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March 21, 2011

**VIA HAND DELIVERY**

filed electronically in docket office on 03/21/11

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

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

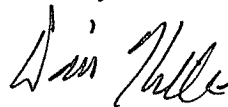
Dear Chairman Freeman:

Enclosed please find Tennessee American Water Company's Post-Hearing Brief in Support of Its Petition to Change and Increase Certain Rates and Charges.

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

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

Sincerely,



David Killion

Enclosure

cc: Mr. David Foster, Chief of Utilities Division (w/o enclosure)  
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Chairman Mary Freeman  
March 21, 2011  
Page 2

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## **TABLE OF CONTENTS**

<b>I. Introduction.....</b>	<b>1</b>
<b>II. Travel of Case.....</b>	<b>6</b>
<b>III. Criteria for Establishing Just and Reasonable Rates.....</b>	<b>9</b>
<b>IV. Test Period and Attrition Period .....</b>	<b>10</b>
<b>V. Contested Issues .....</b>	<b>12</b>
A. Revenues .....	12
Adjustments to Per Book Revenues.....	13
Adjustments for Weather .....	14
1. Declining Water Consumption Must be Considered in Projecting Revenues .....	14
2. The Company’s Revenue Forecasts Consistently Have Been the Most Accurate Predictor of Actual Revenue Levels.....	16
3. TAWC Demonstrated that the CAPD and CRMA’s Revenue Projections will Not Accurately Predict Going-Level Revenues .....	18
4. The Intervenors’ Criticisms of Dr. Spitznagel’s Model Have No Merit .....	20
B. American Water Resources.....	22
C. Expenses .....	26
Cost Savings Measures .....	27
Increased Operations & Maintenance Expenses.....	30
1. Fuel & Power .....	32
2. Chemicals.....	33
3. Waste Disposal.....	34
4. Labor Costs .....	35
5. Management Fees .....	42
6. Insurance Other than Group.....	79
7. Customer Accounting .....	80
8. Uncollectibles .....	80
9. Rents .....	80
10. General Office.....	81
11. Miscellaneous .....	81
12. Maintenance.....	82
13. Unaccounted for Water .....	83
14. Regulatory Expense .....	85
D. Rate of Return .....	90

Capital Structure .....	90
1. The Company's Proposed Capital Structure and the Historical Capital Structures of TAWC and AWWC .....	90
2. Use of Double Leverage .....	92
3. Impact of the CAPD's Proposed 33.72% Common Equity Structure .....	94
Return on Equity .....	95
1. The Company's Proposed Return on Equity .....	95
2. Squaring TAWC's Proposed Return on Equity with the General Economy .....	97
3. The CAPD Fails to Adjust its Return on Equity to Account for the Increased Financial Riskiness of a 33.72% Equity Structure .....	98
4. Additional Errors in the CAPD's Cost of Capital Recommendation .....	99
5. The CAPD's Return on Equity Recommendation is Manifestly Unjust and Would Be Impossible to Achieve, Even if Adopted, Given the CAPD's Recommendations in this Rate Case.....	102
E. Taxes .....	103
Income Tax Expense .....	103
FIN 48 .....	105
Accumulated Deferred Income Taxes (ADITs).....	107
SFAS 109 vs. APB 11.....	107
Property Tax.....	108
F. Rate Base .....	109
Capital Expenditures .....	109
1. Used and Usefulness .....	111
Utility Plant in Service.....	113
Construction Work in Progress (CWIP) .....	113
Working Capital.....	114
Accumulated Depreciation.....	117
G. Valve Maintenance .....	118
H. Rate Structure.....	121
<b>VI. CONCLUSION .....</b>	<b>122</b>

**BEFORE THE TENNESSEE REGULATORY AUTHORITY  
NASHVILLE, TENNESSEE**

**IN RE:**

**PETITION OF TENNESSEE AMERICAN  
WATER COMPANY TO CHANGE AND  
INCREASE CERTAIN RATES AND  
CHARGES SO AS TO PERMIT IT TO  
EARN A FAIR AND ADEQUATE RATE  
OF RETURN ON ITS PROPERTY USED  
AND USEFUL IN FURNISHING WATER  
SERVICE TO ITS CUSTOMERS**

**Docket No. 10-00189**

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**TENNESSEE AMERICAN WATER COMPANY’S  
POST-HEARING BRIEF IN SUPPORT OF ITS PETITION TO  
CHANGE AND INCREASE CERTAIN RATES AND CHARGES**

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Tennessee American Water Company (“TAWC” or the “Company”) submits this post-hearing brief as directed by the Tennessee Regulatory Authority (“TRA”) Directors at the conclusion of the rate case Hearing. As described fully herein, the Company has met its burden of proof on all issues raised in this docket and demonstrated that the Company’s Petition should be granted.

