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BEFORE THE TENNESSEE REGULATORY AUTHORITY
Nashville, Tennessee

IN RE: Petition Of Tennessee American Water Company To Change And Increase Certain Rates And Charges So As To Permit It To Earn A Fair And Adequate Rate Of Return On Its Property Used And Useful In Furnishing Water Service To Its Customers	 Docket No. 10-00189

POST-HEARING BRIEF OF UTILITY WORKERS UNION OF AMERICA, AFL-CIO AND UWUA LOCAL NO. 121

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The Utility Workers Union of America, AFL-CIO ("UWUA") and UWUA Local No. 121 (collectively, "UWUA" or "the Union"), intervenors in this proceeding, hereby submit their Post-Hearing Brief. For the reasons presented in testimony, investigated at trial, and reviewed herein, the Union requests that the Commission condition upon the terms set forth below any rate relief afforded in this proceeding to Tennessee American Water Company ("Company," "TAWC," or "Tennessee American"). As we will demonstrate, the imposition of these conditions is both consistent with the evidentiary record and in accordance with Tennessee law, which the Tennessee Supreme Court has found provides to the Authority "practically plenary authority over the utilities within its jurisdiction."[1]

SUMMARY

While the Company has focused on dollars and cents, money is not the only matter at issue in this case. As part of its review of the proposed rate hike, the Authority is statutorily

[1] *Consumer Advocate Div. v. Greer*, 967 S.W.2d 759, 761-62 (Tenn. 1998) (citing *Tenn. Cable Television Ass'n v. Tenn. Pub. Serv. Comm'n*, 844 S.W.2d 151, 159 (Tenn. Ct. App. 1992)) (internal quotations omitted).

obligated to "take into account the safety, adequacy and efficiency or lack thereof of the service or services furnished by the public utility." Tenn. Code Ann. 65-5-101(a). The Union has sought in this proceeding to present to the Authority the perspective of the Company's workforce[2] on its ability, in current circumstances, to provide the high-quality service TAWC customers demand and deserve, and to which they are entitled by law. We review here the significant service quality issues facing Tennessee American, as well as steps that the Authority can and should take in this proceeding to address these concerns.

While the Union believes the Company needs rate relief sufficient to enable Tennessee American to hire an adequate number of well-trained staff, and to maintain its infrastructure in accordance with good utility practice, rate relief alone is insufficient to ensure that either of those goals will be met. In the last TAWC rate case before the Authority (TRA Docket No. 08-00039, initiated in 2008), the Company sought approval of the inclusion in rates of salary and wage expenses associated with 114 full-time employees ("FTEs"); the Authority approved the inclusion of expenses associated with 109 FTEs.[3] Nonetheless, between the issuance of the January 13, 2009, Order in that case and Mr. Lewis's January 5, 2011, testimony in this proceeding, while the rates charged to customers included the salaries and wages of 109 FTEs, the Company did not maintain an employee workforce of even 109 persons, let alone the 114 FTEs that the Company had asserted were essential to maintaining service. In this proceeding, TAWC forecasts an increased workload in 2011, and the Company has expressed concern that

[2] The Union's perspective is informed by the extensive involvement of its members in almost all aspects of service delivery and related operations. UWUA witness James Lewis testified that the work performed by Union members includes ensuring water quality and proper filtering, operating and maintaining distribution facilities, reading meters, installing new services, and conducting service disconnections. Direct Testimony of James Lewis at 6:6-9, (Jan. 5, 2011) "Lewis Test."

[3] *In re Petition of Tennessee American Water Company to Change and Increase Certain Rates and Charges so as to Permit it to Earn a Fair and Adequate Rate of Return on Its Property Used and Useful in Furnishing Water Service to Its Customers*, Order at 12-13 Docket No. 08-00039, (Tenn. Regulatory Auth., Jan. 13, 2009).

absent adequate staff, it cannot efficiently perform all needed short-term and long-term activities.[4] While the Union is therefore concerned that the requested number of FTEs (110) may not be adequate, at a minimum, steps should be taken to ensure that all 82 hourly positions (included within the 110 FTE number) are filled immediately, and remain filled throughout the period in which the new rates will be in effect.

The short-staffing at TAWC is particularly problematic given the chaotic state of the Company's valve maintenance program. Valves perform a critical function in a water distribution system because they control the flow of water. In an emergency, workers need to know where the valves are located and need to be confident that valves will operate when called upon. The Company's corporate parent, American Water Works Company, Inc. ("American Water" or "Parent Company"), has identified valve maintenance programs as a "best practice,"[5] and the Company itself acknowledges that valve inspection, exercising, and maintenance are fundamental components of "sound water utility practice."[6] Nonetheless, over the past year TAWC has curtailed its valve maintenance activities, and has conducted fewer valve inspections than the Company itself asserts are required to operate in a manner consistent with sound utility practice.[7]

Indeed, as shown at hearing, the Company does not appear to know basic facts about the state of its valves, including how many of the tens of thousands of valves that are used to control water flows in the Tennessee American system are operable--that is, how many will function

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[4] *E.g.*, Rebuttal Testimony of John Watson at 10:22-11:5 (Feb. 8, 2011) ("Watson Rebuttal Test."); and Exhibit No. UWUA-10 of Lewis Test..

[5] Exhibit No. 37.

[6] Exhibit No. 38.

[7] Despite this, the Company testified in this proceeding that it *focused* on preventative maintenance activities in 2010. Watson Rebuttal Test. at 27:22-24.

properly when needed.[8] Company President Watson testified on cross-examination that a time-consuming forensic audit would be needed to determine the number of operable (and inoperable) valves,[9] but, remarkably, announced the very next day (during his presentation of "comments" on valve issues) that only twenty-five of the Company's roughly 26,000 valves were currently inoperable.[10] Later on the same day, Mr. Watson undermined his own estimate, explaining on cross-examination that the requisite valve forensic audit had not been conducted, and that data on the number of operable valves would be subject to the results of the (as yet unplanned) forensic audit.[11]

There was testimony at hearing about covered valves, broken valves, and missing valves,[12] as well as reports of instances in which repairs were not conducted in either a cost-efficient or water-efficient manner because valves needed to slow the flow of water and reduce pressure could not be located or were not functioning.[13] Union witness Marvin "Rusty" Blevins, a former TAWC supervisor, testified that the Company has known that some valves were in a state of disrepair for years, yet no action was taken to repair them.[14] Thus, customers are currently paying rates that include valve infrastructure that the Company knows will not function properly if and when called upon.

When questioned on cross-examination, Company President Watson acknowledged that TAWC had failed to staff its operations in accordance with the authorization received in the last

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[8] The Company conceded in a discovery response that it could not state how many valves were currently operable. Exhibit No. 38 (subsection (c)).

[9] Vol. III.C, Tr. 32:19-33:4.

[10] Vol. IV.D, Tr. 324:2-325:2.

[11] Vol. IV.D, Tr. 339:3-11.

[12] *E.g.*, Vol. III.A, Tr. 22 *et seq.*

[13] Vol. IV.D, Tr. 295:22-296:8.

[14] Vol. IV.D, Tr. 296:9-14.

rate case.[15] As a consequence, the Company's valve maintenance program lacked sufficient human resources, and TAWC was unable during the past year to conduct the requisite valve inspection and maintenance activities.[16] He asserted that these staffing deficiencies were the result of a lack of revenue.

This contention does not comport with the evidence. While needed staff were not hired and needed maintenance activities were curtailed, TAWC's Board of Directors--the majority of whom are American Water Works Service Company ("Service Company") employees, and therefore neither TAWC executives nor "independent" of the Company -- continued to authorize the payment of upstream dividends from Tennessee American to its corporate parent, American Water President Watson explained that these payments are pursuant to a "policy," and that they are consistent with TAWC's "fiduciary obligation" to its shareholders.[17] The Union respectfully disagrees. Paying dividends to American Water corporate -- which holds all of the Company's common stock--while the Company lacks sufficient funds to hire needed and authorized staff, is contrary to the paramount goal of utility regulation, which seeks to ensure that customers paying just and reasonable rates receive reliable and high quality service. Rate regulation provides regulated companies with the opportunity to earn a reasonable return; it does not entitle companies to place the financial needs of a corporate parent ahead of the service needs of a utility's customers. And, to state the obvious, it does not permit the Company to ship needed revenues upstream while simultaneously contending that substantial rate increases are needed to cover revenue shortfalls.

