTS ABOUT THE ASSERTIONS BY MR. BUCKNER ON  
28 PAGE 25 OF HIS TESTIMONY THAT THE SCHUMAKER REPORT'S ANALYSIS  
29 OF TOTAL COST OF AWWSC IS BASED ON A REVIEW OF VARIOUS STUDIES  
30 PREPARED BY TAWC WITNESS MR. BARYENBRUCH?

1 A. Yes. The Company disagrees with the characterization that is made. As part of the RFP  
2 process, the Authority instructed a review of work performed in previous audits of  
3 AWWSC and other studies that had been performed about cost allocation methodologies  
4 including the Tier 1 allocations that allocate costs to the non-regulated entities. Contrary  
5 to the assertions of Mr. Buckner otherwise, the entire section 3 of the Schumaker report  
6 was dedicated to a review of internal controls, SOX controls, internal audits, and  
7 financial reviews, and the report indicated that much of the work done to implement  
8 Sarbanes/Oxley had been performed by some of the largest public accounting firms in the  
9 country including PwC, Ernest & Young and KMPG, and at PwC had recently completed  
10 the SOX 404 Certifications for the 2009 financial statements of AWW. Section III-B of  
11 the report also included discussion of the work performed by the Schumaker team to  
12 determine scientific samples and testing of the AWWSC transactional general ledger  
13 which included approximately 172,000 service transactions and approximately 84,000  
14 overhead transactions. From that analysis six p-card transactions totaling \$333, of which  
15 \$82 was charged to Tennessee American, did not have the required back up. In addition  
16 Section IV, beginning on page 85, included a discussion of the Schumaker & Company  
17 review of a number of AWW processes and costs, including an independent  
18 benchmarking study of AWWSC costs to a group of similar service companies finding  
19 that the cost of AWWSC were reasonable when compared to its peers. Mr. Buckner's  
20 assertion that the Schumaker report only reviewed the reports generated by Mr.  
21 Baryenbruch is unfounded and untrue.

22  
23 Q. DO YOU HAVE COMMENTS ON THE ASSERTION OF MR. BUCKNER ON PAGE  
24 26 OF HIS TESTIMONY THAT INDICATES THE SCHUMAKER & COMPANY  
25 REPORT FOUND THAT THE COST ALLOCATION METHODOLOGIES OF  
26 AWWSC ARE NOT NECESSARILY BASED ON COST CAUSATIVE FACTORS?

27 A. Mr. Buckner's attempt to portray Schumaker & Company's Finding II-2 is not complete  
28 in that the finding indicated the cost allocation methodologies impacting AWWC are  
29 generally reasonable. Recommendation II-2 of the Schumaker report suggests an the  
30 Company perform an analysis to verify that the use of the number of customers for  
31 allocating AWWSC costs among regulated utilities reasonably approximates the use of

1 cost causative factors; and to subsequently make modifications if appropriate. The  
2 Company performed the cost causative allocation study as sponsored by Mr. Uffelman in  
3 his rebuttal testimony in this case and was also filed in Docket Number 09-00086, and  
4 there were no material differences that required modification to the Company's allocation  
5 method.

6  
7 Q. PLEASE ADDRESS THE ASSERTION BY MR. BUCKNER ON PAGE 29 OF HIS  
8 TESTIMONY THAT THE CURRENT ALLOCATION METHODS OF AWWSC  
9 OVER ALLOCATE CHARGES TO TAWC.

10 A. Mr. Buckner attempts to substitute a three factor allocation methodology utilized by  
11 Atmos Energy Corporation that is based on plant in service, customers, and O&M  
12 expenses. However, when asked in discovery requests 26-28 to provide any studies or  
13 analysis performed to determine the three factors utilized by Atmos were, in fact, cost  
14 causative to the various costs generated by AWWSC, his reply was in each instance he  
15 performed no studies or analysis that would support the substitution of Mr. Buckner's  
16 approach for the current customer allocations or the cost causative comparative  
17 allocations done in the study by Mr. Uffelman.

18  
19 Q. CAN YOU GIVE AN EXAMPLE OF WHY THE USE OF PLANT IN SERVICE  
20 WOULD NOT BE A GOOD COST CAUSATIVE ALLOCATION FACTOR FOR  
21 AWWSC COSTS?

22 A. Yes. Recently Kentucky American Water completed a new treatment plant and  
23 transmission facilities to serve the Greater Lexington Fayette area at a cost of \$162  
24 million. The impact of this major construction project doubled the rate base of Kentucky  
25 American Water. Under Mr. Buckner's approach, Kentucky American would experience  
26 a significant increase in its AWWSC costs although they receive no more service from  
27 AWWSC than they did prior to completion of the plant. I believe this is a very good  
28 example of why any arbitrary imposition of allocation factors can badly distort the  
29 allocation of actual costs of AWWSC services to the regulated subsidiaries who obtain  
30 those services from AWWSC.

1 Q. WHAT CONCLUSION DO YOU REACH ABOUT MR. BUCKNER'S PROPOSED  
2 ALLOCATION METHODOLOGY?

3 A. It is my opinion that Mr. Buckner's methodology of adopting the factors utilized by  
4 Atmos Energy without any support or analysis to determine their applicability to the cost  
5 drivers of the functions of AWWSC is without merit and should be rejected in this case.  
6 Mr. Uffleman also provides rebuttal on this topic based on his extensive experience of  
7 working with utilities on cost allocation factors established under sound cost accounting  
8 principles and practices and appropriate study.  
9

10 Q. DO YOU AGREE WITH MR. BUCKNER'S DISALLOWANCE OF 70% OF THE AIP  
11 COSTS FROM THE AWWSC COSTS CHARGED TO TAWC?

12 A. No. I have covered the topic of AIP earlier in this testimony and the rebuttal previously  
13 given on that subject applies equally to the AIP of the employees of AWWSC.  
14

15 Q. PLEASE ADDRESS THE REBUTTAL TESTIMONY OF MR. BUCKNER ON PAGE  
16 33 REGARDING BUSINESS DEVELOPMENT EXPENSES.

17 A. I do not agree with Mr. Buckner and I don't believe the customers in Suck Creek or Lone  
18 Oak who are now TAWC customers agree either. TAWC made significant  
19 improvements to those service areas which prior to TAWC's involvement either had no  
20 service or experienced a myriad of service issues, water quality issues, and high rates. In  
21 addition, customer growth from within the existing service areas or customer growth  
22 through acquisitions is good for existing customers because revenue growth offsets the  
23 need to increase rates and the company's fixed costs are spread over a larger customer  
24 base to the benefit of existing customers. Mr. Buckner provides no analysis nor gives  
25 any recognition to the fact that the Company has been encouraged by various county  
26 officials and government bodies to expand its system when it makes sense to do so.  
27 Obviously, those officials do not share Mr. Buckner's belief that consolidation of water  
28 systems through appropriate acquisitions does not provide benefits to the customers.  
29

30 Q. WHAT SUPPORT FOR HIS POSITION ON BUSINESS DEVELOPMENT COSTS  
31 WAS PROVIDED BY MR. BUCKNER ON PAGE 33 OF HIS TESTIMONY?

