IN 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	)	DOCKET NO. 10-00189
PERMIT IT TO EARN A FAIR AND	)	
ADEQUATE RATE OF RETURN ON	)	
ITS PROPERTY USED AND USEFUL IN	)	
FURNISHING WATER SERVICE TO	)	
ITS CUSTOMERS	)	

CONSUMER ADVOCATE AND PROTECTION DIVISION'S POST-HEARING BRIEF

ROBERT E. COOPER JR., B.P.R. No. 010934
Attorney General and Reporter

RYAN L. MCGEHEE, B.P.R. No. 025559
Assistant Attorney General
MARY LEIGH WHITE B.P.R. No. 026659
Assistant Attorney General
C. SCOTT JACKSON, B.P.R. No. 011005
Senior Counsel
Office of the Tennessee Attorney General
Consumer Advocate and Protection Division
P.O. Box 20207
Nashville, Tennessee 37202-0207
Ph:(615) 741-4657
Fax: (615) 741-1026

TABLE OF CONTENTS

Robert E. Cooper, Jr., Attorney General and Reporter for the State of Tennessee, by and through the Consumer Advocate and Protection Division of the Office of the Attorney General ("Consumer Advocate"), hereby respectfully submits this post-hearing brief in the above-styled matter.

I. INTRODUCTION

On September 17, 2010, Tennessee American Water Company ("TAWC" or "Company") filed a petition to increase customer rates by $9.984 million, or more than 27%.[1] Throughout the course of this rate case, TAWC has updated its financial information as recently as February 22, 2011, and is now seeking an approximate increase of $11.6 million, or 30%. TAWC's rate increase proposal follows closely on the heels of the 2008 rate case in Docket 08-00039, wherein the Tennessee Regulatory Authority ("TRA" or "Authority") authorized a $1.65 million increase in rates.[2] Furthermore, if the Authority awards an increase in this docket, it will mark the fifth rate hike in seven years for TAWC's customers.

TAWC's ratepayers, located in and around Chattanooga, Tennessee, already pay the highest water rates among Tennessee's major cities.[3] And after careful investigation and analysis of TAWC's rate increase proposal in this case, the Consumer Advocate concludes that there is no just or reasonable basis for increasing TAWC's rates 30%. Rather, for the reasons

---

[1] *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*, p.5, September 17, 2010.

[2] *Order*, Docket 08-00039, p.51, January 13, 2009.

[3] *Rebuttal Testimony of John Watson*, Docket 10-00189, Rebuttal Exhibit 3, February 8, 2011.

explained more fully below, the Consumer Advocate maintains that TAWC's rates should only be increase by $1.3 million, or 3.5%.[4]

II. CRITERIA FOR ESTABLISHING PUBLIC UTILITY RATES

Under Tennessee law, the Authority has the power to fix just and reasonable rates.[5] When any public utility seeks to increase an existing rate the utility has the burden of proof to show such an increase is just and reasonable.[6]

Just and reasonable rates should provide a utility with the opportunity to earn a rate of return on used and useful property commensurate with the returns on alternative investments with similar risks.[7] As a general rule, public utility commissions such as the Authority examine investments by a utility to determine whether such investments were "prudent."[8]

In prior cases, the TRA has stated that it considers petitions for a rate increase, filed pursuant to Tenn. Code Ann. § 65-5-203 (now § 65-5-103(a)), in light of the following criteria:

1. The investment or rate base upon which the utility should be permitted to earn a fair rate of return;
2. The proper level of revenues for the utility;
3. The proper level of expenses for the utility; and

---

[4] *Transcript of Proceedings*, Docket 10-00189, Exhibit 90, Schedule 1, March 8, 2011.

[5] Tenn. Code Ann. § 65-5-101(a).

[6] Tenn. Code Ann. § 65-5-103(a).

[7] *Bluefield Water Works & Improvement Co. v. West Virginia Public Service Commission*, 262 U.S. 679, 692-3 (1923); *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944).

[8] *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Serv. Comm'n of Mo.*, 262 U.S. 276, 291 (1923); *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 309 (1989).

4. The rate of return the utility should earn.[9]

The Authority has further stated that it "is obligated to balance the interests of the utilities subject to its jurisdiction with the interests of Tennessee consumers, i.e., it is obligated to fix just and reasonable rates."[10]

In determining rates, the Authority should also ensure that expenses and costs charged to consumers are not so high as to constitute, in effect, capital contributions to the utility:

> But if the amounts charged to operating expenses and credited to the account for depreciation reserve are excessive, to that extent subscribers for the telephone service are required to provide, in effect, capital contributions, not to make good losses incurred by the utility in the service rendered and thus to keep its investment unimpaired, but to secure additional plant and equipment upon which the utility expects a return.[11]

Finally, Tennessee law prohibits any utility from making unjust discriminatory charges or unreasonable preferences in its charges.[12]

III. TEST PERIOD AND ATTRITION PERIOD

Neither the Authority nor the intervening parties are confined by law or regulatory practice to accepting the test year proposed by the regulated utility seeking a rate increase. Tennessee courts have never required the Authority to use a specific test period methodology for

---

[9] *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*, TRA Order, Docket 06-00290, at 20 (June 10, 2008).

[10] *Id.*; *see* also *Tennessee Cable Television Ass'n v. Tennessee Public Service Comm'n*, 844 S.W.2d 151, 159 (Tenn. Ct. App. 1992) (rates should take into consideration the interests of both the consumer and the utility).

[11] *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 607 n. 10 (1944).

[12] Tenn. Code Ann. § 65-4-122.

setting rates; indeed the courts have stated repeatedly that the Authority has the discretion to choose its own test period.[13]

The only limit placed on a ratemaking body is the statutory requirement that rates be just and reasonable. Rates therefore need not be determined using definite rules or precise formulas.[14] Thus, the TRA is not bound by any specific means by which rates are set so long as the end result produces just and reasonable rates.

In setting rates, the TRA has unfettered discretion to select the test year period.[15] A "test year" is a measure of a utility's financial operations and investment over a specific twelve month period. It is the "raw material" for developing an attrition year measure of the utility's financial operations and investment (that is, the utility's Rate Base, Operations and Maintenance Expense, Depreciation Expense, and Taxes). Therefore, as pointed out by Mr. Buckner in his Direct Testimony, the selection of the test year is quite important:

> The selection of the timing of the test year may be the most significant single factor in the rate-making process. The more outdated the test year levels of operations, the more critical is the need for significant restatement to produce representative levels of future conditions.[16]

---

[13] *CF Industries v. T.P.S.C.* 599 S.W. 2d 536, 542 (Tenn.1980); *Powell Telephone v. T.P.S.C.*, 660 S.W.2d 44, 46 (Tenn.1983); *Tennessee Cable Tel. v. T.P.S.C.* 844 S.W. 2d 151, 159 (Tenn.Ct.App. 1992) (cert.denied); *AARP v. T.P.S.C.*, 896 S.W. 2d 127, 133 (Tenn.Ct.App.1994) (cert.denied); and *TAWC v. TRA*, No. M2009-00553-COA-R12-Filed, at 20, January 28, 2001 (see Attached Exhibit TP-1).

[14] *Tennessee Cable Tel. v. T.P.S.C.* 844 S.W. 2d 151, 159 (Tenn.Ct.App. 1992) (cert.denied).

[15] See *Order,* Docket 06-000187 (November 27, 2008), pp.5-6 for a clear example of the Authority's conclusions as to its discretion in selecting a test year period. See also *Powell Telephone v. T.P.S.C.*, 660 S.W.2d 44, 46 (Tenn.1983) (citing *CF Industries v. T.P.S.C.*, 599 S.W. 2d 536, 542 (Tenn.1980)).

[16] *Direct Testimony of Terry Buckner*, Docket 10-00189, p. 9, January 28, 2011. (citing Accounting for Public Utilities, Hahne and Aliff §7.03).

Thus, it is essential that a test year contain and/or be updated with the most accurate and current information available. The test year is used to calculate and forecast the attrition year. An "attrition year," also known as a forecast period, is the "finished product" and is the chief determinant in whether a revenue deficiency or surplus exists such that rates must be adjusted. The attrition year can also be viewed as the first year during which the TRA's rate order will be applied. In this proceeding, both the Consumer Advocate and the company have forecasted the same attrition year period ending in December 2011.

Tennessee American has proposed an historical test year period ending March 31, 2010, which is nearly a year old. In this docket, as it commonly has done in others, the Consumer Advocate has applied a more up-to-date historic test year, ending in September 30, 2010. The use of an up-to-date test year is essential to test the veracity of the company's proposed rate increase. TAWC complains about the Consumer Advocate's use of a more up-to-date historical test year; however, what is lost amid TAWC's arguments is the fact that the goal of this proceeding is not to set a test year agreeable to all the parties, but rather for the Authority to determine for itself the revenue adjustment required for the attrition year. Additionally, there is ample precedent for the TRA to adopt an updated test year.[17]

The Consumer Advocate's methodology of applying a more recent test year has the advantage of providing more accurate and current information for the forecast of the attrition year. This Authority has commonly adopted the Consumer Advocate's approach, at least in part,

[17] *Direct Testimony of William Novak*, Docket 10-00189, p.4:5-13, January 5, 2011.

in final decisions setting rates as a matter of accepted practice before the Authority. Indeed, the final decision of the TRA in TAWC's last rate case explicitly adopts portions of the Consumer Advocate's attrition period forecast, based upon the Consumer Advocate's historic test year which was more current than that of TAWC -- and the Authority has specifically adopted the Consumer Advocate's forecast on the grounds that it was "based on the most current information available."[18]

Accordingly, the Authority should accept the Consumer Advocate's use of a test year ending September 30, 2010 for purposes of forecasting the attrition year ending December 31, 2011.

IV. ATTRITION YEAR REVENUE AT PRESENT RATES

TAWC is projecting attrition year revenue at present rates of $37.2 million,[19] but the Consumer Advocate instead asserts that TAWC should collect $38.2 million from its ratepayers over the same period, even if rates are not increased at all.[20] There are essentially two issues that divide TAWC and the Consumer Advocate in their forecasting of revenue at present rates for the attrition year: (1) the methodology for normalizing revenues and (2) the appropriate amount of volumes that TAWC will sell in the attrition year to its residential and commercial customers.

---

[18] *Order*, TRA Docket 06-00290, p. 40, June 10, 2008.

[19] *Revised Accounting Exhibits and Schedules*, Income Statement – Operating Revenues, February 22, 2010.

[20] *Direct Testimony of John Hughes*, Docket 10-00189, p. 3:10, March 1, 2011.

A. THE AUTHORITY SHOULD REJECT TAWC'S REVENUE FORECAST IN FAVOR OF THE CONSUMER ADVOCATE'S MORE REASONABLE FORECAST.

1. The Company's Weather Normalization Model Produces an Unreasonable Result and Is Unreliable as a Known and Measureable Adjustment

The assumption that weather has an impact on revenues is based on the theory that during a dry year consumers use more water (i.e., watering lawns) and use less water during years when there is more precipitation. To contend with the impact of weather on revenues, TAWC has sought to implement a projection of revenues, based on a model sponsored by Dr. Spitznagel, which takes into account the impact of weather. Dr. Spiztnagel's model is not utilized to predict the weather or provide a tracking mechanism to adjust rates based on weather; rather it is an attempt to provide the best guess of what water consumption would be under "normal weather" conditions. In other words, regardless of the actual weather results, the adjustment to revenues made by TAWC based upon Dr. Spitznagel's projections would be incorporated into rates regardless of the weather or TAWC's actual revenues.

The sole input in Dr. Spitznagel's model for determining "normal weather" is thirty years of Palmer Modified Drought Index ("PMDI") data. While Dr. Spitznagel's model is apparently intended to predict how much water will be consumed by the residential and commercial classes under normal weather conditions, the projection of the model produces a curious result. Dr. Spiztnagel projects consumers will use less water under "normal weather" conditions than consumers used in 2009, one of the wettest years in the Chattanooga area since 1895.[21] The end result of Dr. Spiztnagel's model simply defies reality.

[21] *Transcript of Proceedings*, Docket 10-00189, Vol. III B, p. 143 , March 2, 2011; *Direct Testimony of Michael Gorman*, Docket 10-00189, p. 10, January 5, 2011.

While Dr. Spitznagel acknowledges his model predicts less consumption in 2011 under "normal weather" than in the very wet year of 2009, he relies upon another analysis in support of his WNA proposal showing a declining trend in water consumption over a twenty five year period which was not filed with the TRA until February 8, 2011.[22] However, Mr. Gorman's direct testimony demonstrates that ten, five and three year averages show far less decline in water consumption than Dr. Spiztnagel's projections.[23] Moreover, Dr. Spitznagel's analysis of decades of water consumption may be tainted by the fact the majority of water usage data was developed during the decades TAWC was estimating water bills rather than relying on metered data. [24]

The monthly results produced by Dr. Spitznagel include very low correlations between weather and actual water usage. [25] The proposed WNA is simply unreliable given that it ignores more explanatory variables such as price, income, household size, lot size, population density and the presence of voluntary or mandatory water restrictions.[26] While Dr. Spitznagel relies solely on one factor, a drought index as a measure for weather, the failure to include relevant variables can bias the results of the model.[27] Moreover, the overall accuracy of the model is questionable based on historic results.

---

[22] *Rebuttal Testimony of Edward Spitznagel*, Docket 10-00189, Rebuttal Exhibit ELS-1–ELS-4, February 8, 2011.

[23] *Direct Testimony of Michael Gorman*, Docket No. 10-00189, p. 9-10, January 5, 2011.

[24] *Transcript of Proceedings*, Schumaker Report, Docket 10-00189, Exhibit 29, p.120, March 1, 2011.

[25] *Direct Testimony of William H. Novak*, Docket 10-00189, p. 11-14, January 5, 2011.

[26] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, p. 19-20, January 5, 2011.

[27] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, p. 19-20, January 5, 2011.

Dr. Spitznagel has proposed a WNA projection in TAWC rate cases in 2003, 2004, 2006, 2008 and again in the current rate case. While Dr. Spitznagel's model is apparently intended to be an effective projection over the course of a number of years, the pace of TAWC rate cases every twelve to eighteen months only increases the unreliability of the model. No testing as to how reliable the model is over a period of two years has taken place.[28] While Dr. Spitznagel apparently takes the statistical long view, he believes it is "stupid" to test the reliability of his model over a two year period, which given TAWC's tendency to file frequent rate cases one reasonably could conclude would entail with very little effort.[29]

TAWC has attempted to demonstrate the accuracy of previous WNA projections from prior cases. However, the Company's efforts fail to show any resemblance of accuracy.[30] Rather the WNA projections are shown to be widely inaccurate. For example, even as Dr. Spitznagel is projecting consumers will use less water than they did in 2009, one of the wettest years on record for the area, Company data shows actual water sales as of September 2010 for the residential class are higher than sales in 2009 and Dr. Spiztanegal's projection.[31] Dr. Spitznagel's WNA projection is simply not a "known and measurable" adjustment, but rather a best guess based upon a methodology which is fundamentally unsound for rate-making purposes.

Dr. Spitznagel has ignored or is unfamiliar with considerable academic literature that addresses estimations of water demand.[32] Moreover, TAWC has not provided any academic or

---

[28] *Transcript of Proceedings*, Vol. III B, Docket 10-00189, p. 143 , March 2, 2011.

[29] *Transcript of Proceedings*, Vol. III B, Docket 10-00189, p. 165, March 2, 2011.

[30] *Rebuttal Testimony of Mike Miller*, Docket 10-00189, Rebuttal Exhibit MAM-10, February 8, 2011.

[31] *Rebuttal Testimony of Mike Miller*, Docket 10-00189, Rebuttal Exhibit MAM-10, February 8, 2011.

[32] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, pp. 9-10, January 5, 2011.

peer reviewed articles in support of Dr. Spitznagel's model.[33] There is no scientific or peer reviewed treatise or article endorsing Dr. Spitznagel's WNA model. Moreover, Dr. Spitznagel's WNA is not in wide-spread application. The Kentucky Public Service Commission is the only member of NARUC the Consumer Advocate is aware of which utilizes Dr. Spitznagel's model. Indeed, neighboring states such as Missouri, Virginia and West Virginia, which have large regulated affiliates of TAWC providing water service, currently do not use or have not adopted Dr. Spitznagel's weather normalization model.

There is apparent confusion on the Company's part regarding the use of the Palmer Drought Severity Index ("PDSI") and the PMDI. Dr. Spitznagel claimed at the hearing in this case that the intervenors in the previous 2008 rate case recommended using the PMDI as a replacement for using the original PDSI.[34] However, the record of Docket 08-00039 is clear that no party sought to make any adjustments to Dr. Spitznagel's model. Rather the Consumer Advocate witness Charles King criticized the results and methodology of Dr. Spitznagel and represented that a model based on temperature may be more accurate in the 2008 rate case.[35] Moreover, Chattanooga Regional Manufacturers Association ("CRMA") witness Michael Gorman provided testimony regarding the inaccuracy of Dr. Spitznagel's model as he did in the present case.[36] Thus, no party made the case a different drought index input would be more effective than Dr. Spitznagel's model. Rather, the Consumer Advocate utilized for purposes of impeachment examples of academic criticism of the original PDSI, with which Dr. Spitznagel

[33] *TAWC Response to Consumer Advocate Discovery Request 81(a) and 81(c)*, Docket 10-00189, December 2, 2010.

[34] *Transcript of Proceedings*, Docket 10-00189, Vol. III B, pp. 128, 147 , March 2, 2011.

[35] *Direct Testimony of Charles King*, Docket 08-00039, pp. 12-16, July 30, 2008/July 18, 2008.

[36] *Direct Testimony of Michael Gorman*, Docket 08-00039, pp. 18-21, July 18, 2008.

was apparently unfamiliar.[37] In the 2008 rate case, Dr. Spitznagel opined that of the four Palmer drought indexes available, the original PDSI worked best in his model.[38] However, it is worth noting in this rate case Dr. Spitznagel now sees no difference between utilizing the original PDSI and the PMDI.[39]

2. TAWC's Claim the TRA and Former Public Service Commission Adopted a Weather Normalization Methodology for Water Utilities Since 1989 Is Simply Incorrect

In pre-filed direct testimony, the Company continued the claim the TRA has deviated from a long standing policy of using weather normalization for TAWC for decades dating back to the days of the Tennessee Public Service Commission.[40] Given the Company's claims, the Consumer Advocate engaged Mr. William H. Novak, a professional consultant and former Tennessee Public Service Commission/TRA staff member, who has first-hand knowledge of the weather normalization issue discussed with TAWC dating back to 1989.[41] As recounted in his pre-filed direct testimony, Mr. Novak has extensive experience with weather normalization models. While the Company has claimed it is Mr. Novak who first created a weather normalization model for TAWC, Mr. Novak first produced a model in 1989 as a staff member of the former commission and used the results to *dispute* rather than affirm TAWC's claims

---

[37] *Consumer Advocate's Corrected Post Hearing Brief*, Docket 08-00039, pp. 9-14, September 3, 2008.

[38] *Transcript of Proceeding*, Docket 08-00039, p. 460, August 19, 2008.

[39] *Transcript of Proceeding*, Docket 10-00189, Vol. III B, pp. 128, 147.

[40] *Direct Testimony of Mike Miller*, Docket 10-00189, p. 49, September 23, 2010.

[41] The records of the Tennessee Public Service Commission, the TRA's predecessor, are not available or maintained by any entity of the State of Tennessee. TAWC has some records from old rate cases which the Company allowed the Consumer Advocate to review as part of a discovery request per CAPD Discovery Request #123.

regarding the impact of abnormal weather on water sales.[42] Mr. Novak has found very little correlation between weather and actual water consumption.[43] Moreover, in the 1989 rate case and those that followed the Tennessee Public Service Commission never adopted a weather normalization model for water or electric utilities.[44]

3. The Consumer Advocate's Revenue Forecast Methodology for The Attrition Year Should Be Adopted Because It Reasonably Reflects: (1) The Varying Weather Conditions In Chattanooga Over Recent Years; (2) the Effect of the Recent Economic Downturn; and (3) Anticipated Customer Growth.

The Consumer Advocate submits that its revenue forecast methodology at present rates should be adopted in this case because it more reasonably reflects the actual amount TAWC should collect from its customers during the attrition year. The Consumer Advocate in this docket has forecasted revenues using a 7-year trend analysis for all customer classes, excluding the Industrial Class and the Other Water Utility Class.[45] Using trend analysis, the Consumer Advocate is able to forecast customer growth patterns as well as account for and reflect recent weather patterns and outside economic pressures, all of which should drive the revenue analysis in this case.[46] Identifying trends within actual Company data, for the majority of the customer classes, for the years 2004 through 2010, coupled with adjusting for known and measurable changes, provides what the Consumer Advocate believes is a reliable method for calculating revenues. The Consumer Advocate acknowledges that the initial direct testimony of Consumer

---

[42] *Direct Testimony of William H. Novak*, Docket 10-00189, pp. 8-11, January 5, 2011.

[43] *Transcript of Proceedings*, Docket 10-00189, Vol. VII A, p. 31, March 8, 2011.

[44] *Id.*, p. 33; *Direct Testimony of William H. Novak*, Docket 10-00189, pp. 8-11, January 5, 2011

[45] *Direct Testimony of John Hughes*, Docket 10-00189, pp.6-13, March 1, 2011.

[46] *Transcript of Proceedings*, Docket 10-00189, Vol. IV C, 166:12-13, March 3, 2011.

Advocate Witness John Hughes contained several errors within the excel spreadsheets; however, the Consumer Advocate maintains that the amended direct testimony of John Hughes, filed on March 1, 2011, corrected any material error.

In reference to the Industrial and Other Water Utility customer classes, trending is unnecessary given the low number of customers and the consistently static growth. Rather, the Consumer Advocate has forecasted revenues for these customer classes by calculating billing determinants at the test year ending September 30, 2010, and multiplying those determinants by current rates.[47] TAWC mischaracterizes this common sense approach as "not consistent" in an effort to discredit the Consumer Advocate's methodology.[48] The Consumer Advocate maintains that trending the Industrial and Other Water Utility customer classes is useless because when one commercial customer or other water utility customer enters or leaves the TAWC system it creates a large variance. Attempting to trend these large variances would result in nonsensical data, and thus the Consumer Advocate has properly excluded them from its trending forecast methodology.

TAWC has also criticized the Consumer Advocate's approach for not taking into consideration routes billed more or less than 12 times a year.[49] The Consumer Advocate maintains that this issue has a *de minims* effect on the overall revenue forecast and is unnecessary to predict future incomes.

---

[47] *Direct Testimony of John Hughes*, Docket 10-00189, p. 11:16-19, March 1, 2011.

[48] *Rebuttal Testimony of Shelia Miller*, Docket 10-00189, p. 7:29-30, February 8, 2011.

[49] *Revised Rebuttal Testimony of Mike Miller*, Docket 10-00189, p. 62:5-9, February 17, 2011.

Moreover, the Consumer Advocate would note that its revenue forecast compares favorably with the methodology proposed by Mr. Michael Gorman, witness for CRMA, which is to average the actual data obtained from TAWC for Chattanooga and compute the average consumption of TAWC's residential and commercial customers during the period 2005 through 2009.[50] Mr. Gorman's five-year averages also reflect the actual consumption patterns of TAWC's residential and commercial customers from 2005 through 2009, which quite obviously are based on the actual weather conditions experienced during those years, as well as the impact of the recent economic downturn.[51]

a. The Consumer Advocate's Methodology is More Reflective of Actual Company Results

The Consumer Advocate's methodology is clearly reasonable when compared to TAWC's actual Company results for the twelve months ending December 2010. The Consumer Advocate has forecasted attrition year revenues at $38,251,266.[52] According to actual Company results filed with the TRA, TAWC generated $38,469,186 in revenues for the twelve months ending December 2010.[53] As such, the Consumer Advocate's attrition year forecast is only $218,000 less than TAWC's actual results for 2010. Whereas TAWC's attrition year forecast of $37,296,457 is considerably lower ($1,172,729) than the Company's actual 2010 results.[54]

---

[50] *Direct Testimony of Michael Gorman*, Docket 10-00189, p.10:18-20, January 5, 2011.

[51] *Direct Testimony of Michael Gorman*, Docket 10-00189, p.11:8-11, January 5, 2011.

[52] *Direct Testimony of John Hughes*, Docket 10-00189, p.3:10, March 1, 2011.

[53] *Transcript of Proceedings*, Docket 10-00189, Vol. VI A, Exhibit 78, March 7, 2011.

[54] *TAWC Revised Accounting Exhibits and Schedules*, Docket 10-00189, Income Statement – Operating Revenues, February 22, 2010.

Furthermore, TAWC's forecast uses billing determinants from 2009, which was the 11th wettest year on record since 1895 according to the Palmer Drought Severity Index.[55] Company Witness Edward Spitznagel agreed with the presumption that consumers will use less water during wet periods than during dryer years.[56] The Consumer Advocate asserts that not only is TAWC's forecast unsupported by verifiable data, the single 12 month period of time used in TAWC's forecast is not comparable to actual water usage because it is based on one of the wettest years in modern history. Thus, the Consumer Advocate would urge the Authority to refrain from adopting a revenue forecast that fails to take into consideration realistic trends in weather and economic conditions.

While the Consumer Advocate has forecasted attrition year revenues at $38,251,266 using a 7 year trending analysis, the Consumer Advocate believes TAWC should receive additional revenue from its affiliate American Water Resources ("AWR") which provides non-regulated services such as in-home plumbing protection, water line protection, and sewer line protection to customers of TAWC. City of Chattanooga witness Kim Dismukes testified that AWR receives considerable benefits from the use of TAWC's logo in selling the products listed above, and the Consumer Advocate agrees with this contention.[57] Namely, the Consumer Advocate agrees that that AWR is able to procure customers through its affiliation with the TAWC brand, and thus believes a portion of AWR's revenues should be imputed to TAWC. For these reasons, the Consumer Advocate urges the TRA to review and consider the relationship

[55] *Direct Testimony of Michael Gorman*, Docket 10-00189, p.10:12-14, January 5, 2011.

[56] *Transcript of Proceedings*, Docket 10-00189, Vol. III B, pp.143:20-144:4, March 2, 2011.

[57] *Transcript of Proceedings*, Docket 10-00189, Vol. II C, p.287:5-22, March 1, 2011.

between TAWC and AWR and whether a portion of AWR's revenues should be imputed to TAWC.

b. TAWC's Methodology Is Unverifiable Because There Is No Evidence Supporting TAWC's Calculations

TAWC's forecasting methodology, which as stated above produces considerably lower revenue projections than the actual results, is unverifiable as the record is devoid of evidence supporting its calculations. Not until Mike Miller's rebuttal testimony, filed on February 8, 2010, does the Company reveal, through written testimony, TAWC's methodology in calculating revenues.[58]

Both Company witnesses Mike Miller and Shelia Miller have stated that TAWC's process for forecasting revenues is the most time consuming part of the rate case.[59] Specifically, Mr. Miller stated,[60]

> 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.

The Consumer Advocate maintains that it would be extremely impractical for the Consumer Advocate or other intervening parties to attempt to forecast revenues using the Company's

---

[58] *Revised Rebuttal Testimony of Mike Miller*, Docket 10-00189, pp.58:22-59:18, January 5, 2011.

[59] *Revised Rebuttal Testimony of Mike Miller*, Docket 10-00189, pp. 59:17-18, January 5, 2011, and *Transcript of Proceedings*, Volume VI A, pp.17:7, March 7, 2011.

[60] *Revised Rebuttal Testimony of Mike Miller*, Docket 10-00189, pp. 59:11-18, January 5, 2011.

methodology. Namely, it would be nearly impossible for the Consumer Advocate to complete this 45 day process given there were not even 45 business days between the date TAWC's discovery responses were due and the date for the Intervener's to file testimony.[61]

In regard to forecasting revenues, Mr. Miller has stated that normalization of revenues involves "inherent uncertainty"[62] and Company Witness Edward Spitznagel has stated that his WNA model involves his "best guess."[63] While the Consumer Advocate agrees that normalization of revenues involves a form of "guesswork," the Consumer Advocate would aver that basing a forecasting methodology on multiple years worth of data in order to obtain trends in water usage results in much less "guesswork" than simply basing a revenue forecast on a single 12 month period and attempting to normalize revenues using the impact of weather.