**I. Introduction**

The Company absolutely must be given the opportunity to earn a reasonable rate of return by setting rates at a level that attracts capital, insures the financial integrity of the utility, and provides the level of returns commensurate with investments of similar risk. This much is guaranteed by the United States Constitution as interpreted by the United States Supreme Court.<sup>1</sup> The Company filed its Petition in this case because it has not had a reasonable opportunity to earn a fair rate of return since the 2008 rate case order. In fact, the Company’s return since 2008

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<sup>1</sup> See *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Bluefield Water Works & Improvement Co. v. P.S.C.*, 262 U.S. 679, 692-93 (1923).

has been, at best, dismal (2.8% in 2009 and 2.66% in 2010) and the Company is projected to operate at a loss in the attrition year 2011 if current rates continue to remain in place.<sup>2</sup> Unfortunately, the Intervenor's recommendations in this rate case, if adopted, would do nothing to change this fate. In fact, the CAPD's suggested increase of \$1.1 million would only result in a 0.23% rate of return in the attrition year.<sup>3</sup> The danger of not setting rates at a level that allows the Company to earn a reasonable rate of return is that the Company will not be able to continue fulfilling its public duty of providing safe, reliable and high quality water service to its customers in the Chattanooga area.

The Company now has come before this Authority and presented overwhelming evidence in support of the rate increase. Specifically, the Company has presented thousands of documents, the testimony of its employees, and the testimony of leading experts in their respective fields proving that TAWC's cost of service exceeds its revenues by \$9.984 million.<sup>4</sup>

The Intervenor's love to throw around sound bites about the size of this request and the supposed frequency of rate filings. But when all the facts are examined and the whole picture is viewed, it becomes clear that this rhetoric is misleading. The Company's \$9.984 million request is based upon the actual and conservatively projected cost increases that the Company will incur in the attrition year, its projected revenues that are based on the historically most accurate method for projecting revenues, and the capital investments that must be undertaken to ensure the continued integrity of its infrastructure – an infrastructure that is under unique stresses due to its age and the topography of the Company's service area. The dollar amount of the request in

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<sup>2</sup> Michael A. Miller, Rebuttal Ex. MAM-1.

<sup>3</sup> Michael A. Miller, Rebuttal Ex. MAM-1; Michael A. Miller, Vol. VI A, Tr. 33:4-8 (March 7, 2011).

<sup>4</sup> Indeed, the Company presented evidence, at the TRA's request, showing that the Company actually will incur additional expenses over the requested \$9.984 million. The Company understands that it cannot obtain, and it is not seeking a rate increase over \$9.984 million, but offers this evidence for the Authority to consider in making its decision.

this case reflects the fact that the 2008 rate case order disallowed expenses that the Company necessarily and actually incurred and overstated the Company's projected revenues, all of which prevented the Company from even the opportunity to earn a fair rate of return. This reason, combined with the undeniable increase in expenses and historical decline in water consumption, is why the Company filed its Petition at this time.

First, the Company presented ample indisputable evidence that costs have risen for many of the items that the Company must purchase in order to provide water service. Additionally, the economic recession that hit since the 2008 rate case order greatly diluted the Company's employee retirement funds, which the Company is obligated, by law, to replenish. These cost increases are completely beyond the Company's control. For those costs that TAWC can control, the Company has undertaken substantial cost-savings efforts that have been successful (in the short term), as evidenced by the fact that controllable expenses have increased less than the rate of inflation.<sup>5</sup>

Management fees are a Company expense that the Intervenors ceaselessly pursue and it is obvious that the Intervenors are disappointed now that an independent auditor, approved by the TRA, has evaluated the Company's management fees and submitted a comprehensive management audit confirming the reasonableness of the \$5.226 million in management fee charges to TAWC from the American Water Works Service Company ("AWWSC"). Mr. Michael Miller, Mr. John Watson, and TAWC's experts all established that AWWSC's services are necessary for the provision of water services and that the services are provided by AWWSC at the lower of cost or market. TAWC also proved that its management fees are in line with those charged by comparable utility service companies, and in fact are on the low end of