1 A. He gave no support other than to say the California and Kentucky Commissions had  
2 made similar decisions. This justification for this recommendation is not based on any  
3 independent study or analysis to support that the facts and circumstances in Tennessee  
4 are similar to California or Kentucky.

5  
6 Q. DO YOU AGREE WITH MR. BUCKNER'S DISCUSSION ABOUT EXTERNAL  
7 AFFAIRS COSTS ON PAGE 34 OF HIS TESTIMONY?

8 A. No. Mr. Buckner has not performed any study or analysis to determine what the make up  
9 of the costs in the External Affairs functions or the appropriateness of those costs. The  
10 costs included in external affairs are not just "lobbying" as stated by Mr. Buckner. The  
11 Company believes that maintaining relations with various regulatory agencies, various  
12 local, county, state and national elected leaders who are decision makers about the types  
13 of regulatory mandates that will be imposed on the Company and its customers is good  
14 business protocol for the Company as well as its customers. If the state of Tennessee or  
15 the national EPA is about to pass legislation that would impose regulations on the  
16 Company that could significantly increase the cost of service, the Company believes it  
17 should be at the table to look out for both the interests of the customers and the Company.  
18 Mr. Buckner's portrayal of the External Affairs is simply misplaced.

19  
20 Q. DO YOU AGREE WITH MR. BUCKNER'S DISCUSSION ABOUT THE COMPANY  
21 DOUBLE COUNTING AND EXCESSIVE GROWTH OF PAYROLL INCREASES?

22 A. No. The Company's adjustment for a 3% increase was not strictly related to pay  
23 increases. It also included adjustments for increased pension and OPEB costs based on  
24 the latest Evaluation Reports and general inflation on non-payroll items. In addition, the  
25 historical test-year was not normalized for pay increases granted on January 1, 2010, and  
26 therefore only included three months of that pay increase. The Company's use of the  
27 3.0% over the 21 months appropriately captures the 2010 pay increase and the 2011 pay  
28 increase. In addition, Mr. Buckner's inflation/growth factor is only applied to the payroll  
29 costs from AWWSC, and does not consider the considerable increases in pension and  
30 OPEB costs addressed earlier in this testimony. In addition, instead of using his  
31 September 2010 test-year for this adjustment, he then only applies the inflation factor for

1 15 months instead of the 21 months from March 2010 through the end of the attrition  
2 year ending December 2011.

3  
4 Q. DO YOU AGREE WITH MR. BUCKNER'S DISCUSSION ABOUT THE  
5 NORMALIZATION OF AWWSC EMPLOYEE COUNTS AT SEPTEMBER 2010?

6 A. Mr. Buckner bases this analysis on the difference in AWWSC employees at September  
7 2010 to December 2009. This does not properly match the number of employees in the  
8 historical test-year, it only looks at static employee counts, and not the average over  
9 whichever test-year he selects. In addition, Mr. Buckner has not analyzed whether those  
10 vacancies occurred at the Regional level, at the Corporate level, or even if those  
11 vacancies apply to AWWSC employees who regularly work for TAWC. This adjustment  
12 is simply a generated number that does not look at the average employees of an annual  
13 period and can not be accurate because it only looks at two points in time, it does not  
14 consider replacement hires that are occurring, and does not look at the additional  
15 temporary employees AWWSC may have for vacancy fill-in. Mr. Buckner's proposal is  
16 not founded on any sound analysis or study, is not representative of the FTE's over the  
17 annual period and therefore should be rejected.

18  
19 Q. DO YOU HAVE COMMENTS ON MR. BUCKNER'S REFERENCE TO SEVERAL  
20 OTHER STATE REGULATORY COMMISSIONS' DECISIONS AS ADDRESSED  
21 ON PAGES 36-40 OF HIS TESTIMONY?

22 A. Yes. I do not believe the references are instructive. I am extremely familiar with the  
23 language from the West Virginia Commission Order as I was involved directly in that  
24 case and was the Company's primary witness. The language Mr. Bucker quotes had  
25 nothing to do with AWWSC costs. The Company settled its 2007 Rate Case with the  
26 understanding among the parties that the Company would be filing again in 2008 to  
27 address the Water Loss Study referenced earlier in this testimony to address the needed  
28 increase in capital investment for accelerated main replacement to address the UFW issue  
29 raised by CAD in the 2007 Rate Case. In 2008 the financial crisis occurred and the  
30 Commission put this language in the Order to make it clear they expected the Company  
31 to look for ways to explore all alternatives before seeking increased rates. The Company



1 was surprised by the manner which the Commission portrayed the situation in their Order  
2 given that the Commission knew from the settlement agreement that the Company would  
3 be filing again in 2008. Regardless, the quoted language from the Order had nothing to  
4 do with management fees which were set at the historical test-year level as in all past  
5 WVAVC rate case. West Virginia is a historical test-year state.

6 The New Jersey management audit was not specific to management fees but  
7 rather a comprehensive management audit of the overall NJAWC operations, similar to  
8 the comprehensive management audit of PAWC performed in 2008.

9 Similar to the Order of the Authority in 2008 that leads to the TAWC  
10 management audit, the Ohio Order was followed by a directive from the Commission  
11 Staff to perform a management audit of the AWWSC costs to OHAWC that is currently  
12 ongoing.

13 The California Order was primarily related to call center costs. CAWC does not  
14 provide third party billing and the costs allocated to CAWC from the AWWSC call  
15 center did not account for that fact. Most other issues in the CAWC case referenced were  
16 corrected on re-hearing.

17  
18 Q. DO YOU HAVE COMMENTS ABOUT THE RECOMMENDATION OF MR.  
19 BUCKNER TO INITIATE A NEW AFFILATE AGREEMENT PROCESS BETWEEN  
20 AWWSC AND TAWC?

21 A. Yes. The Schumaker Report in recommendation II-4 states TAWC should provide the  
22 TRA with an informational update regarding the content of the AWWSC/TAWC affiliate  
23 agreement. The Company is currently in the process of completing a report that will  
24 satisfy that recommendation. My involvement in this case has detracted from my ability  
25 to complete that task. That report will be completed in the near future and filed in docket  
26 number 09-00086. The Company has also prepared the cost causative study that  
27 compares the appropriate cost causative allocation factors by AWWSC function to the  
28 customer allocations per the current agreement. A similar cost causative study was  
29 performed for PAWC and both the TAWC and PAWC results were very close to the  
30 results under the current customer allocation. I believe the Authority will have a  
31 significant amount of information on which to assess the current contract and to

1 determine the best path forward. The Company does not believe a new proceeding is  
2 needed or required as recommended by Mr. Buckner.

3  
4 Q. WHAT ARE YOUR CONCLUSION ABOUT MR. BUCKNER'S TESTIMONY AND  
5 RECOMMENDATION FOR MANAGEMENT FEES?

6 A. Mr. Buckner's approach of using the 2004 docket levels plus some adjustment for  
7 inflation is not the appropriate mechanism to determine management fees in this case,  
8 particularly now that the management audit performed by Schumaker and Company is  
9 completed and has been presented in this case. In addition I believe the method proposed  
10 by the CAPD is not cost based, is not known and measurable, and certainly not fair or  
11 reasonable for establishing the rates in this case. It is also apparent from Mr. Buckner's  
12 testimony that he has not analyzed in detail the drivers that increase the management fees  
13 or the shift of functions occurring between TAWC and AWWSC. It appears that Mr.  
14 Buckner not only questions the accuracy of my analysis but my truthfulness as well. That  
15 I don't appreciate and it is simply false. In addition Mr. Buckner's purported allocation  
16 methodology is not supported by any study or analysis.