TAWC has also attempted to criticize the Consumer Advocate's forecasting methodology by stating that in retrospect the Consumer Advocate's forecast in the 2008 rate case didn't adequately predict the actual result.[64] The Consumer Advocate finds this argument without merit. TAWC completely ignores the fact that Catoosa Utility District Authority allowed its contract with TAWC to expire in 2008, resulting in lost revenues of approximately $400,000.[65] No intervening party could have forecasted the loss of such a significant amount of water usage whether their method involved using trend analysis, averages, or billing analysis reports

---

[61] *Order Granting Petitions to Intervene, Reflecting Action Taken at Status Conference and Establishing a Procedural Schedule*, Docket 10-00189, November 12, 2010.

[62] *Revised Rebuttal Testimony of Mike Miller*, Docket 10-00189, p. 61:5-7, February 17, 2011.

[63] *Transcript of Proceedings*, Docket 10-00189, Vol. III B, pp.135:17-136:11, March 2, 2011.

[64] *Transcript of Proceedings*, Docket 10-00189, Vol. VI A, pp.48:2-4, 48:11-19: March 7, 2011.

[65] *Direct Testimony of John Watson*, Docket 10-00189, p. 36:25-27, September 17, 2010, and *Response to TRA's First Data Request*, Docket 10-00189, Question 55, p. 24.

normalized for weather and billing cycles. Attempting to compare and discredit the Consumer Advocate's forecast for 2009, or any intervening parties' forecast for that matter, to 2009 actual results when 2008 contained such an anomaly, is unpersuasive.

c. TAWC's Revenue Forecasting Methodology Creates Unnecessary and Increased Rate Case Expense

In addition, the Consumer Advocate avers that not only does TAWC's revenue forecast methodology not produce a reliable forecast, it creates unnecessary rate case expense. In addition to the cost of the 45 day process, the most time consuming part of TAWC's case, as explained above, the Consumer Advocate believes the WNA model proposed by Dr. Spitznagel is unpersuasive as to the effects of weather on the consumption of water use in the Chattanooga area. This unpersuasive study also comes at a cost to ratepayers, a cost to both prepare the study and a cost to present written and oral testimony as to its veracity.

Unlike the methodology proposed by TAWC in this case -- which attempts to correlate water consumption to the level of assumed moisture through a series of complex regression analyses -- the multi-year trending approach to normalization of water consumption is comprehensible and straightforward in its application, and it reflects the actual water consumption patterns of the utility's own customers in light of weather conditions, conservation efforts, and other important factors, such as the changing economy and demographics.

For the reasons stated above, the Consumer Advocate believe the proof establishes that TAWC's revenue forecast is significantly understated again this year. The Consumer Advocate, therefore, urges the Authority to reject TAWC's revenue forecast and adopt the Consumer Advocate's forecast.

V. ATTRITION YEAR REVENUE REQUIREMENT

The Authority should determine TAWC's revenue requirement in this case by applying the following generally recognized ratemaking formula: Revenue Requirement = (Rate Base x Rate of Return) + Operation and Maintenance Expense + Depreciation + Taxes.[66] In applying this formula to the facts of this case, there are many aspects of each of its components that are undisputed. This section, however, addresses the material areas of dispute between TAWC and the Consumer Advocate that the Authority should closely examine before it decides the revenue requirement in this case.

A. OPERATION AND MAINTENANCE EXPENSE

TAWC is forecasting $24.9 million in operation and maintenance expense for the attrition year; however, the Consumer Advocate asserts that $20.9 million is the more reasonable figure that should be adopted by the Authority.[67] The Consumer Advocate understands expenses generally rise over time, and it also understands TAWC has experienced some increases in expenses since the last rate case, with some increasing at a higher rate than others, such as electricity, gasoline, pensions, and group health insurance. But the Consumer Advocate maintains that total expenses must meet an overall test of reasonableness in light of prevailing business plans, economic conditions, and in comparison to other utilities in Tennessee.[68] In other words, not only does the methodology used to forecast each expense have to be reasonable, but these methodologies, when considered together, must also result in reasonable total expenses

[66] *Direct Testimony of Terry Buckner*, Docket 10-00189, p.8:15-17, January 28, 2010.

[67] *Transcript of Proceedings*, Docket 10-00189, Exhibit 90, Schedule 5, March 8, 2011.

[68] *Transcript of Proceedings*, Docket 10-00189, Vol. VI A, p.39:1-2, March 7, 2011.

consistent with the current business and economic environment. The Consumer Advocate asserts that the proof in this case clearly establishes TAWC's forecast of expenses fails to meet this overall test of reasonableness.

TAWC is a public utility whose costs have soared over the recent years. Indeed, TAWC's forecasted total operation and maintenance expense exceeds the cumulative gross domestic product ("GDP") inflation rate by more than 200% since 2004.[69] And again in this case, TAWC wants to add another 27% increase to the total operation and maintenance expense over the amount the Authority authorized in TAWC's last rate case.[70] By contrast, the number of customers that TAWC will serve in the coming year is anticipated to grow by only approximately 1%.[71]

While the Consumer Advocate maintains TAWC's current and past requests to increase expenses have been unreasonable, the Consumer Advocate believes the TRA's consistent denial of such high expenses is more reflective of TAWC's actual business operations and the economic conditions, especially in light of TAWC's recent series of rate cases. Accordingly, the Consumer Advocate's forecast of a 6.6% increase in Operations and Maintenance expenses since TAWC's last rate case is reasonable and should be adopted.[72] The significant expense items will be discussed in further detail below.

---

[69] *Direct Testimony of Terry Buckner*, Docket 10-00189, Workpaper E-GDP, January 5, 2011 and *Transcript of Proceedings*, Docket 10-00189, Exhibit 78, March 7, 2011.

[70] *Order*, Docket 08-00039, pp.12-31, January 13, 2011, and *Transcript of Proceedings*, Exhibit 90, Schedule 5, March 8, 2011.

[71] *Direct Testimony of John Hughes,* Docket 10-00189, Workpaper R-Customer Growth, March 1, 2011.

[72] *Transcript of Proceedings*, Docket 10-00189, Exhibit 90, Schedule 5, March 8, 2011.

1. TAWC's Attrition Year Forecast for Salaries and Wages Should Be Reduced for Employee Vacancies and Certain Incentive Pay.

It is undisputed that TAWC routinely has vacant employee positions; however, it wants to recover from ratepayers the salaries and wages associated with these vacant positions even though no one is actually on the payroll. Indeed, TAWC did not achieve its authorized level of employees at any time from September 2003 through August 2008.[73] It would appear that reducing the employee head count is how TAWC manages their business[74] creating a feather-bedding line item in their rate petition.

In this case, TAWC has forecasted salaries and wages for 110 employee positions during the attrition year, but it had only 102 employees on the payroll as of March 2010, which was the end of TAWC's test period.[75] The Consumer Advocate has based its salaries and wages on 104 employees in light of TAWC's historical track record in not maintaining authorized employee levels.[76] In fact, even though TAWC was authorized to have 109 employees in their last rate case, it averaged only 104 employees during the Consumer Advocate's test year ended September 2010.[77]

At the hearing, TAWC witness Mr. Watson testified that the Company had increased its employee count to 108 employees, two months into the attrition year.[78] Of the 108 employees,

---

[73] *Direct Testimony of Terry Buckner*, Docket 10-00189, Workpaper E-PAY5, January 5, 2011.

[74] *Transcript of Proceedings,* Docket 10-00189, Vol. II C at 347:23-25, March 1, 2011.

[75] *Direct Testimony of John Watson,* Docket 10-00189, p. 21:14-16, September 17, 2010, and *Direct Testimony of Terry Buckner, Docket 10-00189*, Workpaper E-Pay5, January 5, 2011.

[76] *Direct Testimony of Terry Buckner*, Docket 10-00189, pp. 14:18-15:7, January 28, 2011.

[77] *Direct Testimony of Terry Buckner,* Docket 10-00189, Workpaper E-Pay5, January 5, 2011.

[78] *Transcript of Proceedings,* Docket 10-00189, Vol. I B, p. 139:16, February 28, 2011.

one employee is a registered lobbyist filling a new position of Government Affairs Specialist.[79] The Consumer Advocate contends that ratepayers should not be required to compensate for lobbying and political influence activities as it is unnecessary for the provision of water service.[80] Additionally, to the Consumer Advocate's knowledge, the TRA has never approved a lobbying expense for any regulated utility.[81] As a result, the Consumer Advocate believes that rates should at a maximum be set on 107 employees as the appropriate number for the provision of water service, should the TRA choose not to adopt the Consumer Advocate's recommendation of 104 employees.[82] If the TRA orders an employee complement necessary to provide water service above 107, the Consumer Advocate requests that TAWC provide a monthly report of employees by name and by position to the TRA. While TAWC intends to have a work force of 110 employees in the 2011 attrition year, TAWC believes that any changes to their work force beyond the attrition year are not relevant to the Authority's determination of the Company's rates in this case.[83] Unfilled employee positions, however, should not be used as insurance to guarantee TAWC's rate of return at the expense of safe, adequate, and efficient service to the ratepayers.

In addition to the salaries and wages issue, another payroll-related expense issue involves the incentive pay that TAWC awards its employees for meeting certain performance

---

[79] *Direct Testimony of Terry Buckner*, Docket 10-00189, p.16:15-16, January 28, 2011.

[80] *Direct Testimony of Terry Buckner*, Docket 10-00189, p.16:16-19, January 28, 2011.

[81] *Transcript of Proceedings* ,Docket 10-00189, Vol. II B, pp.110:24-111:4, March 8, 2011.

[82] *Transcript of Proceedings,* Docket 10-00189, Vol. VII B at 80:15-16, March 8, 2011.

[83] *TAWC First Discovery Responses to UWUA*, Docket 10-00189, Question 8 and Question 10, November 15, 2010.

benchmarks. This incentive pay is known as Annual Incentive Plan ("AIP") compensation. The funding of AIP and any award to be provided through AIP is entirely dependent upon the Diluted Earnings Per Share ("EPS") achieving 90.9% of the target.[84] The Consumer Advocate disallowed a portion of this incentive pay in its forecast because ratepayers do not receive any benefit from some of the plan's benchmarks. In particular, as Consumer Advocate witness Mr. Buckner testified, 70% of TAWC's incentive pay is awarded for meeting targeted financial operating results.[85] There is no mechanism under TAWC's incentive plan for ratepayers to share in these increased earnings.[86] Indeed, considering TAWC's soaring expenses, the best opportunity for meeting these financial targets is through increasing ratepayers' water bills.[87] Thus, it is TAWC's shareholders and employees, not its ratepayers, that will receive the benefits of performing these financial benchmarks. For this reason, there is no reasonable basis for charging the financial portion of the incentive plan to ratepayers, as these plan benefits will inure entirely to TAWC's employees and shareholders, whereas the associated burdens will fall directly on ratepayers.[88] Accordingly, the Consumer Advocate has reduced TAWC's AIP expense by 70%, which directly correlates to the incentives paid for achieving the plan's financial benchmarks. This adjustment is consistent with the Authority's decision to disallow the financial portion of TAWC's incentive pay in the 2008 rate case.[89]

---

[84] *TAWC First Data Response to TRA*, Docket 10-00189, Question 37, September 24, 2010.

[85] *Direct Testimony of Terry B*uckner, Docket 10-00189, p.18, January 28, 2010.

[86] *Direct Testimony of Terry B*uckner, Docket 10-00189, p.18, January 28, 2010.

[87] *TAWC First Discovery Responses to UWUA*, Docket 10-00189, Question 1, November 15, 2010.

[88] *Direct Testimony of Terry B*uckner, Docket 10-00189, pp.18-19, January 28, 2010.

[89] *Order*, Docket 08-00039, p. 12, January 13, 2009.

Finally, in regard to the payroll expense, the Consumer Advocate disagrees with TAWC's position on the amount of labor to be capitalized. The capitalized salaries and wages are accounted for in rate base. TAWC opted to limit their capital additions in 2009 to the amount of internal financing, i.e., depreciation expense.[90] As a result, the use of the 15.83% capitalization rate for the test period ending March 2010 is inappropriate because of the stunted plant additions during the test period, which the Consumer Advocate believes is not representative of TAWC's historical plant additions.[91] The Consumer Advocate chose the capitalization rate of 20.57% for the year ending 2008 because the level and mix of plant additions as reported to the TRA in TAWC's annual report mirrors the level and mix of plant additions forecasted by TAWC in the attrition year.[92]

2. TAWC's Attrition Year Management Fees Should Be Reduced To a Reasonable Level.

The Consumer Advocate asserts the single largest factor contributing to TAWC's soaring cost structure in recent years is the large increase in management fees allocated to TAWC by the Company's affiliated service company, American Water Works Service Company ("AWWSC" or "service company"). In part, management fees are the product of a 1989 service agreement between TAWC and AWWSC that provides for the following services: Accounting, Administration, Communication, Corporate Secretarial, Engineering, Financial, Human Resources, Information Systems, Operation, Rates and Revenue, Risk Management, and Water

---

[90] *Direct Testimony of Terry Buckner, Docket 10-00189*, Workpaper E-Pay6, January 5, 2011.

[91] *Direct Testimony of Terry Buckner, Docket 10-00189*, Workpaper E-Pay6, January 5, 2011.

[92] *Direct Testimony of Terry Buckner, Docket 10-00189*, Workpaper E-Pay4A, January 5, 2011.

Quality.[93] However, under the service company agreement TAWC may perform the service with its own personnel or engage another company or person to provide those services on its own behalf.[94]

After the initial agreement, AWWSC began to also allocate costs for Business Development, External Affairs, and Centralized Call Centers, which were not in the service agreement.[95] To fully understand the impact of these fees on TAWC's costs, one must consider TAWC's reorganization, beginning in 2004 and completed in 2005, that removed some of the functions historically performed locally by people in Chattanooga and instead moved those functions to AWWSC to be performed by AWWSC personnel in Belleville, Illinois; Alton, Illinois; Pensacola, Florida; Charleston, West Virginia; and Voorhees, New Jersey.[96] As a result, Management Fees grew from approximately $2.6 million in 2004 to a forecasted amount of $4 million in 2007.[97]

In Docket 04-00288, TAWC represented that the reorganization and 22% increase in management fees to a total of $3,062,940 would "enable the Company to operate more efficiently and cost effectively while at the same time improving and enhancing the services that the Company provides."[98] However, since that time, there have been four rates cases since 2003,

---

[93] *Rebuttal Testimony of Bernard Uffelman*, Docket 10-00189, Exhibit BLU-1 at 42-43, February 8, 2011.

[94] *Rebuttal Testimony of Bernard Uffelman*, Docket 10-00189, Exhibit BLU-1 at 43, February 8, 2011.

[95] *Rebuttal Testimony of Bernard Uffelman*, Docket 10-00189, Exhibit BLU-1 at 96, February 8, 2011.

[96] *TAWC Response to First TRA Data Request*, Docket 10-00189, Question 4, September 24, 2010.

[97] *Direct Testimony of Terry Buckner*, Docket 10-00189, pp. 22-23, January 28, 2011.

[98] *Direct Testimony of Terry Buckner*, pp. 21-22 (citing Direct Testimony of Mike Miller in Docket 04-00288), January 28, 2011.

including the present one. As the TRA noted in the previous 2008 TAWC rate case, between 2004 and the Company's forecast for the 2009 attrition year, management fees have increased 73%.[99] In all three cases, an increase in management fees has been a driving factor of proposed rate increases of 20%, 21%, and 30% respectively.

At the conclusion of Docket No. 06-00290, the TRA ordered TAWC to conduct a management audit to address the prudency of the management fees charged by AAWSC.[100] That management audit was completed by Booz Allen Hamilton and was filed on March 14, 2008, in TRA Docket 08-00039 for review and approval by the TRA.[101] However, after reviewing the audit, the TRA found that the performed management audit "did not adequately address the issue of prudency of the management fees, and that the audit was not an independent audit as ordered in TRA Docket No. 06-00290."[102] As a result, a majority of the panel voted to set the Management Fee attrition year expense amount at $3,529,933 in TRA Docket No. 08-00039.[103] The TRA then ordered the Company to,

> develop a Request for Proposal ("RFP") for a comprehensive management audit by an independent certified public accountant...further, the audit shall evaluate and attest to the charges allocated to TAWC, including the efficiency of processes and/or functions performed on behalf of TAWC, as well as the accuracy and reasonableness of the allocation factors utilized.[104]

---

[99] *Final Order*, Docket 08-00039, p. 21, January 13, 2009.

[100] *Final Order*, 06-00290, p. 51, June 10, 2008.

[101] *Petition,* 08-00039, March 14, 2008.

[102] *Order*, Docket 08-00039, p. 20, January 13, 2009.

[103] *Order*, Docket 08-00039, p. 21, January 13, 2009.

[104] *Direct Testimony of Terry Buckner,* Docket 10-00189, p. 23, January 28, 2011.

As directed by the TRA, the Company began an RFP process for a management audit and ultimately contracted with Schumaker & Company to file an Affiliate Audit Report ("Schumaker Report"), which was submitted to the TRA on September 10, 2010 in TRA Docket No. 09-00086.[105] On September 17, 2010, TAWC filed this rate case. TAWC relies heavily on the Schumaker Report and claims it "confirms the appropriateness of the management fees and confirms the benefits and cost savings that flow to customers from use of the Management Company."[106]

The overarching issue with the Schumaker Report is that it did not audit the affiliated services charges or management fees charged by AWWSC to TAWC on a *rate-making* basis but rather from a "business perspective."[107] In other words, while the Schumaker Report cross-checked the functions of AWWSC to review whether there was any overlap and relied on Baryenbruch's studies, the Schumaker Report did not audit or "drill down" into whether the cost of such services were reasonable on a line item by line item basis or whether the service could be completed at a cheaper cost by TWAC personnel. The Schumaker Report simply stated that "the cost-allocation methodologies impacting TAWC are generally reasonable…the use of number of customers for allocating AWWSC costs…is essentially a simplification mechanism that is not necessarily based on cost causative factors."[108] While the Schumaker Report states the cost-

[105] *Notice of Filing of Schumaker and Company's Affiliate Audit Report of TAWC*, Docket 09-00086, September 10, 2010.

[106] *Revised Rebuttal Testimony of Mike Miller*, Docket 10-00189, p. 122, February 17, 2011.

[107] *Deposition of Patricia H. Schumaker,* Docket 10-00189, pp. 90:15-91:3, February 18, 2011; *Transcript of Proceedings*, Vol. II B, March 1, 2011, p. 154.

[108] *Transcript of Proceedings*, Schumaker Report, Docket 10-00189, Exhibit 29, p. 40, March 1, 2011.

allocation methodologies are generally reasonable, it is completely devoid of audit representation as to whether the actual dollar amounts that make up the allocation are reasonable, outside of reliance on Baryenbruch, which raises concerns regarding the independence of the Schumaker Report.[109]

In summary, the Consumer Advocate submits the Schumaker report does not support the Company's management fee position, some findings in the Schumaker report are based on cursory information that is not supported by documented evidence or detailed analysis of pertinent information, and the cost allocation methodology utilized by the Company is not just and reasonable given the circumstances in this case. Moreover, the Consumer Advocate submits some charges and allocations such as Business Development and External Affairs provide no benefit to consumers and should be excluded.

a. TAWC Has Little or No Control Over Service Company Charges

Both the Company and the Shumaker Report contend there are proper budget controls in place in AWWSC and TAWC operations. The Company "believes the Report indicates that reasonable and appropriate internal controls are in place surrounding the process and costs charged to TAWC from AWWSC."[110] However, the evidence clearly illustrates TAWC has little if any control over the management fees charged by AWWSC. There is only one documented instance in which TAWC challenged a charge from AWWSC.[111] The budget for

[109] *Transcript of Proceedings*, Docket 10-00189, Vol. VII B, pp. 106-107, March 8, 2011.

[110] *Direct Testimony of Mike Miller*, Docket 10-00189, p. 39, September 23, 2010.

[111] *Transcript of Proceeding*, Vol. I C, Docket 10-00189, pp. 283-286, February 28, 2011;Exhibit 11; *TAWC Response to City of Chattanooga Discovery Request 13.*

TAWC's management fees is put together by the service company.[112] The service company itself is in charge of tracking variances from the budget for management fees established by the service company.[113] The threshold for any substantive review of the management fee charges apparently is only crossed when there is a variance between the actual charges of AWWSC and the management fees budget.[114] Any dispute as to the budget is resolved by Mr. Nick Rowe, president of the Eastern Division of AWWSC, and himself a member of TAWC Board of Directors.[115] While TAWC's Board of Directors approves the Company's business plan, which includes the service company budget, five of the eight members of TAWC's Board of Directors are also service company employees.[116] Moreover, the amount of direct charges from 2005 to 2009, which constitute work performed by the service company on behalf of TAWC, including capital expenditures, represent only 7.4% to 10.9% of the service company charges paid by TAWC.[117]

There is little to support the contention TAWC has any real independence and control of the management fees. While the charges themselves are labeled "management fees," TAWC avers the label is really a misnomer and considers the services provided by AWWSC to be "support services."[118] Moreover, TAWC claims to do what it can to reduce them.[119] Yet the

---

[112] *Transcript of Proceeding*, Docket 10-00189, Vol. I C, pp. 291-292, February 28, 2011

[113] *Transcript of Proceeding*, Docket 10-00189, Vol. I C, pp. 292, February 28, 2011

[114] *Transcript of Proceeding*, Docket 10-00189, Vol. I C, pp. 294-295, February 28, 201

[115] *Transcript of Proceedings*, Docket 10-00189, Vol. VI B, p. 165, March 7, 2011.

[116] *Transcript of Proceedings*, Docket 10-00189, Vol. III A, p. 8, March 2, 2011.

[117] *Transcript of Proceedings*, Schumaker Report, Docket 10-00189, Exhibit 29, pp. 26-27, March 1, 2011.

[118] *Transcript of Proceedings*, Docket 10-00189, Vol. I B, pp. 132-133, February 28, 2011.

management fees incurred have continued to grow at a rate greater than any reasonable economic measurement of growth well beyond the rate-making forecasts of TAWC.[120]

When TAWC discusses its "belt-tightening" efforts, one must consider what expenses and operations are actually subject to cuts and those which are not subject to cuts or serious scrutiny. For example, TAWC defers items such as valve maintenance and holds employee positions responsible for such work vacant.[121] Capital projects have been consistently deferred.[122] Yet, the increases in charges for management fees or "support services" are apparently off limits to any consideration of "belt tightening" even as they grow beyond any reasonable economic growth rate.[123] Moreover, dividends to AWWC, which TAWC seems unable to defer, are paid as a matter of policy.[124] Even as TAWC defers items of capital improvement and maintenance in the water system and holds vacant employee positions, the service company always receives full payment from TAWC for its charges and American Water Works receives its dividend at the expense of local operations. In the simplest of terms, administrative costs, such as the ever growing management fees paid to the service company, are off limits to "belt tightening" as a business decision to control and lower TAWC's expenses in an effort to achieve a maximum rate of return. Given the service company's hold and control over TAWC, the claim that TAWC is a stand-alone company with full control over its operations and

---

[119] *Id.*, p. 134.

[120] *Direct Testimony of Terry Buckner*, Docket 10-00189, pp. 35-36, January 28, 2011.

[121] *Transcript of Proceedings*, Docket 10-00189, Vol. II C, pp. 343-344, March 1, 2011.

[122] *TAWC Response to First Discovery Request of CRMA*, Docket 10-00189, Question 30, December 2, 2011.

[123] *Direct Testimony of Terry Buckner*, Docket 10-00189, p. 24, January 28, 2011.

[124] *Transcript of Proceedinsg*, Docket 10-00189, Vol. II C, pp. 345-346, March 1, 2011.

management fees is simply implausible. The extent of control AWWSC has over TAWC is such that the Authority should consider whether regulatory measures such as "ring fencing" are necessary to prevent the draining of resources away from TAWC's local operations.

Moreover, there is no support for the claim TAWC has any real control of the charges incurred from the service company. The only documented evidence of a charge challenged by TAWC was provided in response to City of Chattanooga Discovery Request 13, a request that sought information concerning all service company charges challenged from 2007 to 2010. Even the sole challenge to a service company charge is telling. In an e-mail dated March 3, 2010, from Kevin Rogers, a former service company employee now working for TAWC, challenged an accounting charge based on his personal knowledge of the work done by a specific service company employee.[125] One must consider whether the charge would have been challenged at all had Mr. Rogers not had personal knowledge of the specific service company employee and his activities.

On this same issue of the ability or inclination of TAWC to contest or have some control over service company charges and the review process conducted by AWWSC, the Schumaker Report relies not on documented facts or evidence, but rather representations made in interviews with service company employees and TAWC personnel.[126] The interview notes themselves cited in the Schumaker Report in support of this conclusion contain very little if any information on the issue, and absolutely no detail concerning actual charges that have been challenged. The Consumer Advocate can find no documented examples of service company charges challenged

[125] *Transcript of Proceedings*, Docket 10-00189, Vol. IC, pp. 283-286, February 28, 2011;Exhibit 11; *TAWC Response to City of Chattanooga Discovery Request 13.*

[126] *Transcript of Proceedings*, Docket 10-00189, Vol. II B, pp. 162-163. March 1, 2011.

by TAWC within the 101 information requests made by Schumaker & Company in the preparation of the audit. Ms. Schumaker acknowledged she made no information request for such information because she believed it was unavailable.[127]

Thus, without documented evidence of challenges made by TAWC or charges removed from TAWC's bill following a review by the service company, Schumaker & Company appears to have simply taken the service company's and TAWC's word for it. Nor did Ms. Schumaker or the Schumaker Report have any information or findings concerning how many times the management fee charges had exceeded the budget.[128] Yet, the Schumaker's cursory examination of TAWC controls and systems to control costs from AWWSC suggests only "moderate improvement" is necessary.[129] Given the evidence, the Schumaker Report's summary conclusions rely upon information supplied by the Company are simply unsupported by facts.

One must note the Schumaker Report states the service company charges account for roughly 20% of TAWC's total operating expenses on an annual basis since 2005. Thus, the extent of the budget controls and steps taken by both TAWC and AWWSC over the management fees would appear to be an essential issue to thoroughly investigate and confirm with factual documentation, which apparently was not the course of action taken here. Moreover, Ms. Schumaker acknowledged a recent audit of New Jersey American Water Company ("NJAWC") by NorthStar Consulting that included a review of affiliate transactions between NJAWC and AWWSC, which came to a conclusion that contrasts the Schumaker Report finding that there are

[127] Transcript of Proceedings, Docket 10-00189, Vol. II B, pp. 162-163. March 1, 2011.

[128] Transcript of Proceeding, Docket 10-00189, Vol. II A, p. 136, March 1, 2011.

[129] *Transcript of Proceedings*, Schumaker Report, Docket 10-00189, Exhibit 29, p. 11, March 1, 2011.

sufficient budget controls in place.[130] The respective audits cover transactions from the same service company, although Ms. Schumaker contended TAWC has, or may have, more ability than NJAWC to control and challenge service company charges. [131]

The Schumaker Report did conclude there is a lack of sufficient internal auditing within AWWSC and that even those audits that do take place are of insufficient scope.[132] Of the 40 internal audits undertaken in the American Water Works system between 2004 and 2009, only two have been related to affiliate transactions.[133] This is a rather eye opening finding considering the amount of charges, both direct and indirect, which flow from AWWSC to regulated affiliates like TAWC and the controversies over management fees both in this state and numerous other jurisdictions.[134] The affiliated service company's personnel not only allocate costs to TAWC, but are the primary source of capital[135] for plant investment; determine the group health insurance benefits;[136] determine the pension plan benefits;[137] determine the regulatory expenses;[138] and determine insurance other than group expense.[139] In effect, the local

---

[130] *Transcript of Proceedings*, Docket 10-00189, Vol. II A, pp. 135-136, March 1, 2011.

[131] *Transcript of Proceedings*, Docket 10-00189, Vol. II A, p. 139, March 1, 2011.

[132] *Transcript of Proceedings*, Schumaker Report, Docket 10-00189, Exhibit 29, pp. 71-72, March 1, 2011.

[133] *Transcript of Proceedings*, Schumaker Report, Docket 10-00189, Exhibit 29, Exhibit III-8, March 1, 2011.