In these circumstances, the UWUA asks that the rate relief approved in this proceeding

[15] Vol. II.C, Tr. 341:20-342:5.

[16] Vol. II.C, Tr. 340:18-21.

[17] Vol. II.C, Tr. 345:10-14; 346:6-10.

be conditioned as follows:

(1) The Company should be required to fill at least all 82 hourly positions immediately, and to maintain at least that level of hourly FTEs throughout the period in which the approved rates are in effect.

(2) The Company should be required to submit quarterly reports to the Authority (a) stating the actual number of FTEs employed during the previous quarter; (b) identifying any differences between actual and authorized FTE levels; (c) explaining the reasons for any under-staffing (i.e., levels below the authorized number of FTEs); and (d) providing the date by which any vacancy will be filled.

(3) In the event that the Company fails to maintain a workforce level consistent with its authorized level, and to fill vacancies quickly and routinely, TAWC should be subject to a financial penalty, in an amount and under such terms as may be determined by the Authority.[18]

(4) The Company should be required to conduct the "forensic" valve audit referenced by witness Watson, and thereby determine baseline numbers of operable (and inoperable) large and small valves in the TAWC system. The audit should be completed within six (6) months of the issuance of the Order resolving this proceeding. The results of the audit should be submitted in a subsequent filing with the Authority.

(5) The Company should be required to staff the valve maintenance program with

[18] Union witness Lewis testified that the penalty could take the form of a reduction in the return on equity component of its rates. In such an instance, Mr. Lewis properly suggested that the penalty remain in place until the staffing shortage is rectified. Lewis Test. at 20:11-16.

sufficient personnel to ensure that TAWC is able to complete valve inspections in accordance with established protocols (i.e., all of the valves larger than 16" on a biannual basis, and all valves 16" or less on a once-every-five-years cycle), and to conduct in a timely manner whatever maintenance, repair, or replacement activities are warranted.

(6) The Company should be required to submit quarterly reports to the Authority stating: (a) the target number of larger and smaller valves to be inspected, exercised, and maintained during that quarter (if the number of valves to be inspected and exercised is fewer than the practice set forth in Condition No. 5 would dictate, then the Company should be required to explain the basis for the reduction and to specify by when TAWC plans to make up the shortfall); (b) the number of valves that were in fact inspected, exercised, and maintained during the quarter; (c) the number of valves that were in need of repair or replacement; (d) by when such valves were (or will be) repaired or replaced; and (e) the number of valves which are in need of repair or replacement, but which the Company has concluded will not be repaired or replaced, and which should therefore be removed from rate base.

(7) The Company should be prohibited from paying dividends to its corporate parent (or preferred shareholders) where the payment would result in the equity portion of the Company's capital structure falling below its current level, 43.6%, or such equity level as the Commission approves in establishing the rates in this proceeding. TAWC may seek TRA permission to pay dividends that would be contrary to this limitation, but in such instance would

bear the burden of demonstrating that payment of the dividend would not have a material impact on Company staffing or the provision of reliable and cost-effective service to customers.

ARGUMENT

I. THE TRA HAS LEGAL AUTHORITY TO CONDITION ITS APPROVAL OF A PROPOSED RATE INCREASE

As a general matter, "[t]he power to approve implies the power to disapprove and the power to disapprove necessarily includes the lesser power to condition an approval." *Southern Pac. Co. v. Olympian Dredging Co.*, 260 U.S. 205, 208 (1922). The TRA has particularly broad powers over the utilities it regulates and clear legal authority to impose the UWUA-proposed conditions, each of which is tailored to address staffing and maintenance issues that currently compromise the quality of the service provided by the Company to customers. Tennessee law gives the TRA "practically plenary authority over the utilities within its jurisdiction."[19] In particular, the TRA's "primary grant of authority"[20] states:

> The authority has general supervisory and regulatory power, jurisdiction, and control over all public utilities, and also over their *property, property rights, facilities, and franchises*, so far as may be necessary for the purpose of carrying out the provisions of this chapter.

Tenn. Code Ann. § 65-4-104 (emphasis added). In interpreting that provision, the Tennessee Code mandates that:

> This chapter shall not be construed as being in derogation of the common law, but shall be given a liberal construction, and any doubt as to the existence or extent of a power conferred on the authority by this chapter or chapters 1, 3 and 5 of this title shall be resolved in favor of the existence of the power, to the end that the

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[19] *Greer*, 967 S.W.2d at 761-62 (citing *Tenn. Cable Television Ass'n* 844 S.W.2d at 159) (internal quotations omitted).

[20] *BellSouth Adver. & Publ'g Corp. v. Tenn. Regulatory Auth.*, 79 S.W.3d 506, 512 (Tenn. 2002), *cert. denied*, 537 U.S. 1189 (2003).

> authority may effectively govern and control the public utilities placed under its jurisdiction by this chapter.

Id. § 65-4-106. *See also Briley v. Cumberland Water Co.*, 389 S.W.2d 278 (Tenn. 1965).

Tennessee Code Section 65-117 further enumerates the powers of the Authority, which include the power to:

> (1) Investigate, upon its own initiative or upon complaint in writing, any matter concerning any public utility . . . ;
>
> (3) After hearing, by order in writing, fix just and reasonable standards, classifications, regulations, practices or services to be furnished, imposed, observed and followed thereafter by any public utility; [and]
>
> (4) After hearing, by order in writing, ascertain and fix adequate and serviceable standards for the measurement of quantity, quality, pressure, voltage, or other condition, pertaining to the supply of the product or service rendered by any public utility, and to prescribe reasonable regulations for examination, test and measurement of such product or service.

Tenn. Code Ann. § 65-4-117. The General Assembly has also empowered the TRA to "adopt rules governing the procedure prescribed or authorized" including "rules implementing, interpreting, or making specific the various laws which [the TRA] enforces or administers." *Id.* § 65-2-102(1)-(2); *see also Greer*, 967 S.W.2d at 761-62.

Thus, the Authority has broad jurisdiction to impose requirements on the Company necessary to ensure that safe and adequate service as statutorily mandated is provided. Each of the Union's proposed conditions is designed to remedy staffing and maintenance issues which implicate the safety and adequacy of the service offered by the Company.

II. THE AUTHORITY SHOULD GRANT THE COMPANY'S REQUEST FOR AUTHORIZATION TO INCLUDE IN RATES THE EXPENSES ASSOCIATED WITH AT LEAST 82 HOURLY FULL-TIME EMPLOYEES

The staffing question in this rate proceeding has two interrelated components: (a) what number of full-time personnel the Company is authorized to include in rates (for salary/wage purposes) by the Authority, and (b) how to ensure that the Company actually hires and retains that authorized number of employees throughout the period the rates set in this proceeding are in effect. The first component concerns rates; the second directly implicates the Company's commitment to service quality.

For the reasons set forth in witness Lewis's testimony (both pre-filed and at hearing), the Union is primarily concerned that the Authority approve the inclusion in rates of expenses associated with all 82 of the hourly employees included as part of the Company's requested 110 FTE level. In part because the Company appears to have a higher-than-normal ratio of supervisory-to-hourly personnel (and also because as will be shown, important maintenance activities are not currently being conducted), there should be no dispute that, at a minimum, all of these hourly employees are needed to conduct Company operations and are essential to the delivery of services to customers.

In addition, the Authority should impose conditions upon the Company to ensure that it both fills all authorized positions immediately, and retains employees in those positions for the entirety of the period in which the rates will be in effect. As was emphasized at trial, the issue is not simply the number of employees on the Company payroll on the first day of the hearing; the issue is what the staffing levels will look like once this proceeding is completed.[21] Witness Lewis explained why such a condition is needed, noting that "in recent years the Company has failed to properly staff its operations. In other words, we are concerned not only with the employee number today but what it will be going forward." Vol. IV.D, Tr. 249:3-7.