17 The Authority should consider the Schumaker Report for what it is, which is an  
18 independent comprehensive management audit that was completed by a highly reputable  
19 and qualified audit team. The Schumaker Report confirms the appropriateness of the  
20 management fees and confirms the benefits and cost savings that flow to the customers  
21 from the use of the Management Company.

22  
23 Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

24 A. Yes.

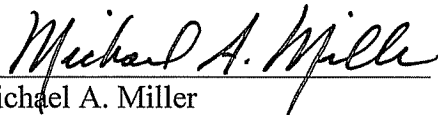
**TENNESSEE REGULATORY AUTHORITY**

**STATE OF WEST VIRGINIA**

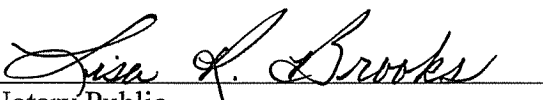
**COUNTY OF KANAWHA**

BEFORE ME, the undersigned authority, duly commissioned and qualified in and for the State and County aforesaid, personally came and appeared Michael A. Miller, being by me first duly sworn deposed and said that:

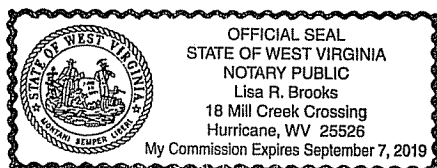
He is appearing as a witness on behalf of Tennessee-American Water Company before the Tennessee Regulatory Authority, and if present before the Authority and duly sworn, his rebuttal testimony would set forth in the annexed transcript consisting of 121 pages.

  
Michael A. Miller

Sworn to and subscribed before me  
this 8<sup>th</sup> day of February 2011.

  
Notary Public

My commission expires September 7, 2019.



This file has been produced natively on the accompanying disk:

Rebuttal Exhibit MAM-1 TN Achieved ROE on equity structure.xls

This file has been produced natively on the accompanying disk:

Rebuttal Exhibit MAM-2-CAPD End Results Test.XLS

This file has been produced natively on the accompanying disk:

Rebuttal Exhibit MAM-3 Comparative Capital Structure.xlsx

This file has been produced natively on the accompanying disk:

Rebuttal Exhibit MAM-4 Analysis of LT Int. Rates.xls

This file has been produced natively on the accompanying disk:

Rebuttal Exhibit MAM-5 Current AWW ROE's.XLS



This file has been produced natively on the accompanying disk:

Rebuttal Exhibit MAM-6 Recommended Capital Structure.xlsx

**Tennessee American Water Company  
Deferred Tax Reconciliation**

<u>Line #</u>		(1) 2010 Case Proper FAS 109 <u>Approach</u>	(2) 2010 Case CAPD (Revised) FAS 109 <u>Approach</u>
(1)	Regulatory Asset	8,375,977	8,375,977
(2)	ADITS	<u>(31,014,034)</u>	<u>(31,014,034)</u>
(3)	ADITS Utilized for Rate Recovery	(22,638,057)	(22,638,057)
(4)	FIN 48 reserve	0	(2,068,329)
(5)		(22,638,057)	(24,706,386)
(6)	WACC	8.38%	* 8.38%
(7)		(1,897,069)	(2,070,395)
(8)	Rev conversion factor	1.67319346	1.67319346
(9)	Total rev requirement	(3,174,164)	(3,464,172)
	Current Tax on Reversal of Timing Difference on Pre-1981 Property and Gross-up of AFUDC	623,832	0
(10)			
(11)		(2,550,332)	(3,464,172)

\*used Company's WACC for comparison purposes



Tennessee American Water Company  
Test Year Ended 03/31/10  
Lead/Lag Study

Line No.	Gross Receipt Tax				taxable period				Avg Service Period	Lag/Lead	Dollars Days	Cumulative Total	Percent to Total
1	Account	Doc Type	Voucher	Paid	Amount	Service Period From	To						
2													
3													
4													
5													
6	685440	PS	42278439	7/24/2009	531,330.00	7/1/2009	6/30/2010	182.00	(159.00)	(84,481,470.00)	727,184.00	100.00%	
7	685440	PS	42348195	10/22/2009	195,854.00	7/1/2009	6/30/2010	182.00	(69.00)	(13,513,926.00)	195,854.00	26.93%	
15													
16													
17													
18													

Average Lag for Gross Receipt Tax

Computation of Working Capital

Line No.	Item	Amount
1		
2		
3		
4		
5		
6		
7	Prepaid Taxes	284,235
8		
9	Materials & Supplies	254,110
10		
11	Deferred Regulatory Expenses	630,897
12		
13	Unamortized Debt Expense	460,845
14		
15	Other Deferred Debits	280,983
16		
17	Lead - Lag Study	927,000
18		
19	Total	2,838,070
20		
21	Less:	
22		
23	Incidental Collections	1,562,812
24		
25	Total	1,562,812
26		
27	Working Capital Requirement	1,275,258
28		
29		
30		
31		
32		
33		
34		
35		
36		
37		
38		
39		
40		
41		
42		
43		

Computation of Working Capital  
Lead/Lag Study

Line No.	Description	Days	Amount
1			
2			
3			
4			
5	Net Operating Funds		37,296,455
6	Average Daily Operating Funds		102,182
7			
8	Composite Average Days Interval Between:		
9			
10	(A) Date Service Furnished and Date Collections Deposited	43.53	
11			
12	(B) Date Expenses Incurred and Date of Payment	34.45	
13			
14	(C) Net Interval	9.08	
15			
16	Operating Funds Advanced		927,445
17			
18	Lead/Lag Study Capital		927,445
19			
20	Use		927,000
21			
22			
23			
24			
25			
26			
27			
28			
29			
30			
31			
32			
33			
34			
35			
36			
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42			
43			
44			
45			

Composite Average Days Interval between Date Expenses  
are Incurred and Date of Payment

Test Year: Twelve Months Ended: March 31, 2010  
Revised Exhibit No. 1, Schedule 3  
Page 3 of 6