[134] *Direct Testimony of Terry Buckner*, Docket 10-00189, pp. 36-40, January 28, 2011

[135] *Transcript of Proceedings,* Docket 10-00189, Vol. I C, p. 266:8-10, February 28, 2011.

[136] *Transcript of Proceedings,* Docket 10-00189, Vol. I C, p. 266:8-10, February 28, 2011.

[137] *Transcript of Proceedings,* Docket 10-00189, Vol. I C, p. 255:10-12, February 28, 2011.

[138] *Transcript of Proceedings,* Docket 10-00189, Vol. VI A, p. 65:23-25, March 7, 2011.

[139] *TAWC Response to First Data Request of TRA*, Docket 10-00189, Question 13, September 24, 2010.

management of TAWC is hamstrung by a gauntlet of AWWSC management oversight resulting in imprudent management of TAWC's financial resources. Rather than change the AWWSC business model and its faulty cost of service structure to better control costs, TAWC's management has chosen to file repeated rate cases[140] seeking more revenues from the ratepayers.

b. The Cost to Market Studies Cited by The Schumaker Report and Sponsored by Mr. Baryenbruch Offer No Substantive Evidence

In the Schumaker Report, Finding II-3 states, "American Water has performed numerous cost-to-market comparisons as a means to verify that AWWSC costs are equal to or lower than what they would be if outsourced to third-party organizations."[141] The Schumaker Report goes on to summarize and outline Mr. Baryenbruch's various studies submitted during various rate cases on behalf of TAWC and TAWC affiliates. However, the reliance of the Schumaker Report on the cost-to-market comparisons by "independent consultants" Baryenbruch & Company ("Baryenbruch") and Deloitte & Touche has not convinced the Consumer Advocate that AWWSC costs are equal to or lower than what they would be if outsourced to third party organizations. Patrick L. Baryenbruch, Baryenbruch, was and has been a witness on behalf of TAWC and has performed similar studies on behalf of AWWSC affiliated companies.[142]

Out of the 43 comparative analysis reports prepared by Baryenbruch, there has never been a finding that the costs paid by a utility to a management company are considered unreasonable.[143] Therefore, the Consumer Advocate questions the independence of the

---

[140] *TAWC Petition*, Dockets 03-00118, 04-00288, 06-00290, 08-00039, 10-00189.

[141] *Transcript of Proceedings*, Schumaker Report, Docket 10-00189, Exhibit 29, p. 42, March 1, 2011.

[142] *Transcript of Proceedings*, Schumaker Report, Docket 10-00189, Exhibit 29, pp. 42-44, March 1, 2011.

[143] *Transcript of Proceedings,* Docket 10-00189, Vol. IV C, p. 199:18-22, March 3, 2011.

Schumaker Report to the extent it relies on the Baryenbruch's studies and methdologies.[144] Moreover, the Deloitte & Touche Report cited in the Schumaker Report was rejected by the Illinois Commerce Commission in a 2010 rate case for TAWC affiliate Illinois American Water Company ("IAWC"). [145]

The City of Chattanooga addressed in great depth the unreliability of Mr. Baryenbruch's analysis throughout the course of this rate case. The Consumer Advocate expressly adopts the City of Chattanooga's criticisms of Mr. Baryenbruch's study as laid out in during the hearing and enumerated in the City's post-hearing brief. The Consumer Advocate must note Mr. Baryenbruch's analysis and methodology submitted in this case are essentially the same as that submitted in the 2006 rate case with the addition of one question and answer Mr. Baryenbruch imposes upon on himself.[146] The addition is a question which asks whether the service company charges to TAWC in the company's test year are reasonable.[147] At the hearing, Mr. Baryenbruch testified he developed this aspect of his analysis in response to the "concerns about being able to look at a single metric to determine reasonableness" supposedly expressed by TRA Director Ron Jones during testimony of Mr. Baryenbruch in the 2006 rate case hearing.[148]

However, Director Jones in no way expressed the need for an additional or single metric to determine the reasonableness of the charges. Rather, Director Jones questioned Mr.

---

[144] *Transcript of Proceedings*, Docket 10-00189, Vol. VII B, pp. 106-107, March 8, 2011.

[145] *Order of the Illinois Commerce Commission*, Illinois American Water Company, Docket 09-0319, 2010 WL 1753119(Ill.C.C.)*44(p.30), April 13, 2010. Copy attached to *Direct Testimony of Terry Buckner*, January 5, 2011.

[146] *Transcript of Proceeding*, Docket 10-00189, Vol. V B, p. 113, March 4, 2011.

[147] *Response to Consumer Advocate's Second Discovery Request 7*

[148] *Transcript of Proceeding*, Docket 10-00189, Vol. V B, p. 113, March 4, 2011.

Baryenbruch as to how one could determine whether the charges from the service company were for work that was actually *needed.*

> Q. **Director Jones**: Yes. Okay. Do you have an opinion as to how this Authority could assess whether the actual charges that are being allocated to Tennessee American Water Company is for work that's actually needed? Do you have an opinion as to how we can make that assessment? Because I think you're testifying to the correctness of the allocations themselves, but not to whether or not the work being performed is work that's needed. Or have I mischaracterized?
>
> A . **Mr. Baryenbruch**: Yes. I guess I would look at year-over-year changes in service company charges. *It's very difficult to make an ultimate determination, though, as to the appropriateness of the charges in this -- I'm sure in this instance, because it really does require a lot of in-depth work,* almost like a management audit, to make that determination, and in other instances I've seen where the management audits are done separate from the rate case. But I think to the extent that I show who does what in terms of services in the back of this -- in the back of my report in Schedule 10, you can feel some degree of comfort that there's distinct responsibilities, utility-related responsibilities between service company and Tennessee American.

Docket 06-00290, *Transcript of Proceeding*, p.520-521, April 19, 2007 (emphasis added). Thus, Director Jones was looking well beyond Mr. Baryenbruch's analysis or a single metric to provide additional assurance. Cursory examinations and peer groups of electric and natural gas utilities were not sufficient in the 2006 and 2008 rates cases. Nor are they sufficient now.

Mr. Baryenbruch claims states such as Illinois and Ohio have accepted his methodology.[149] However, in recent rate cases with regulated affiliates of TAWC, both Illinois and Ohio rejected the management fee amounts sought by the respective companies. The 2010 Illinois Commerce Commission ("Illinois Commission") order is of particular interest. At the conclusion of an earlier 2007 rate case for IAWC in which Mr. Baryenbruch submitted his

[149] *Rebuttal Testimony of Patrick Baryenbruch*, pp. 44-45, February 8, 2011.

market cost study, the Illinois Commission ordered an additional study comparing the cost of each service obtained from the service company to costs of such services obtained through competitive bidding on the open market.[150] Thus, given the Commission's 2007 order, one can reasonably conclude the Illinois Commission was not satisfied with Mr. Baryenbruch's analysis. Following the 2007 case and in response to the Illinois Commission, IAWC responded with the Dellotte and Touche Report in the 2010 rate case sponsored by Mr. Uffelman. Mr. Uffelman's study in the 2010 proceeding, which utilized a similar cost to market study as that produced by Mr. Baryenbruch[151], was rejected.[152] Thus, any claim the Illinois Commission has accepted Mr. Baryenbruch's analysis is not correct.

Mr. Baryenbruch's criteria for the reasonableness of the management fees in this matter is based solely on a comparison to a peer group of electric and natural gas utilities.[153] Rates should be set on a just and reasonable basis rather than based on a comparative value to the rates of other utilities. Furthermore, there is insufficient evidence or depth of factual knowledge to conclude there is no duplication or overlap in work performed by the service company and TAWC. It is difficult to pin point how one can review the Schumaker workpapers and interview notes and conclude with confidence there is no duplication or overlap in work performed by the Service Company and TAWC.

---

[150] *Order of the Illinois Commerce Commission*, Illinois American Water Company, Docket 09-0319, 2010 WL 1753119(Ill.C.C.)*44(p.30), April 13, 2010. Copy attached to *Direct Testimony of Terry Buckner*, January 5, 2011.

[151] *Transcript of Proceedings*, Docket 10-00189, Vol. IV A, pp. 45-46, March 3, 2011.

[152] *Order of the Illinois Commerce Commission*, Illinois American Water Company, Docket 09-0319, 2010 WL 1753119(Ill.C.C.)*44(p.30), April 13, 2010. Copy attached to *Direct Testimony of Terry Buckner*, January 5, 2011.

[153] *Transcript of Proceedings*, Docket 10-00189, Vol. IV C, p. 176-177, March 3, 2011.

c. The Cost Allocation Methodology Utilized by AWWSC Is Not Just and Reasonable

The Schumaker Report concludes "the cost-allocation methodologies impacting TAWC are generally reasonable....the use of number of customers for allocating AWWSC costs....is essentially a simplification mechanism that is not necessarily based on cost causative factors."[154] In an effort to remediate the finding in the Schumaker Report that AWWSC doesn't necessarily allocate indirect costs based on cost causative factors, TAWC presented a "Customer Based Cost Allocation Analysis" ("Uffelman Report") by TAWC witness Bernard Uffelman. The study is based on a Tier One factors utilized for an identical study for Pennsylvania American Water Company ("PAWC"). For the PAWC study, two or three different renditions were considered and utilized different factors and different results.[155] Mr. Uffelman, Mr. Miller, and other service company personnel apparently settled on applying the Tier One factors only to common or indirect costs in comparison to allocating such costs on basis of the number of customers.[156]

During the Hearing, Mr. Uffelman admitted that there are many different types of allocation factors and metrics for allocating costs and different results can be obtained by using various combinations of these different factors not included in his study.[157] Mr. Uffelman also

---

[154] *Transcript of Proceedings*, Schumaker Report, Docket 10-00189, Exhibit 29, p. 40, March 1, 2011.

[155] *Transcript of Proceedings*, Docket 10-00189, Vol. IV A, p. 10, March 3, 2011.

[156] *Transcript of Proceedings*, Docket 10-00189, Vol. IV A, p. 11, March 3, 2011.

[157] *Transcript of Proceedings,* Docket 10-00189, Vol. IV A, p. 14:15-17, March 3, 2011, and *Transcript of Proceedings,* Vol. IV A, p. 15:8-9, March 3, 2011.

stated that TAWC would be charged approximately $120,000 less by AWWSC if his method of allocation, namely Tier One factors, was used.[158]

***********Begin Confidential Information***********

[redacted]

***********End Confidential Information***********

The Uffelman study submitted in this docket serves little more than to prop up AWWSC's entrenched allocation methodology using the number of customers. The Uffelman study does not support the audit finding of the Schumaker Report, instead it supports the concept of cost allocation based on the number of customers as a "rational and reasonable way to allocate."[160] The Uffelman study reasons that the number of customers is less volatile than other cost allocation factors.[161] However, the number of customers can be very volatile in the near future given the impending loss of 200,000 customers with the sale of New Mexico American Water Company and Arizona American Water Company.[162]

---

[158] *Transcript of Proceedings,* Docket 10-00189, Vol. IV A, p. 27:5, March 3, 2011.

[159] *Transcript of Proceedings*, Docket 10-00189, Vol. IV A, p. 53, March 3, 2011.

[160] *Direct Testimony of Terry Buckner,* Docket 10-00189, p. 26, January 28, 2011.

[161] *Direct Testimony of Terry Buckner,* Docket 10-00189, pp. 26-27, January 28, 2011.

[162] *Transcript of Proceedings*, Docket 10-00189, Vol. VI, p. 130, March 7, 2011.

The Consumer Advocate agrees with the portion of the Schumaker Report that states that the AWWSC allocation method is "not necessarily based on cost causative factors" and would aver that a proper allocation method would be to apply the allocation to indirect costs based on direct cost causative factors through the use of equally weighted percentage of Plant in Service, Direct Operations and Maintenance Expense and Number of Customers.[163] This is the same composite allocation methodology used by Atmos Energy Corporation and Tennessee Wastewater Systems.[164]

Mr. Uffelman admitted Atmos Energy Corporation's methodology would be a comparison worth looking at if there were similarities in terms of the number of customers, corporate structure, and types of services. [165] The Consumer Advocate submits Atmos Energy is comparable to TAWC in terms of the number of customers, corporate structure, number of jurisdictions it serves and the types of services provided.[166] Moreover, Mr. Uffelman agreed if the TRA found an allocation methodology unreasonable, it could adopt its own method.[167]

The Consumer Advocate agrees with Mr. Uffelman's contention that it is preferable to directly allocate costs whenever possible.[168] However, an allocation of AWWSC costs does not

---

[163] *Direct Testimony of Terry Buckner,* Docket 10-00189, pp. 30-31, January 28, 2011.

[164] *Direct Testimony of Terry Buckner,* Docket 10-00189, p. 31, January 28, 2011.

[165] *Transcript of Proceedings,* Docket 10-00189, Vol. IV A, p. 40:11-17, March 3, 2011, and *Transcript of Proceedings,* Docket 10-00189, Vol. IV A, p.43:9-13, March 3, 2011.

[166] *Transcript of Proceedings,* Docket 10-00189, Vol. VII, pp. 104-106, March 8, 2011.

[167] *Transcript of Proceedings,* Docket 10-00189, Vol. IV A, p. 43:9-13, March 3, 2011.

[168] *Transcript of Proceedings,* Docket 10-00189, Vol. IV A, p. 62:15-18, March 3, 2011.

mean that an actual service has been provided.[169] In fact, only 16% of the total management fee amount of $5.1 million was direct charged in 2009.[170] Thus, the bulk of the charges from AWWSC to TAWC are allocations of indirect and residual costs based solely on the number of customers TAWC has. While TAWC maintains there should be no change in the Tier Two allocations based solely on the number of customers, the Consumer Advocate submits the use of a composite factor, utilizing many cost-causative elements, and already in use with other Tennessee public utilities is a just and reasonable methodology for application to TAWC for rate-making purposes.

d. TAWC's Attrition Year Forecast for Management Fees Is Unreliable

The projected growth of TAWC forecast for management fees is greater than the growth projected in AWWSC's total budget of charges to affiliates. The Company's management fee test year figure is $4,962,171. TAWC's management fee forecast for attrition year is $5,226,034, which is a 5.32% increase from the test period. However, total AWWSC charges as of March 31, 2010, September 30, 2010 and the 2011 AWWSC budget show overall growth of AWWSC charges of only 0.21 %:

[169] *Transcript of Proceedings,* Docket 10-00189, Vol. III A, p. 91:4-8, March 2, 2011.

[170] *Rebuttal Testimony of Bernard Uffelman*, Docket 10-00189, Exhibit BLU-1 at 95, February 8, 2011.

AWWSC Charges as of 12 months ending March 31, 2010[171]	AWWSC Charges as of 12 months ending September 30, 2010[172]	2011 AWWSC Budget[173]	Percentage Growth Since March 31, 2010
$221,570,938	$221,149,134	$221,943,942	0.21%

Thus, while AWWSC has projected far less growth in charges in the 2011 service company budget, TAWC's growth factor is out of step with the service company's overall budget. Given the bulk of the charges from the AWWSC to TAWC are indirect cost allocations rather than work done directly on behalf of TAWC and the minimal growth of the projected AWWSC charges, the growth in management fees projected by TAWC is seemingly unsupportable and thus, unreliable.

e. The Management Fees Paid by TAWC Have Not Produced Savings

TAWC witness Mike Miller testified, based on his assumptions of the expenses that would have been incurred had there been no reorganization, that the reorganization resulted in an estimated cost savings of $1.230 million.[174] The Consumer Advocate disputes this testimony because, based on the actual management fees charged to TAWC rather than Mr. Miller's assumed expenses, it is clear that management fees have actually increase sharply since the reorganization.[175]

---

[171] *TAWC Response to CAPD's First Discovery Request*, Question 102, Attachment 1, p. 17.

[172] *TAWC Response to CAPD's First Discovery Request*, Question 39, Supplemental Attachment, p. 7.

[173] *TAWC Response to CAPD's Second Discovery Request*, Question 4, Attachment, p. 2.

[174] *Transcript of Proceedings,* Docket 10-00189, Vol.VI A, p. 39:18, March 7, 2011.

[175] *See* attached Exhibit O&M-1.

Mr. Miller's analysis of management fees is presented in his Exhibit MAM-11. For purposes of his analysis, labor and benefits, as well as management fees, and AWWSC capital costs must be considered together to determine the amount of cost savings attributable to the reorganization. However, the Consumer Advocate contends that Mr. Miller's Exhibit MAM-11 has four major flaws: (1) the starting point of his analysis should have been the year 2005, which was the completion year of the reorganization; (2) it increases labor annually by 3.5% when TAWC direct testimony in preceding dockets states it increases labor by 3%; (3) it does not recognize TAWC's revised Group Insurance and Pension costs; and (4) only the incremental capital costs should have been recognized since 2005. Correction for the flaws in Exhibit MAM-11 results in a net cost of $41,405 and evaporates the estimated savings of $1.230 million.[176] Clearly, TAWC understated the impact of the reorganization,[177] especially in light of the loss of Tennessee jobs and the reduction of TAWC's economic presence in the community.

Using the 2005 amounts as forecasted by TAWC in TRA Docket No. 04-00288 as a starting point, the Consumer Advocate contends that the reorganization has cost ratepayers $1.6 million for the attrition year ended 2011. [178] Using this approach, it closely mirrors the increase in management fees from 2005 through the attrition year amount of $1,659,901, as shown at the bottom on Exhibit MAM-10, which is a 46.55% increase.[179] Accordingly, the reorganization pumped an additional $1.6 million of expenses into TAWC's cost structure in the form of

[176] *See* attached Exhibit O&M-2.

[177] *Rebuttal Testimony of Mike Miller*, Docket 06-00290, p. 54, April 9, 2007.

[178] *Direct Testimony of Mike Miller*, Docket 10-00189, MAM-10, September 24, 2010.

[179] *Direct Testimony of Mike Miller*, Docket 10-00189, MAM-10, September 24, 2010.

management fees, without any corresponding decrease in TAWC's local expenses. So rather than creating a cost savings of $1.230 million, as proposed by Mr. Miller's assumptions, the reorganization has actually cost ratepayers more than $1.6 million in additional charges. After the conclusion of the proof in this case, the Consumer Advocate does not believe TAWC has justified these additional costs. The Consumer Advocate maintains, for the reasons stated below, that TAWC's management audit failed to properly address the prudence or reasonableness of these fees.

Because management fees are forecasted to have increased by over 46% since completion of the reorganization without an offset in TAWC's local expenses,[180] and because the management audit failed to explain why such a huge increase in fees is prudent or reasonable, the Consumer Advocate asserts TAWC's management fees should be reduced. If TAWC's management fees are not trimmed in this case, ratepayers, who have already paid more than a million dollars a year in higher management fees since TAWC's reorganization in 2004, will continue to pay these exorbitant fees without any measurable benefits flowing to them. This is not fair to the ratepayers, especially in light of TAWC's inaccurate allegations that the reorganization would result in cost savings and efficiencies. The Authority should bear in mind that in the 2008 rate case, a similar analysis conducted by the Company resulted in a calculation of total savings of approximately $26,000 which in this has suddenly projected to $1.2 million in savings.[181] From the Consumer Advocate's viewpoint, all the reorganization has done is to cause a permanent million-dollar bump in TAWC's cost structure.

---

[180] *Direct Testimony of Terry Buckner,* Docket 10-00189, p. 24, January 28, 2011.

[181] *Direct Testimony of Terry Buckner*, p. 28, January 28, 2011.

f. The Consumer Advocate's Recommendation for the Appropriate Level of Management Fees Should Be Adopted

Given the reasons, arguments and facts made in the preceding sub-sections, the Consumer Advocate recommends the TRA adopt a management fee amount of $3.5 million to $3.65 million based on the following: (1) composite allocation factor utilized by Atmos Energy Corporation; (2) eliminate the allocated amount for External Affairs[182]; (3) eliminate 70% of the AIP allocated to TAWC related to plan's financial benchmarks[183]; (4) eliminate the allocated amount for Business Development[184]; (5) eliminate excessive growth above current GDP and TAWC customer growth[185]; (6) eliminate non-recurring accounting expense[186]; (7) normalize payroll to the latest test year level[187]; (8) limit the payroll growth to 2.5%[188]; and (9) eliminate the Stock Compensation expense[189].

Accordingly, the Consumer Advocate proposes an approximate $1.7 million downward adjustment in the attrition year management fees -- $3.5 to $3.65 million as opposed to TAWC's forecast of $5.226 million.[190] Furthermore, this $1.7 million reduction would help offset

---

[182] *Direct Testimony of Terry Buckner*, p. 34, January 28, 2011.

[183] *Direct Testimony of Terry Buckner*, pp. 31-33, January 28, 2011.

[184] *Direct Testimony of Terry Buckner*, pp. 33-34, January 28, 2011.

[185] *Direct Testimony of Terry Buckner*, pp. 35-36, January 28, 2011.

[186] *Direct Testimony of Terry Buckner*, pp. 34-35, January 28, 2011.

[187] *Direct Testimony of Terry Buckner*, p. 36, January 28, 2011.

[188] *Direct Testimony of Terry Buckner*, p. 35, January 28, 2011.

[189] *Direct Testimony of Terry Buckner*, p. 33, January 28, 2011.

[190] *TAWC Revised Accounting Exhibits and Workpapers*, Docket 10-00189, Exhibit 2, Schedule 3, Line 11, February 22, 2010.

TAWC's $1.6 million increase in the level of management fees caused by the reorganization. As argued above, this reduction in fees should be made in the interest of ratepayers because the million-dollar bump in TAWC's management fees has not been offset by cost savings at the local level and has not been shown to be either prudent or reasonable. Since there are no discernible ratepayer benefits from these additional charges, the Consumer Advocate urges the Authority to remove them from the ratepayers' bills.

3. The Authority Should Reduce Regulatory Expenses to a Just and Reasonable Level.

Regulatory Expense includes the following items: (1) Cost of Rate Case Expenses (2) Cost of Service studies; and (3) Cost of Depreciation studies.

On March 8, 2008, the Authority, by motion, ordered TAWC to provide detailed evidence of rate case expense to demonstrate that the rate case expenses being claimed are necessary, reasonable, and prudent.[191] The Authority then proposed a hearing date of March 28, 2011, wherein the parties would present testimony and live witnesses as to the issue of rate case expense.[192] On March 16, 2011, the parties in this docket stipulated to a rate case expense amount of $645,000 in order to expedite the proceedings.[193] The Stipulation was absent any agreement as to the amortization of the rate case expenses; therefore, the Consumer Advocate recommends a three year amortization for this amount in this docket, for a maximum of $215,000 each year. The Consumer Advocate has also included the amortization of rate case

---

[191] *Transcript of Proceedings,* Docket 10-00189, Vol. II B, p.126:17-22, March 8, 2011.

[192] *Transcript of Proceedings,* Docket 10-00189, Vol. II B, p. 127:3-12, March 8, 2011.

[193] *Joint Motion for Approval of Rate Case Expense*, Docket 10-00189, March, 16, 2011.

costs in TRA Docket No. 06-00290 at $44,443 and TRA Docket No. 08-00039 at $68,750 in its attrition year regulatory expense calculation.[194]

In regard to the amortization of cost of service studies, the Consumer Advocate has included only the amortization of the cost of service studies performed in TRA Docket No. 06-00290 at $8,000 per year[195] and in TRA Docket No. 08-00039 at $3,200 per year.[196] The Consumer Advocate maintains that the cost of service study in this docket should not be adopted because the Company has chosen not to implement the results of the study.[197] Therefore, the Consumer Advocate has disallowed the cost for that study in its attrition year calculation.

The Consumer Advocate has included the remaining amortization of the depreciation study in TRA Docket No. 08-00039, amounting to $7,826.[198]

As a result, the Consumer Advocate recommends that the TRA adopt the Consumer Advocate's calculation of Regulatory Expenses and order such expenses not to exceed $347,209, rather than adopting TAWC's unreasonable forecast.

In this case, TAWC requests to increase its regulatory expenses to a total recovery of approximately $0.847 million, while it states the cost of this year's rate case will exceed another $1 million.[199] TAWC has included $275,000 of rate case expense from Docket No. 08-00039,

---

[194] *Transcript of Proceedings*, Docket 10-00189, Exhibit 90, RB-Deferred Rate Case Expense, March 8, 2011.

[195] *Direct Testimony of Terry Buckner*, Docket 10-00189, p. 42, January 28, 2011.

[196] *Direct Testimony of Terry Buckner*, Docket 10-00189, p. 42, January 28, 2011.

[197] *Direct Testimony of Hal Novak*, Docket 10-00189, p. 6, January 5, 2011.

[198] *Transcript of Proceedings*, Docket 10-00189, Exhibit 90, RB-Depreciation Study, March 8, 2011.

[199] *Rebuttal Testimony of Mike Miller*, Docket 10-00189, p. 84, February 8, 2011.

which cannot be resolved in this docket until the State of Tennessee Court of Appeals issues its mandate.[200]

Throughout the travel of this case, TAWC has constantly blamed the intervening parties for the increased cost of bringing this rate case. In particular, TAWC asserts that the Consumer Advocate's discovery requests are of a "different nature" and that the Consumer Advocate's use of a different test period drives up the cost of these proceedings.[201] This argument is without merit. Indeed, the Consumer Advocate has not treated this case, nor the 2008 rate case, any differently than it treats any other rate case filed by any other public utility regulated by the TRA. It is consistent practice for the Consumer Advocate to use the most recent data available in presenting its counter-arguments, which results in an updated test year. Although the Consumer Advocate uses the same methodology in forecasting attrition year amounts in every rate case, it is important to note that no other utility has approached a level of rate case expense near the $1 million expense claimed by TAWC. There is no denying that a major rate case like this, where in a utility is requesting an $11.6 million increase, is complex and requires the analysis of voluminous data. The Consumer Advocate maintains it is perfectly reasonable to require TAWC to answer discovery questions, including subparts, in light of all the contested issues in this matter, most of which are very technical and complex (such as the WNA, management audit, and income taxes). Gathering the necessary data through discovery was absolutely necessary for the Consumer Advocate's participation in this docket. But, as complex as these cases are, it should not cost ratepayers over $1 million to complete them.

---

[200] *Rebuttal Testimony of Mike Miller*, Docket 10-00189, p. 84, February 8, 2011.

[201] *Transcript of Proceedings,* Docket 10-00189, Vol.VI A, p. 58:12, March 7, 2011.

Furthermore, there is little doubt that a portion of TAWC's rate case expenses were incurred for the benefit of its shareholders. The ratemaking process before the Authority, as well as other states, is an adversarial one in which the parties argue contested issues. This process produces just and reasonable rates, but only after the Authority sorts through the company's arguments -- which, if accepted, would generally increase rates for the benefit of shareholders -- as well as the interveners' arguments -- which, if accepted, would generally decrease rates for the benefit of ratepayers. As such, ratepayers should not be charged with the portion from which shareholders derive their benefit.

The change in circumstances reflects the natural progression of a public utility intent on maximizing profits by frequent rate case filings, charging ratepayers the cost of these filings, inflating salaries, bonuses and management fees to the benefit of parent company managers, officials and directors and inflating rate case expenses. The Consumer Advocate urges the TRA against accepting TAWC claims that the interveners have somehow forced TAWC into a litigate-first mentality. As for the Consumer Advocate, it is simply trying to carry-out its duties and obligations pursuant to Tennessee Code Ann. § 65-4-118. For these reasons, the Consumer Advocate submits that its rate case expense forecast should be adopted.

4. The Authority Should Disallow a Portion of Pension Expense.

***********Begin Confidential Information***********

[redacted]

[redacted]

[202] *Direct Testimony of Terry Buckner*, Docket 10-00189, p. 41, January 28, 2011.

[redacted]

***********End Confidential Information***********

The Consumer Advocate avers TAWC's supplemental ERISA pension contribution amount is not a known and measurable amount. Therefore, the original funding amount per the latest known actuarial valuation at July 1, 2009, should be used to set rates net of the Consumer Advocate's capitalization rate. Consequently, TAWC's Pension Expense amount should be rejected by the TRA.

5. The Authority Should Maintain the 15% Standard for Unaccounted for Water Loss and Should Reduce Chemicals, Fuel, and Power Expenses for TAWC's Unaccounted-For Water Loss Above 15%.