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<sup>5</sup> See Michael A. Miller, Rebuttal Ex. MAM-12, at 2, 3 of 3.



comparable utilities as shown by both of the Cost Comparison studies – one completed by the independent management auditors and a second independent cost comparison study completed by Mr. Baryenbruch. The Management Audit and testimony of Ms. Schumaker, coupled with the evidence presented by the other TAWC experts in this case, should once and for all put this issue to rest. Despite the Intervenor's hopes and best efforts, they cannot overcome the evidence in this case, which clearly proves that the management fees sought are appropriate.

Second, revenues continue to decline due to the downward trend in per customer water usage – a trend that is irrefutable and that has continued for more than 20 years.<sup>6</sup> The historical data does not lie. Moreover, the revenues and water consumption projected by the TRA in 2008 were far greater than the Company's actual revenues and water consumption in 2009 and 2010, guaranteeing a revenue deficiency. Upon the suggestion of the Tennessee Court of Appeals, the Company provided a comparison in this case of its historic revenue projections, which utilize Dr. Edward Sptiznagel's statistical forecasting model, along with the other parties' historic revenue projections, to actual historic consumption data. The results could not be clearer – Dr. Sptiznagel's customer usage projections have been far more accurate than any other party's projections. Dr. Sptiznagel's projection of reduced water consumption for the attrition year, combined with stagnant customer growth, undeniably leads to reduced revenues for the Company.

The Company also presented the testimony of Dr. James Vander Weide, a leading cost of capital expert, who conducted an in-depth economic study of comparable utility companies. Based on that study, in his expert opinion, an 11.5% return on equity utilizing the Company's actual stand alone capital structure is appropriate. The CAPD was the only other party to

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<sup>6</sup> This fact does not change even if there are certain years reaching historical drought levels, which cause revenues to increase. Rates must not be set on abnormal consumption years, but rather on normalized years.

propose an alternative return on equity and capital structure through its witness, Dr. Christopher Klein. No matter how Dr. Klein calculated his recommendation, the result he proposes gives TAWC a 33.72% equity structure – despite the fact it has never come close to a 33.72% equity structure and that this equity structure is significantly lower than those of Dr. Klein’s proxy companies. Further, he compounds his flawed analysis by arguing for a 9.0% return on equity. Dr. Vander Weide and Mr. Miller testified, unequivocally, that this combination would make it extremely difficult to attract capital, would create a capital structure that makes TAWC “non investment grade”, and that this combination has no basis, whatsoever, in financial theory.

The Company also demonstrated, and there was no credible evidence to the contrary, that there are many needed capital expenditures in the attrition year that it no longer can put off due to lack of funding. TAWC’s infrastructure is over 135 years old and extraordinary pressure is needed to pump water to its mountainous service areas. Without adequate funding for these capital expenditures, serious service issues could become a reality.

Finally, the Company presented the testimony of Mr. Miller and Mr. James Warren, one of the nation’s top regulatory tax experts, to demonstrate that the Company has \$1.068 million in revenue requirement due to a tax liability that it is not recovering in rates. Mr. Warren’s testimony, and even Mr. Buckner’s own admissions on cross-examination, illustrate that the CAPD’s income tax calculation did not adjust to include two sources of TAWC’s actual tax liability. There is no doubt that TAWC is entitled to recover its tax liability in rates, and now is the time for the Authority to make these needed corrections to the Company’s rates.

The Company has clearly demonstrated that its revenues are \$9.984 million below the cost of providing water service, and the evidence supporting the Company’s request is in fact overwhelming. When combined with the fact that the impact on the typical residential customer

is only 15 cents a day, it becomes abundantly clear that the just and reasonable course for this Authority to take is to grant the Company's Petition.

## **II. Travel of Case**

On September 17, 2010, the Company filed its Petition seeking a rate increase to allow it to "attract the necessary capital required to continue to provide adequate water service to the people of the City of Chattanooga and surrounding area and to meet the demand for water service in the foreseeable future."<sup>7</sup> In the Petition, TAWC proposed to place into effect customer rates that will produce an overall rate of return of 8.38% on a rate base of \$125,472,973.<sup>8</sup> The additional revenue requirement would be approximately \$9,984,463.<sup>9</sup> At a regularly scheduled Authority Conference held on September 27, 2010, the panel voted unanimously to convene a contested case proceeding and to appoint the Chairman of the Authority as Hearing Officer for the purpose of preparing this matter for hearing, including handling preliminary matters and establishing a procedural schedule to completion.