Line No.	Description	Amount	Post Payment or (Lead) Days	Dollar Days
1				
2				
3				
4				
5	Payrolls Charged to Expense - Hourly	3,674,972	17.08	62,768,518
6	Payrolls Charged to Expense - Salary	1,858,687	17.08	31,746,371
7	Purchased Water	50,962	36.44	1,857,055
8	Fuel and Power	2,511,238	28.04	70,415,101
9	Chemicals	1,069,369	23.64	25,279,892
10	Waste Disposal	197,386	73.61	14,529,558
11	AWWS Charges	5,226,034	(11.97)	(62,555,632)
12	Group Insurance	1,075,184	(13.63)	(14,684,751)
13	OPEB's	959,573	(1.63)	(1,564,105)
14	Pensions	1,645,113	(1.63)	(2,681,534)
15	Regulatory Expense	379,918	76.64	29,116,916
16	Insurance Other than Group	485,904	(40.00)	(19,436,151)
17	Rents	8,706	(33.42)	(290,952)
18	Uncollectibles	198,122	0.00	0
19	Maintenance Expense	1,110,317	21.74	24,138,284
20	Amortizations	0	0.00	0
21				
22				
23	Other Operating Expenses	3,023,526	34.05	102,951,058
24	Total O & M Expenses	23,475,010		
25				
26				
27	Depreciation and Amortization	4,877,687	0.00	0
28	Taxes, Other than Income			
29	Payroll	438,774	15.79	6,928,245
30	Property Tax	2,936,068	241.00	707,592,388
31	Franchise Tax	377,690	37.50	14,163,375
32	Utility Tax	117,779	267.00	31,446,993
33	Gross Receipts Tax	529,961	(134.76)	(71,417,544)
34	FIT-Current	0	29.64	(13,604,671)
35	SIT-Current	0	29.64	(3,060,804)
36	Deferred Taxes	0	0.00	0
37	Interest Expense	0	85.08	348,012,849
38	Preferred Dividends	0	45.63	3,155,543
39	Net Earnings	0	0.00	0
40	Net Operating Funds	387,752		
41		37,296,455		1,284,836,002
42				
43	Average Days Interval between Date Expenses are Incurred and Date of Payment		34.45	
44				
45				
46				
47				
48				
49				
50				

Tennessee American Water Company  
Test Year Ended 03/31/10  
Lead/Lag Study

Line No.	Gross Receipt Tax				taxable period				Avg Service Period	Lag/Lead	Dollars Days	Cumulative Total	Percent to Total
1	Account	Doc Type	Voucher	Paid	Amount	Service Period From	To						
2													
3													
4													
5													
6	685440	PS	42278439	7/24/2009	531,330.00	7/1/2009	6/30/2010	182.00	(159.00)	(84,481,470.00)	727,184.00	100.00%	
7	685440	PS	42348195	10/22/2009	195,854.00	7/1/2009	6/30/2010	182.00	(69.00)	(13,513,926.00)	195,854.00	26.93%	
15													
16					<u>727,184.00</u>					<u>(97,995,396.00)</u>			
17													
18										<u>(134.76)</u>			

Average Lag for Gross Receipt Tax



Computation of Working Capital

Line No.	Item	Amount
1	Prepaid Taxes	284,235
2		
3	Materials & Supplies	254,110
4		
5	Deferred Regulatory Expenses	630,897
6	Unamortized Debt Expense	460,845
7		
8	Other Deferred Debits	280,983
9		
10	Lead - Lag Study	927,000
11		
12	Total	2,838,070
13		
14	Less:	
15		
16	Incidental Collections	1,562,812
17		
18	Total	1,562,812
19		
20	Working Capital Requirement	1,275,258
21		
22		
23		
24		
25		
26		
27		
28		
29		
30		
31		
32		
33		
34		
35		
36		
37		
38		
39		
40		
41		
42		
43		

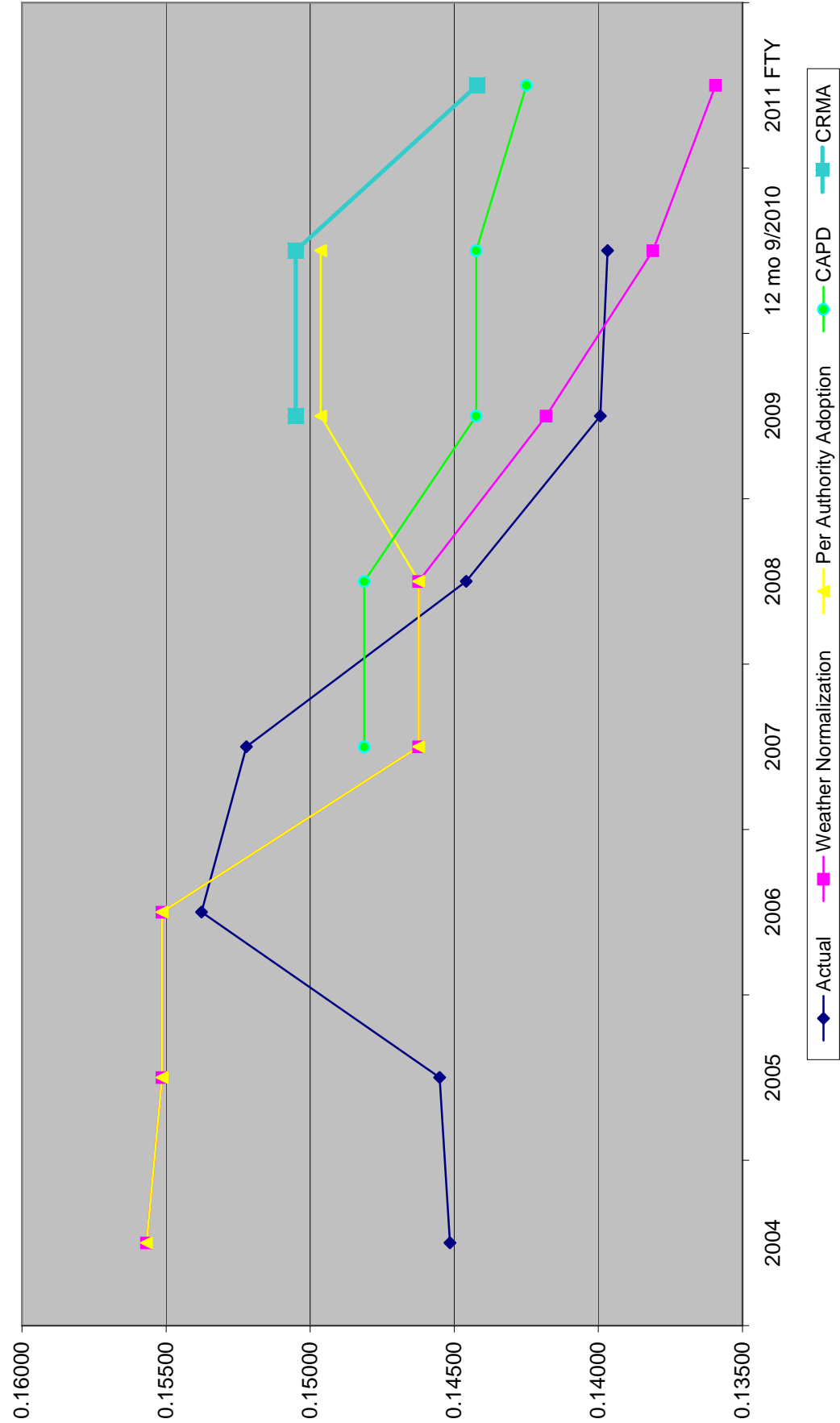
Composite Average Days Interval between Date Expenses  
are Incurred and Date of Payment