Consistent with the Authority's decision in TAWC's 2008 rate case which has seen been affirmed by the Court of Appeals, the Consumer Advocate has applied a 15% cap to unaccounted

---

[203] *TAWC Revised Accounting Exhibits and Workpapers*, Docket 10-00189, Exhibit 2, Schedule 3, p. 1, February 22, 2010.

[204] *Direct Testimony of Terry Buckner*, Docket 10-00189, p. 41, January 28, 2011.

[205] *TAWC Response to First Discovery Request of the Consumer Advocate*, Docket 10-00189, Question 48, Confidential Attachment, p. 5, November 15, 2010.

[206] *TAWC Response to First Discovery Request of the Consumer Advocate*, Docket 10-00189, Question 48, Confidential Attachment, p. 5, November 15, 2010.

for water in its calculation of Chemical expense and Fuel and Power expense.[207] The amount of unaccounted for water continues to increase. Information provided to the Authority Staff clearly demonstrates the amount of unaccounted for water has grown since 2007:

Unaccounted For Water of TAWC Per Response to "TRA-01-Q013-FUEL AND POWER"

2007	2008	2009	3 Year Average	Test Year
19.95%	20.06%	23.16%	21.06%	23.75%

At the hearing, the Company denied the trend is worsening and contended the policy should be reversed.[208] Clearly the trend is in fact worsening. Despite the clear evidence that nearly one in every four gallons of treated water is lost due to leaks in the Company's system, the Company expects the businesses and households of Chattanooga to bear the burden for the waste in power and chemical costs used to treat the millions of gallons of water that are lost through the Company's lack of efforts of maintaining an efficient water system. The TRA's policy of applying the 15% unaccounted water standard recognizes consumers should not be made to bear the cost of wasteful expenses.

6. The Authority Should Adopt the Consumer Advocate's Forecast of Insurance Other Than Group Expense.

In its initial filing with the TRA, TAWC requested $485,904 for the expense of Insurance Other Than Group. Insurance Other Than Group includes workers compensation, auto liability, general liability, etc.[209] The initial insurance premiums are paid to the insurer, but during the year

[207] *Revised Direct Testimony of Terry Buckner*, p. 19-21, January 28, 2011.

[208] *Transcript of Proceedings*, VI B, p. 129-130, March 7, 2011.

[209] TAWC response Consumer Advocate Question #32.

the insurer provides retroactive adjustments based on the claims experience of the insured.[210] The Consumer Advocate's use of a test period ending September 2010 includes retroactive adjustment amounts and is included in its forecast. However, TAWC's forecast does not reflect the net effect on Insurance Other Than Group.[211]

Therefore, the Consumer Advocate believes that its forecast of Insurance Other Group of $322,151 is just and reasonable and the TAWC's forecast amount should be rejected by the TRA.

7. The Authority Should Adopt The Consumer Advocate's Test Period and Growth Factor for Forecasting Miscellaneous and Other Expenses.

The Consumer Advocate's attrition year forecast for miscellaneous and other expenses is lower than TAWC's forecast due to the Consumer Advocate's use of a more recent test year, as well as the application of a growth factor composed of the current inflation rate and anticipated customer growth rate. As more fully discussed in Section III, supra, the Consumer Advocate submits that its test year ended September 2010 is superior to TAWC's test year ended March 2010 because it captures a more accurate picture of the current business and economic conditions affecting today's utility rates. Furthermore, application of a growth factor that recognizes today's inflationary increases on prices due to current economic conditions, as well as increases in expenses due to TAWC's expanding customer base, fully and appropriately accounts for expected growth in miscellaneous and other expenses. And while this growth factor does not separate particular miscellaneous and other expenses for special consideration, it nonetheless recognizes that some expenses in these categories are increasing at a faster rate than others

[210] *Id.*

[211] *Transcript of Proceedings,* Docket 10-00189 Vol. VI A, p. 13:6-10, March 7, 2011.

through application of a composite inflation and customer growth rate to recent test year expense levels.

The Consumer Advocate urges the Authority to carefully consider the parties' operation and expense forecasts, as well as their competing forecasting methodologies, and decide upon a total operation and maintenance expense that is just and reasonable for ratepayers. TAWC's costs have risen sharply in recent years, and the Consumer Advocate maintains that its forecast of another 6% increase in total expenses since last year's rate case provides for a reasonable amount of overall growth, especially for such a short period of time. The Authority therefore should not approve a total operation and maintenance expense amount that exceeds the Consumer Advocate's total expense forecast of $20.9 million.

B. TAXES

1. The Authority Should Use the APB 11 Approach to Determine the Proper Amount of Accumulated Deferred Income Tax Expense for Ratemaking Purposes to Prevent an Intergenerational Inequity

In TAWC's original filing, the Company calculated both its Accumulated Deferred Income Tax ("ADIT") Expense and Deferred Income Tax Expense using the Accounting Principles Board Opinion No. 11 ("APB 11") approach.[212] As a result, TAWC's original petition did not include the amortization of regulatory assets defined by the Financial Accounting Standards Board's ("FASB") promulgation of Statement of Financial Accounting Standards ("SFAS") No. 71.[213] However, when TAWC filed rebuttal testimony on February 17, 2010, the Company had changed its position and was instead recommending that the TRA adopt FASB's

[212] *Direct Testimony of Mike Miller*, Docket 10-00189, p. 58:16-19, September 17, 2010.

[213] *Direct Testimony of Mike Miller*, Docket 10-00189, Exhibit MAM-13, September 17, 2010.

SFAS 109 approach, an approach which does include the amortization of SFAS 71 regulatory assets.[214] The change from the Company's initial APB 11 approach to a SFAS 109 approach resulted in an approximate $1,000,000 increase in TAWC's proposed revenue requirement.[215] In other words, TAWC's change in position resulted in an effective $1,000,000 charge to ratepayers.

The Consumer Advocate believes the TRA should adopt TAWC's initial APB 11 approach to the calculation of ADIT's, an approach that is more appropriate for use in a ratemaking proceeding, for two reasons: (1) the use of the SFAS 109 approach creates an intergenerational inequity because it requires current ratepayers to repay a "tax break" that was provided to previous ratepayers. In essence, today's ratepayers would be required to pay for a benefit they never received; and (2) SFAS 109 requires the amortization of SFAS 71 regulatory assets, which are assets that a regulatory authority must approve as SFAS 71 compliant. The TRA has made no such determination prior to this proceeding.[216]

a. The use of the SFAS 109 approach creates an intergenerational inequity because it requires current ratepayers to repay a "tax break" that was provided to previous ratepayers. In essence, today's ratepayers would be required to pay for a benefit they never received.

While the use of the SFAS 109 approach is required for financial accounting purposes to be compliant with Generally Accepted Accounting Principles ("GAAP"), it is not a requirement for use in regulatory rate recovery proceedings.[217] Rather, a regulatory authority such as the

---

[214] *Revised Rebuttal Testimony of Mike Miller*, Docket 10-00189, Exhibit MAM-7, February 17, 2011.

[215] *Revised Rebuttal Testimony of Mike Miller*, Docket 10-00189, Exhibit MAM-7, February 17, 2011.

[216] *Transcript of Proceedings*, Docket 10-00189, Vol. VII B, 11:10, March 8, 2011.

[217] *Revised Rebuttal Testimony of Mike Miller*, Docket 10-00189, p. 34:16-25, February 17, 2011.

TRA may adopt either the APB 11 approach or the SFAS 109 approach.[218] TAWC does not dispute that APB 11 may be adopted by the TRA, and acknowledges that other states have adopted the approach.[219] When asked why some states would choose the SFAS 109 methodology rather than the APB 11 approach, Company Expert Witness James Warren stated that he believed it was just a matter of "convenience" because the SFAS 109 approach is required for financial reporting purposes.[220] While it may be more "convenient" for TAWC to maintain ADIT's using the same methodology for financial reporting and regulatory ratemaking, the reality of using the SFAS 109 approach in this case for regulatory ratemaking purposes results in ratepayers being charged $1,000,000 for TAWC's "convenience."[221]

Per the Company's original filing, the APB 11 approach does not require the amortization of the SFAS 71 regulatory assets and results in the exclusion of the approximate $1,000,000 in TAWC's proposed revenue requirement.[222] In effect, the $1,000,000 represents the taxes that were owed on regulatory assets that were obtained by the company prior to 1981.[223] Essentially, previous ratepayers paid less for water services as a result of this "tax break" on pre-1981 flow-through property, while today's ratepayers will have to pay more for water services in order to repay this "tax break." This results in what the Consumer Advocate believes is an

---

[218] *Transcript of Proceedings*, Docket 10-00189, Vol. II A, p. 36:2, March 1, 2011.

[219] *Revised Rebuttal Testimony of Mike Miller*, Docket 10-00189, p. 39:12-13, February 17, 2011.

[220] *Transcript of Proceedings*, Docket 10-00189, Vol. II A, p. 46:2-10, March 1, 2011.

[221] *Revised Rebuttal Testimony of Mike Miller*, Docket 10-00189, Exhibit MAM-7, February 17, 2011 and *Transcript of Proceedings*, Docket 10-00189, Vol. VI A, p. 91:9-10, March 7, 2011.

[222] *Revised Rebuttal Testimony of Mike Miller*, Docket 10-00189, Exhibit MAM-7, February 17, 2011 and *Transcript of Proceedings*, Docket 10-00189, Vol. VI A, p. 91:9-10, March 7, 2011.

[223] *Revised Rebuttal Testimony of Mike Miller*, Docket 10-00189, pp. 40:29-41:3, February 17, 2011.

intergenerational inequity.[224] Namely, it is inappropriate in a ratemaking context to require current ratepayers to pay for a benefit they never received in light of the monopolistic character of TAWC, wherein ratepayers do not have the ability to seek services elsewhere when dissatisfied with the cost of their water services.[225] Company Witness, Mr. Warren, illustrates this intergenerational inequity by stating,

> "...I'm not a big proponent of flow-through accounting to begin with. Because if you happen to be a [TAWC] ratepayer when there's a huge deduction, you get a reduction in tax expense and great, and then if you move out of the service territory, the poor people that are left are the ones that are going to experience the payback."[226]

Accordingly, the Authority should adopt the APB 11 approach first proposed by TAWC in their original filing because, according to the Company's calculations, the APB 11 approach did not include the additional $1,000,000 in revenue requirement which cures the intergenerational inequity that would result from using the SFAS 109 approach.[227]

Should the TRA adopt the SFAS 109 approach in this case, the Consumer Advocate disputes that TAWC has provided sufficient evidence to prove that its calculation of $623,832 for the current income tax amount related to the reversal of the SFAS 109 regulatory assets for the pre-1981 flow-through property and the AFUDC gross-up, is proper. TAWC contends that the $623,832 must be "grossed-up" by a "gross-up" factor of 1.673 in order to calculate the

---

[224] *Rebuttal Testimony of Terry Buckner*, Docket 10-00189, p. 7:8-14, February 24, 2011.

[225] *Rebuttal Testimony of Terry Buckner*, Docket 10-00189, p. 7:8-14, February 24, 2011.

[226] *Transcript of Proceedings*, Docket 10-00189, Vol. II A, pp. 46:22-47-3, March 1, 2011.

[227] *Transcript of Proceedings*, Docket 10-00189, Vol. VI A, p. 91:9-10, March 7, 2011.

additional revenue requirement needed to pay the ADIT.[228] However, the Consumer Advocate is not persuaded that the $623,832 is not already grossed-up because TAWC has provided no evidence to support its calculation. The Consumer Advocate contends, and Company Expert Witness James Warren agrees, that the formula for calculating the regulatory asset account is the following[229]:

Regulated Asset = Temporary Differences x Enacted Tax Rate x Gross Up Factor

According to this formula, the Consumer Advocate maintains that it is likely that TAWC's regulated asset amount of $623,832 has already been grossed-up and to again "gross-up" the amount to approximately $1,000,000 would be inappropriate. Specifically, Mr. Warren stated that "...if you have a regulatory asset, it is a grossed-up amount already. It reflects the fact that when you receive that money it's going to be taxable."[230] Mr. Warren then stated that he "presumed"[231] Mr. Miller's calculation of $623,832 should be the non-grossed up amount but then admitted that he wasn't given any workpapers to verify the calculation.[232] Accordingly, the Consumer Advocate avers that it is likely the $623,832 has already been grossed-up and to again gross-up the amount would be to the detriment of TAWC's ratepayers and would be highly improper given the lack of verifiable proof.

b. SFAS 109 requires the amortization of SFAS 71 regulatory assets, which are assets that a regulatory authority must approve as SFAS 71 compliant. The TRA has made no such determination in this proceeding.

---

[228] *Transcript of Proceedings*, Docket 10-00189, Vol. VI A, p. 87:10-16, March 3, 2011.

[229] *Transcript of Proceedings*, Docket 10-00189, Vol. II A, p. 37:17-22, March 1, 2011.

[230] *Transcript of Proceedings*, Docket 10-00189, Vol. II A, p. 43:13-16, March 1, 2011.

[231] *Transcript of Proceedings*, Docket 10-00189, Vol. II A, p. 44:15-18, March 1, 2011.

[232] *Transcript of Proceedings*, Docket 10-00189, Vol. II A, p. 45:8, March 1, 2011.

The Consumer Advocate believes the TRA should adopt TAWC's original approach (APB 11) in calculating ADIT in order to prevent the circumvention of the TRA's authority in determining whether certain regulatory assets are compliant with SFAS 71. "Regulatory assets" and "regulatory liabilities" have a very specific and technical meaning in FASB's financial accounting world. Under FASB's SFAS 71, the TRA may permit the recovery of these regulatory assets in a future period.[233] The Consumer Advocate maintains that the adoption of TAWC's proposed SFAS 109 approach before the TRA has approved the regulated assets as compliant with SFAS 71 is improper. As such, the Consumer Advocate would again state that the adoption of TAWC's APB 11 approach contained within their original filing should be adopted in this proceeding as it is more appropriate in the ratemaking context.[234]

Furthermore, the Consumer Advocate believes the Allowance for Funds Used During Construction ("AFUDC") equity assets should not be recognized as SFAS 71 assets. The TRA has historically included Construction Work In Process ("CWIP") in a utility's rate base.[235] When asked by TRA Staff about the treatment of AFUDC when CWIP is included in rate base, Mr. Warren stated, "...[I]f CWIP is included in rate base, there generally isn't any AFUDC at all because you are earning a return currently on it."[236] Accordingly, the AFUDC amounts should be reversed and removed from rate base, as well as any amortization of AFUDC should be removed from the Income Tax Expense.

---

[233] *Statement of Financial Accounting Standards No. 71*, Financial Accounting Standards Board, at ¶ 3, (December 1982).

[235] *Transcript of Proceedings*, Docket 10-00189, Vol. II A, p. 51:11, March 1, 2011.

[236] *Transcript of Proceedings*, Docket 10-00189, Vol. II A, p. 51:20-23, March 1, 2011.

2. FIN 48 Amounts Should Be Included In Rate Base Because the Majority of the Liabilities Have Not Been Classified as High Risk

The Company maintains that Financial Accounting Series FASB Interpretation No. 48 (FIN 48) represents the difference between the Company's position taken on the tax return versus the position utilizing the "more likely than not" standard as required under GAAP, and the Consumer Advocate agrees with this contention.[237] The Consumer Advocate disagrees with TAWC's position that the FIN 48 must be excluded from the financial statements because it represents an uncertain liability that does not reduce rate base until the uncertainty has been removed by audit, statute expiration, or law change.[238] However, TAWC has provided evidence that only 30% of its FIN 48 liabilities are classified as "more likely than not" to be recognized by the IRS.[239] It would then follow that 70% of TAWC's FIN 48 liabilities are less likely than not to be recognized by the IRS, a known and measurable amount that the Consumer Advocate believes should be included in the Company's financial statements.

The Consumer Advocate asserts that the entire FIN 48 liability amount should be included in the financial statements for setting rates in this docket because only 30% have been classified as higher risk.[240] At a minimum, the Consumer Advocate would aver that 70% of the FIN 48 liability amounts must be included in this rate case as they are less than likely not to be disallowed. Furthermore, given TAWC's tendency to consistently file for rate increases on a two year basis, the Consumer Advocate is confident that the TRA can take corrective action if any

---

[237] *Direct Testimony of Mike Miller*, Docket 10-00189, p. 65:13-15, September 17, 2010.

[238] *Direct Testimony of Mike Miller*, Docket 10-00189, p. 65:21-24, September 17, 2010.

[239] *Revised Rebuttal Testimony of Mike Miller*, Docket 10-00189, p. 48:10-11, February 17, 2011.

[240] *Revised Rebuttal Testimony of Mike Miller*, Docket 10-00189, pp. 46:13:15, February 17, 2011.

portion of the FIN 48 liabilities are disallowed by the IRS between now and the time of the Company's next filing.[241]

Additionally, the statute of limitations on certain FIN 48 liabilities will run in 2012, which is less than a year away, which the Consumer Advocate believes makes it less likely that these liabilities will be disallowed by the IRS.[242]

3. The Authority Should Adopt the Statutory Tax Rates for the Calculation of Excise Taxes and Federal Income Taxes

The Consumer Advocate avers that all revenues, less expenses, other taxes and interest expense should be taxed at the statutory rates of 6.5% for state excise tax purposes and at 35% for federal income tax purposes.[243] The Consumer Advocate's position is consistent with the position adopted by TAWC in this proceeding.

C. RATE BASE

The Consumer Advocate asserts that the Authority should approve an attrition year rate base of $115 million, which is $5.9 million lower than TAWC's projected rate base of $120.9 million.[244] The Consumer Advocate's forecast for rate base is higher primarily due to including $2.1 million of FIN 48 as a reduction to rate base, which was excluded from this case by TAWC.[245] In addition, the Consumer Advocate's rate base is about $2.2 million lower due to its

---

[241] *Direct Testimony of Terry Buckner*, Docket 10-00189, p. 56:9-11, January 28, 2011.

[242] *Transcript of Proceedings*, Docket 10-00189, Vol. VII B, p. 91:9-15, March 8, 2011, and *Revised Rebuttal Testimony of Mike Miller*, Docket 10-00189, p. 47:3, February 17, 2011.

[243] *Direct Testimony of Terry Buckner*, Docket 10-00189, Amended Consumer Advocate Exhibit, Schedule 7, January 28, 2011.

[244] *Transcript of Proceedings*, Docket 10-00189, Exhibit 91, Rate Base Slide, March 8, 2011.

[245] *Transcript of Proceedings*, Docket 10-00189, Exhibit 90, Amended Workpaper RB-ADIT, March 8, 2011.

use of a more recent test year, as well as more appropriate forecasting methodologies. The largest remaining difference of $1 million is the computation of working capital, which is closely aligned with the level of operating revenues, operating expenses, interest expense, taxes and return ordered by the TRA.[246]

The appropriate methodologies for forecasting rate base, as well as the other components of the general ratemaking formula, are important; accordingly, the TRA may choose to address them in its decision of this case. The Consumer Advocate urges the TRA to refrain from selecting from the parties' opposing methodologies in a way that would result in a total rate base amount that is higher than the total being proposed by either of the parties. As noted previously, not only should the individual components of rate base be reasonable, but the methodologies used to forecast these components, when considered together, should produce an overall result that is also reasonable.

The TRA should pay close attention to TAWC's shifting of its budgeted capital spending; and importantly, for the reasons set forth below, this shift should not be used as a basis to increase the Consumer Advocate's overall rate base above the amount of its original attrition year forecast.

There is an interrelationship between Construction Work in Progress ("CWIP") and Utility Plant in Service ("UPIS"). Capital spending projects are accounted for in CWIP as they are being constructed (such as the extension of a water main), but they are moved from CWIP to UPIS once the asset is placed into service (when the water begins to flow through the new main

[246] *Transcript of Proceedings*, Docket 10-00189, Exhibit 90, Amended Workpaper RB-Working Capital Requirement, March 8, 2011.

to ratepayers). Both CWIP and UPIS are additions to rate base; however, the cost of a particular project cannot be accounted for in both CWIP and UPIS at the same time in order to prevent the double counting of this cost. Because of this interrelationship between these accounts, a revision to the CWIP forecast must also result in a revision to the UPIS forecast. Additionally, because UPIS is used as a basis to calculate depreciation, a revision to the UPIS forecast would also affect the forecast for depreciation expense. A revision to the depreciation expense forecast would obviously affect accumulated depreciation, as well as federal and state income taxes. Of course, all of these revisions would undoubtedly change the revenue requirement.

TAWC contends that an additional $1,545,192 of capital spending will occur in 2011 because the Company had not spent all of their budgeted dollars in 2010.[247] Indeed, TAWC has not fulfilled their capital budgets for the last five years.[248] Given TAWC's recent history, the Consumer Advocate believes the additional capital spending will not occur in 2011. This belief is based on the reality that TAWC flows much of their net income to its parent, American Water Works Company ("AWWC") in the form of dividends.[249] Secondly, American Water has finite investment capital. TAWC believes American Water will invest its capital in regulated jurisdiction where it can guarantee a rate of return.[250] For example, Pennsylvania-American Water Company has a Distribution System Improvement Charge ("DSIC"), which is collected from the ratepayer to guarantee a 10.20% ROE on eligible plant improvements.[251] The

[247] *Rebuttal Testimony of Shelia Miller*, Docket 10-00189, p. 14, February 8, 2011.

[248] *TAWC Response to First Discovery Request of CRMA*, Docket 10-00189, Question 30, December 2, 2011.

[249] *TAWC Response to First TRA Data Request*, Question 5, Attachment 3, p. 8, September 24, 2010.

[250] *Transcript of Proceedings,* Docket 10-00189, Vol.VI B, p. 132:13-18, March 7, 2011.

[251] Pennsylvania-American Water Company Tariff Water-PA P.U.C. No. 4. First Revised Page 12B1-B2.

Consumer Advocate disagrees with this type of mechanism and believes that an ROE is an opportunity, rather than a guarantee. Therefore, in order to solve this inequity the Consumer Advocate recommends the TRA institute a safeguard for TAWC's equity by limiting TAWC's dividend payments to American Water in cases where TAWC receives little to no capital investment. This idea is compatible with the Utility Workers Union of America's ("UWUA') proposal regarding "ring fencing" found in its post-hearing brief.

Finally, the Consumer Advocate asserts that 37 lead/lag days should be utilized in the TRA's lead/lag study for TAWC.[252] Approximately 37 lag days has been utilized by the TRA in Chattanooga Gas TRA Docket #09-00183[253] and Atmos Energy TRA Docket #08-00197[254].

For these reasons, the Consumer Advocate urges the Authority to adopt its rate base forecast.

VI. COST OF CAPITAL AND RATE OF RETURN

The next general area of contention in this Docket is TAWC's cost of capital and the Rate of Return ("ROR") that it should be allowed the opportunity to earn. Included within this section is a discussion of the appropriate capital structure for TAWC, the Company's allowable Return on Equity ("ROE") and the methods of determining those rates. While the ultimate positions of the parties lead to a difference in revenue required of several million dollars, a closer analysis shows that a few key differences drive the large variation in result and that the basic approaches of the parties are not that dissimilar.

---

[252] *Direct Testimony of Terry Buckner*, Docket 10-00189, p. 52, Schedule 7, January 28, 2011.

[253] *Direct Testimony of Ronnie Hanson*, Docket 09-00183, Exhibit RDH-3.

[254] *Direct Testimony of Tom Peterson*, Docket 08-00197, Exhibit THP-CWC1 A.

TAWC's expert witness on cost of capital issues, Dr. James Vander Weide, calls for the Company to be allowed an ROE of 11.5%, and he applies that ROE to the capital structure advanced by TAWC Treasurer, Mike Miller. That capital structure is essentially the actual capital structure of TAWC at the point in time of the filing of this rate case, without any adjustment for historical changes or the fact that TAWC is a wholly owned subsidiary of AWWC.

On the other hand, Dr. Chris Klein, the expert witness testifying on behalf of the Consumer Advocate contends that TAWC should be allowed a total ROE of 9.0% and that this rate should be applied to a capital structure derived from the historical structure of TAWC adjusted for the fact that TAWC has no equity investors other than its parent AWWC. He does this by employing the double leveraging method that has long been approved by the TRA.

The differences in the final opinions of Dr. Klein and Dr. Vander Weide come despite the many similarities in their approaches. Both use similar groups of water and natural gas transmission companies for their comparison. Both analyze the cost of equity using the Discounted Cash Flow ("DCF") and Capital Asset Pricing Model ("CAPM") methods, although Dr. Vander Weide also utilizes the Risk Premium model in his analysis. Dr. Klein adopts the cost of debt, both short and long term, and the cost of preferred stock suggested by Mr. Miller.[255] The key driver in the disparity in their opinions is whether TAWC is viewed as a standalone company or whether the analysis has to reflect the fact that TAWC is wholly owned by AWWC and that AWWC provides the capital TAWC uses for its operations. That difference in approach is most readily apparent in the capital structure utilized in the cost of capital analysis.

[255] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, p. 5:19-21, January 21, 2011.

A. HISTORICAL ANALYSIS OF TAWC'S CAPITAL STRUCTURE IS APPROPRIATE TO PREDICT THE FUTURE CAPITAL STRUCTURE.

Dr. Vander Weide did no independent analysis to derive the appropriate capital structure for the TRA to use in setting TAWC's just and reasonable rates going forward. He merely utilizes the capital structure proposed by the Company's Treasurer and witness Mr. Mike Miller. As Mr. Miller testified, this structure is essentially the actual capital structure of TAWC at a point in time, namely the time of preparing the case and filing it with the TRA. TAWC proposes that the TRA use a capital structure composed of 51.386% long term debt, 3.453% short term debt, 1.126% preferred stock and total equity of 44.035%. The 44.035% of total equity is made up of common stock (24.345%) and retained earnings (19.690%).[256]

Dr. Klein analyzed the actual historical capital structure of TAWC and compared that with the capital structure proposed by Mr. Miller. He found that the current and proposed short term debt was approximately half of the short term debt historically owed by TAWC and so he adjusted his capital structure to reflect this fact.[257] This led Dr. Klein to propose an historically accurate capital structure for TAWC of 48.71% long term debt, 6.45% short term debt, 1.24% preferred stock and 43.6% common stock.[258] Other than the adjustment for short term debt versus long term debt, the final proposals are not materially different.

Because the proposed capital structure for TAWC put forward by Mr. Miller is at a point in time, it does not reflect the actual capital structure that TAWC has had in place over the recent

---

[256] *Revised Rebuttal Testimony of Mike Miller*, Docket 10-00189, p. 18:16-28 and Exhibit MAM-3, February 17, 2011.

[257] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, Exhibit, p. 3, January 21, 2011.

[258] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, Exhibit, p. 2, January 21, 2011.

past. It is also worth noting that the Company has sole discretion as to when it wants to file a new rate case and therefore has the full ability to make alterations to its capital structure at the time of filing in order to maximize its rate of return when calculating new rates. The historical approach utilized by Dr. Klein accounts for the ebb and flow of long term versus short term debt that surely will follow during the time the new rates are in effect by placing them in an historical context. Accordingly, an historical analysis of TAWC's capital structure inevitably leads to the most accurate analysis of what the capital structure will be throughout the term of the new rate structure.

B. DOUBLE LEVERAGING IS THE APPROPRIATE METHOD TO ADJUST TAWC'S CAPITAL STRUCTURE TO ACCOUNT FOR THE REALITIES OF THE PARENT/SUBSIDIARY RELATIONSHIP

Calculating TAWC's historical capital structure does not end the analysis. Dr. Vander Weide merely adopts the TAWC point in time capital structure advocated by Mr. Miller and applies the rates he derives from his formulas to that structure, despite the fact that TAWC has no equity shareholders other than its parent, AWWC. Dr. Klein, however, adjusts the applicable structure to reflect the fact that TAWC has no equity investors and anyone wishing to make an equity investment in TAWC would have to purchase the stock of AWWC, the parent company. The method long endorsed by the TRA to account for this fact is the method known as double leveraging, whereby the full capital structure of the parent company is substituted for the equity component of the subsidiary. This reflects the reality that equity investors must look at the total capital structure of the parent when analyzing whether to invest equity capital in AWWC or not.