A. The Authority Has the Power and Jurisdiction to Address the Company's Staffing and Maintenance Deficiencies

In considering whether to approve a change in rates, the Authority is mandated to "take

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[21] Vol. I.A, Tr. 109:18-23.

into account the safety, adequacy and efficiency or lack thereof of the service or services furnished by the public utility." Tenn. Code Ann. § 65-5-103(a). The staffing and maintenance issues raised by the Union in this proceeding go to the heart of that inquiry. In addition, under Tennessee law:

> No public utility shall . . . provide or maintain any service that is unsafe, improper, inadequate, or withhold or refuse any service which can reasonably be demanded and furnished when ordered by the authority.

Tenn. Code Ann. § 65-4-115. As discussed in detail below, the evidence adduced in this proceeding demonstrates that unsafe, improper, and inadequate service is the direct result of the Company's failure to properly staff its operations and perform needed maintenance. Accordingly, those issues are proper subjects for Authority consideration.

B. The Authority Should Approve the Company's Proposed Level of Hourly Positions and Ensure That They Remain Filled

According to witness Watson, the Company needs 110 full-time employees. In his direct testimony, Mr. Watson explained that "[e]ach of these employees is directly and integrally involved in the provision of water service to the customers of TAWC." Direct Testimony of John S. Watson at 21:16-17 (Sept. 23, 2010) ("Watson Test."). In response to a data request, which is Exhibit No. UWUA-2 to witness Lewis's testimony, the Company states that 82 of these positions are for hourly employees and 28 are for managerial employees. Mr. Lewis notes that this "means roughly one managerial employee for every three hourly employees. In my experience, this is a higher than average ratio of management to hourly employees, especially for a private company." Lewis Test. at 7:17-19.

In response to certain discovery requests, the Company provided detailed justification for its request for 110 FTEs. For example, Exhibit No. UWUA-7 to witness Lewis's testimony is a discovery response in which witness Watson states:

> The Company has assessed its current operation and believes the compliment [sic] of 110 full time positions requested in this case is necessary to: i) carry out its public service obligation, ii) meet customer demands for customer service, water quality and iii) carry out the administrative functions of the Company. That determination has been made through discussion with Mr. Watson and the management staff of TAWC and been authorized by the Company's Board of Directors.

Similarly, Company witnesses Watson and Miller represented in response to another UWUA request (included as Exhibit No. UWUA-8 to witness Lewis's testimony) that:

> In order to maintain an appropriate level of service going forward, the Company needs 110 full-time employees and an appropriate rate of return to be able to employ this level of employees.

Finally, witness Watson, in responding to another UWUA data request on this topic, (included as Exhibit No. UWUA-9 to witness Lewis's testimony), stated:

> The Company's requested employee level of 110 employees in this case has been supported by significant amounts of testimony and working papers filed with the TRA and provided to the intervenors in this case. The process which the Company went through to determine the 110 employee level in this case is the same process the Company goes through each year in determining the appropriate level and mix of employees needed to meet its business needs and provide adequate service.

Tennessee American went on to explain what could happen if the full complement of FTEs is not authorized. As explained by witness Lewis:

> In response to discovery requests from the UWUA, the Company explained that because it does not currently have sufficient employees, TAWC (1) is unable to address long-term maintenance issues efficiently and cost-effectively; and (2) cannot complete required short-term service needs without overtime and other actions.

Lewis Test. at 14:12-15. Through the referenced discovery responses, included in Exhibit No. UWUA-10 to the testimony of witness Lewis, the Company has made plain that it believes that absent a full complement of employees, Tennessee American will face short and long term maintenance/service quality issues. Witness Watson explains:

> There are long term maintenance issues the Company is not able to address in a manner that would be more efficient and cost effective in the long run due to the shortage of funding. Examples of long term maintenance issues include: 1) valve operation and maintenance, 2) cross connection programs, and 3) enhanced addressing of main breaks.

The Company was also asked in the same data request to "state the 'day-to-day service' needs of customers that are not currently being met as a result of these vacancies." TAWC stated:

> All service needs are being adequately addressed on a short term basis through the use of currently existing employees, through the use of overtime, and in some instances through the redistribution of employees to meet immediate service needs. The Company's efforts to adequately address service needs in the short term, however, will not work over the long term. The Company cannot continue to adequately address service needs on a long term basis without obtaining the appropriate staffing levels that have been proposed in this rate case.

At trial, witness Watson stated the Company's bottom line in terms of staffing needs: "[T]he water system here needs people. It is largely about the people being able to do the work . . . ." Vol. III.A, Tr. 67:7-8.[22]

We note that the 110 FTE number proposed by the Company is only one employee more than the number authorized in the 2008 rate case, and probably undercounts the number of field operations personnel that will be needed going forward. Mr. Watson stated in his rebuttal testimony (at 10:22) that the Company predicts a substantially increased workload in 2011. He expanded on this point at hearing, noting that during 2011 there will be

> an increase in the number of meters based on the age or the period of time the meter has been in service. This is not necessarily a level amount of meters per year that we're talking about doing.

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[22] We note that witness Lewis reiterated the Company's concern with respect to overtime, noting that "[w]hile the number of overtime hours has declined in recent years, the Company forecasts a substantial increase in overtime hours during the test year." Lewis Test. at 18:4-5.

> So this is an increase, maybe somewhat this year more, but it relates to some work that we were doing back in 2006 that again has arisen somewhat on a cyclical basis. But, certainly, this is work that's important because it's the company's cash register that we need to make sure is operating properly.

Vol. III.A, Tr. 71:12-22.

Given this testimony, the data responses referenced above, and the evident staffing shortages detailed *infra* with respect to the valve maintenance program, there should be no dispute as to the inclusion for rate purposes of at least the 82 hourly (i.e., non-supervisory) positions that are included in the 110 FTE-number proposed by the Company. *See* Vol. IV.D, Tr. 278 (testimony of Mr. Lewis). These employees provide essential services to customers, and appear to be the bare minimum number of full-time hourly or field personnel that are required to assure efficient operations.

C. The Authority Should Impose Conditions upon the Company to Ensure That the Proposed Full-Time Employee Level Is Maintained Throughout the Period During Which the New Rates Will Be in Effect

Evidence adduced at hearing makes plain that the Authority not only needs to adopt an appropriate employee number for rate purposes, but must also take steps to ensure that the Company in fact hires the requisite number of personnel and maintains employment at that level throughout the rate effective period.

Mr. Lewis demonstrated in his testimony that the Company's performance with respect to staffing levels since the 2008 rate case is, to put it mildly, troubling. As part of his testimony, Mr. Lewis provided a chart that set forth certain "key staffing data points." Lewis Test. at 5. The chart includes the following data:

Full-Time Employee Staffing Level Requested by TAWC in 2008 Rate Case	114 Full-Time employees
Full-time Employee Staffing Level Granted by Authority in 2008 Rate Case	109 Full-Time employees
Full-time Employee Staffing Level as of January 31, 2009	107 Full-Time employees
Full-Time Employee Staffing Level as of November 1, 2010	103 Full-Time employees
Full-Time Employee Staffing Level as of January 2011 (Estimated)	87 Full-Time employees
Full-time Employee Staffing Level Requested by TAWC in 2010 Rate Case	110 Full-Time employees

Putting these data in context, Mr. Lewis testified:

> According to TAWC's Quarterly Report of Total Employees for the period ending January 1, 2009, as of that time the Company had 80 union-represented employees, and had six (6) additional union-represented positions that were vacant. TAWC's overall employment level at that time was 107 full-time employees.
>
> As of October 2010, the portion of the unionized workforce represented by Local 121 consisted of 77 employees. Since that time, eight (8) members of Local 121 have been fired by the Company, and three (3) others have retired as of the beginning of this year (2011). I am not aware that any of these positions have been filled. My understanding is that at the present time there are 66 TAWC employees represented by Local 121.

Lewis Test. at 5:8-6:3. Mr. Watson confirmed at trial that the Company did not maintain an FTE staff of 109 employees at any time between the January 2009 issuance of the Order in the 2008 rate case and the initiation by the Company of the instant rate proceeding. Vol. III.A, Tr. 62:15-63:1. Indeed, that circumstance remained the case as of the time of the hearing in this proceeding. Vol. III.A, Tr. 66:25-67:1 (108 FTEs as of cross-examination of Mr. Watson).