Line No.	Description	Amount	Post Payment or (Lead) Days	Dollar Days
1				
2				
3				
4				
5	Payrolls Charged to Expense - Hourly	3,674,972	17.08	62,768,518
6	Payrolls Charged to Expense - Salary	1,858,687	17.08	31,746,371
7	Purchased Water	50,962	36.44	1,857,055
8	Fuel and Power	2,511,238	28.04	70,415,101
9	Chemicals	1,069,369	23.64	25,279,892
10	Waste Disposal	197,386	73.61	14,529,558
11	AWWS Charges	5,226,034	(11.97)	(62,555,632)
12	Group Insurance	1,075,184	(13.63)	(14,684,751)
13	OPEB's	959,573	(1.63)	(1,564,105)
14	Pensions	1,645,113	(1.63)	(2,681,534)
15	Regulatory Expense	379,918	76.64	29,116,916
16	Insurance Other than Group	485,904	(40.00)	(19,436,151)
17	Rents	8,706	(33.42)	(290,952)
18	Uncollectibles	198,122	0.00	0
19	Maintenance Expense	1,110,317	21.74	24,138,284
20	Amortizations	0	0.00	0
21				
22				
23	Other Operating Expenses	3,023,526	34.05	102,951,058
24	Total O & M Expenses	23,475,010		
25				
26				
27	Depreciation and Amortization	4,877,687	0.00	0
28	Taxes, Other than Income			
29	Payroll	438,774	15.79	6,928,245
30	Property Tax	2,936,068	241.00	707,592,388
31	Franchise Tax	377,690	37.50	14,163,375
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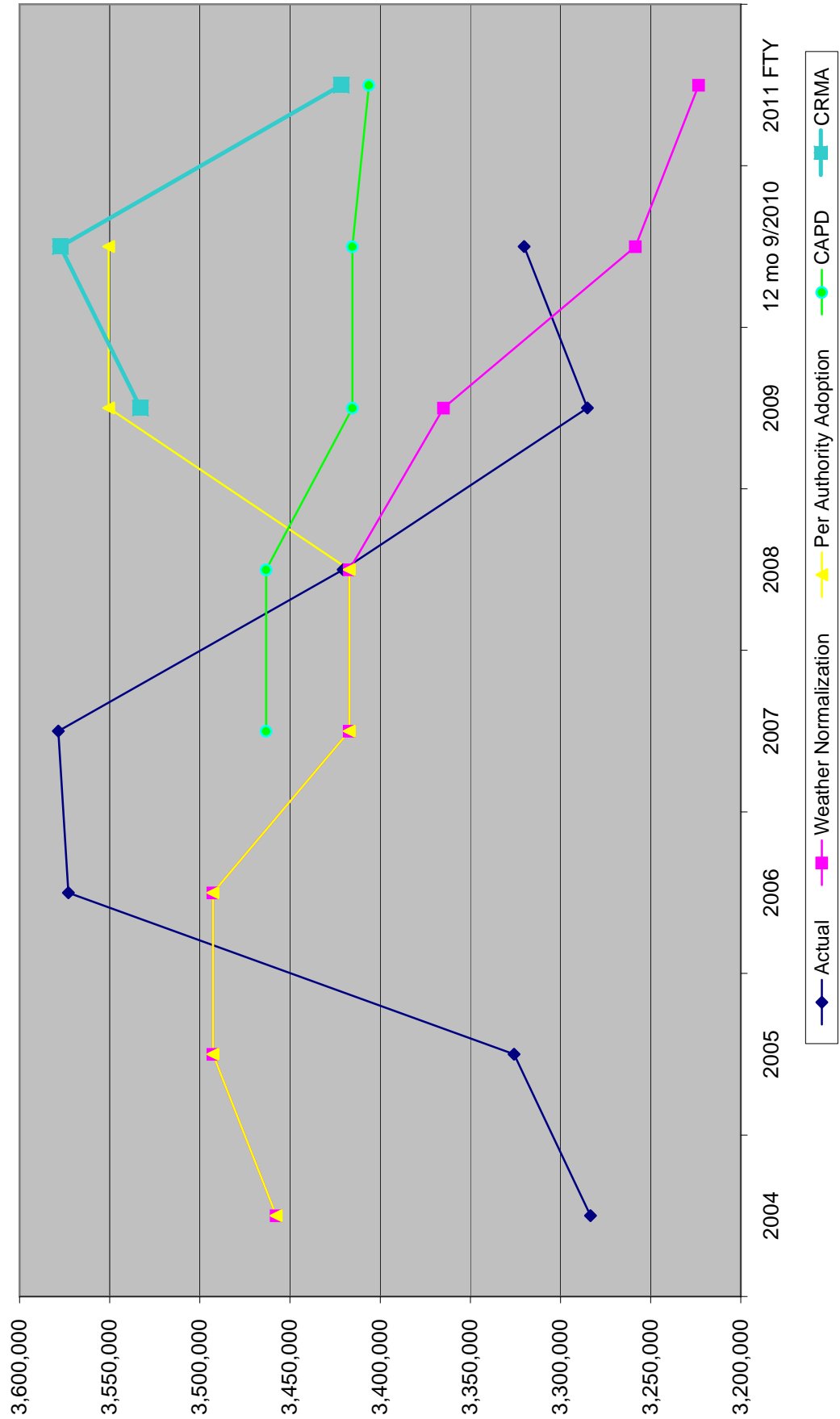
**Tennessee American Water  
Rate Base Comparison & Company Recommendation**

	<u>TAWC</u>	<u>CAPD Revised</u>	<u>Company Recommendation Based on Rebuttal Testimony</u>
UPIS	226,384,490	225,496,162	225,496,162
CWIP	4,201,421	2,681,318	4,201,421 Based on Rebuttal Testimony of Sheila Miller
UP Capital Lease	1,590,500	1,590,500	1,590,500
Working Capital	1,011,258	834,497	1,275,258 Based on Rebuttal Testimony of Michael Miller
Total Additions	<u>233,187,669</u>	<u>230,602,477</u>	<u>232,563,341</u>
Acc Depr	72,578,044	73,137,622	73,137,622
Acc Amort UP Capital Lease	1,387,269	1,387,268	1,387,268
Acc DIT	17,153,815	25,288,933	22,638,057 Based on Rebuttal Testimony of M. Miller (Rebuttal Exhibit MAM-7)
CAC	6,383,603	5,786,757	5,786,757
CIAC	10,131,112	9,932,550	9,932,550
Unamtz ITC	26,899	26,899	26,899
UPAA	53,954	74,850	74,850
Total deductions	<u>107,714,696</u>	<u>115,634,879</u>	<u>112,984,003</u>
Rate Base	<u>125,472,973</u>	<u>114,967,598</u>	<u>119,579,338</u>