The historical capital structure of AWWC as reported by the Company is 21.68% long term debt, 0.99% short term debt and 77.33% common equity.[259] When that ratio of debt and equity is applied to the 43.6% historical common equity component for TAWC by using double leveraging, it produces the ratio of debt and equity shown on Dr. Klein's Exhibit page 2.[260] It is this capital structure to which Dr. Klein applies the return rates he derives from his use of the applicable formulas.

The Company witnesses Mr. Miller and Dr. Vander Weide object to the use of double leveraging despite the TRA's long standing adoption of the practice. In fact, the application of double leveraging to TAWC goes back at least to 1983 as evidenced by the Order of the TRA's predecessor body in a TAWC rate opinion in Docket U-83-7226 which was on remand from the Davidson County Chancery Court as Docket U-85-7338. On page 18 of that Order the PSC stated that the Commission "has consistently recognized the effect of double leverage in a parent-subsidiary relationship in every case in which the issue has been raised."[261] The PSC specifically found the double leveraging method to be appropriate in TAWC's then pending rate case and indicated that it was the same double leveraging method that the Commission had expressly adopted in TAWC's previous rate case. There can be no doubt that the TRA and its predecessor have consistently endorsed double leveraging in parent-subsidiary relationships and have applied it to TAWC for close to 30 years. While Dr. Vander Weide admitted at the hearing that he was not aware of this PSC Order, he indicated that even if he had been, it would not have

---

[259] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, Exhibit, p. 4, January 21, 2011.

[260] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, Exhibit, p. 2, January 21, 2011.

[261] *TAWC Response to Consumer Advocate's First Discovery Request, Question 123*, Docket 10-00189, January 4, 2011.

made any difference in his analysis.[262] TAWC has put forward no new argument in this Docket to justify the TRA moving away from this long held precedent.

The Company continues to propose that the TRA treat TAWC as though it were a standalone company and not a subsidiary of AWWC. The Company ignores the fact that TAWC receives all of its equity capital from its parent and makes no adjustment to account for this reality. The complaint the Company raises about Dr. Klein's analysis, that it allegedly produces a capital structure of "only 33.72%" equity ignores that double leveraging imports the whole capital structure of the parent for the 43.6% of TAWC common equity. AWWC's historical common equity is actually 77.33% and that is the figure that influences the final cost of capital figure. The constant refrain in TAWC's testimony from Dr. Vander Weide and Mr. Miller that Dr. Klein has underestimated the common equity of TAWC and therefore he underestimates the risk faced by TAWC investors shows that they want the TRA to treat TAWC as though it were a small independent water company, and not one that has access to the capital markets afforded to an affiliate of one of the largest water utility companies in the United States.

As will be discussed in more detail below in the section concerning the differences in proxy companies, TAWC resists any analysis that treats TAWC as a subsidiary of AWWC and wants to compare TAWC to small independent water companies a fraction of the size of AWWC. TAWC rightfully points out that these smaller utilities are more risky than AWWC with its diverse regulated and non-regulated operations. The flaw in their analysis is their continued attempt to cast TAWC as a small water company serving only 74,500 customers in southeastern Tennessee and ignoring TAWC's true cost of equity, that of its parent.

[262] *Transcript of Proceedings*, Docket 10-00189, Vol. V C, pp. 166: 9-14 and 169: 3-7, March 4, 2011.

Interestingly, AWWC does not ignore TAWC when it comes time for the parent to receive a dividend from TAWC. TAWC paid to its parent AWWC total dividends of $1,237,881 in 2009 and $967,769 in 2010, hardly the actions of a small standalone water company.[263]

Dr. Klein's historical analysis of TAWC's capital structure gives a truer picture of the actual capital structure TAWC can be expected to sustain over the course of the time that the new rates awarded in this Docket will be in effect. The structure at a given point in time, especially a point in time within the sole control of AWWC, simply cannot be as accurate for rate making purposes. Further, Dr. Klein's use of the time-tested precedent of double leveraging properly accounts for the benefits TAWC receives in raising capital as a subsidiary of AWWC instead of as a small standalone water company. It passes those benefits along to the ratepayers of Chattanooga, Cleveland and southeastern Tennessee instead of reserving them for AWWC and its shareholders. Simply put, Dr. Klein properly calculated the correct historical capital structure of TAWC and properly applied the double leveraging method to that structure to arrive at the appropriate capital structure for the TRA to use in arriving at the proper cost of capital for TAWC in this Docket.

C. DR. KLEIN'S PROXY GROUP MOST CLOSELY RESEMBLES THE TRUE CHARACTERISTICS OF TAWC

The second major area of disagreement between Dr. Klein and Dr. Vander Weide concerns the proxy group of utility companies that each assembled to use in analyzing the return that TAWC investors should expect. Both use a group of water utilities and both use a group of

[263] *Transcript of Proceedings*, Docket 10-00189, Vol. III A, p. 65: 14-22, March 2, 2011, with promised information provided by counsel for TAWC on March 18, 2011.

natural gas utilities and their comparator groups share many of the same companies. However, there are differences that have an effect on the outcome of each man's analysis. Each group is examined separately.

1. Dr. Klein's Water Company Proxy Group Properly Accounts for the TAWC/AWWC Relationship

The water company proxy groups used by Dr. Klein and Dr. Vander Weide are surprisingly similar given the wide disparity in the ultimate outcome advocated by each expert. Dr. Klein uses four companies in his group and Dr. Vander Weide uses eight. However, all four of the companies used by Dr. Klein (which includes AWWC) are also included in Dr. Vander Weide's group of eight.[264] So, the only real point of contention between the two is the propriety of using the additional four companies chosen by Dr. Vander Weide.

Everyone agrees that it is statistically preferable to use more companies in the comparator group rather than fewer. The relatively small number of water companies comparable in size to AWWC makes it difficult to find a large group of comparator water companies. However, for the analysis to be probative, the companies compared must be substantially similar. The Consumer Advocate contends that the additional four companies utilized by Dr. Vander Weide illustrate TAWC's continued attempts to characterize TAWC as a small standalone water company and not a subsidiary of the large AWWC network of companies. Dr. Klein limited his water company comparable group to companies of at least $900 million in total capital.[265] This insures that they are more comparable with AWWC which has a total capital of over $11 billion.

---

[264] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, Exhibit, p. 5, January 21, 2011, and *Direct Testimony of Dr. James H. Vander Weide*, Docket 10-00189, Exhibit JVW-1 Schedule 1, September 17, 2010.

[265] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, p. 12:16-20, January 21, 2011.

The four small water companies in Dr. Vander Weide's proxy group range in size from a market value of only $120 million to $239 million, hardly comparable to AWWC.[266]

The four companies utilized by Dr. Vander Weide and not by Dr. Klein are all well under $900 Million in size and thus, not truly comparable to AWWC. When commenting in his rebuttal testimony on Dr. Klein's choice of water companies, Dr. Vander Weide focuses on the risk levels of those companies and ignores the fact that the four are much smaller than AWWC and are, in fact closer to the size of TAWC alone.[267] As Dr. Klein explains, companies that are only one tenth the size of AWWC may be similar to TAWC but they do not have sufficient similarities with AWWC to warrant their inclusion in a group of companies to use in arriving at AWWC's cost of equity.[268] A recognition that AWWC's cost of equity is the true measure of TAWC's costs in raising capital mandates the exclusion of the four small water companies utilized by Dr. Vander Weide and not by Dr. Klein.

2. Dr. Klein's Natural Gas Company Proxy Group Most Closely Resembles the Characteristics of AWWC

Because there are so few water companies that are truly comparable to AWWC, both experts turn to other utilities to come up with comparable companies. Both look to the natural gas industry and both settle on nine natural gas companies for their comparator group. Once

[266] *Direct Testimony of Dr. James H. Vander Weide*, Docket 10-00189, Exhibit JVW-1 Schedule 1, September 17, 2011.

[267] *Rebuttal Testimony of Dr. James H. Vander Weide*, Docket 10-00189, p. 6: 4-16, February 8, 2011.

[268] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, pp. 16:22-17:6, January 21, 2011.

again, there is significant agreement as six of the companies used as comparable firms are in both experts' proxy group.[269]

Because there is such broad agreement between Dr. Klein and Dr. Vander Weide on the appropriate gas companies for their proxy groups, neither spends much time in their testimony criticizing the choices of the other. In his direct testimony, Dr. Klein indicated that he rejected the three companies chosen only by Dr. Vander Weide, at least partially because they are not primarily utilities.[270] Because some of the companies have significant operations other than the delivery of a necessary utility by pipeline to end consumers and TAWC does not, it makes them not as appropriate for comparison purposes. For this reason Dr. Klein did not adopt the full comparison group of Dr. Vander Weide.

In his rebuttal testimony when he had a chance to respond to Dr. Klein's criticism of his choices for his gas proxy group, Dr. Vander Weide merely reiterated his contention that their risk rating is similar to AWWC and that they are therefore comparable.[271] This ignores Dr. Klein's contention that their significant non-utility delivery operations make them not as good a fit as the six companies both have in common. Dr. Vander Weide also passed up the opportunity to state any objection to the three companies used by Dr. Klein which he did not include in his gas company proxy group. Therefore, based on the record in this Docket, the TRA has ample basis to determine that the nine natural gas companies used by Dr. Klein are most comparable and therefore most appropriate to use in analyzing AWWC's cost of equity.

---

[269] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, Exhibit, p. 5, January 21, 2011, and *Direct Testimony of Dr. James H. Vander Weide,* Docket 10-00189, Exhibit JVW-1 Schedule 2, September 17, 2011.

[270] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, p. 17:1-7, January 21, 2011.

[271] *Rebuttal Testimony of Dr. James H. Vander Weide*, Docket 10-00189, p. 31:18-32:9, February 8, 2011.

D. FORMULAS FOR CALCULATING RETURN ON EQUITY

As with the other components of the cost of capital calculations, there is much agreement between Dr. Klein and Dr. Vander Weide on the use of formulas for calculating TAWC's appropriate return on equity. Both men utilize the Discounted Cash Flow ("DCF") method. Both men analyze the Capital Asset Pricing Model ("CAPM") although Dr. Vander Weide criticizes the CAPM as underestimating the result for companies with a beta less than one and advises the TRA to give it no weight. Finally, Dr. Vander Weide also uses the Risk Premium method for calculating his allowable return on equity. Dr. Klein discounts the Risk Premium method because he believes it is not appropriate due to the fact that that utility stocks and bonds face different risks. Each method is reviewed separately to highlight the different approaches of the two experts.

1. Discounted Cash Flow Method (DCF)

Both economists use the DCF method as part of their calculation of the appropriate return on equity for TAWC. The DCF is a measure of the expected value of a company's cash flow to an investor, discounted for its present value. The formula for the DCF model shows the rate of return an investor in a stock can expect to receive by calculating the dividend yield (the expected dividend divided by the current price of the stock) plus the expected growth rate of that dividend.[272]

The major points of contention in their uses of the DCF model are Dr. Klein's use of an annual model and Dr. Vander Weide advocating for a quarterly model; the proper way to

[272] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, p. 11: 3-10, January 21, 2011.

estimate dividend growth generally; and the proper value for the expected growth of AWWC's dividend.

The first major point of contention between Dr. Klein and Dr. Vander Weide is the use of an annual or quarterly DCF model. Dr. Vander Weide advocates for the use of a quarterly DCF model because as he accurately points out, the companies being analyzed under the model pay their dividends quarterly. Dr. Vander Weide believes that using the annual model to calculate the cost of equity for a company that pays dividends quarterly underestimates the cost of equity by 25 basis points.[273] In his direct testimony Dr. Klein criticizes Dr. Vander Weide's use of the quarterly model for recognizing payment of dividends without also recognizing the fact that revenue reporting for utility rate setting purposes assumes that all of a company's revenues will be earned at the end of the year.[274] Dr. Klein's use of the annual DCF model offsets the company's benefit from continually accruing earnings while only reporting them annually for regulatory purposes. It is not proper to give the company the benefit of the quarterly payment of dividends without offsetting the continual accrual of the earnings used to pay those dividends. Dr. Klein also points to the continual accrual of earnings over the course of the year rather than suddenly at year end as also offsetting the flotation costs of the securities issued by TAWC or the comparable companies. Flotation costs are the costs of actually issuing the securities sold in the capital markets. The flotation costs calculated by Dr. Vander Weide add another five percent to his calculation.[275] Dr. Klein readily admits that flotation costs exist, but contends that the time

[273] *Rebuttal Testimony of Dr. James H. Vander Weide*, Docket 10-00189, p. 9:3-5, February 8, 2011.

[274] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, p. 18:13-21, January 21, 2011.

[275] *Direct Testimony of Dr. James H. Vander Weide*, Docket 10-00189, p. 20: 5-8, September 17, 2010.

value benefit of the continual accrual of earnings over the year offsets those minimal flotation costs.[276] The higher profits of firms receiving earnings throughout the year and still properly reporting them annually for regulatory purposes are sufficient to offset any flotation costs.

The second major point of contention with regard to the DCF is the proper way to estimate dividend growth generally. Dr. Klein uses the projected growth in dividends for his proxy group that is found in the nationally known service Value Line.[277] Dr. Vander Weide took a different approach. He utilized the earnings growth rates from the service of I/B/E/S as the basis for his analysis.[278] Dr. Klein did not have the I/B/E/S pay service available to him and TAWC declined to provide it even though asked in discovery.[279] In his rebuttal testimony Dr. Vander Weide referred to a study he participated in that asserts using historical data rather than analysts' earnings expectations leads to an underestimate of the dividend yield.[280] The use of anticipated dividend growth is nonetheless more appropriate given the fact that it is those dividends that generate the investor cash flow that is being measured in the Discounted Cash Flow or DCF method and not the earnings growth. Measuring the anticipated growth in the proxy companies dividends using the Value Line projections of that growth produces the

[276] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, p. 18: 21-22, January 21, 2011.

[277] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, pp. 11:11-12:-10, January 21, 2011.

[278] *Direct Testimony of Dr. James H. Vander Weide*, Docket 10-00189, pp. 16:20-17:6, September 17, 2010.

[279] *Transcript of Proceedings* , Docket 10-00189, Vol. VI C, p. 298:12-22, March 7, 2011, and *First Discovery Request of the Consumer Advocate and Protection Division to Tennessee American Water Company*, Docket 10-00189, Request 10, October 20, 2010.

[280] *Rebuttal Testimony of Dr. James Vander Weide*, Docket 10-00189, p. 15: 3-22, February 8, 2011.

minimum growth that an investor can expect and Dr. Klein uses this to set the lower bound of a reasonable return on equity that an investor would expect.[281]

The final major point of contention with regard to the DCF model is the calculation of AWWC's dividend growth. Value Line did not have an earnings growth projection for AWWC and the dividend growth projection produced a result that was out of line with all other similar utilities.[282] The resulting DCF calculation for AWWC using the Value Line projections ranged from 3.5% to 19% and indicated it was unreliable.[283] Therefore Dr. Klein turned to the historical dividend growth and earnings growth data for AWWC reported in Value Line and arrived at a minimum growth in dividends that an investor could expect of 5%.[284] Once again, Dr. Klein used this data to set the minimum return that an investor would expect and used that to set the lower end of the band of reasonableness He found that to be 8.6%.[285]

Dr. Vander Weide claims that historical data underestimates the dividend yield when compared to analysts' growth projections.[286] This overlooks the fact that Dr. Klein does not use the historical data or the Value Line projections to set the exact return but rather the low end of the range of returns that an investor would reasonably expect to receive. As such, using Value Line projections of dividend growth for the proxy companies and historical growth data for

---

[281] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, p. 13: 3-9, January 21, 2011.

[282] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, pp. 11:18-12:2, January 21, 2011.

[283] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, Exhibit, p. 5, January 21, 2011.

[284] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, p. 12: 3-10, January 21, 2011.

[285] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, p. 13:3-9, January 21, 2011.

[286] *Rebuttal Testimony of Dr. James H. Vander Weide*, Docket 10-00189, p. 22: 5-14, February 8, 2011.

AWWC produces the appropriate figure for the minimum rate of return on equity that an investor in AWWC would expect.

2. Capital Asset Pricing Model (CAPM)

Dr. Klein uses the CAPM to set the upper end of his range of reasonableness. The CAPM derives the risk premium an investor would require for a specific stock by taking the risk free investment rate and adding to it the risk premium for a broad portfolio of stocks adjusted for the riskiness of the particular stock being measured.[287] Dr. Vander Weide performed the CAPM analysis but concluded that it should be given little or no weight by the TRA. Dr. Vander Weide's objections to the CAPM and more particularly Dr. Klein's use of it fall into two categories, the appropriate measure of the risk free rate and the result of using CAPM on stocks with a beta of less than one.

The first issue with the CAPM is the appropriate measure of the risk free rate. The CAPM starts with the return on a risk free investment. All parties agree that there is no such thing as a truly risk free investment and that the best available measure of that rate is US Government securities. Dr. Klein uses the current return on 5 year US Treasury Notes whereas Dr. Vander Weide uses the return on 20 year US Treasury Bonds. Dr. Klein believes that holding a fixed return investment over time injects some risk into the equation as inflation will necessarily affect the return on a US Treasury security. The shortest instrument, 30 day US Treasury Bills, would ordinarily be the best measure of a true risk free investment but the historically low interest rate following the 2008-2009 financial crises renders their use

[287] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, p. 13:10-19, January 21, 2011.

inappropriate. Dr. Klein therefore uses the shortest duration US Treasury instrument that has returns relatively unaffected by the anomalous interest environment.[288]

Dr. Vander Weide, on the other hand proposes using 20 year US Treasury Bonds as his risk free benchmark, arguing that the 20 year maturity more closely matches the time horizon that shareholders expect to hold utility stocks like AWWC.[289] The CAPM requires as a base the true rate of return on a risk free investment. Holding a bond or other US Treasury instrument over time necessarily injects a level of uncertainty and thus risk into any evaluation of an expected or required return. The fact that some and perhaps many investors hold utility stocks for an extended term does not decrease the risk of holding a US Treasury instrument with a long life span and the risk associated with that is reflected in the return on those longer US Treasury instruments. Logically, if this were not the case then all US Treasury instruments would have the same return regardless of their length of time to maturity. Clearly Dr. Klein's use of the shortest duration US Treasury instrument that is relatively unaffected by today's anomalous interest environment is the correct measure of the true risk free rate required by the CAPM.

Dr. Vander Weide's second complaint about the CAPM is his contention that it underestimates the rate of return for companies whose stock has a beta of less than one.[290] Beta is a measure of the relative riskiness of companies and is used in measuring their riskiness against other possible investments.[291] It is not contested that AWWC and all of the companies

---

[288] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, p. 14:4-17, January 21, 2011.

[289] *Rebuttal Testimony of Dr. James H. Vander Weide*, Docket 10-00189, p. 19:17-21, February 8, 2011.

[290] *Rebuttal Testimony of Dr. James H. Vander Weide*, Docket 10-00189, pp. 20:17-22:14, February 8, 2011.

[291] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, p. 15:3-11, January 21, 2011.

used by both experts in their proxy groups have betas of less than one.[292] However, Dr. Vander Weide's criticism misses the mark because Dr. Klein ultimately uses a beta of one to set the upper end of his range of appropriate equity returns in this Docket. As Dr. Klein explains in his direct testimony, he recognized Dr. Vander Weide's objection to using the CAPM where the target stocks have a beta of less than one. He also recognizes that investors would require a lower rate of return on less risky utility stocks with a beta of less than one than they would for a company with a beta of one.[293]

Dr. Klein uses a beta of one, or less risky than AWWC is in actuality, to set the upper bound of his range of acceptable equity returns that investors in AWWC would demand. This eliminates the bias against companies with a beta of less than one that in Dr. Vander Weide's mind disqualifies the CAPM. Dr. Klein's analysis shows that the upper end of the range of an appropriate rate of return on equity for AWWC is 9.6%.[294]

3. Risk Premium Model

Dr. Vander Weide, having discarded the CAPM utilized the Risk Premium analysis to further refine his analysis. The Risk Premium analysis compares the return on utility equities with the return on utility bonds rather than comparing the return on those equities with the risk free rate of return as does the CAPM.[295] Dr. Klein did not employ this model and believes that it is not the best measure of the return that investors would require of AWWC equities.

---

[292] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, Exhibit, p. 5, January 21, 2011.

[293] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, p. 15:12-20, January 21, 2011.

[294] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, p. 15: 1-2, January 21, 2011.

[295] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, p. 17:8-11, January 21, 2011.

As Dr. Klein explains in his testimony, utility stocks and bonds are affected differently by the risk of inflation and the risk of default. The return on bonds includes not just the time value of money but also the risk that inflation will erode the return over time and that a default by the issuer will wipe out the investment entirely. Utility stocks on the other hand are not subject to the same inflation risk since stock prices and stock returns will adjust for changes in inflation as the companies adjust the prices for their products. They also are also not subject in the same way to default risk since stock returns can rise when profits far exceed default levels even if the probability of default does not change.[296] Because stocks and bonds are not subject to the same risks of future inflation or underlying default, the Risk Premium analysis that compares the return on utility equities with the return on utility bonds is not the best measure of the investors' required rate of return on an equity investment.

As Dr. Klein clearly lays out in his testimony, the CAPM which measures the difference between the stock returns and a risk free rate of return isolates the added return required for the risk embodied in stocks over and above the return required to offset the time value of money.[297] It is, therefore, the appropriate measure in this Docket.

E. TAWC HAS PRESENTED INSUFFICIENT EVIDENCE TO JUSTIFY THE UNPRECEDENTED INCREASE IN THE RETURN ON EQUITY APPROVED IN THE LAST TAWC RATE CASE

TAWC was last before the TRA in 2008 when they sought an increase in rates in Docket 08-00039 ("the 2008 rate case"). The 2008 rate case was filed on March 14, 2008, and the TRA heard testimony in Chattanooga during the week of August, 18 2008. The new rates went into in

[296] *Direct Testimony of Dr. Christopher C. Klein,* Docket 10-00189, p. 17: 16-22, January 21, 2011.

[297] *Direct Testimony of Dr. Christopher C. Klein,* Docket 10-00189, p. 17:8-15, January 21, 2011.

effect on October 1, 2008. In that Docket the TRA approved an allowable return on equity ("ROE") for TAWC of 10.2%.[298] While the basic structure and condition of TAWC and AWWC haven't changed substantially in the intervening two years, the American economy has. The 2008 rate case was heard and decided just as the American economy was beginning to feel the effects of the largest economic downturn since the Great Depression.

The evidence introduced in the 2008 rate case, including the analysis of comparable companies and expected investor returns reflect those expectations at a point in time when markets and investor confidence were at historic high points. Although the general American economy has rebounded from the depths of the crisis in late 2008 and early to mid 2009, surely TAWC is not arguing that investors expect to receive returns on their equity investments today that are higher than those expected before the crash. Yet that is exactly what TAWC proposes. Dr. Vander Weide proposes a range of acceptable equity returns from 10.9% to 12.3%[299] and the Company is requesting that the TRA adopt an ROE of 11.5%.[300] TAWC applies this inflated rate to TAWC's capital structure in effect at the time TAWC chose to file its rate case and not the historical capital structure it has maintained over the past several years. TAWC ignores the relationship with AWWC that it touts as so beneficial when it is arguing for rate payers to shoulder unprecedented management fees to AWWC affiliates. The culmination of this analysis is TAWC's request for an overall rate of return of 8.372%.[301]

---

[298] *Final Order*, Docket 08-00039, p. 51, January 13, 2009.

[299] *Direct Testimony of Dr. James H. Vander Weide*, Docket 10-00189, p. 44:11-17, September 17, 2011.

[300] *Revised Rebuttal Testimony of Mike Miller*, Docket 10-00189, Exhibit MAM-3, February 17, 2011.

[301] *Revised Rebuttal Testimony of Mike Miller*, Docket 10-00189, Exhibit MAM-3, February 17, 2011.

Not only in this Docket, but around the country, AWWC and its affiliates routinely ask for an ROE far in excess of that last awarded by the TRA in 2008.[302] As has been examined above, Dr. Vander Weide makes a series of assumptions and adjustments to bring in factors which are not appropriate for the circumstances of the TAWC/AWWC relationship and have the effect of driving up his proposed rates. All of this flies in the face of the inescapable conclusion that nothing presented in this Docket justifies any increase in TAWC's allowed rates of return, much less the jump in ROE from the 10.2% ordered in the 2008 rate case to the 11.5% sought in this Docket.

The better analysis is that presented by Dr. Klein which utilizes the double leveraging method to find the true cost of equity for TAWC given that all equity capital is in fact raised by AWWC. He utilizes appropriately sized comparator companies that operate as utility distributors and not in other areas of utility generation or delivery. He does not make unneeded adjustments to account for factors already compensated for by his methods. This results in a range of acceptable equity returns from 8.6 to 9.6% and Dr. Klein recommends an ROE of 9.0%. He applies this to his double leveraged capital structure and concludes that TAWC should receive an overall ROR of 6.84%.[303]

The better analysis presented by Dr. Klein reflects the reality in the markets and in the American economy since TAWC was last before the TRA. The Consumer Advocate asks the TRA not to grant TAWC the unprecedented increase in returns they seek and to instead order the

[302] *Transcript of Proceedings*, Docket 10-00189, Vol. V C, Exhibit 75, March 4, 2011.

[303] *Direct Testimony of Dr. Christopher C. Klein*, Docket 10-00189, Exhibit, p. 2, January 21, 2011.

rational returns suggested by Dr. Klein and that they be applied to a capital structure which properly recognizes the reality of how TAWC raises the capital it needs.

VII. REVENUE CONVERSION FACTOR

The gross revenue conversion factor is a calculation that shows how much gross operating revenue should be adjusted to compensate for any forecasted surplus or deficiency in net operating profits earned by TAWC. There is a difference between the parties in the forecast of the gross revenue conversion factor due to different revenue forecasts and TAWC's use of a three year average for calculating an uncollectible percentage. The TRA properly adopted the Consumer Advocate's methodology for computing the factor in the 2008 rate case, and should do so again this year.[304]

VIII. REVENUE DEFICIENCY

Based on the foregoing, the Consumer Advocate concludes that the rates presently charged to TAWC's customers are more than sufficient to cover TAWC's expenses and taxes, as well as provide a fair rate of return to its investors. Indeed, the Consumer Advocate's accounting forecast, when coupled with its rate of return recommendation, supports a rate increase of approximately $1.3 million.[305]

IX. RATE DESIGN

The Consumer Advocate is proposing that any increase or decrease in rates be spread evenly across the board to all ratepayer classes and locations.[306] As Mr. Buckner testified, "[t]his

---

[304] TRA Order, 08-00039, at 46 (January 13, 2009).

[305] Amended Consumer Advocate Exhibit. Schedule 1, Line 8.

[306] Buckner Direct at 63.

approach would assure that the benefits or burdens created by any rate adjustment in this case are shared proportionately by all customers."[307] The Consumer Advocate recognizes the settlement reached between TAWC and CRMA regarding rate design; however, does not support or object to the agreement.

The Consumer Advocate's across the board plan is the fairest plan and should be adopted by the Authority.[308]

X. CONCLUSION

For the foregoing reasons, the Authority should find that TAWC's petition to increase water rates is without merit. In light of the facts of this record, TAWC has not carried its burden of proving that a rate increase would be just and reasonable at this time. The Authority therefore should deny TAWC's proposed rate increase and, instead, increase the water rates charged to TAWC's customers by $1.3 million as recommended by the Consumer Advocate.

RESPECTFULLY SUBMITTED,

MARY LEIGH WHITE, B.P.R No. 026659
Assistant Attorney General
Office of the Attorney General and Reporter
Consumer Advocate and Protection Division
425 Fifth Avenue North
Nashville, TN 37243
(615) 741-4657

Dated: March 21, 2011

[307] *Id.*

[308] If the Authority includes Walden's Ridge in this case, however, the Consumer Advocate urges it to assure that the rate charged to Walden's Ridge covers any revenue requirement attributable to serving Walden's Ridge.