During his cross-examination, Mr. Watson's repeated explanation for Tennessee American's under-staffing was that the Company lacked sufficient revenue to hire needed employees.[23] In the 2008 rate case, the Authority approved an FTE number that was five (5) persons less than the level requested by the Company (i.e., 114 FTEs vs. the 109 FTEs approved by the Authority). When asked why the Company had nonetheless failed to staff at the level it had contended was essential, Mr. Watson responded that "[s]ince the order in the 2008 rate case, the Company has not achieved the revenue requirement that it sought in the last case, or was awarded in the last case." *Id.* Tr. 63:13-15. Mr. Watson referred during cross-examination to "trying to find the best we could do with the resources we had and the financial situation we were in." *Id.* Tr. 58:7-9. Elsewhere during his examination, Mr. Watson stated, "I knew I didn't have the revenues. I knew I had -- 2010 was going to be a year that we did not nearly approach the 10.2 percent return on equity and we're continuing the decline. So at that point, we had to do what we could to manage the business." Vol. II.C, Tr. 343:20-25. He went on to testify:

> [T]he authority that I had was to manage the business as best I could, and I didn't have anything near what the Authority had granted me as the opportunity in 2010 to make that work. It didn't -- it didn't work. The revenue wasn't there. The expenses were higher. We had to make decisions to manage the business.

Id. Tr. 344:11-17.

Whatever the Company's financial situation may be, the data presented in this proceeding on staffing levels demonstrate that TAWC has not treated full staffing of its field operations as a corporate priority. Mr. Watson confirmed on cross-examination that during the roughly two and

[23] *See e.g.*, Vol. III.A, Tr. 75-76. In response to a question about why TAWC is unable to maintain relatively full employment, Mr. Watson replied: "I think I'm going to go back to what I told you before. It's the financial situation. Our financial situation doesn't permit us always to fill every -- to do everything that we would like to do. As such, that places us in a position where we have to manage to what we can afford." *Id.* Tr. 75:24-76:4.

one-half years between April 2008 and September 2010, the number of field personnel employed by TAWC had dropped by nearly 14 percent, from 72 to 62. Vol. III.A, Tr. 53:24-54:3. He stated that the reasons for the drop-off included retirements, bidding from department to department, and that "we did not have the financial wherewithal to be able to replace all those people." *Id.* Tr. 55:22-23. This is particularly troubling because, according to the Company's own data, the categorization of "Field/network operations" includes essentially every employee responsible for maintenance and repair work at the Company. In particular, it includes heavy equipment operators, truck driver utility workers, distribution clerks, field operations supervisors, and meter repair positions. Exh. 45. Meanwhile, over the same period, the Company's "administrative personnel" increased a full 50%, from 8 to 12 FTE, which Mr. Watson testified included at least two entirely new positions. It appears then, that Field Operations work, which is critical to the Company's delivery of high-quality service to customers, has borne the brunt of Tennessee American's claimed financial hardship.

TAWC's staffing deficiencies are also troubling for other reasons. As will be addressed *infra*, Mr. Watson's concern that the Company did not have the money to hire needed staff is at odds with contemporaneous decisions by the TAWC Board to pay substantial upstream dividends to its corporate parent, American Water. The Authority should take steps to ensure that the Company is prohibited in the future from bowing to pressure to pad the pockets of the Company's corporate parent ahead of the need to hire sufficient employees. Moreover, and as will also be reviewed below, the failure to staff Company operations at appropriate levels has led to deficiencies in the conduct of the Company's important valve maintenance program. Valve failures can have direct and adverse impacts on the safe and time-efficient repair of water leaks, which is an important aspect of ensuring high quality customer service. When service interruptions occur, TAWC is obligated by the Authority's regulations to "endeavor to re-establish service with the shortest possible delay consistent with the safety to its customers and the general public." Tenn. Comp. R. & Regs. 1220-4-3-.42(2). There is no assurance that the Company can meet this obligation if it is neither conducting all needed valve inspections nor performing whatever maintenance is required as a result of these inspections.

In these circumstances, the UWUA urges that any rate relief provided in this proceeding be conditioned upon a requirement that the Company fill all open hourly positions immediately, and that it maintain an authorized FTE level of at least 82 hourly FTEs throughout the period in which the approved rates are in effect. The Company should have no quarrel with this request, as it is consistent with its stated intentions. Mr. Watson stated in addressing valve maintenance program issues, "the secret is, you've got to have the people. That's what makes this work." Vol. IV.D, Tr. 325:6-8. He went on to expand on this point during a subsequent cross-examination colloquy with UWUA counsel:

> Q. I believe you said with respect to valve maintenance, the secret is you have to have the people. I believe you said that this afternoon. Now, you've asked for authorization to hire more people in this case; is that correct?
>
> A. Yes, I have.
>
> Q. And if you get that authorization, you will hire those people; is that correct?
>
> A. I would look forward to it, and I'm almost there. But I'd look forward to doing the rest.
>
> Q. And you'll -- and when you get them, you'll do your best to keep them in their jobs; is that correct?
>
> A. Yes, sir. I think that's part of my responsibility.
>
> Q. Okay. And if folks leave, you'll do your best to fill the positions; is that correct?

A. Yes, sir, I'll do my best.

Vol. IV.D, Tr. 339:17-340:9. As a further indication that this condition should pose no issue for the Company, Mr. Watson testified as of the week of hearing in this matter that the Company currently had 108 FTEs on the payroll, an increase of eleven (11) FTEs in the period between January 31 and February 28, 2011. Vol. III.A, Tr. 76:8-12; Rebuttal Testimony of John Watson at 9:12-15.[24]

Given the importance of -- and seeming inability of the Company's Board of Directors to ensure -- full hourly staffing, the UWUA urges that the Authority condition rate relief to require Tennessee American to report certain staffing information on an ongoing basis. Specifically, the Union asks that the Company be required to submit quarterly reports to the Authority: (a) stating the actual number of FTEs employed during the previous quarter; (b) identifying any differences between actual and authorized FTE levels; (c) explaining the reasons for any under-staffing (i.e., levels below the authorized number of FTEs); and (d) providing the date by which any vacancy will be filled. Again, this should not be controversial. When questioned on cross-examination, Mr. Watson stated that the Company "would be agreeable to report the number of people we have at work at points in time all through the year." Vol. III.A, Tr. 69:5-7.

Finally, in the event that the Company fails to maintain a workforce level consistent with its authorized level, and to fill vacancies quickly and routinely, TAWC should be subject to a financial penalty, in an amount and under such terms as may be determined by the Authority. Union witness Lewis testified that the penalty could take the form of a reduction in the return on

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[24] We note that in his rebuttal testimony, Mr. Watson expressed concern that the Company might have difficulty maintaining employment levels. The Company's ability to add 11 FTEs in the month of February indicates that any such concern is overstated. Moreover, and as was noted at hearing, current unemployment levels in both Tennessee (including Hamilton County) and Georgia are significant, making it hard to credit any claim that TAWC will have trouble finding workers. Vol. III.A, Tr. 74:23-75:16. Similarly, Mr. Lewis testified that, depending on the skill level sought by the Company, "they can get a lot of employees." Vol. IV.D, Tr. 269:11-15.

equity component of its rates. In such instance, Mr. Lewis noted that the penalty would remain in place until the staffing shortage is rectified. Lewis Test. at 20:11-16. Witness Lewis succinctly explained the basis for the potential penalty during his hearing testimony: "Well, if there's no penalty, then they can do what they've done in the past and we'll never have those employees that were promised, that this Authority granted them." Vol. IV.D, Tr. 267:4-7.

III. THE AUTHORITY SHOULD ENSURE THAT THE COMPANY'S VALVE MAINTENANCE PROGRAM IS PROPERLY STAFFED AND THAT NEEDED REPAIR AND REPLACEMENT ACTIVITIES ARE UNDERTAKEN IN A TIMELY WAY

Mr. Lewis's testimony recites concerns--expressed by the Company--about the state of its valve maintenance program. Specifically, in a data response included as Exhibit No. UWUA-10 to Mr. Lewis's presentation, TAWC states that there are "long term maintenance issues" that the Company is "not able to address in a manner that would be more efficient and cost effective in the long run due to the shortage of funding." Examples of those long term maintenance issues include "valve operation and maintenance." *Id.*

Unfortunately, as became abundantly clear at hearing, the issues facing the Company's valve maintenance program are immediate and significant, and bear directly on the provision of safe and efficient customer service. We review these issues below, and pose conditions that the Union urges the Authority to impose in order to rectify significant and current deficiencies in the valve program.