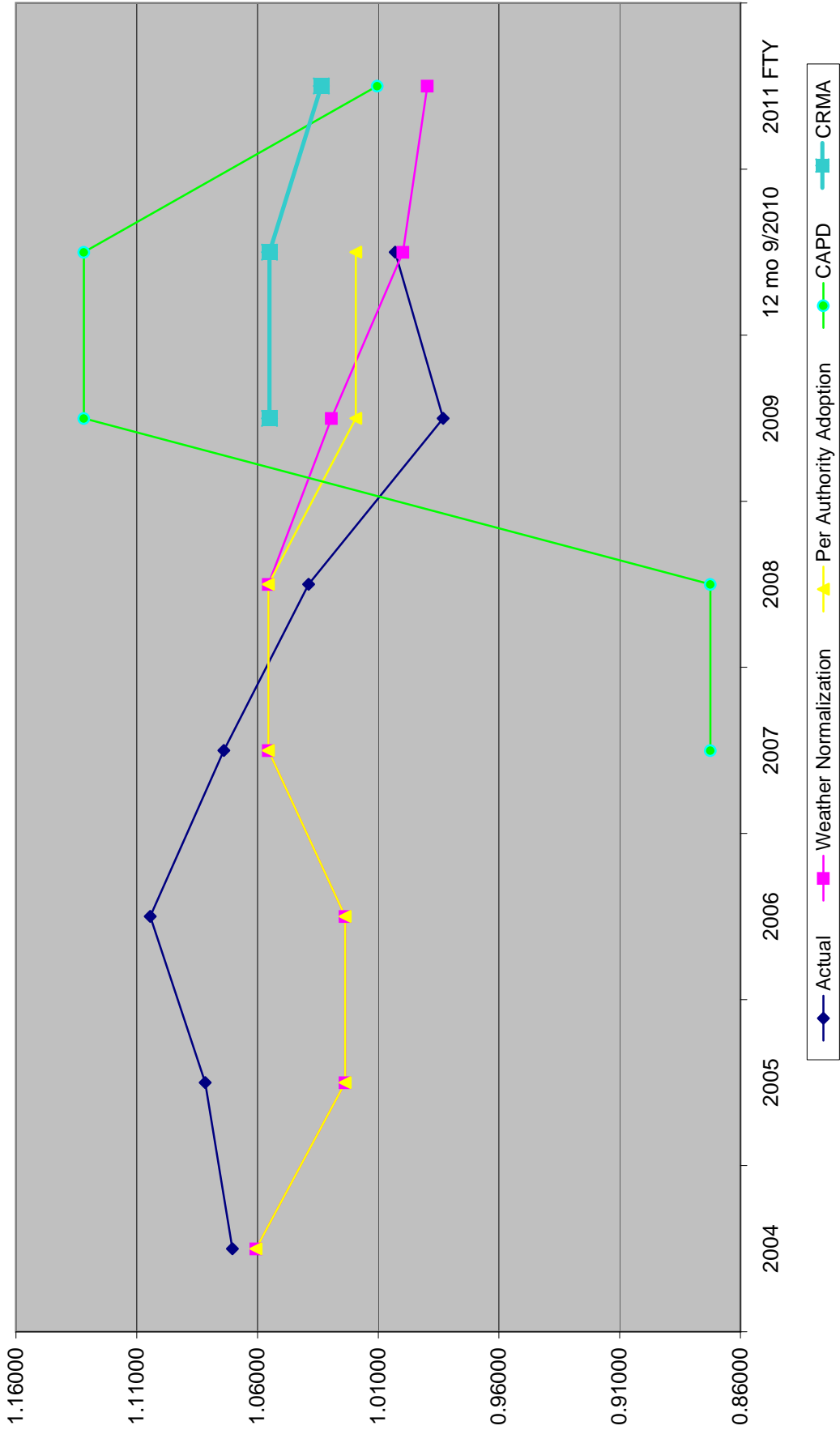
Tennessee American Water  
Residential Usage Per Customer Per Day



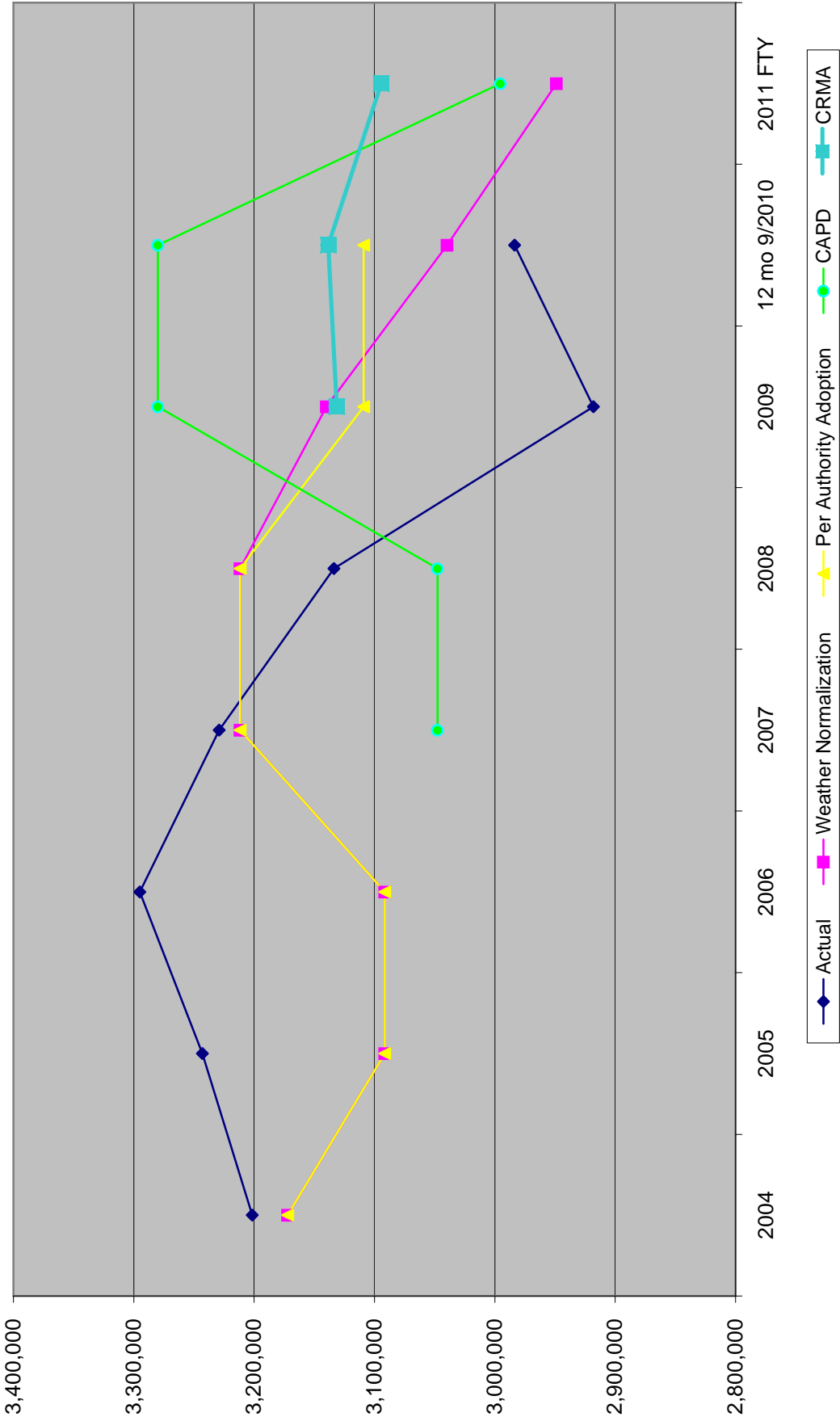
### Tennessee American Water Residential Usage



Tennessee American Water  
Commercial Usage Per Customer Per Day



Tennessee American Water  
Commercial Usage



Graphs:

**Residential Usage**

	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>12 mo 9/2010</u>	<u>2011 FTY</u>
Actual	3,126,697	3,283,285	3,325,788	3,572,940	3,578,466	3,420,547	3,285,001	3,320,201	
Per Dr. Spitznagel Weather Normalized Approach		3,457,692	3,492,754	3,492,754	3,417,160	3,417,160	3,364,805	3,258,361	3,223,390
Per Authority Adoption (or Settlement)		3,457,692	3,492,754	3,492,754	3,417,160	3,417,160	3,550,563	3,550,563	
Per CAPD					3,463,189	3,463,189	3,415,361	3,415,361	3,406,254
Per CRMA							3,532,984	3,577,369	3,421,513

**Commercial Usage**

	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>12 mo 9/2010</u>	<u>2011 FTY</u>
Actual	2,956,248	3,201,592	3,242,916	3,295,033	3,229,097	3,133,691	2,918,191	2,983,618	
Per Dr. Spitznagel Weather Normalized Approach		3,172,233	3,091,494	3,091,494	3,211,679	3,211,679	3,140,014	3,039,690	2,948,888
Per Authority Adoption (or Settlement)		3,172,233	3,091,494	3,091,494	3,211,679	3,211,679	3,109,069	3,109,069	
Per CAPD					3,047,593	3,047,593	3,279,990	3,279,990	2,995,350
Per CRMA							3,131,430	3,138,361	3,094,319

**Residential usage per customer per day**

	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>12 mo 9/2010</u>	<u>2011 FTY</u>
Actual	0.14054	0.14515	0.14551	0.15377	0.15221	0.14459	0.13994	0.13968	
Per Dr. Spitznagel Weather Normalized Approach		0.15568	0.15514	0.15514	0.14623	0.14623	0.14181	0.13811	0.13593
Per Authority Adoption (or Settlement)		0.15568	0.15514	0.15514	0.14623	0.14623	0.14964	0.14964	
Per CAPD					0.14812	0.14812	0.14424	0.14424	0.14249
Per CRMA							0.15050	0.15050	0.14420

**Commercial usage per customer per day**

	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>12 mo 9/2010</u>	<u>2011 FTY</u>
Actual	0.9805	1.07035	1.08165	1.10441	1.07391	1.03877	0.98316	1.00298	
Per Dr. Spitznagel Weather Normalized Approach		1.06066	1.02367	1.02367	1.05543	1.05543	1.02941	0.99975	0.98964
Per Authority Adoption (or Settlement)		1.06066	1.02367	1.02367	1.05543	1.05543	1.01926	1.01926	
Per CAPD					0.87247	0.87247	1.13192	1.13192	1.01040
Per CRMA							1.05500	1.05500	1.03360



TENNESSEE AMERICAN WATER COMPANY  
REGULATORY EXPENSES  
ATTRITION YEAR ENDING DECEMBER 31, 2011

<b>Add'l 2008 Rate Case</b>
275,000
275,000.00

<b>2010 Rate Filing:</b>	645,000
Outside Rate Case Prep Fees	644
Legal	1,069,484
Cost of Money	27,863
Other	142,501
Total cost	1,240,492
3 year amtz	413,497

<b>Cost of Service Study</b>
24,360
24,360
8,120
3 year amtz

	<u>2006 RC</u>	<u>2008 RC</u>
Balance 3/31/10	131,158	137,500
Amtz	7,286.58	65,579
Balance @ 12/31/10	65,579	68,750

2006 case-9 months	65,579
2008 rate case	7,638.89
2010 rate case	413,497
<b>2008 rate case - appeals court order docket no. 08-00039</b>	<b>275,000</b>

**2008 Cost of Service Study**

Balance 3/31/10	\$	17,191
Amtz	955	\$ 8,596
Balance 12/31/10	9 mos remaining	\$ 8,596

**2008 Depreciation Study**

Balance 3/31/10	\$	15,651
Amtz	869.5	\$ 7,826
Balance 12/31/10	9 mos remaining	\$ 7,826

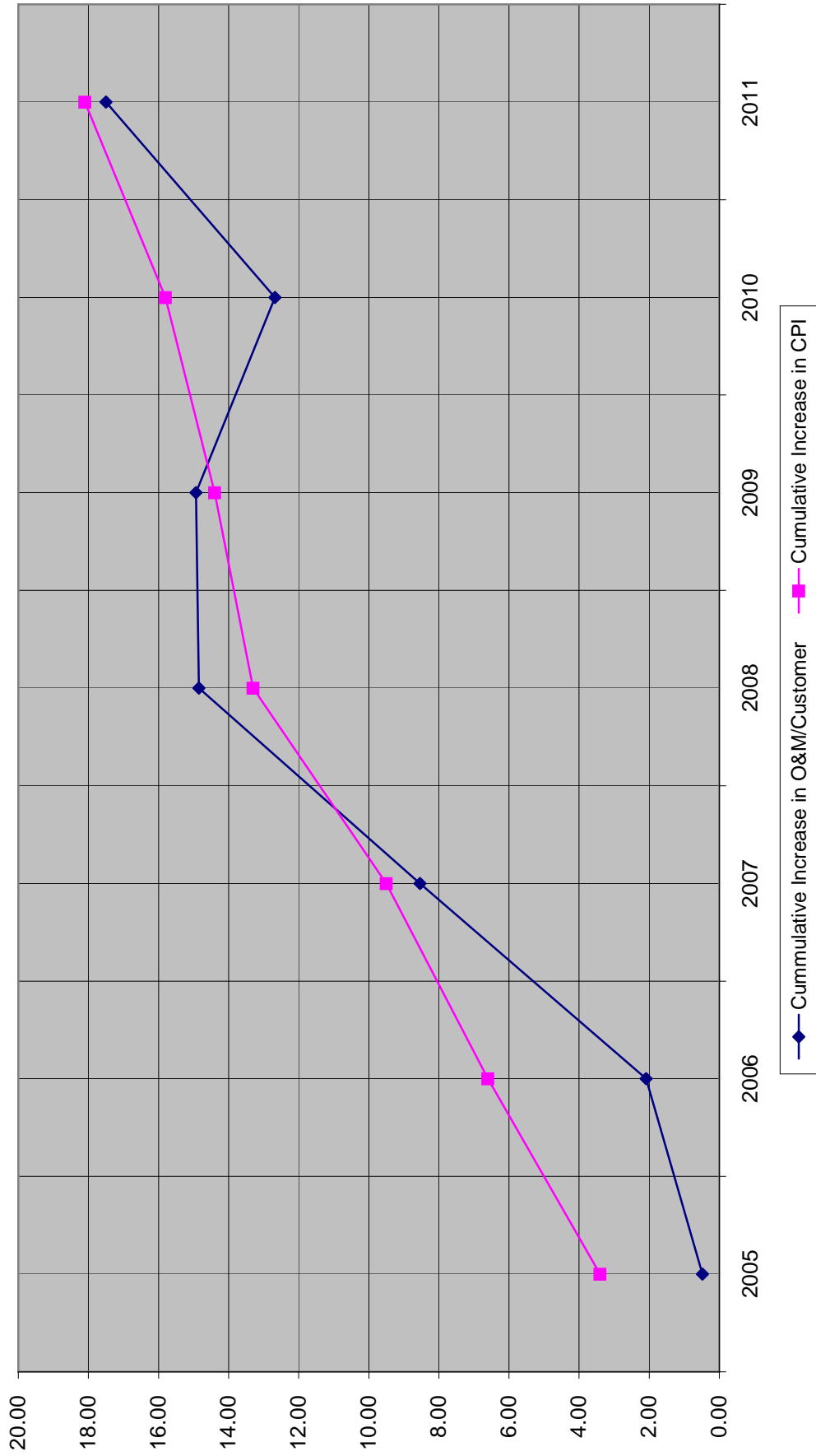
<b>2010 COS</b>	8,120
<b>2008 COS</b>	8,596
<b>2008 Depr Study</b>	7,826
	\$ 24,542
	24,542