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing was served via U.S. Mail or electronic mail upon:

R. Dale Grimes
Bass, Berry & Sims PLC
150 Third Avenue South, Suite 2800
Nashville, TN 37201

Henry Walker
Bradley Arant Boult Cummings, LLP
1600 Division St., Suite 700
Nashville, TN 37203

David C. Higney
Grant, Konvalinka & Harrison, P.C.
Ninth Floor, Republic Centre
633 Chestnut St.
Chattanooga, TN 37450-0900

Mark Brooks
521 Central Avenue
Nashville, TN 37211

Donald L. Scholes
Branstetter, Stranch & Jennings, PLLC
227 Second Avenue, North
Fourth Floor
Nashville, TN 37219

Frederick L. Hitchcock
1000 Tallan Building
Two Union Square
Chattanooga, TN 37402

Scott H. Strauss
Katharine M. Mapes, Esq.
Spiegel & McDiarmid, LLP
1333 New Hampshire Ave., N.W.
Washington, DC 20036

Mary Leigh White

on this the 21 day of March, 2011.

OFFICE OF THE ATTORNEY GENERAL - STATE OF TENNESSEE
CONSUMER ADVOCATE AND PROTECTION DIVISION
ANALYSIS OF MANAGEMENT FEES
TENNESSEE AMERICAN WATER COMPANY - TRA DOCKET #10-00189

EXHIBIT O&M 1

Line No.	Description	A/ 2005	B/ 2006	B/ 2007	B/ 2008	B/ 2009	B/ 2010	B/ 2011	C/ TAWC Amounts	Calculation of Net (Savings) Loss
1	Labor	$ 4,383,883	$ 4,515,399	$ 4,650,861	$ 4,790,387	$ 4,934,099	$ 5,082,122	$ 5,234,586	$ 5,680,299	$ 445,713
2	Group Insurance	1,386,004	1,597,632	1,560,850	1,686,566	2,088,306	2,180,844	2,227,908	2,434,923	207,015
3	Pension	892,790	1,169,074	700,024	1,349,486	1,284,614	1,278,890	1,814,508	2,062,140	247,632
4	Fully Loaded Labor Cost	$ 6,662,677	$ 7,282,105	$ 6,911,735	$ 7,826,439	$ 8,307,019	$ 8,541,856	$ 9,277,002	$ 10,177,362	$ 900,360
5	Management Fees	3,062,940	3,537,696	3,392,650	3,962,615	4,216,223	4,237,304	4,567,814	5,226,034	658,220
6	Total Labor and Management Fee:	$ 9,725,617	$ 10,819,801	$ 10,304,386	$ 11,789,055	$ 12,523,242	$ 12,779,160	$ 13,844,815	$ 15,403,396	$ 1,558,581

A/ Per TAWC Exhibits TRA Docket #04-00288
B/ Labor grown at 3%* annually; Group Insurance and Pensions at cost per employee (Exhibit MAM-11, Page 2 of 2) times 106 employees; and
Management Fees grown at Fully Loaded Cost per customer (Exhibit MAM-11, Page 2 of 2).
* Labor grown at 3% per R. Ferrell Direct Testimony in TRA Docket #03-00118 at Page 8; P. Diskin Direct Testimony in TRA Docket #04-00288 at Page 9;
Sheila Miller Direct Testimony in TRA Docket #06-00290 at Page 7; and TRA Docket #08-00(TAWC Response to TRA First Set of Data Requests, #33, Article 4, Section 1.
C/ Revised TAWC Exhibit No. 2, Schedule 3, Page 1 of 1.

OFFICE OF THE ATTORNEY GENERAL - STATE OF TENNESSEE
CONSUMER ADVOCATE AND PROTECTION DIVISION
ANALYSIS OF MANAGEMENT FEES
TENNESSEE AMERICAN WATER COMPANY - TRA DOCKET #10-00189

EXHIBIT O&M 2

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
	As Approved in TAWC Case No. 03-00118 Attrition Yr. 3/31/2004	2004 Labor Cost Inflated	2005 Labor Cost Inflated	2006 Labor Cost Inflated	2007 Labor Cost Inflated	2008 Labor Cost Inflated	2009 Labor Cost Inflated	2010 Labor Cost Inflated	2011 Labor Cost Inflated	REVISED Attrition Year Request by Company	Calculation of Net (Savings) Loss
Labor (Pay Increase of 3% per TAWC testimony)	5,066,666	5,218,666	5,375,226	5,536,483	5,702,577	5,873,655	6,049,864	6,231,360	6,418,301	5,680,299	(738,002)
Group Insurance	1,463,924	1,725,805	2,060,248	1,912,718	1,868,573	2,019,194	2,600,127	2,810,892	2,667,250	2,434,923	(232,327)
Pensions	387,985	141,820	344,848	1,151,099	689,269	1,328,785	1,264,904	1,259,218	1,786,644	2,062,140	275,496
Fully Loaded Labor Cost	6,918,575	7,086,291	7,780,321	8,600,300	8,260,419	9,221,633	9,814,896	10,101,470	10,872,195	10,177,362	(694,833)
Management Fees	2,507,276	2,535,587	2,607,536	3,010,950	2,886,018	3,371,134	3,585,394	3,604,736	3,884,502	5,226,034	1,341,532
Total Labor & Management Fees	9,425,851	9,621,878	10,387,856	11,611,250	11,146,437	12,592,768	13,400,290	13,706,206	14,756,697	15,403,396	646,699
Adjustments Not Accounted For in Labor & Benefits Analysis:											
Incremental Depreciation and Capital Costs for AWWSC Facilities that would have been reflected in depreciation, maintenance and interest costs if functions had stayed at TAWC.											(605,294)
TAWC response to Consumer Advocate Q90 - SUPPLEMENTAL PAGE 4-5 OF 5.											
Total Costs from Shift of Functions to AWWSC											41,405

Footnotes:

Note 1: The calculation of inflation factors used to determine the pro-forma 2011 costs shown in column 9 above are included on page 2 of this Exhibit.

	2003	2004	2005	2006	2007	2008	2009	2010 Projected	2011 Projected
TAWC Actual Loaded Labor Costs									
AVG. # Employees	118.17	100.17	98.33	102.33	107.08	107.00	105.00	108.00	110.00
Labor	4,858,845	4,212,010	3,765,383	4,256,528	4,664,401	5,046,198	5,123,043	5,228,000	5,412,000
Group Insurance	1,363,154	1,362,217	1,563,967	1,542,409	1,576,752	1,702,524	2,068,630	2,222,000	2,312,000
Pensions	439,268	136,107	316,289	1,128,624	707,180	1,382,254	1,272,526	1,303,000	1,883,000
Fully Loaded Cost	6,661,267	5,710,334	5,647,639	6,927,561	6,948,333	8,109,976	8,464,199		
Management Fees	2,324,942	4,012,316	3,752,617	4,312,528	4,725,529	5,021,435	4,879,920	5,257,000	5,636,000
Note: management fee level included in case 04-00288			3,062,840						
Cost per Employee									
Labor	41,119	42,050	39,087	41,595	43,559	47,151	48,791	48,407	49,200
Group Insurance	11,536	13,600	16,235	15,072	14,725	15,911	19,701	20,574	21,018
Pensions	3,717	1,359	3,304	11,029	6,604	12,731	12,119	12,065	17,118
Fully Loaded Cost per employee	56,372	57,008	58,626	67,696	64,887	75,794	80,611	81,046	87,336
		% Increase	% Increase	% Increase	% Increase	% Increase	% Increase	% Increase	% Increase
Labor		1.023	0.930	1.064	1.047	1.082	1.035	0.992	1.016
Group Insurance		1.179	1.194	0.928	0.977	1.081	1.238	1.044	1.022
Pensions		0.366	2.432	3.338	0.599	1.928	0.952	0.996	1.419
Fully Loaded Cost per customer		1.011	1.028	1.155	0.959	1.168	1.064	1.005	1.078

TP-1

IN THE COURT OF APPEALS OF TENNESSEE
AT NASHVILLE
August 30, 2010 Session

TENNESSEE AMERICAN WATER COMPANY, v. THE TENNESSEE REGULATORY AUTHORITY, et al.

Appeal from the Tennessee Regulatory Authority
No. 08-00039

No. M2009-00553-COA-R12-CV - Filed January 28, 2011

The Tennessee American Water Company petitioned the Tennessee Regulatory Authority to approve a revision to the existing rates it charges its customers for water. The Authority authorized a revision in the existing tariffs but made several rulings adverse to the plaintiff. Plaintiff has appealed numerous issues. On appeal, we affirm the rulings of the Authority, except its ruling which only allowed plaintiff to recover one-half of the rate case expenses. We hold that ruling was arbitrary and we require the Authority to pay the full amount of the rate case expenses claim.

Tenn. R. App. P.12 Petition for Review; Judgment of the Tennessee Regulatory Authority Affirmed in Part and Reversed in Part.

HERSCHEL PICKENS FRANKS, P.J., delivered the opinion of the Court, in which CHARLES D. SUSANO, JR., J., and. D. MICHAEL SWINEY, J., joined.

R. Dale Grimes, Nashville, Tennessee, for the Appellant, Tennessee American Water Company.

J. Richard Collier, Kelly Cashman-Grams and Shilina B. Brown, Nashville, Tennessee, for the Appellee, Tennessee Regulatory Authority.

Robert E. Cooper, Jr., Attorney General and Reporter, Michael E. Moore, Solicitor General, and Ryan McGehee, Assistant Attorney General, Nashville, Tennessee, for the Appellee, Consumer Advocate and Protection Division of the Office of the Tennessee Attorney General.

Frederick L. Hitchcock, Harold L. North, Jr., Tom Greenholtz, Michael A. McMahan and Valerie L. Malueg, Chattanooga, Tennessee, for the Appellee, City of Chattanooga.

OPINION

Background

Appellant, Tennessee American Water Company (TAWC), is an investor-owned public utility that provides water service to residential, industrial, commercial and municipal customers in the City of Chattanooga, Tennessee and area. It is a wholly owned subsidiary of American Water Works Company, Inc. (Parent Company). Parent Company is a holding company that owns numerous operating subsidiaries providing water services in locations across the United States.

TAWC, is required to obtain approval from the Tennessee Regulatory Authority (TRA or Authority), before implementing an increase in the rates it charges its customers. Tenn. Code Ann. § 65-5-103(a). TAWC's rates must be set forth in tariffs filed with and approved by TRA and TAWC can only charge the rates set forth in a duly filed and effective tariff. Tenn. Code Ann. § 65-5-102; Tenn. Comp. R. & Regs. 1220-4-1-.03. If TAWC wants to implement a rate increase due to increased expenses or investments or decreased revenues or for any other reason, it is required to file a revision to the existing tariffs and a petition asking TRA to approve the revision to the existing rates. Tenn. Code Ann. § 65-5-103; Tenn. Comp. R. & Reg. 1220-4-1-.03 to .06.

On March 14, 2008, TAWC filed its petition (2008 Rate Case) with the TRA in which it sought approval of "customer rates that will produce an overall rate of return of 8.514% on a rate base of $119,881,506". Along with the petition, TAWC filed the pre-filed testimony of nine witnesses, a Management Report and documentary evidence in support of the requested rate increase. This petition was TAWC's fourth such filing within a five year period.

On April 7, 2008, the TRA panel initially assigned to the 2008 Rate Case voted to suspend the proposed tariff from April 13, 2008 to July 11, 2008 and to convene a contested case proceeding and appoint a Hearing Officer for the purpose of preparing the matter for hearing before the panel.

On April 1, 2008, the Consumer Advocate and Protection Division of the Office of the Attorney General (Consumer Advocate or CAPD) filed a petition to intervene. The Chattanooga Manufactures Association (CMA) filed a petition to intervene, and the City of Chattanooga (the City) likewise filed a petition to intervene. There was no opposition to the petitions to intervene and the TRA permitted the interventions.

Between May 12, 2008 and mid-August 2008 extensive discovery was conducted by the parties and multiple motions were filed regarding discovery disputes. The hearing on the 2008 Rate Case commenced in Chattanooga on August 18, 2008 and continued there until

August 22, 2008. The hearing was then reconvened in Nashville on August 26, 2008 and concluded on August 27, 2008.

The TRA panel held public deliberations on September 22, 2008. The TRA made numerous determinations of TAWC's revenues, expenses, rate base and rate of return for the attrition year and concluded that TAWC had a revenue deficiency of $1,655,541. Accordingly, the TRA granted a rate increase to increase the revenue by $1,655,541. The TRA also ordered a "Request for Proposal" for an extensive management audit by an independent certified accountant of the management fees incurred by the TAWC from American Water Works Service Company (Service Company). The Request for Proposal was to be filed with the TRA no later than September 28, 2008.

On January 13, 2009, TRA entered the final order in the 2008 rate case, and TAWC filed a petition for direct review of numerous aspects of the TRA's decision pursuant to Tenn. Code Ann. § 4-5-322(b)(1)(B)(iii) with the Middle Section of this Court. The Appellant, separately filed a motion to transfer the appeal of this case to the Eastern Section of the Court, which was granted.

Summary of Evidence Before the Authority

In ruling on TAWC's petition in the 2008 Rate Case, the TRA was required to make determinations on a number of complex components that must be considered when fixing just and reasonable rates and the Final Order of January 13, 2009 reflects those determinations. TAWC has sought review of the following contested issues that were a part of the multiple factors considered by the TRA: The selection of the test period; revenues, specifically Weather Adjustment Normalization; management fees, including the cost of the Management Audit performed by TAWC; fuel and power expenses, specifically the establishment of an unaccounted-for water loss percentage; and regulatory expense.

TAWC contends that TRA erred in applying more than one test year to TAWC's expenses, revenues and rate base. A "test period" or "test year" is a measure of a utility's financial operations and investments over a specific twelve month period. A test year is used to build an "attrition year", which is the forecast used to set rates. In this rate case TAWC urged TRA to use an historical test year ending on November 30, 2007 and the Consumer Advocate used a test year ending March 31, 2008. Both TAWC and the Consumer Advocate utilized an attrition year ending August 31, 2009. The issue of utilizing only TAWC's proposed test year was contested. In its final decision, the TRA utilized portions of both test years for different determinations. The agency utilized the test period which it found to best fit the individual item being forecasted. Although TAWC contends that it was the policy of TRA in past rate cases to apply only one test period to all issues, the Consumer Advocate correctly pointed to the evidence that TRA had utilized multiple test year periods in the 2006 rate case.

TAWC described management fees as follows:

> Management fees are the charges from American Water Works Service Company ("AWWSC") for services provided under the 1989 Service Company contract. Those services consist of services related to accounting, administration, communication, corporate secretarial, engineering, finance, human resources, information systems, operations, rates and revenue, risk management, water quality and other services as agreed by the Company. These services are billed at cost to TAWC.

In the 2008 Rate Case, TAWC sought in its initial filing $4,335,190 for management fees.

In order to address this issue on appeal, a review of a portion of the Final Order in the 2006 Rate Case is required. As part of the 2006 Rate Case, TAWC initially requested management fees in the amount of $4,064,421. The Consumer Advocate requested that management fees be set in the amount of $3,021,111. The City and the CMA argued that the TRA should not approve any management fees as TAWC had not met its burden of proof on the issue. The TRA concluded that management fees for the attrition period should be $3,979,825. The TRA also ordered that TAWC have a management audit performed. The Final Order from the 2006 Rate Case specified the requirement of a management audit as follows:

> TAWC should have a management audit performed in compliance with Sarbanes-Oxley requirements and submit the results to the Authority in one year or, if the audit is not complete in one year, submit a status report on the audit in one year. This audit should determine whether all costs allocated to TAWC were incurred as a result of prudent or imprudent management decisions by TAWC's parent and should address the reasonableness of the methodology used to allocate costs to TAWC.

TRA had directed TAWC to submit the results of a management audit or a status report on the management audit within one year of deliberations in the 2006 Rate Case, which occurred on May 15, 2007. However, less than a year later, on March 14, 2008, TAWC filed its Petition in this case, the 2008 Rate Case, and with the Petition, it submitted a report prepared by the management consulting firm Booz Allen Hamilton (Booz Allen). This report was entitled and referred to by a Booz Allen vice-president, Joseph Van den Berg, who sponsored the report as an "Independent Cost Assessment Report". Mr. Van den Berg testified that the report was prepared in compliance with the 2006 Rate Case Final Order's requirement that a management audit be submitted to the TRA.

TAWC supported its request for management fees with the Booz Allen Report and Mr. Van den Berg's testimony as well as with testimony from TAWC officers and employees. TAWC offered evidence regarding the amount of projected management fees in the attrition year and attributed the increase in fees since the 2006 Rate Case to factors such as labor and benefits costs. TAWC further presented evidence that because the Service Company's costs and benefits are shared by all American Water subsidiaries, TAWC is able to deliver more prompt and reliable service to its customers. There was evidence that the

Service Company offers a wide range of services to TAWC, including a customer call center, accounting, operations, rates and revenues, administration, auditing, information systems, communications, human resources, risk management, finance, legal, water quality and engineering. The Company witnesses offered testimony that all of these services were necessary for TAWC to provide a high quality of service to its customers and that if the Service Company was not employed, TAWC would have to obtain the same services elsewhere. TAWC provided evidence that if it shifted the services provided by the Service Company to the local level, the cost to TAWC would be higher because TAWC would have to hire full-time employees and outside contractors who would not bill at cost as the Service Company does.

The Company presented evidence to show that the Service Company was able to achieve cost savings based on its model that allows TAWC and other American Water subsidiaries to share in the cost of employing specialists, some of whom would not be needed in a full-time basis at a single utility. The Booz Allen consultant, Mr. Van den Berg, stated that in his opinion the service company model is a cost-effective way to operate utilities. Michael Miller, treasure/comptroller of the Company, attempted to explain the increase in management fees between 2004 and 2008. He stated that in 2004 and 2005 the Parent Company had instituted a company-wide reorganization that had shifted a number of full-time positions from TAWC to the Service Company. He claimed that this action resulted in a reduction in the growth of local labor costs that by 2008 had actually offset the increase in management fees by $1,239,713.

This evidence was presented in support of TAWC's initial request for management fees of $4,335,190. The Consumer Advocate arrived at a forecasted amount of $3,453, 233 for the attrition period. The other intervenors, the City and the CMA, did not provide an alternative amount for management fees to the TRA, but rather the City urged that no management fees, including the cost of the management audit, be allowed until TAWC obtained a proper audit which would be reviewed in a later proceeding.

After review of the testimony, a majority of the TRA panel concluded that the management fees for the attrition period should be set at $3,529,933. This amount was based on the Company's forecasted 2005 management fee amount with an annual customer growth/inflation factor.

The TRA panel's decision on the amount of management fees was split two to one. All of the panel members, however, agreed that the Booz Allen Report submitted by TAWC did not comply with the TRA's directive in the 2006 Rate Case Final Order and did not support approval of TAWC's request to recover management fees in the 2008 Rate Case.

The deliberations of the members of the panel on this issue offer insight as to why the panel did not accept TAWC's management fees for the attrition year and why the panel rejected the Booz Allen Report. Director Roberson, as part of a motion, stated that he had no doubt that the Service Company had incurred legitimate expenses, but he had a problem

determining whether the amount of management fees requested by the Company to pay the Service Company was "a just and reasonable amount based on prudent expenditures." He went on to state that the audit the TRA had ordered TAWC to conduct and provide to the TRA in the 2006 Rate Case could have answered this important question "if it had been conducted properly." He noted that the evidence presented showed that in the five and a half years from 2004 to the forecasted attrition period in the 2008 Rate Case, management fees had increased by 73%. The Director also addressed the testimony of Michael Miller regarding the company-wide reorganization that had shifted positions from TAWC in Chattanooga to the Service Company. He stated that there was less than $26,000 in efficiency gained by the reorganization since 2004 and that he had expected greater efficiency. He also stated that he looked forward to reviewing the conclusions of the comprehensive audit that was ordered in the 2006 Rate Case once it was properly prepared. He stressed that if the management audit shows that the management fees are prudent, the TRA will revisit the matter of management fees on its own motion or on motion of a party. He then explained his methodology for arriving at the management fees he approved.

Chairman Hargett voted in favor of Director Roberson's motion and added to the deliberations regarding the management audit ordered in the 2006 Rate Case. First the Chairman recapped the Final Order which required TAWC to submit a management audit to TRA: "The audit was to determine whether all costs allocated to [TAWC] were incurred as a result of prudent or imprudent management decisions by [the Service Company]." He then noted that the audit was to address the reasonableness of the methodology used to allocate costs to TAWC. Chairman Hargett expressed dissatisfaction with the Booz Allen Report as it did not meet those stated guidelines. He also expressed skepticism that Booz Allen was an independent company for purposes of conducting the audit as Mr. Van Den Berg, who oversaw the audit for Booz Allen, "frequently provides testimony for American Water Works Company in rate cases in other states." Finally the Chairman stated that he agreed with the methodology employed by the Director in arriving at the management fee figure of $3,529,933.

Director Freeman did not vote in favor of the management fees as proposed by Director Roberson and support by Chairman Hargett as he found that the Booz Allen Report submitted by TAWC did "not lend the evidence to support an increase in management fees from the last [2006] case." Based on this lack of evidence, Director Freeman stated that the management fees amount granted in the 2006 Rate Case should be adopted in the 2008 Rate Case.

> The Final Order in the 2008 Rate Case addressed the Booz Allen report as follows: Based on its evaluation, the City recommended disallowance of all costs related to the Booz Allen Report and all [the Service Company's] management fees and allocated cost until the Company obtains an audit that conforms to the specifications of the TRA and the new audit report is examined in a later proceeding. The City claimed, in part, that Booz Allen is not an independent public accounting firm; Booz Allen did not conduct an "audit" as required by the TRA or SOX [Sarbanes-Oxley regulations];

and Booz Allen did not conduct an audit in conformance with the rules of the Public Accounting Oversight Board. . . .

The Final Order concluded:

The record shows that from 2004 to the Company's forecasted attrition period in this docket, management fees have increased seventy-three percent during the five and one-half year time period. There was a fifty-nine percent increase between the 2004 fees and the fees approved in Docket No. 06-00290 [the 2006 Rate Case]. Therefore, a majority of the panel voted to set the Management Fee attrition year expense amount at $3,529,933. This amount was based on the Company's forecasted 2005 Management Fee amount from Docket No. 04-00288 [2005] as used by the Consumer Advocate in this docket. The majority of the panel voted to change the growth factor to include all customer growth instead of one-half of customer growth, as used by the Consumer Advocate.

Because of unresolved questions regarding management fees assessed by the service company and requested by TAWC in Docket No. 06-00290 [the 2006 Rate Case], the TRA ordered TAWC to perform a management audit to determine whether all costs allocated to TAWC were incurred as a result of prudent or imprudent management decisions by TAWC's parent and to address the reasonableness of the methodology used to allocate cost to TAWC.

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

> TAWC should have a management audit performed in compliance with Sarbanes-Oxley requirements and submit the results to the Authority in one year or, if the audit is not complete in one year, submit a status report on the audit in one year. This audit should determine whether all costs allocated to TAWC were incurred as a result of prudent or imprudent management decisions by TAWC's parent and should address the reasonableness of the methodology used to allocate costs to TAWC.

A majority of the panel found that the management audit performed did not adequately address the issue of prudency of the management fees, and that the audit was not an independent audit as ordered in Docket No. 06-00290. The Booz Allen witness, Joe Van den Berg, who performed the management audit required by the TRA also provided testimony on behalf of TAWC in other dockets, both before the TRA and other utility commissions. For this reason, the panel determined that the independence of the selected audit firm was impaired. Further, the audit did not address the primary concerns of the Authority that the costs were the result of prudent management decisions.

Based on the foregoing findings regarding the Booz Allen Report, the TRA excluded

amortization of the cost of the Booz Allen Report from the management fees. The Final Order also stated that because TAWC had not developed a Request For Proposal (REF) for a comprehensive management audit by an independent certified public accountant, as ordered in the 2006 Rate Case Final Order, TAWC had not complied with TRA's directive. The 2008 Rate Case Final Order provided specific criteria for a new audit:

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

On appeal, TAWC contends that the evidence presented to the TRA showed that the Booz Allen Report featured an in-depth analysis of the prudence of management decisions and cost allocation to TAWC by employment of management audit methodology and definition of prudence that has been used and accepted in multiple other jurisdictions. TAWC contends that Booz Allen examined and determined the prudence of TAWC's management decisions by examining seven aspects of the relationship between the Service Company and the Company and showed that the Service Company's costs per customer were less than most other utility companies that use a service company. Based on this finding, the report concluded that TAWC receives fair, reasonable and competitive charges from the Service Company.

Further, TAWC contends on appeal that the Booz Allen Report was in complete compliance with the applicable provisions of the Sarbanes-Oxley requirements as mandated by the 2006 Rate Case Final Order. Mr. Van den Berg stated in his pre-filed testimony that the Booz Allen report and his testimony were intended to address the part of the Final Order of the 2006 Rate Case that 'TAWC have a management audit performed in compliance with Sarbanes-Oxley requirements'". Mr. Van den Berg also testified at the hearing on the issue of compliance with Sarbanes-Oxley. He stated that it was his understanding that the only Sarbanes-Oxley requirement that pertains to a management audit, as opposed to a financial audit, was that the firm conducting the management audit be independent from the company that it audited. Mr. Van den Berg claimed that the audit Booz Allen conducted was an independent audit, but on cross-examination, admitted that he had done consulting work for TAWC on the previous rate case and that in the past several years he had done consulting work and testified in rate cases for subsidiaries of the Parent Company in Minnesota, Missouri and Indiana.

Appellees find multiple faults with the Booz Allen Report and Mr. Van den Berg's testimony. For instance, appellees argue that Mr. Van den Berg did not undertake any analysis of whether the level of administration services, audit services, communication

services and legal services that were charged by the Service Company to TAWC were the right level or quantity. Appellees claim Mr. Van den Berg did not undertake any independent analysis to determine whether the Service Company was actually providing the services it was billing to TAWC. An example of this allegation provided by appellees is that Mr. Van den Berg testified that he believed the charges for accounting services billed to TAWC were appropriate merely because the category of accounting services was included in the service agreement between the Service Company and TAWC. There was no evidence that he had examined the actual accounting services provided.

Appellees also assert that Booz Allen further did not undertake to study or determine whether amounts paid by TAWC for services were for the correct quantity or volume of service. The allegation is based on Mr. Van den Berg's testimony that other than having discussions with TAWC management, Mr. Van den Berg did not consider whether the services provided by the Service Company overlapped or duplicated activities conducted by TAWC employees nor did he consider the labor and benefits expense that TAWC was incurring locally. Appellees point to numerous other examples in the Booz Allen Report and in Mr. Van den Berg's testimony where there was no analysis of whether the services delivered to TAWC were necessary, reasonable and prudent. They also point out that the Booz Allen Report did not define prudence, imprudence or reasonableness.

The City offered the testimony of economic consultant Michael Majoros, Jr. as to why the Booz Allen Report was not a management audit, why it did not comply with Sarbanes-Oxley requirements and why it otherwise did not meet the requirements set forth in the Final Order of the 2006 Rate Case.

Mr. Majoros described the Sarbanes-Oxley Act of 2002:

> Sarbanes-Oxley(SOX) is an Act co-authored by Senator's [sic] Sarbanes and Oxley and signed into law by President George W. Bush. It emanates from the ENRON and other corporate scandals in [the] early part of President Bush's first term. SOX requires detailed audits by independent certified public accountants. The purpose of the law is "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws and for other purposes.

Mr. Majoros was then asked how an "audit" is defined by Sarbanes-Oxley. In response he quoted Section 2(a)(2) of the Act as defining an audit as: "An examination of the financial statements of any issuer by an independent public accounting firm in accordance with the rules of the Board or the Commission (or, for the period preceding the adoption of applicable rules of the Board under section 103, in accordance with then-applicable generally accepted auditing and related standards for such purposes), for the purpose of expressing an opinion on such statements". In Mr. Majoros' opinion, the Booz Allen Report was not an audit, as described by Sarbanes-Oxley, but an "assessment" and he noted that Mr. Van den

Berg never referred to the report as an audit.[1] Mr. Majoros provided three principal reasons that the Booz Allen Report was not a management audit: (1) the report did not determine and apply definitions of prudence, imprudence, or reasonableness; (2) it did not determine whether the internal controls at the Service Company were designed to catch imprudent costs; and (3) its conclusions were subjective and were not based on objective audit tests or standards. He also explained that there were well-defined standards for preparation of a management audit of a utility as provided in the National Association of Regulatory Utility Commissioners publication, "Fundamental of Management Audits, Vol. I" and that Booz Allen had not utilized these standards.