A. The Company Recognizes That a Valve Maintenance Program Is a Sound Water Utility Practice, but Has Failed to Meet Its Program Obligations

The Company's water distribution system includes literally tens of thousands of valves, which perform the critical function of controlling water flows on the system. As explained by witness Watson, the Company's valves include roughly 450 larger than 16" valves, and 26,000 16" or smaller valves. Vol. II.C, Tr. 334. Mr. Blevins provided a simple explanation of their significance to efficient water system operations: valves are used for "stopping the water flow." Vol. IV.D, Tr. 291:21-22. The importance of the role played by valves in system operations, especially in enabling workers to respond efficiently and safely to water leaks, cannot be overstated. As explained by Mr. Blevins, "You know, the quicker you can get the problem isolated, you know, hopefully, the people around, you know, the less interruption of service that they would have. And, of course, obviously, it would be a lesser loss of water the quicker you could make that shutoff." *Id.* Tr. 303:21-304:1.

Tennessee American has a valve inspection, exercising, and maintenance program. The inspection component consists of a service person reviewing a map to find valve locations, followed by a physical inspection of a given area. The purpose of the inspections is to locate the valves to be examined. Vol. II.C, Tr. 315-16. The exercising component of the program involves physically turning the valve to ensure that it is operational. *Id.* Tr. 316. Finally, the maintenance component involves conducting those activities central to keeping each valve in good working order—e.g., oiling the valve, adjusting the valve box, and conducting any needed repair or replacement. *Id.* Tr. 317.

There is no dispute as to the importance of the valve program, or its connection to good utility practice. Mr. Watson testified that "our belief is that an inspection program assists us in operating our valves when we need them. Operating our valves for a routine purpose and also making it available for maintenance of other distribution facilities." *Id.* Tr. 319:3-7. He went on to note that valve maintenance "is a good idea," stating that "I believe it's on that list of things that we believe are appropriate for a water utility to do." *Id.* Tr. 320-21. In this regard, Mr. Watson testified to a difference between TAWC and companies that have no valve maintenance program, noting that those companies "don't know the condition of their valves. The valves are then not in good condition and not ready to be [operated]." *Id.* Tr. 324:5-7.

American Water, Tennessee American's corporate parent, has identified a valve maintenance program as a "best operating practice," and recommends that its operating subsidiaries implement such a program. At hearing, Mr. Watson was shown a 2007 American Water publication on the matter, included in the record as Exhibit No. 37. The document, which was prepared by a "practice development team" that included personnel from the various American Water operating subsidiaries, including TAWC,[25] states (*Id.* at page 1 of 10) that its purpose is to

> ensure that American Water Works Company, Inc. and its regulated subsidiaries, including, for purposes of this practice, American Water Works Service Company, Inc., . . . develop and utilize a consistent program to effectively inspect and maintain valves within its distribution systems in order to ensure the operational integrity of these assets and to optimize the utilization of personnel resources.

The document explains why American Water has concluded that such programs are important:

> Effective valve maintenance is important to local operations as a pro-active program may increase valve reliability, reduce valve failure, and extend valve life. The failure of valves as a result of insufficient maintenance may result in extensive damage to infrastructure and/or property loss, extended service interruptions to our customers and can lead to costly repairs or replacement activities.

Mr. Watson confirmed that he was in general agreement with this statement. Vol. II.C, Tr. 331:13-24.

Notwithstanding the absence of any dispute as to the importance of the valve maintenance program, it became clear at hearing that at least since the last rate case (if not longer) the Company has curtailed its valve maintenance operations and is neither conducting a

[25] The TAWC individual on the "team" was Monty Bishop, the Company's former Network Superintendent. Vol. II.C, Tr. 330:2-9. Mr. Watson explained that Mr. Bishop was someone whose judgment Mr. Watson both

sufficient number of inspections nor, it appears, performing timely valve repairs when needed. Mr. Watson responded to a discovery request (included in the record as Exhibit No. 38) by stating that it was "sound water utility practice" to inspect 20 percent of the Company's "small" valves (those 16" or less) every year, so that all such valves would be inspected every five years. Witness Watson confirmed that as the Company has roughly 26,000 small valves in its system, this practice requires 5,200 small valve inspections per year. Vol. II.C, Tr. 339:1-22. In his rebuttal presentation, Mr. Watson recounts that in 2009 the Company exceeded this target by conducting 5,898 such small valve inspections. Watson Rebuttal Test. at 27:19-20.

However, on cross-examination concerning an additional discovery response dealing with the number of valve inspections conducted during 2009 and 2010 (and included in the record as Exhibit No. 39), Mr. Watson explained that during 2009 only 3,055 small valve inspections were conducted pursuant to the valve program; the remainder (i.e., 2,843 inspections) were apparently simply instances in which valves were operated for reasons having nothing to do with the valve maintenance program (e.g., main breaks). Vol. III.A, Tr. 15-17 ("It was not part of the program, but, nonetheless, employees did operate valves." *Id.* Tr. 17:2-4.) Based on this explanation, it seems clear that maintenance program small valve inspections for 2009 in fact fell well below the target level dictated by "sound water utility practice."

In 2010, the wheels on the TAWC valve maintenance program came off altogether. The Company's target for small valve inspections was only 2,400 valves, Watson Rebuttal Test. at 27:21, or less than one-half the number dictated by sound water utility practice. Mr. Watson testified that the Company conducted 2,064 such inspections during 2010, but based on the information provided in the data response referenced earlier (Exhibit No. 39), it appears that the

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respected and relied upon. *Id.* Tr. 330:10-16.

actual number of small valve program inspections conducted last year was only 997.[26]

In addition, Exhibit No. 40 is a "Valve Condition Listing," which contains a multi-page list of valves that were discovered to be, *inter alia,* covered, broken, missing (listed as "could not locate"), or subject to other non-operating characterizations. The common thread for the 282 items on the list appears to be that the valves were examined (or, at least, efforts were made to examine them) as part of the valve maintenance program, and they were not determined to be in good working order. The connection between this listing and the 2010 program inspections can be drawn because (a) the Company has explained that the list was prepared by Mr. Haddock (Vol. III.A, Tr. 19:16-20:4); (b) his job was to conduct valve inspections;[27] (c) Mr. Haddock was in the process of "compiling a log of broken valves," Vol. IV.D, Tr. 305:19-20 (testimony of Mr. Blevins); and (d) Mr. Watson testified that while he did not know for certain, the list included as Exhibit No. 40 was "probably only for the 2010 period." Vol. III.A, Tr. 23:18. If Exhibit No. 40 is a log of 2010-inspected small valves that were either determined to be broken or could not be determined to be operable, then it appears that in excess of 28 percent of the small valves for which inspections were conducted in 2010 fall into this category (282/997=28.3%).[28]

The dramatic decline in inspections in 2010 does not square with Mr. Watson's statement in his rebuttal testimony that, in 2009 and 2010, "[t]he credit crisis and weak economy led to constructions of fewer new housing units in our service area, so employees who normally

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[26] Mr. Watson confirmed that for purposes of determining the number of inspections conducted under the valve maintenance program, the 2009 and 2010 data columns on Exhibit No. 39 would have the identical import. Vol. III.A, Tr. 17:15-18:3. The 997 figure is derived by subtracting the listed number of large valves.

[27] Vol. IV.D, Tr. 287:7-9 (Mr. Blevins, who was for a period of months Mr. Haddock's supervisor, states that Mr. Haddock's "responsibilities were to go out each day and locate, operate, and document valves in the system.").