During September and October 2010, the Consumer Advocate and Protection Division of the Office of the Attorney General (the "CAPD"), the Chattanooga Regional Manufacturers Association (the "CRMA"), the City of Chattanooga (the "City"), the Utility Workers Union of America, AFL-CIO and UWUA Local 121 (the "Union"), Walden's Ridge Utility District, and the town of Signal Mountain (collectively, "Intervenors") all filed Petitions to Intervene. By Order dated October 12, 2010, the Hearing Officer granted the intervention petitions of the

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<sup>7</sup> Petition at 5, Docket No. 10-00189 (Sept. 17, 2010).

<sup>8</sup> *Id.* TAWC's current position with respect to a just and reasonable rate of return and rate base amount is discussed in the sections titled "Rate Base" and "Rate of Return," *infra*.

<sup>9</sup> *Id.*

CAPD, the CRMA, and the City.<sup>10</sup> By Order dated November 12, 2010 the Hearing Officer granted the intervention petitions of the Union, Walden's Ridge Utility District, and the town of Signal Mountain and established a Procedural Schedule.<sup>11</sup> The Procedural Schedule called for discovery to commence on November 1, 2010.<sup>12</sup> On January 14, 2011 the Hearing Officer entered an Order modifying the Procedural Schedule with respect to responses to the second round of discovery.<sup>13</sup> On January 31, 2011 the Authority issued its Notice of Hearing that set this matter for hearing beginning February 28, 2011. The Notice also set the Pre-Hearing conference in this matter for February 25, 2011.<sup>14</sup> The hearing was then held February 28, 2011 through March 4, 2011 in Chattanooga, Tennessee and March 7, 2011 through March 8, 2011 in Nashville, Tennessee.

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<sup>10</sup> See Order Granting Petitions to Intervene and Requiring the Parties to Submit a Proposed Procedural Schedule and Protective Order (Oct. 12, 2010). The Authority's Order of October 12, 2010 stated in a footnote that "TAWC's Petition was submitted to the Authority on September 17, 2010, but do (sic) to an incomplete filing the Petition and supporting testimony were withdrawn from the TRA and were resubmitted and filed on September 23, 2010." TAWC respectfully submits that this assertion was mistaken. TAWC's Petition and supporting testimony were filed correctly pursuant to the Authority's guidelines on September 17, 2010. After TAWC's Petition was filed, TAWC notified the Authority that certain filing documents had been uploaded incorrectly on the Authority's website. After working with the Authority's Docket Manager for a number of days to correct the website issue, TAWC voluntarily prepared a disc for the Authority's Docket Manager on September 23, 2010 containing consolidated versions of the .PDF files that had previously been filed with the Authority. Neither the Petition nor any supporting testimony was ever withdrawn or resubmitted. The Authority's assertion is inconsistent with the fact that the Authority issued its first data request on September 20, 2010 and the fact that the CAPD filed its Petition to Intervene on September 21, 2010. Moreover, the Authority itself stated in its November 8, 2010 Order that TAWC filed its Petition on September 17, 2010. See Order Suspending Tariff for Ninety Days, Convening a Contested Case and Appointing a Hearing Officer (Nov. 8, 2010).

<sup>11</sup> See Order Granting Petitions to Intervene, Reflecting Action Taken at Status Conference and Establishing a Procedural Schedule, at 9 (Nov. 12, 2010).

<sup>12</sup> As explained below in the section titled "Regulatory Expense," TAWC continues to assert that the level of discovery and discovery disputes in this case was unreasonable. Rather than recount all of the time and money the Intervenor forced TAWC to waste on unnecessary discovery issues in this case, TAWC submits that the record speaks for itself.

<sup>13</sup> Order Modifying Procedural Schedule and Setting Status Conference (Jan. 14, 2011).

<sup>14</sup> Notice of Hearing (Jan. 31, 2011).