Mr. Majoros further detailed twelve deficiencies in the Booz Allen Report, referenced as BAH, that caused it to be non-compliant with Sarbanes-Oxley (SOX)requirements:

> BAH is not an independent public accounting firm. [2]
> BAH did not conduct an "audit" as specified by SOX.
> BAH did not conduct an audit in conformity with or even cite to the rules of the Public Company Accounting Oversight Board.
> BAH did not cite to professional standards and did not comply with stringent standards SOX requires.
> BAH's report did not include a concurring or second partner review and approval of such report.
> BAH's report did not contain any management attestations.
> BAH's report is not independent, it was reviewed and edited by management.
> BAH's report did not describe the scope of the auditor's testing of the internal control structure and procedures required by section 404(b) Internal Control Evaluation and Reporting.
> BAH's report did not present the findings of the auditor from such testing.
> BAH's report did not provide an evaluation of whether AWWSC's [the Service Company's] internal control structure and procedures include maintenance of records that in reasonable detail accurately and fairly reflect the transactions reported to BAH by AWWSC.
> BAH' report did not provide an evaluation of whether such internal control structure and procedures provide reasonable assurance that transactions are recorded as necessary to permit calculation of costs conforming to TRA requirements, and that receipts and expenditures underlying those costs are being made only in accordance with authorizations or management and directors in conformance with TRA rules.
> BAH's report did not contain a description, at a minimum, of material weaknesses in such internal controls, and of any material noncompliance found on the basis of such testing.

---

[1] As noted above in footnote 2, Mr. Van den Berg testified that although he had referred to the report as a "cost assessment" he used the term "assessment" synonymously with audit. In fact, the Booz Allen report also refers to "report" and "audit"interchangeably in the first paragraph.

[2]Booz Allen Hamilton refers to itself as a "Strategy and Technology Consulting Firm" on its website.

Mr. Majoros summarized his opinions as follows:

> BAH did not conduct a management audit in compliance with Sarbanes-Oxley requirements to determine whether all costs allocated to TAWC were incurred as a result of prudent or imprudent management decisions by TAWC's parent and the reasonableness of the methodology used to allocate costs to TAWC, as TRA specified in Docket No. 06-00290. The BAH Report is merely an expansion of the type of study Mr Baryenbruch submitted in Docket no. 06-00290 which led to the TRA's Sarbanes-Oxley requirement. BAH did not conclude audit test work of specific transactions to determine if they were the result of prudent or imprudent management decisions. Nor did he determine or verify if AWWSC's internal controls were designed to catch imprudent and unreasonable costs. The BAH Report is not useful for ratemaking purposes. None of the costs of the BAH Report should be charged to ratepayers in any way. Furthermore, I recommend disallowance of all AWWSC management fees and allocated costs until the originally specified audit is conducted and examined in a later proceeding.

TAWC offered the testimony of Mark Manner, an attorney and purported expert on the Sarbanes-Oxley requirements, in rebuttal to Mr. Majoros' opinions. Mr. Manner provided an overview of the Sarbanes-Oxley Act of 2002, also known as the Public Company Accounting Reform and Investor Protection Act of 2002. According to Mr. Manner, the Act was designed to improve existing safeguards for protecting investors in public companies from corporate accounting fraud, primarily by improving the accuracy and reliability of public company disclosures and by strengthening the independence of accounting firms auditing those disclosures. Mr. Manner first gave a definition of a management audit:

> [A] "management audit" is a broad and general term. It is often used to describe management consulting services that are used to assist in the evaluation of the performance of a company's management or operations. The precise scope of a "management audit" is generally subject to additional description or definition by the party requesting such an audit.

Mr. Manner went on to distinguish a "management audit" from a "financial statement audit" which he defined as an "evaluation or assessment of a [c]ompany's balance sheet, income statement, cash flow statement, and related notes. A financial statement audit leads to an audit report providing an opinion as to whether the financial statements of a company fairly present the financial positions and results of operations of a company in accordance with generally accepted accounting principles. He explained that the word "audit" for purposes of Sarbanes-Oxley is defined narrowly as an "examination of the financial statements of any issuer by an independent public accounting firm . . . ." Therefore, when Sarbanes-Oxley addresses "audit" requirements and standards it applies to financial statement audits of publically traded companies and does not apply to a "management audit". In Mr. Manner's pre-filed testimony, he was asked the question "what does Sarbanes-Oxley require for a "management audit" or for any other types of non-financial statement audits?" His

response to this question is key to understanding his and TAWC's position regarding the 2006 Rate Case Final Order's requirement that TAWC's management audit be compliant with Sarbanes-Oxley:

> Sarbanes-Oxley makes it clear that the independent public accounting firm that audits the AWWC [the Parent Company] financial statements, in this case PricewaterhouseCoopers ("PWC"), is prohibited from providing certain services that Sarbanes-Oxley defines as "non-audit" services" such as the management audit. This prohibition requires an independent third-party, other than AWWC's independent public accounting firm, to conduct the management audit. This requirement of independence for the management audit can be fulfilled by having another party, accounting firm or otherwise, conduct the management audit. AWWC complied with this requirement by hiring Booz Allen to conduct the management audit.
>
> Otherwise, . . . Sarbanes-Oxley sets forth requirements for financial statement audits rather than management audits or other types of audits. This becomes obvious upon reviewing the Sarbanes-Oxley definition of "audit" that covers "an examination of the financial statements . . . for the purpose of expressing an opinion on such statements" and the definition of "non-audit services," which covers professional services "other than those provided in connection with an audit or other review of the issuer's financial statement."
>
> * * * *
>
> Although Sarbanes-Oxley's applicability to management audits is limited to independence as discussed above, I note that the management audit filed in this case pursuant to the TRA Order is based on financial information underlying the financial statements of AWWC that were prepared and audited in compliance with applicable Sarbanes-Oxley provisions, and was from a company that was in compliance with applicable Sarbanes-Oxley provisions.(emphasis supplied, citations omitted).

Mr. Manner stated that the TRA Final Order in the 2006 Rate Case specified that the management audit should be performed in compliance with Sarbanes-Oxley, which Mr. Majoros incorrectly interpreted as requiring a financial audit process. It was Mr. Manner's opinion that the correct interpretation of the Order is that it was a "clear request that the management audit be prepared by an independent firm." He also reiterated that "the Booz Allen management audit incorporates and is underpinned by financial information from a Sarbanes-Oxley compliant company that flows from financial statements prepared and audited [by PWC] in compliance with Sarbanes-Oxley", thus the Booz Allen report satisfied the TRA's mandate that it be compliant with Sarbanes-Oxley.

Mr. Manner did not address Mr. Majoros's primary opinion the Booz Allen Report did not address whether all costs allocated to TAWC were incurred as a result of prudent or imprudent management decisions by TAWC's parent and the reasonableness of the

methodology used to allocate costs to TAWC.

The Final Order contains the following discussion of how the panel determined attrition period revenues:

> The panel adopted attrition period Revenues of $38,934,309. In doing so, the panel used a combination of the Company's, the Consumer Advocate's, and its own forecasts. The panel found neither the Company's nor the Consumer Advocate's methodology for forecasting residential and commercial average usage persuasive and instead performed its own analysis, examining average usage trends for the residential and commercial classes over the four years ended March 31, 2005, 2006, 2007 and 2008. The Authority adopted residential class attrition period revenues based on this methodology and the Company's forecasted number of bills. For commercial class, the analysis produced a result almost identical to the Company's forecast; therefore, the Authority adopted TAWC's commercial class attrition period revenue forecast.

The TRA, in addressing weather normalization adjustment (WNA) in the Final Order, noted that TAWC had inaccurately represented that the agency had previously adopted the model the Company used in forecasting residential and commercial average usage. The Order states:

> In earlier TAWC rate case dockets, Docket Nos. 03-00118 and 04-00288, TAWC's revenues were settled. Although the parties in those dockets settled on the amounts proposed by TAWC, the settlements did not mention any agreed upon methodology for calculating those revenues. The Company's revenue forecast was adopted in Docket No. 06-00290; however, the Authority did not adopt or endorse TAWC's WNA model. In this docket, the panel did not adopt the Company's entire revenue forecast or the Company's WNA model. Nevertheless, the Authority adopted the Company's commercial class attrition period revenue in this docket because despite disagreeing with the Company's methodology, the result was reasonable.

TAWC projected Regulatory Expenses of $543,384 in its Petition. This amount included the unamortized portion of the 2006 Rate Case regulatory expenses and the estimated cost of the 2008 Rate Case. The Consumer Advocate estimated $341,868 for Regulatory Expenses for the attrition period and the CMA projected Regulatory Expenses in the amount of $287,111. The expenses incurred in this case were higher than the 2006 Rate Case due, according to TAWC, to contentious discovery and multiple pre-hearing motions and hearings. TAWC, in its brief, claims that the reasonableness of the Rate Case expenses was uncontested. This statement is not borne out by the filings and testimony of the intervenors on this issue. In fact, the intervenors argued that the attorneys' fees claimed by TAWC as part of its regulatory expense were not reasonable and should not be approved by the TRA. The TRA rejected the arguments of the intervenors, but did look at whether the expense of regulatory proceedings should be apportioned and determined that it would be appropriate for TAWC shareholders to bear a portion of the Company's rate case expense

as follows:

> The panel noted that in the future the Authority should closely examine the costs associated with rate case filings to determine the portions to be recovered from rate payers and shareholders. The panel voted to allow one-half of this docket's rate case expense of $275,000 in the calculation of the Regulatory Expense. The panel voted to have one-half of the rate case expense, the cost of the service study, the cost of the depreciation study, and the unamortized balance of the previous case amortized over a three year period. Thus, the panel adopted $194,852 as the Regulatory Expense for the attrition period.

In any water system, some water is lost through leaks or waterline breaks. Also, a portion of water provided to customers is not billed, for example water used in fighting fires and used in leak detection. The lost or unbilled water is referred to as unaccounted-for water (UfW). TAWC presented testimony that its UfW for the attrition year was 19.97 % which is approximately 5% higher than the industry standard for acceptable UfW of 15%. The Consumer Advocate and CMA, through expert testimony, cross-examination of TAWC witnesses and post-hearing briefs, made the argument that the amount of TAWC's chemical and fuel and power costs incorporated in rates should be adjusted by 15% to provide incentive for the Company to maintain its water system more efficiently and prevent wasted costs for non-revenue producing treated water.

TAWC presented testimony that although all water systems have UfW, a system located in a mountainous area, such as Chattanooga, or that has older infrastructure, as does TAWC, may have more UfW than otherwise situated or newer systems. Based on these circumstances, TAWC argued that the 15% UfW industry standard should not apply to TAWC. The Company also presented evidence regarding its effort to reduce the level of UfW by introducing a non-revenue water program, increasing leak detection in the system and conducting a water audit.

There was also testimony a UfW standard of 15% has been generally accepted by at least two regulatory agencies in other states and is generally accepted in the water utility industry. In fact, Mr. Watson, the president of TAWC, admitted that the Company itself sets a 15 % UfW target for itself and that the 15% standard is a good industry average. CMA witness Michael Gorman recommended that an acceptable UfW standard should be no more than 15%. He based his recommendations on two studies relied upon by the water utility industry. The TRA determined in the Final Order that the 15% standard should apply to TAWC to encourage conservation of natural resources.

The issues presented for review are:

A. Did the TRA err when it employed a rate-making methodology that utilized more than one test year?

B. Whether the TRA's determination of management fees was arbitrary and capricious or in violation of Tenn. Code Ann. § 65-5-103?

1. Whether the TRA's decision to disallow recovery of the expense of a TRA ordered management audit was arbitrary and capricious?

C. Whether the TRA properly normalized revenues using a reasonable weather normalization adjustment methodology?

D. Whether the decision to reduce the recovery of rate case expense was a lawful exercise of discretion supported by material and substantial evidence?

E. Whether the TRA's decision to cap unaccounted-for water at 15% was a lawful exercise of discretion supported by material and substantial evidence?

This Court's review of the TRA's actions is confined to the record. Tenn. Code Ann. §4-5-322(g). The standard of review to be employed by the Court is provided by Tenn. Code Ann. §4-5-322(h) as follows:

> The court may affirm the decision of the agency or remand the case for further proceedings. The court may reverse or modify the decision if the rights of the petitioner have been prejudiced because the administrative findings, inferences, conclusions or decisions are:
>
> (1) In violation of constitutional or statutory provisions;
> (2) In excess of the statutory authority of the agency;
> (3) Made upon unlawful procedure;
> (4) Arbitrary or capricious or characterized by abuse of discretion or clearly unwarranted exercise of discretion; or
> (5)(A) Unsupported by evidence that is both substantial and material in the light of the entire record.
> (B) In determining the substantiality of evidence, the court shall take into account whatever in the record fairly detracts from its weight, but the court shall not substitute its judgment for that of the agency as to the weight of the evidence on questions of fact.

This Court's review is for the "very limited purpose of determining whether the Commission has acted arbitrarily, or in excess of jurisdiction, or otherwise unlawfully." *CF Indus. v. Tennessee Pub. Serv. Comm'n*, 599 S.W.2d 536, 540 (Tenn. 1980)(citing *City of Whitwell v. Fowler*, 208 Tenn. 80, 83, 343 S.W.2d 897, 899 (1961)). Review is restricted to the record and the TRA's finding may not be reversed or modified unless arbitrary or capricious or characterized by an abuse, or clearly unwarranted exercise of discretion and must stand if supported by substantial and material evidence. *Id.* The Tennessee Supreme Court discussed the degree of deference the reviewing court should give to the administrative

agency as follows:

> The criteria by which the [Authority] should be guided have received only generalized comments in our reported decisions. This is proper because the courts are playing a limited role in reviewing actions which essentially are legislative in character. Rate making is not a judicial function and we accord the [Authority] great deference in reviewing its decisions. On fixing rates in general the Court has spoken in terms of what is just and reasonable "under the proven circumstances," of "regard to all relevant facts" and to a rate "in the zone of reasonableness."

C. F. Indust. at 542 (citing *Southern Bell T. & T. Co. v. Tennessee Public Serv. Com'n.*, 202 Tenn. 465, 304 S.W.2d 640 (1957)).

Moreover, this Court will not disturb a reasonable decision of an agency with expertise, experience and knowledge in the appropriate field. *S. Ry. Co. v. State Bd. of Equalization*, 682 S.W.2d 196, 199 (Tenn. 1984)(citing *Griffin v. State*, 595 S.W.2d 96, 99 (Tenn. Crim. App. 1980)). There is also a presumption that the rates so established are correct and any party who attacks the Commission's findings has the burden of proving that they are illegal or unjust and unreasonable. *CF Indus.* at 540 (citing *Southern Bell T. & T. Co.*, 202 Tenn. 465, 304 S.W.2d 640 (1957)). When the rates set by the agency are attacked there is a heavy burden on those who attacked them to make a convincing showing that the rates are invalid. *S. Bell Tel. & Tel. Co.*, 304 S.W.2d at 649.

This Court discussed the standards of review for Tenn. Code Ann. § 4-5-322(h)(4) and Tenn. Code Ann. § 4-5-322(h)(5) in *Jackson Mobilphone Co., Inc. v. Tennessee Pub. Serv. Comm'n*, 876 S.W.2d 106, 110-11 (Tenn. Ct. App. 1993) with specificity, as follows:

> The standards of review in Tenn. Code Ann. § 4-5-322(h)(4) and Tenn. Code Ann. § 4-5-322(h)(5) are narrower than the standard of review normally applicable to other civil cases. They are also related but are not synonymous. Agency decisions not supported by substantial and material evidence are arbitrary and capricious. *C.F. Indus., Inc. v. Tennessee Public Serv. Comm'n*, 599 S.W.2d 536, 540 (Tenn.1980); *Pace v. Garbage Disposal Dist. of Washington County*, 54 Tenn. App. 263, 266, 390 S.W.2d 461, 463 (1965). However, agency decisions with adequate evidentiary support may still be arbitrary and capricious if caused by a clear error in judgment. *Bowman Transp., Inc. v. Arkansas-Best Freight Sys., Inc.*, 419 U.S. 281, 284, 95 S.Ct. 438, 441-42, 42 L.Ed.2d 447 (1974); *Girard v. City of Glenn Falls*, 173 A.D.2d 113, 577 N.Y.S.2d 496, 499 (1991); 5 Kenneth C. Davis, *Administrative Law Treatise* § 29:7, at 358 (2d ed. 1984).
>
> A reviewing court should not apply Tenn.Code Ann. § 4-5-322(h)(4)' s "arbitrary and capricious" standard of review mechanically. In its broadest sense, the standard requires the court to determine whether the administrative agency has made a clear error in judgment. *American Paper Inst. v. American Elec. Power Serv. Corp.*, 461 U.S. 402, 413, 103 S.Ct. 1921, 1928, 76 L.Ed.2d 22 (1983); *Citizens to Preserve*

Overton Park, Inc. v. Volpe, 401 U.S. 402, 416, 91 S.Ct. 814, 823-24, 28 L.Ed.2d 136 (1971). An arbitrary decision is one that is not based on any course of reasoning or exercise of judgment, *State ex rel. Nixon v. McCanless,* 176 Tenn. 352, 354, 141 S.W.2d 885, 886 (1940), or one that disregards the facts or circumstances of the case without some basis that would lead a reasonable person to reach the same conclusion. *Wagner v. City of Omaha,* 236 Neb. 843, 464 N.W.2d 175, 180 (1991); *Ramsey v. Department of Human Servs.,* 301 Ark. 285, 783 S.W.2d 361, 364 (1990).

Likewise, a reviewing court should not apply Tenn.Code Ann. § 4-5-322(h)(5)'s "substantial and material evidence" test mechanically. Instead, the court should review the record carefully to determine whether the administrative agency's decision is supported by "such relevant evidence as a rational mind might accept to support a rational conclusion." *Clay County Manor v. State Dep't of Health & Environment,* 849 S.W.2d 755, 759 (Tenn.1993); *Southern Ry. v. State Bd. of Equalization,* 682 S.W.2d 196, 199 (Tenn.1984). The court need not reweigh the evidence, *Humana of Tennessee v. Tennessee Health Facilities Comm'n,* 551 S.W.2d 664, 667 (Tenn.1977), and the agency's decision need not be supported by a preponderance of the evidence. *Street v. State Bd. of Equalization,* 812 S.W.2d 583, 585 (Tenn.App.1990). The evidence will be sufficient if it furnishes a reasonably sound factual basis for the decision being reviewed. *Wayne County v. Tennessee Solid Waste Disposal Control Bd.,* 756 S.W.2d 274, 279 (Tenn.App.1988).

Jackson Mobilphone at 110 - 111.

The substantial and material evidence standard has been described as requiring "something less than a preponderance of the evidence . . . but more than a scintilla or glimmer." " *Bd. of Prof'l Responsibility v. Allison,* 284 S.W.3d 316, 322 (Tenn.2009)(citing *Jones v. Bureau of TennCare,* 94 S.W.3d 495, 501 (Tenn.Ct. App.2002)).

The TRA's conclusions of law are subject to a *de novo* review without a presumption of correctness. *Tennessee Envtl. Council, Inc. v. Tennessee Water Quality Control Bd.,* 254 S.W.3d 396, 402 (Tenn. Ct. App. 2007).

A fundamental tenet of the legislative function of ratemaking requires the balancing of the utility's interest in performing its public duties and earning a reasonable return on investment. *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm 'n of W. Va.,* 262 U.S. 679, 691 - 693 (1923). Rates are set for the future, and the estimated effect of all reasonably expected changes affecting the rate of return, including increases in expenses and investments, must be taken into consideration in the establishment of a rate. *Am. Asss 'n. of Retired Persons v. Tenn. Pub. Sev. Comm 'n.,* 896 S.W. 2d 127, 133 (Tenn. Ct. App. 1995). Thus, " a rate should be reasonable not only when it is first established but also for a reasonable time thereafter." *Southern Bell Tel. & Tel..* 304 S.W. 2d at 647(citing *McCardle v. Indianapolis Water Co.,* 272 U. S. 400 (1926)).

A necessary component of utility ratemaking is the authority of TRA to "fix" just and reasonable rates, not simply to approve or deny a utility's request. This Court, in *Consumer Advocate Div. v. Bissell*, noted:

> [T]he legislature has recognized that a public utility may set its own rates, subject to the PSC's power to suspend the rates for a certain period of time while it makes the utility prove that the rates are just and reasonable. *Cumberland Tel. & Tel. Co. v. Railroad and Public Utilities Commission*, 287 F. 406 (M.D.Tenn.1921). If the utility fails to carry that burden, the **agency has the additional authority to fix** rates that meet the just and reasonable criteria. *CF Industries v. Tennessee Public Service Commission*, 599 S.W.2d 536 (Tenn.1980).

Bissell, No. 01-A-01-9601-BC00049, 1996 WL 482970 at * 2 (Tenn. Ct. App. Aug. 28, 1996)(emphasis added).

In ratemaking proceedings, the burden of showing the proposed rates are just and reasonable rests with the utility seeking the change in rates. (Tenn. Code Ann. § 65-5-103(a).

TAWC argues that TRA's use of multiple test years was an arbitrary change of its policy unsupported by substantial and material evidence. In support of this argument it cites *United Cities Gas Co. v. Tennessee Public Serv. Com'n*, 789 S.W.2d 256 (Tenn. 1990). That case, however, held that "the administrative body is and must be free to change its mind and, if there is substantial and material evidence to justify the change, the courts have no reason to overturn the new holding. *Id.* at 259 (citing *Public Service Commission v. General Telephone Company, etc.*, 555 S.W.2d 395 (Tenn.1977)).

TAWC and TRA both set out the rate making methodology employed by the TRA in their briefs. TAWC, relying in part on the testimony of the Consumer Advocate's witness, Terry Buckner, explained that in rate cases, TRA uses a standard methodology to determine if the rates proposed by a utility are just and reasonable. The utility selects a historical "test period" which is usually a recently completed twelve month period. Detailed information regarding the utility's revenues, expenses, rate base and cost of capital for the selected test year is then analyzed. Based on the data from the selected test period, a forecast of revenues, expenses, rate base, and cost of capital is created for the "attrition period" or "attrition year", usually a twelve month period commencing approximately at the anticipated conclusion of the rate case. The attrition period is to be representative of the period of any rate adjustment and is also viewed as the first year during which the TRA's rate order will be applied. Mr. Buckner explained that the selection of the test year is quite important:

> The selection of the timing of the test year may be the most significant single factor in the rate-making process. The more outdated the test year levels operations, the more critical is the need for significant restatement to produce representative levels of future conditions.

Mr. Buckner went on to explain that in the 2008 Rate Case TAWC used a test year that ended November 2007 and an attrition year ending August 2009, whereas the Consumer Advocate used a test year ending March 2008 and its attrition year ending August 2009. He explained that the Consumer Advocate used the later test year "[i]n an effort to eliminate outdated financial information and to shorten the forecast window. . . . " *(Id.* at 0647).

The TRA stated in the Final Order that it is "not limited to adopting one test period for use throughout the case" and that both TAWC's and the Consumer Advocate's tendered test periods were acceptable and that it voted to use "the test period which best fits the individual items being forecasted." In addition, the TRA performed its own analysis for revenues and examined average usage trends over the four years ended March 2005, 2006, 2007 and 2008. The TRA then used this resulting revenue forecast to determine chemical and fuel expenses and it decided not to use a test period analysis when calculating management fees. TAWC contends that TRA's use of multiple test years in the 2008 Rate Case was a departure from its prior policy and that TRA had "expressly rejected the use of multiple test years in the 2006 Rate Case. TAWC claims that in the 2006 Rate Case, TRA stated that it rejected the multiple test periods utilized by Consumer Advocate and accepted TAWC's uniform test period. However, TAWC's contention that TRA rejected the use of multiple test periods is not born out by the June 10, 2008 Order in the 2006 Rate Case. That Order states as follows:

> The Company selected a historical test period of the twelve months ended June 30, 2006 and an attrition period of the twelve months ending February 29, 2008. . . .
>
> The CAPD used a test period of the twelve months ended December 31, 2006 for Revenues. The CAPD used a test period of the twelve months ended October 31, 2006 for the majority of Operations and Maintenance Expenses. For labor related expenses, the CAPD adopted the Company's actual employee level as of January 31, 2007. The CAPD forecast the Plant in Service and Accumulated Depreciation was based on actual balances at December 31, 2006 plus monthly additions and retirements as provided by the Company. The attendant depreciation expense was calculated upon resulting balances. . . .
>
> The panel rejected the multiple test periods utilized by CAPD to forecast Revenues and Expenses and accepted the Company's uniform test period of the twelve months ended June 30, 2006 for Revenues and Expenses, except in the instance of Insurance Other Than Group where abnormal monthly bookings were noted. Further, the panel voted to accept the test period of the twelve months ended June 30, 2006 for Revenues and Expenses, except in the instance of Insurance Other Than Group where abnormal bookings were noted. Further the panel voted to accept the test period of the twelve months ended June 30, 2006 for Rate Base components to which the Company and the CAPD agree in their projections. For Rate Base components to which there was dispute among the Parties, the panel adopted the actual average thirteen month ending at December 31, 2006. . . .

(Final Order, TRA Docket No. 06-00290, June 10, 2006, pp. 19 - 20 (2006 Rate Case)).

The foregoing excerpt from the Final Order from the 2006 Rate Case shows that while TRA did not accept the specific multiple test periods advocated by CAPD for various factions of the rate case, it did not reject the use of multiple test periods when it found them appropriate. In fact, TRA specifically rejected TAWC's test period of the twelve months ending on June 30, 2006 for the Rate Base components that were in dispute among the parties, and instead, applied a test period ending December 31, 2006. *Id.*

Accordingly, TAWC's contention that TRA's use of multiple test periods in the 2008 Rate Case was an arbitrary change of policy that is unsupported by the substantial and material evidence fails, as the Final Order from the 2006 Rate Case clearly shows that TRA utilized more than one test year in that case. [3]

We note that the TRA's discretion with regard to setting rates and the manner in which the agency utilizes test periods is settled law. The TRA has the discretion to utilize an historical test period, a forecast period, a combination of these where necessary, or any other accepted method of rate making necessary to give a fair rate of return. *Powell Tel. Co. v. Tennessee Pub. Serv. Comm'n*, 660 S.W.2d 44, 46 (Tenn. 1983); *Am. Ass'n of Retired Persons v. Tennessee Pub. Serv. Comm'n*, 896 S.W.2d 127, 133 (Tenn. Ct. App. 1994). The Supreme Court in *Powell* noted that "there is no statutory nor decisional law that specifies any particular approach that must be followed by the Commission. Fundamentally, the establishment of just and reasonable rates is a value judgment to be made by the Commission in the exercise of its sound regulatory judgment and discretion." *Powell* at 46 (citing *CF Industries.*, 599 S.W.2d at 542.

Accordingly, neither the courts nor the legislature has established any precise method or formula in setting rates, and the TRA is not bound by any particular approach. *CF Industries,* 599 S.W.2d at 543. As the TRA noted in the Final Order of the 2008 Rate Case, it is not limited to adopting one specific test period in order to make known and measurable adjustments to produce just and reasonable rates. There is simply no requirement that the TRA utilize the specific test period proposed by a public utility.

TAWC contends that the TRA's Final Order in the 2008 Rate case regarding management fees was arbitrary and capricious and violated Tenn Code Ann. § 65-5-103 as it was not supported by substantial and material evidence, did not allow recovery for reasonably expected expenses and was based on the TRA's disregard of overwhelming undisputed evidence. TAWC also contends that the TRA was in error when it rejected

[3] The City of Chattanooga appealed the decision of the TRA in the 2006 Rate Case. TAWC, as appellee, did not raise the issue of whether TRA's use of more than one test period in the 2006 Rate Case was an arbitrary derivation from standing TRA policy. *See City of Chattanooga v. Tennessee Regulatory Auth.*, M2008-01733-COA-R12-CV, 2010 WL 2867128 (Tenn. Ct. App. July 21, 2010).

TAWC's projected attrition year management fees of $4,335,190 and, instead, set the management fees for the attrition year at $3,529, 933. TAWC finds fault with the TRA's setting of management fees based on the amount TAWC forecasted for 2005 in a 2004 Rate Case, which TRA then adjusted upward for inflation and customer growth.