[28] Mr. Watson was uncertain as to the reason for the existence of the log, noting that it is "something that [has] not historically" been prepared, and that it is not "normal for us to have prepared." Vol. III.A, Tr. 24:1-3. Of course, the absence of a firm understanding of the number of operable valves on the system is itself a significant part of the

engaged in new service installations were reassigned to maintenance work." Watson Rebuttal Test. at 27:27-30. When asked to explain this significant reduction in inspections in spite of the fact that the Company was ostensibly focusing on maintenance at that point in time, Mr. Watson blamed the lack of personnel, which was itself attributable to a lack of revenue. As he stated on cross-examination: "I knew I didn't have the revenues. I knew I had -- 2010 was going to be a year that we did not nearly approach the 10.2 percent return on equity and we're continuing the decline. So at that point, we had to do what we could to manage the business." Vol. II.C, Tr. 343:20-25. In 2010, "manag[ing] the business" apparently meant not conducting needed valve maintenance because of a failure to achieve the rate of return approved by the TRA in the last rate case.[29] At the same time, and as mentioned above (and reviewed in detail below), the Company's Board of Directors continued to dividend revenues from TAWC to its corporate parent. Indeed, Mr. Watson testified on cross-examination that there was no discussion at the Board meetings during 2010 about cutting either dividends (or the management fees paid to the Service Company) in order to retain additional cash within the Company to hire needed staff and to complete valve inspections.

Nor, serious as it is, is the failure to conduct needed inspections the only issue regarding the Company's valve program. In reality, is it only a component of a larger picture of emerging valve program issues. The Company's paper record system for its valves (featuring data recorded on "valve cards") has left Tennessee American unable to provide a fundamental piece of information: the Company does not know the number of valves on the TAWC system that are currently operable. According to witness Watson, obtaining that information would require a

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problem.

[29] Mr. Blevins confirmed this assessment, stating that at the end of his tenure with the Company (late in 2010), he did not think that the Company had sufficient staff conducting valve maintenance. Vol. IV.D, Tr. 290:4-25. As to why this was the case, Mr. Blevins stated that "we were holding vacancies and expenses." *Id.* Tr. 290:24-25.

"long audit" that would involve "a very, very long process." Vol. III.A, Tr. 32:19-33:4. Thus, at the current time, and unless and until the audit is conducted, there is simply no way to know how many of the Company's tens of thousands of valves are currently in condition to operate if called upon. (As noted above, the rough cut data introduced at hearing indicates that it may be the case that something on the order of nearly *one-third* of the small valves inspected in 2010 could not be verified as operable.)

Pending a comprehensive review and the implementation of a more thorough maintenance program, it will apparently remain the case that work crews attempting to conduct emergency leak repairs will face situations in which they have difficulty locating an operating valve or valves that will reduce water pressure and facilitate the swift completion of the repair. UWUA witness Blevins testified that while serving as a supervisor on repair jobs, he recalled instances in which "you'd have to turn a series of valves to try and find one that would operate properly in order to do the repair." Vol. IV.D, Tr. 291:13-15. Mr. Blevins also recalled occasions where the repair work would be done without reducing water pressure because the valves were not functioning properly. *Id.* Tr. 295:22-296:17. He noted that such operations raise safety issues, pointing out that having working valves is always better because it "would make the repair visible and, you know, the excavation as safe as it could be." *Id.* Tr. 299:11-12.

Similarly, when asked whether he was aware of situations in which valves were in disrepair for a number of years, Mr. Blevins responded: "Yes. My experience in making main repairs. You know, we ran into that often." *Id.* Tr. 288:24-25. Mr. Blevins related that to the "best of [his] knowledge," it was known in the Company that there were valves in disrepair that were not being repaired. *Id.* Tr. 296:9-14. He also noted that while he was not aware of any log of broken valves, he did have "some handwritten valves that I -- you know, on my desk, just for my notation." *Id.* Tr. 305:21-22. The issue of long-standing valve disrepair would be brought up in departmental meetings, "we had group discussions," in that it might be asked "why it took longer to make that repair." *Id.* Tr. 296:12-17. To state the obvious, the Company should not be allowing valves needed to conduct repairs to remain in states of disrepair for extended periods of time. Nor should field supervisors be forced to rely on handwritten lists instead of accurate, Company-collated, up-to-date information while attempting to perform repair work in a timely and safe manner.

B. The Commission Should Impose Several Conditions with Respect to the Valve Maintenance Program

Based on the foregoing, there are at least three separate conditions that the Authority should impose upon any grant of rate relief to ensure that issues with the Company's valve maintenance program are addressed:

The "Forensic Audit." The Commission should impose a condition requiring the Company to conduct the "forensic [valve] audit" referenced by Mr. Watson. The purpose of the audit is to ensure that TAWC has a firm handle on an essential piece of data: how many of the Company's more than 26,000 large and small valves will in fact function properly if called upon to operate. There was no dispute from TAWC as to the need for or interest in conducting the audit. Mr. Watson testified on cross-examination that he would "love to do it," Vol. III.A, Tr. 33:12-18, though he expressed concern that he did not have the funding to complete the audit. *Id.* The latter claim is hard to credit, in that Mr. Watson nowhere explained what he believed the audit would cost and because, as discussed, TAWC continues to pay substantial dividends to its parent company.

Mr. Watson testified that absent a valve maintenance program, a utility does not "know the condition of their valves." Vol. II.C, Tr. 324:5-6. Thus, until the audit is conducted, TAWC will not know how many of its valves are in fact operable. In these circumstances, and given the absence of opposition from Tennessee American, the Company should be directed to conduct the forensic audit, and to complete it within six (6) months. Once completed, the results of the audit will establish baseline information on the efficacy of the Company's valves, and should provide either (a) assurance that the Company's maintenance program is functioning properly; or (b) a roadmap for what the Company needs to do to get any issues TAWC may have with respect to its valves under control.

Program Staffing. In response to questioning from Director Kyle, Mr. Lewis confirmed the obvious in stating that the Company would be likely to do a better job on their valve maintenance if they were adequately staffed. Vol. IV.D, Tr. 277:17-25. To ensure that this concern is addressed, the Company should be required to staff its valve maintenance program with sufficient personnel to ensure that TAWC is able to complete valve inspections in accordance with established protocols (i.e., all of the valves larger than 16" on a biannual basis, and all valves 16" or less on an every-five-years cycle), and to conduct whatever repairs or other maintenance (including replacements) are needed in a timely manner. Mr. Watson (supported by the testimony of Mr. Blevins) expressed repeated concerns that he did not have the bodies to conduct the requisite number of valve inspections. The Company should be directed to rectify this situation, and to indicate the number of personnel assigned to valve maintenance activities as part of the quarterly staffing reports referenced *supra.*

Valve Reporting. There were issues in this proceeding concerning the status of the Company's valve maintenance records. Going forward, the Authority should take steps to ensure that the efforts undertaken by the Company pursuant to its valve maintenance program are properly documented. Mr. Watson expressed no objection to this concept. As stated in the following cross-examination colloquy with counsel:

> Q. Mr. Watson, if the Authority wanted to be assured that valve maintenance inspection and operation work was going forward, would the company be amenable to providing quarterly reports to the Authority that included targeted number of inspections, the number conducted, the number of repair/replacement activities done? Would they be amenable to something like that?
>
> A. Depending on the level of detail, certainly we would be amenable to doing that. I guess, to whatever extent we can be cooperative, we would certainly want to do that.

Vol. III.A, Tr. 34:21-35:6.

Given this understanding, and the record that has been compiled in this proceeding with respect to valve issues, the Union asks that the Authority direct the Company to submit, on a quarterly basis, a report to the Authority stating: (a) the target number of larger and smaller valves inspected, exercised, and maintained during that quarter (if the number of valves to be inspected and exercised is less than the "sound water utility practice" described by the Company, then it should be required to explain the basis for the reduction and to state how quickly TAWC plans to make up the shortfall); (b) the number of valves that were in fact inspected, exercised, and maintained during the quarter; (c) the number of valves that were in need of repair or replacement; (d) by when such valves were (or will be) repaired or replaced; and (e) the number of valves which are in need of repair or replacement, but which the Company has concluded will not be repaired or replaced, and which should therefore be removed from rate base.