During the first status conference on October 18, 2010 the Hearing Officer expanded the CAPD's discovery limits to 80 discovery requests, including subparts.<sup>15</sup> The Hearing Officer ruled that all other Intervenors were limited to the Authority's rule of 40 discovery requests absent any motions to propound additional discovery.<sup>16</sup> The parties commenced discovery in accordance with the Procedural Schedule on November 1, 2010. Including subparts, on November 1, 2010 TAWC was served with 215 discovery requests from the CAPD, 125 discovery requests from the City, 61 discovery requests from the Union, and 63 requests from the CRMA. All of these sets of discovery were well in excess of the Hearing Officer's announced discovery limits, so the CAPD, City and Union all filed motions to exceed discovery limits.<sup>17</sup> TAWC opposed expanding the Authority's discovery limits because the Intervenors' additional requests were largely duplicative, irrelevant, and would only result in increased rate case expense. The Company propounded 16 or fewer discovery requests to each of the Intervenors during the first round of discovery.

The second round of discovery saw the CAPD propound an additional 8 requests, the City 27 requests, the CRMA 6 requests and the Union 12 requests, while the Company propounded 4 requests to the Union, 20 to the CRMA, 40 to the City and 35 to the CAPD. The CAPD later sought leave for an unprecedented third round of discovery in which it propounded another two requests. The Authority issued data requests to TAWC on September 20, 2010, October 26, 2010, January 28, 2011, February 4, 2011, and February 15, 2011. The data requests

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<sup>15</sup> See Order Granting Petitions to Intervene, Reflecting Action Taken at Status Conference and Establishing a Procedural Schedule, at 5-6 (Nov. 12, 2010).

<sup>16</sup> *Id.*

<sup>17</sup> See Union's Motion for Leave to Serve More than Forty Discovery Requests (Nov. 1, 2010); City's Motion for Permission to Propound Additional Discovery Requests (Nov. 1, 2010); Motion of the CAPD for Leave to Issue More than Eighty Discovery Requests (Nov. 1, 2010).

from the Authority totaled 170 questions, not including subparts. In total, TAWC responded to a record 497 discovery requests, not including subparts.<sup>18</sup>

All parties filed a number of objections to the discovery requests of the other parties. Similarly, a number of motions to compel were heard by the Hearing Officer regarding alleged deficiencies in discovery responses. In all, two meet and confer conferences and two status conferences were required to resolve disputes solely related to the first round of discovery. All discovery disputes were eventually resolved by agreement or ruling prior to the hearing.

### **III. Criteria for Establishing Just and Reasonable Rates**

Pursuant to Tennessee Code Annotated § 65-5-101, it is the duty of the Tennessee Regulatory Authority to set utility rates that are “just and reasonable.” This charge requires the Authority to examine not only what is just and reasonable for the customer, but also what is a just and reasonable rate of return for the utility company.<sup>19</sup> “When these rates are fixed so low that the utility cannot get a fair return this amounts to the taking of property for public use without just compensation and is confiscatory.”<sup>20</sup>

The Authority has traditionally considered four criteria when determining the appropriate rate for a utility:<sup>21</sup>

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

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<sup>18</sup> It appears there were a record number of filings in this case. A total of 262 filings were made before the date of the Hearing on the Merits, compared to 119 and 137 total filings in the last Atmos Energy and Chattanooga Gas rate cases, respectively. *See* Trial Ex. 1, at 27.

<sup>19</sup> *Southern Bell Tel. & Telegraph Co. v. Tenn. Public Serv. Comm’n*, 304 S.W.2d 640, 642-43 (Tenn. 1957).

<sup>20</sup> *Id.* at 643.

<sup>21</sup> *See, e.g.*, Final Order, Docket No. 08-00039, at 8 (Jan. 13, 2009).

These criteria must be examined in the context of the United States Supreme Court's guidance on establishing a fair rate of return, to wit:<sup>22</sup>

- 1) The rate of return should maintain the financial integrity of the company;
- 2) The rate of return should allow the company to attract capital for investment and operations; and
- 3) The rate of return on equity should be commensurate with returns investors could achieve by investing in other enterprises of corresponding risk.