While TAWC contends that its request for management fees of $4,335,190 was supported by"overwhelming undisputed evidence" this is not supported by the record. The record shows that the City and Consumer Advocate presented a vast amount of substantial and material evidence that not only contradicted the evidence put forth by TAWC but supported the final decision made by the TRA. The issue of the management fees requested by TAWC and the Booz Allen Report are inextricably intertwined in the reasoning and Final Order of the TRA in this case. The City and the Consumer Advocate produced extensive evidence regarding the deficiencies of the Booz Allen Report, some of which are detailed heretofore. The TRA was obviously persuaded by this evidence as it concluded in the Final Order that the Booz Allen Report did not adequately address the prudency of the charges imposed on TAWC by the Service Company.

The record in this case demonstrates that the TRA did not act arbitrarily in limiting the amount of management fees for TAWC. In its broadest sense, the arbitrary and capricious standard requires this Court to determine whether the administrative agency has made a clear error in judgment or a decision not based on any course of reasoning or exercise in judgement. *Jackson Mobilphone*, 876 S.W.2d at 110-11. The TRA's decision to reject the Booz Allen Report and other evidence submitted by TAWC to substantiate its projected management fees is supported by material and substantial evidence submitted by the intervenors that a "rational mind might accept to support a rational conclusion". Thus, TAWC did not meet its "heavy" burden of proof that it was entitled to recover $4,335,190 for management fees. Accordingly, we affirm the TRA's decision to award a lessor amount for management fees than requested by TAWC, which was an appropriate exercise of the agency's discretion.

TAWC also appeals the TRA's finding that Booz Allen did not conduct an independent audit as required by the Final Order in the 2006 Rate Case. The TRA found that Mr. Van den Berg, who sponsored the Booz Allen Report, was not independent of TAWC because he had testified on behalf of the Company before the TRA and in other states as an expert witness on behalf of the Parent Company. TAWC contends that the independence imposed by TRA in its Final Order in the 2008 Rate Case was never required in the Final Order in the 2006 Rate Case. This argument is contrary to the testimony of two of TAWC's own witnesses. The Final Order in the 2006 Rate Case mandated that the management audit be in compliance with Sarbanes-Oxley requirements. Mr. Van den Berg and Mr. Manner testified that the only requirement contained in Sarbanes-Oxley that pertains to a management audit or a non-financial audit was that the audit be conducted by an independent firm. As the Final Order in the 2006 Rate Case required compliance with Sarbanes-Oxley and Sarbanes-Oxley requires a nonfinancial auditor to be independent of the company being audited, the Final Order mandated independence. We find this argument without merit.

There is, however, a valid question as to whether the TRA's finding that Booz Allen was not independent of TAWC was correct. Mr. Manner and Mr. Van den Berg, testifying on behalf of TAWC, both stated that the independence requirement in Sarbanes-Oxley as to non-financial statement audits means that such an audit could not be conducted by the financial auditors who conducted financial audits for a company. They both interpreted this provision to mean only that PricewaterhouseCoopers, the financial auditors for TAWC, could not have conducted the management audit of TAWC under the independence requirement of Sarbanes Oxley. Thus, TAWC takes the position that if independence had been required by the Final Order, then Booz Allen was an independent auditor as it was never TAWC's financial auditor. The TRA and the other appellees contend that because Mr. Van den Berg had acted as an expert witness for TAWC and its Parent Company in other matters, he was an advocate for the company and could not be independent. The TRA also points to the testimony of Mr. Van den Berg that he submitted a draft of the Booz Allen Report to TAWC to review and make corrections before he put it in final form as proof that he did not conduct an independent audit. In fact, Mr. Van den Berg stated that TAWC did make some changes to the facts presented in the draft report but made no modification of the analysis. However, we have already affirmed the TRA's rejection of TAWC's requested management fees on another basis, i.e., that TAWC did not meet its burden of proof to show that the charges it requested were prudent.

TAWC also appeals the TRA's setting the projected management fees for the attrition year at $3,529,933 based on the management fees forecasted for 2005 with an upward adjustment for inflation and customer growth. This methodology was advanced by the Consumer Advocate and accepted by the TRA only after the agency determined that the Booz Allen Report and the other evidence presented by TAWC was insufficient to meet TAWC's burden of proof as to the prudency of the Service Company's charges to TAWC.

This issue was addressed by the TRA panel at the hearing. Director Roberson stated that he had no doubt that the Service Company had incurred legitimate expenses, but he could not determine whether the amount of management fees requested by the Company was "a just and reasonable amount based on prudent expenditures" from the Booz Allen Report. He then recommended adopting the methodology advanced by the Consumer Advocate as a way to include management fees in the rate. Director Roberson made it clear that once TAWC had a properly prepared comprehensive management audit done, the TRA would revisit the matter of management fees if the audit showed that the management fees requested were prudent. Accordingly, the Final Order left the 2008 Rate Case open so that TAWC could have the opportunity to obtain a properly conducted management audit in compliance with the Order and submit it to the TRA for consideration. This audit was to be filed within six months of September 22, 2008. Until such time as a management audit was submitted to the TRA, the agency, in recognition that TAWC had incurred some management fees, set

the management fees at $3,529,933.[4]

TAWC objects to the TRA utilizing the methodology proposed by the Consumer Advocate on the basis that the agency had rejected the same methodology, which had also been proposed by the Consumer Advocate, in the 2006 Rate Case. TAWC contends that the TRA's use of this methodology was not supported by the record, failed to give substantial weight to the TRA's 2006 Order and was made without good cause and prior notice to the parties. TAWC maintains that the 2005 forecast made in 2004 Rate Case is not material and there is substantial evidence to support such a decision on management fees in the 2008 Rate Case.

Based on the Authority's finding as to the inadequacy of the Booz Allen Report, there was no substantive evidence before the TRA to support the reasonableness, necessity and prudence of the increase in management fees sought by TAWC. The transcript of the panel's deliberations makes clear that the members accepted that some management fees had been incurred by TAWC. Left with such an evidentiary vacuum, caused by TAWC, the agency used its discretion and arrived at its own value judgment based on its findings in the 2004 Rate Case. The management fees set by the TRA were to be revisited within six months upon a filing of an appropriate management audit by TAWC. The setting of just and reasonable rates is a value judgment to be made by the TRA in the exercise of its sound regulatory judgment and discretion. *CF Indus.* 599 S.W.2d at 542. The TRA recognized the need to set management fees but found that it was provided with inadequate proof as to the prudence of the fees requested by TAWC. Using the fees from 2005 was a reasonable, temporary solution to the dilemma until TAWC could submit a proper management audit. As noted, the arbitrary and capricious standard requires this Court to determine whether the administrative agency has made a clear error in judgment or a decision not based on any course of reasoning or exercise in judgement. *Jackson Mobilphone*, 876 S.W.2d at 110-11. We hold this action was not arbitrary and capricious and the use of the 2005 management fees, under the circumstances, was not error.

TAWC argues that the TRA erred when it disallowed TAWC's request to recover $285,000 it paid for the preparation of the Booz Allen Report. To support this position, TAWC makes the same argument it made regarding its argument that the TRA erred when it did not accept the findings of the Booz Allen Report. The TRA panel concluded that the Booz Allen Report did not comply with the Final Order in the 2006 Rate Case because it did not adequately address the prudency of the management fee and because Mr. Van den Berg, the sponsor of the Report, was not independent as required by Sarbanes-Oxley. Based on this finding, the TRA declined to include the cost of the Report in the requested rate. As noted, we find that there was substantial and material evidence in the record to support the TRA's finding that the Booz Allen Report was inadequate because it did not sufficiently address whether the costs allocated to TAWC were incurred as a result of prudent management

[4] The record does not establish whether a management audit was submitted within the six month period or, if one was presented to the TRA, or whether the management fees were adjusted.

decisions. We hold the TRA did not abuse its discretion when it declined to accept the management fees requested by TAWC. We also find that as the Booz Allen Report could not be used by the TRA to determine whether the requested fees were prudent and necessary, the rate payers should not be required to pay for the cost of the Report. The TRA's disallowance of the cost of the report is affirmed.

TAWC claims, that in calculating revenues, the TRA departed from its long-standing practice by rejecting the use of a weather normalization adjustment (WNA) methodology based on data collected over an extended number of years without substantial and material evidence to justify the change. The Consumer Advocate, in its brief, explained "normalization" in the rate-making context: "In setting just and reasonable rates, it is standard practice to attempt to "normalize" or adjust projections of revenues and expenses for a variety of know and measurable changes. If such adjustments are not made, revenues and expenses may dramatically exceed or drastically fall short of expectations with a variety of consequences for consumers and TAWC." The revenues of a water utility can be effected by the amount of precipitation experienced in the utility's area. A drought may cause consumers to use more water for watering their lawns and a period of excessive rain may cause the consumers to use less water. In rate-making the forecasting of revenues is an essential element in the process. If revenues are projected to be lower in the future and expenses are expected to rise, the revenue requirement, and thus the rates, will be higher. Therefore, if water usage per customer is predicted to decrease, rates will need to be higher to cover expenses. Here, TAWC's proposed WNA methodology projected a reduction in revenue of approximately $1.3 million dollars.

As part of the 2008 Rate Case, TAWC introduced testimony from its expert witness, Dr. Edward Spitznagle, a professor of mathematics and statistics. Dr. Spitznagle explained that he tested several models for weather normalization and concluded that soil moisture was the most accurate predictor of future water consumption. Dr. Spitznagle employed a set of soil moisture data that was complied over the past thirty years to normalize the forecast and is set out in the Palmer Drought Severity Index (PDSI). The Company's projected attrition period Revenues was $37,142,460. The Consumer Advocate forecasted revenue for the attrition period at a higher level, $39,492,768 and made no normalizing adjustments. The TRA panel adopted attrition period revenues of $38,934,309 by using a combination of the Company's, the Consumer Advocate's, and its own forecast. In its Final Order, the TRA explained that it "found neither the Company's nor the Consumer Advocate's methodology for forecasting residential and commercial average usage persuasive and instead performed its own analysis, examining average usage trends for the residential and commercial classes over the four years ended March 31, 2005, 2006, 2007 and 2008." The TRA explained that it adopted residential class attrition period revenues based on this methodology and the Company's forecasted number of bills. For the commercial class, the TRA's analysis produced almost the identical result the TAWC had arrived at, thus it adopted the TAWC's commercial class attrition period forecasted revenue.

TAWC claims that TRA had consistently approved the use of weather normalization

for forecasting revenue in prior rate cases. The TRA, however, rejected this claim explicitly in the Final Order when it stated:

> As to the weather normalization adjustment ("WNA"), the Company made representations that the model it used in forecasting residential and commercial average usage had be previously adopted by the Authority. Not withstanding an occasional concurrence by Intervenor witnesses, this assertion is incorrect. In earlier TAWC rate case dockets, Docket Nos. 03-00118 and 04-00288, TAWC's revenues were settled. Although the parties in those dockets settled on the amounts proposed by TAWC, the settlements did not mention any agreed upon methodology for calculating those revenues. The Company's revenue forecast was adopted in Docket No. 06-00290; however, the Authority did not adopt or endorse TAWC's WNA model. In this docket, the panel did not adopt the Company's entire revenue forecast or the Company's WNA model. Nevertheless, the Authority adopted the Company's commercial class attrition period revenue in this docket because despite disagreeing with the Company's methodology, the result was reasonable.

TAWC responds to the TRA's denial in the Final Order that it had "adopted" WNA methodology by stating that the TRA's incorporation of TAWC's WNAs into the orders approving settlement in Docket Nos. 03-00118 and 04-00288 and express adoption of TAWC's revenue adjustments in the 2006 Rate Case [Docket No. 06-00290] undermines the TRA's denial that it had adopted the WNA methodology. TAWC argues that "it is clear that the TRA has in practice routinely accepted and reinforced the use of WNA methodology in attrition year revenue projections, and the TRA's rejection of the WNA methodology in the instant matter departs from this precedent." TAWC goes on to claim, without citation to statute or case law, that under Tennessee law, the TRA may not alter its long-standing policy of using WNA for revenue projections unless there is substantial and material evidence supporting and justifying the decision. TAWC claims that the TRA did not make its decision to reject the methodology supported by TAWC based on substantial and material evidence and did not explain why it rejected the methodology. Tennessee law, however, does not provide that the TRA is bound to follow rate-making methodology it has employed in the past. The Tennessee Supreme Court discussed in detail the process of rate-making in *CF Indus. v. Tennessee Pub. Serv. Comm'n*, 599 S.W.2d 536 (Tenn. 1980) and explained why the TRA's predecessor, the Tennessee Public Service Commission, was not bound by any one rate-making methodology as follows:

> The criteria by which the Commission should be guided have received only generalized comments in our reported decisions. This is proper because the courts are playing a limited role in reviewing actions which essentially are legislative in character. Rate making is not a judicial function and we accord the Commission great deference in reviewing its decisions. On fixing rates in general the Court has spoken in terms of what is just and reasonable "under the proven circumstances," of "regard to all relevant facts" and to a rate "in the zone of reasonableness." *Southern Bell Telephone & Telegraph Co. v. Tennessee Public Service Com'n.*, 202 Tenn. 465, 304

S.W.2d 640 (1957).

The Uniform Administrative Procedures Act authorizes the agency to take notice of "generally recognized technical and scientific facts within the agency's specialized knowledge," and in the evaluation of evidence the agency is specifically authorized to utilize its "experience, technical competence, and specialized knowledge." Section 4-5-1097, T.C.A.

Thus, the Public Service Commission in rate making and design cases is not solely governed by the proof although, of course, there must be an adequate evidentiary predicate. **The Commission, however, is not hamstrung by the naked record. It may consider all relevant circumstances shown by the record, all recognized technical and scientific facts pertinent to the issue under consideration and may superimpose upon the entire transaction its own expertise, technical competence and specialized knowledge. Thus focusing upon the issues, the Commission decides that which is just and reasonable. This is the litmus test nothing more, nothing less.**

In *United Inter-Mountain Telephone Co. v. Public Service Com'n*, 555 S.W.2d 389 (Tenn.1977), this Court noted that "(t)he impact of the Administrative Procedures Act on the review of the decisions made by state boards, commissions and agencies, including the Public Service Commission, is massive " (emphasis supplied), and pointed out that "(i)t casts upon the Commission the heavy burden of a sound, reasoned, and judicious approach in the exercise of its jurisdiction." 555 S.W.2d at 392.

We reiterate that neither the legislature nor the courts have established any precise formula or yardstick to guide the Commission. As pointed out by the Georgia Supreme Court in *Allied Chemical Corp. v. Georgia Power Co.*, 224 S.E.2d 396 (Ga.1976): The process of setting rates is not required to follow any particular course, so long as the end result does not violate the "just and reasonable requirement" requirement . . . . 224 S.E.2d at 399.

The Oklahoma Supreme Court, in Application of Arkansas Louisiana Gas Co., 558 P.2d 376 (Okl.1976), pointed out:

> Commission is not bound by a single formula or a combination of formulas in fixing rates and none is exclusive or more favored than the others. (citation omitted) There is no precise statutory or court announced basis for determining the justness or reasonableness of class rate level structures or relationships, the Court generally holding that rate making is the responsibility of a regulatory commission effectively exercising its discretion upon sufficient evidence before it. 558 P.2d at 379.

Finally, we adopt the concise and correct conclusions of the Minnesota Supreme Court in St. Paul Area Chamber of Commerce v. Minnesota Public Service Com'n., 312 Minn. 250, 251 N.W.2d 350 (1977):

> (W)e must presume that the members of the commission itself, with their supporting staff, have in their grasp practical knowledge in the field of utilities regulation not possessed by either the courts or laymen in general.
>
> The commission, in order to carry out its mandate from the legislature to establish "just and reasonable" rates, must be able to draw on its own internal sources of knowledge and experience. As with the legislature itself, we assume that it does so in each instance and that we ought not to interfere unless it should clearly exceed its statutory powers. 251 N.W.2d at 354.

We cannot say on this record that the Commission exceeded its regulatory judgment and discretion in acting without a cost of service study in a rate design case. The imposition of this requirement would be an unwarranted intrusion into the rate making process.

CF Indus., 599 S.W.2d., 542-43(emphasis added); *see also Powell Tel. Co.*, 660 S.W.2d at 46.

Based on the Supreme Court's pronouncements in *CF Industries*, the TRA is not required to follow a particular methodology it has used in the past as long as the methodology it chooses allows it to arrive a determination of a rate that is just and reasonable. Moreover, the TRA is not limited to considering just what is in the record as it may consider, in addition to the proof, "recognized technical and scientific facts pertinent to the issue" and may "superimpose . . . its own expertise, technical competence and specialized knowledge."

TAWC's contention that the TRA must use WNA as part of its revenue projection methodology is without merit. The TRA is only required to use its regulatory judgment and exercise its discretion to decide what is a just and reasonable rate.

The TRA's rejection of TAWC's proposed use of WNA calculations is amply supported by material and substantial evidence in the record. The consistency and end result of the proposed WNA was challenged by the intervenors, particularly the Consumer Advocate. Terry Buckner, testifying for the Consumer Advocate, explained that in the 2006 Rate Case, the impact of Dr. Spitznagle's WNA was a $221,000 downward adjustment to the projected revenue for the attrition year. This projection, when examined in retrospect, was incorrect as TAWC's revenues after the 2006 Rate Case actually increased. Mr. Buckner went on to explain that notwithstanding this result, a year later, Dr. Spitznagle's WNA revenue adjustment jumped downward again from $221,000 to $1.36 million in the 2008 Rate Case.

According to Mr. Buckner, after little more than updating the model to include a slightly different 30 year picture of PDSI data, the WNA's calculation resulted in a rate adjustment six times greater than the adjustment proposed in the 2006 Rate Case. *Id.*

The Consumer Advocate's witness also stated that the final result of the WNA model relied on by Dr. Spitznagle produced a result that defied common sense. His model calculated that residential consumers will use 141 gallons of water per day. Based on the WNA model's projections, TAWC would sell less water to residential customers than it did in 2004 when customers were estimated to use 146 gallons of water a day. According to PDSI data in the record, 2004 was the fourth wettest year in Chattanooga out of 113 years. Thus, the WNA model relied on by TAWC projected that the Company would sell less water under "normal weather conditions" than it did during one of the wettest years on record. The Consumer Advocate concluded that given that 2004 was an exceedingly wet year and that the record shows that TAWC was delivering water to 3,000 more residential customers in 2008 than it did in 2004, "the end result of Dr. Spitzenagel's WNA mode defies economic reality" and is not reasonable and credible.

Dr. Spitzenagel testified that while his WNA models had been used in three rate cases before the TRA filed since 2003, he had only reviewed the accuracy of these WNA forecasts by comparing them to the actual revenue for one of those years. A retrospective comparison of the models' results with the real revenues would have been a simple exercise to demonstrate the accuracy or inaccuracy of the Company's WNA forecasts. The record also shows that TAWC relied on Dr. Spitznagle's analysis that showed a marked decline in water usage over the past thirty years. However, the intervenors showed that, in fact, water usage over ten-year, five-year and three-year average periods show the decline in usage has ended.

Evidence was introduced at the hearing that called into question the value of the PDSI, the drought index employed by Dr. Spitznagle to calculate the WNA. In a publication by the National Academy of Sciences, the water regression analysis used by Dr. Spitznagle was addressed and the limitations of the use of the PDSI was noted with references to specific academic criticism of the PDSI. This publication was introduced into evidence and after the hearing, the TRA formally took administrative notice of the publication. There was further evidence in the record that the use of the PDSI for normalizing water usage by public utilities is not widespread.

When the TRA rejected the weather normalization methodology sponsored by TAWC, its decision was clearly supported by substantial and material evidence in the record. As explained in the Final Order, after considering the testimony of the expert witnesses presented by the parties, the TRA exercised its discretion and utilized its own experience, knowledge and expertise in its determination of the weather normalization adjustment to project revenues. The TRA conducted its own analysis based an examination of average usage trends for the residential and commercial classes over a four-year period. The years used in this analysis, 2005 - 2008, included periods of drought and high amounts of rainfall. The TRA's use of an average of usage trends over the four year period took into account the

impact of weather as well as other impacting factors is accounted for and built into the consumer usage utilized in the analysis. The TRA took the results of this methodology and adopted normalized revenues for the residential customers that was independent of the forecasts proposed by both the Company and the Consumer Advocate. *Id.* The results arrived at by the TRA for the commercial customers was almost identical to that proposed by TAWC, thus the TRA adopted the Company's forecast for that class of consumers. *Id.* There was evidence to show that the methodology used by the TRA based on years of actual consumer usage is a common method of normalizing revenues for water utilities. Based on the foregoing, the methodology utilized by the TRA was a common and accepted practice, based on material and substantial evidence and was within the TRA's sound regulatory judgment.

TAWC contends that the TRA's decision to reduce the Company's recovery of Rate Case Expenses was an unlawful exercise of discretion and unsupported by material and substantial evidence. The Company argues that the award of $275,000, only half of its projected expenses, should be reversed because: (1) the decision represents a change in policy without substantial and material evidence to support the change; (2) the decision disregards the facts and circumstances of the case without providing any rationale or explanation that might lead a reasonable person to draw the same conclusion; and (3) the decision violates Tenn. Code Ann. § 65-5-103's "just and reasonable" standard by failing to take into consideration the estimated effect of reasonably expected expenses".

In support of its contention that the TRA departed from its usual policy and custom of allowing utilities recovery of rate case expenses, the Company cites to the following three cases where such an award was made. In the 2006 Rate Case, In *In re Aqua Utilities Co.*, and *In re Chattanooga Gas Co.*

TAWC contends that by disallowing one half of the Company's proposed rate case expenses, the TRA "made and abrupt and unexpected change in the sound policy of allowing full recovery of rate case expenses without any explanation or substantial and material evidentiary support for the change." TAWC further argues that the change in "policy" was particularly inappropriate because the TRA concluded that a rate increase was needed, although the approved increase was less than the Company had requested.

TAWC states that the expense of the rate case was reasonable, necessary and conservative given how highly contentious and heavily litigated the 2008 Rate Case was. We acknowledge that extensive discovery, multiple motions and multiple hearings occurred in the pre-hearing phase of the 2008 Rate Case. At the hearing itself multiple witnesses filed prepared testimony and testified before the panel. The record on appeal consists of sixty-two volumes and 9319 pages, the hearing transcript is contained in twenty-two volumes and is 2240 pages. We recognize and accept that this work was generated at considerable expense.

TAWC states that no substantial and material evidence was offered that the rate expenses sought were unreasonable and that the evidence offered by TAWC regarding the

reasonableness of the expenses was not contradicted by any party. The Company cites the Consumer Advocate's witness, Mr. Buckner, as testifying that the number of issues being contested and the complexity of those issues necessarily increases the costs of rate cases.

On appeal, the TRA does not dispute that reasonable and properly incurred expenses associated with a rate case should be recoverable by a utility. In support of this concept, the TRA cites to *W. Ohio Gas Co. v. Pub. Utilities Comm'n of Ohio*, 294 U.S. 63, 68, 55 S. Ct. 316, 319, 79 L. Ed. 761 (1935) wherein the United States Supreme Court held that a public utility cannot include negligent or wasteful losses among its operating charges in a rate proceeding and only property and necessary expenses should be recovered. The TRA acknowledges that it is through the rates approved by the TRA and paid by the utility's customers that TAWC recovers all of its necessary operating expenses. However, TRA takes the position that the ability of a utility to recover its expenses is not "absolute nor immutable" and it is "neither arbitrary or capricious when, in the exercise of its judgment and discretion, the Authority disallows recovery of expenses that it deems unnecessary, improvident, or improper."

The TRA goes on to justify its decision to allow only one-half of the rate case expenses proposed by TAWC and leave the remaining half to be paid by the Company's shareholders by providing details of the costs of the "four labor-intensive utility cases [filed] in the five years spanning 2003 through 2008". According to the agency, the total requested rate case expenses associated with those four cases was $1.325 million although the actual expenses were estimated to be in excess of $1 million each for the 2006 and 2008 rate cases. The TRA, in its brief expresses its growing concern that TAWC has developed a distinct pattern of filing "increasingly frequent and progressively more costly rate cases . . . in rapid succession . . . . " The TRA states in its brief, "particularly in light of its poor history of substantiating the requests [for regulatory expenses] that it makes, demonstrating little restraint, the Company's expectation of passing on larger and larger rates case expenses year over year to its ratepayers, is inexplicable and untenable."

The TRA makes clear in its appellate brief that it disapproves of the TAWC's trend of filing frequent, increasingly expensive and litigious rate cases and even went as far as to contend that "in light of the Company's history and pattern of filing unsubstantiated rate cases, particularly evident in this case, the inordinate costs involved here are unreasonable. However, the record and Final Order are devoid of the foregoing accusations made by the TRA about TAWC. The record and Final Order do not explain what specific expenses the TRA deemed unnecessary, improvident, or improper or that the Authority closely examined the costs associated with the rate case to determine the portion to be recovered from rate payers and the portion to be born by the shareholders. Such an examination should have taken place and its results included in the record and Final Order. Based on the lack of such findings, the TRA's decision to only include one half of the cost of the rate case in the rate was arbitrary. Accordingly, we reverse the Commission of the TRA on this issue and award TAWC the full amount of its proposed rate case expenses.

Finally, the TAWC contends that the TRA'S decision to cap UfW at 15% was an abuse of discretion and unsupported by material and substantial evidence. The Company takes the position that the TRA has historically taken into consideration all of TAWC's costs for fuel, power, and chemicals in determining TAWC's forecasted expenses. The Company explained that these costs directly relate to the treatment and pumping of all water in the distribution system whether it is water delivered and billed to customers or UfW. The Company states on appeal that TRA "has historically allowed TAWC to recoup the full costs of treating and providing all of its water regardless of the volume of UfW in the system." TAWC claims that TRA "broke" from this historical policy in its final order when it capped the percentage of UfW it could include in the forecast for fuel, power and chemical costs to 15%. The Final Order states that "[r]ecognizing the importance of conserving water, which is one of the state's most valuable natural resources, the panel established a baseline efficiency standard. Based on the evidence presented, the panel limited the unaccounted-for-water percentage to fifteen percent." TAWC contends that the TRA could not have based this decision on the evidence as it clearly showed that TAWC's attrition year UfW would be 19.97% and that this level is reasonable based on the age of the water system and its geographical location in a mountainous area.

First, as to the historical precedent argument made by TAWC, while the TRA may not have ever set a 15% standard for UfW in a rate case brought by TAWC, it has recently imposed such a standard in other rate cases involving other TRA regulated water utilities. The Authority points to the 2006 rate case *In re Aqua Utilities Co.*, TRA Docket No. 06-00187. In that case, while establishing a standard UfW percentage for ratemaking purposes, the panel said:

> Generally, the Authority finds a ten percent (10%) unaccounted-for-water level, as recommended by the American Water Works Association, is the proper percentage for purposes of setting rates, ***absent good cause shown.*** (Emphasis provided).

The TRA found that Aqua Utilities had shown good cause to increase the standard UfW percentage in that case to 15%. TRA claims that its decision in *Aqua* "pioneered" the Authority's policy concerning UfW and the reasonableness of utilizing a 15 % UfW standard was likewise included in a later settlement agreement between the parties in a rate case filed by Hickory Star Water Co., and approved by the TRA on December 30, 2008.[5]

The record demonstrates there was material and substantial evidence presented to the TRA regarding the use of the 15% standard. The president of TAWC , Mr. Martin, agreed that the 15% standard is used internally at TAWC and that it is a "good industry average." The TRA's use of the 15% UfW standard was based on material and substantial evidence and

---

[5] *See In re Aqua Utilities Co.*, TRA Docket No. 06-00187, *Final Order*, 2007 WL 4812199 at *5 (Tenn. Reg. Auth. Nov. 27, 2007); *In re Petition of Hickory Star Water Co. LLC for Approval of Adjustment of its Rates and Charges*, TRA Docket No. 08-00051, *Order Approving Settlement Agreement*, Ex. A, Proposed Settlement Agreement (Dec. 30, 2008).

was not arbitrary. We affirm the TRA's order as to UfW.

In conclusion, we affirm the ruling of the TRA's except for its ruling excluding one-half of the expenses TAWC sought to recover as rate case expenses.

In our discretion we assess 80% of the costs of the appeal to Tennessee American Water Company, and 20% of the expenses on appeal to the Tennessee Regulatory Authority.

HERSCHEL PICKENS FRANKS, P.J.