Electronic Records. Finally, while not necessarily a formal condition, we think that it is important for the Company to give serious thought to putting its valve maintenance records into an electronic data base. Again, we see no basis for dispute. As stated by Mr. Watson during his "comment session" on valve issues:

> We have been doing routine maintenance on our system, and

> we've got a lot of records. They're not all easily gathered up and put in a response to a data request because it's a lot of information. I've got a lot of paper records. I'd love to convert them all to computer, but, you know, that costs money, and it takes people to put it in, and it's just one of those things. So we've got a lot of records. That's just the facts.

Vol. IV.D, Tr. 319:16-24. We do not know the cost of any such conversion, but the ability to search valve records without the necessity to pour through tens of thousands of individual valve cards should be of significant benefit to the Company and, by extension, its customers and regulators. In these circumstances, the Union asks that the Company be obligated to, at a minimum, provide to the Authority an estimate of the cost for the conversion.

IV. THE AUTHORITY SHOULD CONDITION TAWC'S PAYMENT OF DIVIDENDS TO THE PARENT COMPANY TO ENSURE THAT SUFFICIENT EQUITY REMAINS WITH TAWC

Absent approval from the Authority, Tennessee American should be prohibited from paying dividends to its corporate parent if such a payment would cause the percentage of equity in the Company's capital structure to drop below 43.6 %.[30] This condition should not constitute an undue hardship for the Company,[31] and is a necessary safeguard given the evidence in this proceeding. As recounted above, that evidence shows that upstream dividends have been paid by TAWC even while it asserts that it lacks the funds needed either to staff operations fully or to conduct maintenance that the Company acknowledges is consistent with sound water utility practice. Equally important, imposition of this condition is well within the broad legal authority of the TRA, and has been successfully imposed by utility commissions in several other states.

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[30] Or below whatever equity level the Authority permits the Company to earn a return on, should it choose a different figure.

[31] As noted in the testimony of Consumer Advocate witness Professor Klein, the 43.6% figure is the recent historical average percentage of equity in the Company's current capital structure. Moreover, if and when there are material changes, the Company is able under the proposed condition to seek dividend payment authorization from the TRA.

A. Tennessee American Has Been Paying Upstream Dividends While Asserting That It Lacks the Funds to Perform Necessary Maintenance Work

As discussed *supra*, TAWC is not performing needed valve maintenance program work. Company President Watson testified repeatedly that maintenance work has lapsed because the Company simply has not had the money to hire the staff to perform it. For example, in discussing why the Company failed to conduct all of its targeted 2010 valve inspections (which were themselves well below the level that TAWC considers consistent with sound water utility practice), Mr. Watson testified:

> [W]hat I didn't have is I didn't have the revenue that was a component of what I needed from the rate increase in my actual financial -- available to me financially to do the work. In other words, my -- the revenue requirement that I needed to perform the work, I did not have in actual revenue. And I also had expenses that had increased during that period of time that I had to manage including labor.

Vol. II.C, Tr. 342:9-16. Notwithstanding the lack of revenues sufficient to conduct maintenance, the Company has somehow continued to pay substantial dividends to its parent company, American Water. In 2009, the Company paid $1.24 million in dividends to its parent company, while failing to staff its operations consistent with either: (a) the number of FTEs it claimed to the Authority were needed for efficient operations; or (b) the lesser number that was authorized by the TRA.[32] In 2010, even as the Company was requesting almost a 30% rate increase, TAWC paid over $950,000 in dividends[33] and continued not to conduct requisite maintenance or to staff its operations consistent with either its request to the Authority or its resulting authorization.

[32] By way of comparison, TAWC's total labor budget for the 12 months ending in March 31, 2010 was $5,167,248. Even if the labor budget for 2009 was significantly lower, the dividends paid likely amounted to at least 20% of the total labor budget and, if used to address staffing shortages, could easily have rectified the problem. Exhibit 15.

[33] At hearing, Mr. Watson agreed to provide the full amount of dividends paid in 2010 to counsel. That information was provided by counsel for the Company via e-mail on March 18. 2011.

In the face of these facts, Mr. Watson stated at trial that during 2009 and 2010, the TAWC Board of Directors did not even consider eliminating dividends to the Parent Company until there were improvements in TAWC's financial situation:

> Q. Well, did you go to your corporate parent and say, we can't pay a dividend this year because we don't have enough people to conduct inspections that we need to conduct to ensure sound water utility practice?
>
> A. I have a policy regarding dividends that I am expected to follow as Tennessee American president, and the board of directors authorized the dividend as prescribed by the policy.
>
> . . . .
>
> Q. Was consideration given to skip a dividend?
>
> A. I have a fiduciary responsibility to balance the interest of my stockholders, my customers, and the business; to operate as best I can when I'm earning less than the return, less than the revenue, and greater expenses.
>
> The dividend, if there was one, which wasn't paid in each quarter, was the dividend that was appropriate given the level of earnings.

Vol. II.C, Tr. 345:6-13, 346:4-13. Similarly, Mr. Watson was unable to recall a single conversation during 2010 at the board level about the possibility of reducing the dividends paid to the Parent Company (or management fees paid to the Service Company) and using the resulting savings to fund additional staffing. *Id.* Tr. 345:14-22. Thus, even where Mr. Watson asserts that the Company does not have the funds to carry out what he views as sound utility practice, the Company's officers and board appear to believe that it is beyond discussion that substantial dividends on common stock should continue to be paid to the parent company under TAWC's dividend policy.

Mr. Watson's testimony at trial concerning the dividending "policy" is difficult to square with his assertions about the Company's finances. Specifically, according to witness Miller, the Company's dividend policy is for TAWC to "pay 75% of net income as common dividends on a cumulative basis for each fiscal year ending the third quarter of each year. This policy has been in place for many years and is expected to continue through 2010/2011."[34] However, apparently the Company considers itself to have substantial "net income" to pay in dividends at the same time it states it cannot afford to hire authorized staff and to conduct needed maintenance. It appears, then, that Tennessee American considers much of its O&M budget -- even that part related to maintenance necessary to ensure a high quality of service -- discretionary and secondary to generating net income to the parent company. Mr. Watson's repeated references to "managing the business" apparently refers to foregoing necessary and proper maintenance to minimize costs and thereby generate profit (*i.e.,* retained earnings) that can be paid as dividends to the upstream parent company. Such a system is not consistent with fulfillment of the Company's public service obligations to Chattanooga customers. Nor does the Company have internal controls or conditions to prevent such a situation. Mr. Watson acknowledged at trial that a majority of the TAWC Board of Directors (five of eight members) are employees of the Service Company. Vol. III.A, Tr. 8:4. Only two are, in Mr. Watson's words, "independent"[35] (the eighth is Mr. Watson himself). *Id.* Tr. 8:8. Thus, the entity that determines whether a dividend should be paid is majority-populated by personnel who are more closely aligned with

[34] This statement is made in Data Response TN-CAPD-01-Part II-Q6.

[35] Nor are these directors independent under New York Stock Exchange standards (on which American Water is listed). Under those rules, "[n]o director qualifies as 'independent' unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company)." N.Y. Stock Exch., *New York Stock Exchange Listed Company Manual* § 3 (2009), *available at* http://nysemanual.nyse.com/LCM/sections/ (follow "Section 3" hyperlink) (independence tests at Section 303.A.02(a)-(b)(v)).

American Water corporate than with TAWC.[36]

More broadly, while Mr. Watson is correct that he has a fiduciary duty to the Company's shareholders (which, in the case of common stock, is held entirely by TAWC's corporate parent), his analysis ignores the Company's duty as a regulated utility to serve the public in accordance with Tennessee law. A utility company in Tennessee must not

> provide or maintain any service that is unsafe, improper, or inadequate, or withhold or refuse any service which can reasonably be demanded and furnished when ordered by the authority.

Tenn. Code Ann. § 65-4-115. In addition, Tennessee regulations provide that:

> Each utility shall make all reasonable efforts to prevent interruptions of service and when such interruptions occur shall endeavor to re-establish service with the shortest possible delay consistent with the safety of its customers and the general public.

Tenn. Comp. R. & Regs. 1220-4-3-.42(2). Mr. Watson has acknowledged that valve maintenance is a part of sound water utility practice, and the testimony at trial shows that a properly functioning valve maintenance program should shorten outage duration and help to ensure that employees can perform their jobs in a safe and efficient manner. By short-staffing and failing to perform needed valve inspections, while continuing (if not in order) to pay upstream dividends, the Company is failing to act consistent with its obligations under these provisions.