#### **IV. Test Period and Attrition Period**

To determine the proper level of revenues and expenses for the utility, the Authority has traditionally accepted the following methodology: (a) select a historic test year; (b) normalize the test year to reflect normal year revenues, annualize partial year expenses, and eliminate non-recurring expenses; and (c) determine an attrition year, which is adjusted for known and measurable changes that are reasonably expected to occur in the attrition year. In this case, TAWC selected a historical test period of the twelve months ending March 31, 2010.<sup>23</sup> TAWC made normalizing adjustments to the test year as well as adjustments for known and measurable changes to develop a forecast for the attrition period, the twelve months ending December 31, 2011.<sup>24</sup>

Rather than using the Company's historic test period, and contesting any adjustment it believed the Company improperly included or overlooked, the CAPD unnecessarily increased the costs of this case by employing an entirely different historic test period consisting of the twelve months ending September 30, 2010.<sup>25</sup> Of course, the Petition in this case was filed prior

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<sup>22</sup> See *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) and *Bluefield Water Works & Improvement Co. v. P.S.C.*, 262 U.S. 679, 692-93 (1923).

<sup>23</sup> Sheila Miller, Pre-Filed Direct Testimony, at 4.

<sup>24</sup> Sheila Miller, Pre-Filed Direct Testimony, at 4.

<sup>25</sup> Terry Buckner, Pre-Filed Non-Confidential Amended Direct Testimony, at 10.

to the conclusion of that test period, so the results for the CAPD's test period were unknown and unknowable to TAWC as of the date of the Petition. Compounding the problem of selecting an inappropriate test period, the CAPD then again – as in past cases – failed to make appropriate normalizing adjustments to the test year. Instead of making appropriate adjustments, for numerous categories the CAPD merely made an inflation adjustment.<sup>26</sup> The CAPD selected the same attrition period as used by TAWC, consisting of the twelve months ending December 31, 2011.<sup>27</sup>

When known and measurable costs are available, the Authority should consider those costs in place of a general inflation adjustment.<sup>28</sup> Throughout the course of the rate case, TAWC undertook to advise the Authority when it became aware of any additional known and measurable adjustments after the filing of its Petition on September 17, 2010. TAWC presented updated known and measurable changes in response to TRA data requests, pre-filed rebuttal testimony and live testimony at the Hearing.<sup>29</sup> The Intervenors generally objected to the presentation of such updated information even though the Intervenors have historically acknowledged that consideration of such known and measurable expenses was appropriate and beneficial.<sup>30</sup> The Authority's statutory authority is undoubtedly broad enough to allow it to

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<sup>26</sup> See, e.g., Sheila A. Miller, Pre-Filed Rebuttal Testimony, at 5, 7.

<sup>27</sup> Terry Buckner, Pre-Filed Non-Confidential Amended Direct Testimony, at 10.

<sup>28</sup> See *In re Petition of United Telephone Company to Change and Increase Certain Intrastate 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 Telephone Service to its Customers in Tennessee and to Adopt New and Realistic Depreciation Rates for Central Office Equipment* (Petition filed May 22, 2001), Docket No. 01-00451, 2002 Tenn. PUC LEXIS 139 (April 30, 2002).

<sup>29</sup> For example, additional known and measurable items were updated at the specific request of the TRA on February 14, 2011, February 16, 2011, and February 22, 2011. See Notice of Filing of Revised Accounting Exhibits and Work Papers (Feb. 14, 2011); Notice of Filing of Supplemental Revised Accounting Exhibits and Work Papers (Feb. 16, 2011); February 22nd Notice of Filing of Supplemental Revised Accounting Exhibits and Work Papers (Feb. 22, 2011).

<sup>30</sup> Terry Buckner, Docket No. 08-00039 Vol. XVI, Tr. 1666:19-23 (Aug. 26, 2008) (“Q: And you think it’s important for the TRA to consider the latest known and measurable data when setting rates in this case, correct? A: Yes sir. I think that’s to a benefit of their decision, yes.”).



consider this information,<sup>31</sup> and the Authority's past practices indicate a preference for admitting and considering these newly discovered changes.<sup>32</sup>

## **V. Contested Issues**

### **A. Revenues**

Thirty-three (33%) percent of the Company's rate increase requested in this case is attributable to the fact that the Company's revenues are projected to be lower than those projected by the Authority in setting rates in the 2008 case.<sup>33</sup> Similar differences between actual sales revenues and those projected by the Authority in 2008 have plagued the Company ever since and have prevented the Company from having the opportunity to earn the rate of return established by the Authority in the 2008 rate case. These decreases were caused by lower average residential water consumption levels as well as reduced sales to the industrial and commercial customer classes. The four-year historical residential average usage per customer used by the Authority to set attrition year revenue levels in 2008 included two of the hottest and driest years on record, necessarily ensuring that the Company's actual revenues would be less than predicted in ensuing years unless those years also turned out to be record dry years.<sup>34</sup>

In this case, the Company presented evidence demonstrating that its projected attrition year revenues were properly normalized, including a normalization to account for the impact of weather on water sales, and that the Company's normalization method is the most likely to

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<sup>31</sup> See Tenn. Code Ann. § 65-5-101 (2011).