847,368

## Tennessee American Water Key Performance Indicators

	Trends			
	2007	2008	2009	2010
Overall Customer Satisfaction	96.0%	83.0%	86.0%	86.7%
Service Quality Satisfaction	84.0%	80.0%	89.0%	84.0%
Customer Complaints	11	15	18	12
Customer Appointments Met Timely	99.6%	99.8%	99.6%	99.5%
Service Orders Completed as Scheduled	99.8%	99.996%	99.7%	98.7%
Non Pay Shut-offs Worked	99.5%	99.0%	97.3%	92.6%
O&M Efficiency Rate	55.2%	64.1%	62.7%	61.6%
Operating Margin	22.3%	13.9%	14.6%	15.4%
Account Receivable over 90 days	N/A	10.2%	8.4%	5.2%
Estimated Meter Reads	0.8%	0.6%	0.0%	0.0%
Valve Operations	1,933	2,664	3,403	2,224
Hydrant Inspections	5,654	5,464	5,898	4,126
Environmental Notice of Violation	0	0	0	0
OSHA Recordable Injury Rate	15.4	4.9	4.2	8.9
Recordable Vehicle Accidents	6	1	3	1
General Liability Claims	26	26	37	31
Overtime Hours	4,770	3,682	3,682	4,058

**TENNESSEE AMERICAN WATER COMPANY**  
**Detail of O & M Costs**



**Tennessee American Water  
Detail of O&M Costs**

	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>12/31/2011</u>	FTY
Labor	4,212,010	3,765,383	4,256,528	4,664,401	5,045,198	5,126,043	5,228,000	5,680,299	
Purchased Water	34,173	50,635	53,119	53,351	45,196	39,327	55,000	50,962	
Fuel & Power	1,604,033	1,588,696	2,231,924	2,276,874	2,626,285	2,382,233	2,600,000	2,511,238	56.56%
Chemicals	712,030	835,399	989,613	1,091,507	1,113,328	1,265,535	1,030,000	1,069,369	50.19%
Waste Disposal	136,373	161,150	156,389	151,324	167,955	159,077	195,000	197,386	
Management Fees	3,770,383	3,262,357	2,887,986	3,768,450	3,746,524	3,456,500	3,667,772	3,606,210	
Insurance Other	663,569	484,633	501,775	528,319	457,922	473,954	291,000	485,904	
Customer Accounting	972,605	1,147,599	1,304,538	1,125,626	1,355,726	1,569,440	1,048,000	1,221,169	
Rents	37,254	39,988	43,474	22,397	9,281	9,286	9,000	8,706	
General Office	239,363	1,045,754	324,503	223,739	261,676	207,670	179,000	217,933	
Miscellaneous	1,761,313	1,853,160	1,827,888	1,776,561	1,857,766	1,914,109	1,763,000	2,005,675	
Maintenance	529,521	641,096	753,371	824,087	916,440	942,777	1,164,000	1,110,317	109.68%
Total O&M Expense (See Note 1)	14,672,627	14,875,850	15,331,108	16,506,636	17,603,297	17,545,951	17,229,772	18,165,168	
Customers	72,013	72,660	73,701	74,540	74,774	74,475	74,814	75,249	
O*M Cost per Customer	203.75	204.73	208.02	221.45	235.42	235.60	230.30	241.40	
Annual Increase		0.48%	1.60%	6.46%	6.31%	0.07%	-2.25%	4.82%	
<b>Cummulative Increase in O&amp;M/Customer</b>		<b>0.48%</b>	<b>2.09%</b>	<b>8.54%</b>	<b>14.85%</b>	<b>14.93%</b>	<b>12.68%</b>	<b>17.50%</b>	
Consumer Price Index		3.40%	3.20%	2.90%	3.80%	1.10%	1.40%	2.30%	
<b>Cummulative Increase in CPI</b>		<b>3.40%</b>	<b>6.60%</b>	<b>9.50%</b>	<b>13.30%</b>	<b>14.40%</b>	<b>15.80%</b>	<b>18.10%</b>	

**Note 1:** Excludes non-recurring write-offs of reg. assets disallowed for rate recovery, SOX implementation costs, divestiture costs and NNS reclassification.

Also excludes Group Insurance and Pension costs which have been driven by financial market conditions other than inflation, for both AWWSC & TAW

Also excludes depreciation expense at AWWSC due to change of policy in 2007 concerning purchases of IT hardware & software by AWWSC. This change resulted in an at cost recovery through AWWSC vs. historical rate base at TAW which resulted in a return on the investment saving TAW customers the return component.

Tennessee American Water Company  
Revised ERISA Pension Expense & FAS 106 OPEB Costs

	Latest Towers Watson Actuarial Determination of 2011 Costs for AWW	TAWC Allocation Percentage	2011 TAWC Cost	TAWC Cost per Filing	Increase to Attrition Year Costs Above Original Filing
ERISA Minimum Pension Contribution	137,600,000	1.78%	2,449,880	1,954,440	
TAWC O&M Percentage			84.17%	84.17%	
			2,062,140	1,645,113	417,027
FAS 017 OPEB Costs	46,500,000	3.00%	1,395,000	1,140,000	
			84.17%	84.17%	
			1,174,215	959,573	214,641

**Tennessee - American Water Company**  
**Comparison of Average Usage to Peer Water Utilities**  
**Based on avg usage 5.537CCF or 4.153 (1,000 gallons)**

<b>Utility</b>	<b>Bill</b>
Tennessee American Water Co.	16.62
United Water Arkansas	25.60
Aqua Utilities Florida	
Group 1	24.82
Group 2	37.31
Group 3	37.49
Group 4	46.07
Indiantown Company, Inc. - FL	19.81
Lake Utility Services - FL	15.62
North Fort Myers Utility - FL	24.41
North Sumter Utility Company LLC - FL	14.90
Rainbow Springs Utilities , LC - FL	14.03
Royal Utility Company - FL	23.11
Sanlando Utilities Corporation - FL	7.59
Southlake Utilities, Inc. - FL	13.17
Utilities Inc. of Florida	
Marion County	13.02
Orange County	21.49
Pasco County	28.40
Pinellas County	24.21
Seminole County	18.80
Water Service Corporation of Kentucky	19.74
The Empire District Electric Co. - MO	24.34
Kiawah Island Utility	35.97
AQUA VIRGINIA, INC.	
Greenville Division	46.53
Bucksport Division	29.33
Freeport Division	37.58
Camden and Rockland Division	43.90
Hartland Division	39.27
Kezar Falls Division	38.72
Millinocket Division	33.32
Oakland Division	53.42
Skowhegan Division	32.78
United Water of Virginia	51.65