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[36] This is also true of TAWC's leadership and management structure as a whole. Michael Miller, the Director of Rates and Regulation at the Service Company is also the Treasurer and Comptroller of Tennessee American. Vol. VI.B, Tr.161:24-162:1. Mr. Miller is based in West Virginia and divides his time between four American Water subsidiaries; as part of his duties in Tennessee, he reviews the TAWC's budget and suggests that items be raised or lowered (as do other employees of the service company). *Id.* Tr. 162-64, 166. While he communicates frequently with Mr. Watson, Mr. Miller testified that most of the contact is by phone rather than on the ground at TAWC headquarters. *Id.* Tr. 166:17-22. Similarly, before the budget is sent to the Board of Directors for approval, American Water Service Company Eastern Division president Nick Rowe will resolve any disputes as to the contents of the budget. *Id.* Tr. 165:6-14. Mr. Rowe is also himself a member of the TAWC Board. *Id.* Tr. 165. As shown, ultimate decision-making authority at Tennessee American rests largely with service company personnel rather than local management involved in the day-to-day Company operations.

B. The TRA Has Legal Authority to Impose Minimum Equity Standards on TAWC

As discussed earlier, the TRA possesses "practically plenary authority" to regulate the State's utilities, and is given explicit jurisdiction over a utility's "property" so far as necessary to carry out Tennessee law. Tenn. Code Ann. § 65-4-104. The revenues of Tennessee American -- the same revenues it has been paying in dividends to the Parent Company -- constitute "property" of the Company and thus fall within the Authority's regulatory jurisdiction. Because, as discussed, these dividends should not be paid where so doing impairs the ability of Tennessee American to fulfill its statutory public service obligations, the TRA has clear authority to place limitations on this practice. That TAWC has a "policy" of paying particular dividends to the Parent Company is irrelevant to the TRA's authority here--parties cannot "contract away" what, by state law, resides with the Authority. *In re Generic Docket Addressing Rural Universal Service,* 2001 Tenn. PUC LEXIS 153, at *40 (Tenn. Regulatory Auth., May 9, 2001).

C. Other State Commissions Have Successfully Implemented Similar "Ring Fencing" Measures in Response to Analogous Concerns

In response to the potential for parent companies to drain the finances of regulated subsidiaries, utility commissions in a number of states have imposed minimum equity standards for regulated utilities and, separately or in addition, required commission pre-approval for the payment of utility dividends that would reduce utility equity or retained earnings below a specified level. For example, in 2009 the Maryland Public Service Commission imposed conditions on Baltimore Gas & Electric ("BGE") with respect to dividends paid by it as a wholly-owned operating subsidiary to Constellation Energy Group ("CEG"), its corporate parent. As stated by the Commission:

> Until further order of the Commission, BGE may not pay dividends to CEG if BGE's equity level after the dividend payment would fall below 48%, and may not pay dividends under any circumstances if BGE's credit rating falls below investment grade, as determined by any two of the three major credit rating agencies.

In re Balt. Gas & Elec. Co., Order No. 82986 at 4, Case No. 9173, Phase II (Md. Pub. Serv. Comm'n, Oct. 30, 2009).[37] The Maryland Commission intended this condition to address precisely the same structural issues seen at Tennessee American, explaining that it "helps to ameliorate [the] concern that the . . . insiders who dominate BGE's Board can vote to declare dividends when an independent board . . . otherwise would not." *Id.* at 48. The commission found that this would result in "a better and safer arrangement for ratepayers and one that [the Commission] can verify through reporting." *Id.*

Other Commissions have done likewise. For instance, the Kentucky Public Service Commission has imposed a similar condition on another American Water subsidiary, Kentucky-American Water. *In re Kentucky-American Water Company's Request for Approval of Payment of Dividend*, Order at 1, Case No. 2009-00359 (Ky. Pub. Serv. Comm'n, May 14, 2010). In that case, the Commission held that the utility "violat[ed] the provisions of a Commission Order by making, without prior Commission approval, dividend payments in 2009 that exceeded five percent of its retained earnings . . . . "). In Oregon, meanwhile, the Public Utility Commission held that Portland General Electric "must maintain the common equity portion of its capital structure at 48 percent or higher unless the Commission approves a different level, and must notify the Commission of certain dividends and distributions to Enron." *In re the Application of ENRON CORP for an Order Authorizing the Exercise of Influence Over Portland General Electric Company*, Order No. 97-196 at 6, Docket No. UM 814 (Or. Pub. Util. Comm'n, June 4,

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[37] *available at*
http://webapp.psc.state.md.us/Intranet/Casenum/NewIndex3_VOpenFile.cfm?ServerFilePath=C:\Casenum\9100-

1997).[38] These examples demonstrate that restrictions on dividend payments to parent companies can be an effective and acceptable regulatory solution in situations in which internal controls have failed to materialize.

CONCLUSION

WHEREFORE, for the foregoing reasons, the UWUA asks that any rate relief awarded to Tennessee American in this proceeding should be conditioned as follows:

- The Company should be required to fill at least all 82 hourly positions immediately, and to maintain at least that level of hourly FTEs throughout the period in which the approved rates are in effect.
- The Company should be required to submit quarterly reports to the Authority: (a) stating the actual number of FTEs employed during the previous quarter; (b) identifying any differences between actual and authorized FTE levels; (c) explaining the reasons for any under-staffing (i.e., levels below the authorized number of FTEs); and (d) providing the date by which any vacancy will be filled.
- In the event that the Company fails to maintain a workforce level consistent with its authorized level, and to fill vacancies quickly and routinely, TAWC should be subject to a financial penalty, in an amount and under such terms as may be determined by the Authority.
- The Company should be required to conduct the "forensic" valve audit referenced by witness Watson, and thereby determine baseline numbers of operable (and inoperable) large and small valves in the TAWC system. The audit should be

[38] Some commentors, including Standard & Poors, stated that these ring-fencing measures "served to largely insulate PGE from Enron's subsequent woes." Standard & Poor's, Jan 16, 2003, "RatingsDirect," entitled "An Enron

completed within six (6) months of the issuance of the Order resolving this proceeding. The results of the audit should be submitted in a subsequent filing with the Authority.

- The Company should be required to staff the valve maintenance program with sufficient personnel to ensure that TAWC is able to complete valve inspections in accordance with established protocols (i.e., all of the valves larger than 16" on a biannual basis, and all valves 16" or less on an every-five-years cycle), and to conduct in a timely manner whatever maintenance, repair, or replacement activities are warranted.
- The Company should be required to submit quarterly reports to the Authority stating: (a) the target number of larger and smaller valves to be inspected, exercised, and maintained during that quarter (if the number of valves to be inspected and exercised is fewer than the practice set forth in Condition No. 5 would dictate, then the Company should be required to explain the basis for the reduction and to specify by when TAWC plans to make up the shortfall); (b) the number of valves that were in fact inspected, exercised, and maintained during the quarter; (c) the number of valves that were in need of repair or replacement; (d) by when such valves were (or will be) repaired or replaced; and (e) the number of valves which are in need of repair or replacement, but which the Company has concluded will not be repaired or replaced, and which should therefore be removed from rate base.
- The Company should be prohibited from paying dividends to its corporate parent (or preferred shareholders) where the payment would result in the equity portion of the

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Subsidiary is 'Ring-Fenced.'"

Company's capital structure falling below its current level, 43.6%, or such equity level as the Commission approves in establishing the rates in this proceeding. TAWC may seek TRA permission to pay dividends that would be contrary to this limitation, but in such instance would bear the burden of demonstrating that payment of the dividend would not have a material impact on Company staffing or the provision of reliable and cost-effective service to customers.

In addition, the Authority should impose whatever additional conditions it concludes are needed to ensure that the conditions stated herein are fulfilled in a complete and timely manner.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Scott H. Strauss, counsel for UWUA Intervenors, hereby certify that on the 21st day of March, 2011, caused a true and correct copy of the foregoing Brief to be served upon all parties of record via U.S. mail or facsimile.

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