<sup>32</sup> See, e.g., *In re Petition of United Telephone Company to Change and Increase Certain Intrastate 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 Telephone Service to its Customers in Tennessee and to Adopt New and Realistic Depreciation Rates for Central Office Equipment*, Docket No. 01-00451, 2002 Tenn. PUC LEXIS 139 (April 30, 2002) (admitting and considering revised schedules four days prior to hearing); *In re Nashville Gas Company Application for Approval of Negotiated Gas Redelivery Agreement with State Industries*, Docket No. 98-00338, 1999 Tenn. PUC LEXIS 129 (July 6, 1999) (allowing amendment of petition after the conclusion of hearing).

<sup>33</sup> Michael A. Miller, Exhibit MAM-2; Michael A. Miller, Pre-Filed Direct Testimony, at 6, 51 (Sept. 17, 2010).

<sup>34</sup> Michael A. Miller, Pre-Filed Direct Testimony, at 51 (Sept. 17, 2010).

predict the actual sales levels in the attrition year. The Authority should adopt the Company's properly normalized attrition year revenue forecast to ensure that the Company has the fair opportunity to achieve the designated rate of return.

#### Adjustments to Per Book Revenues

For the attrition year 2011, the Company projects revenues of \$37,296,457 under current rates.<sup>35</sup> This amount was obtained by making the standard, widely-recognized adjustments to the historical test year and normalizing for customer growth and a normal year of consumption using Dr. Edward Spitznagel's water consumption forecast for the residential and commercial customer classifications.

Properly normalizing the historical test year is the most accurate basis upon which to project attrition year revenues. The normalization adjustments to the historical test year undertaken by the Company include the following:

- Normalizing billing routes that were billed more or less than 12 times in the year to properly reflect the billing determinates for a 365 day period;
- Annualizing the rate increases for Walden's Ridge, Signal Mountain, Fort Oglethorpe and annualizing the rate decrease for the commercial classification;
- Eliminating the net change in accrued revenues;
- Adjusting for a duplicate miscellaneous invoice sent March 2010 to one commercial customer;
- Reviewing large industrial customer usage to determine any abnormal billing during the year, and making adjustments to account for the addition or loss of large customers;
- Implementing weather normalization adjustment to the residential and commercial customer classes.

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<sup>35</sup> TAWC Exhibit 4, Schedule 1.

To determine customer growth in the attrition year, the Company utilized the average of customer growth over a 23 year period to compensate for any volatility in customers over the years or in recent months.<sup>36</sup> Accordingly, the Company projected the total number of residential meters to be 788,366, a 3,840 increase from the Company's historical test-year.<sup>37</sup>

In contrast, the CAPD uses a grossly exaggerated projection of a 8,524 meter increase in the attrition year, despite the fact that between 2008 and 2009 residential meters actually decreased by 3,092 meters and between 2009 and 2010 there was only a meager growth of 1,312 meters.<sup>38</sup> The CAPD's projection is inconsistent and completely out of line with recent meter trends and does not take into account 23 years worth of historical growth data.

#### Adjustments for Weather

##### **1. Declining Water Consumption Must be Considered in Projecting Revenues**

The Company also normalized the test year to establish a normal year of water consumption for the attrition year for the residential and commercial classes. To understand the validity of the Company and the Intervenors' consumption projections, known long-term historical trends in water usage must first be understood. Water usage directly correlates to revenues; when water consumption drops, so do the Company's revenues. The Company put forth substantial testimony and statistical evidence demonstrating that water consumption has continued to decline over the years.<sup>39</sup> None of the Intervenors have contested this fact.<sup>40</sup>

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<sup>36</sup> Sheila Miller, Vol. VI A, Tr. 7:7-11 (March 7, 2011).

<sup>37</sup> Sheila Miller, Rebuttal Exhibit SAM-4.

<sup>38</sup> Sheila Miller, Rebuttal Exhibit SAM-4; Sheila Miller, Rebuttal Testimony, at 13 (Feb. 8, 2011); Sheila Miller, Vol. VI A, Tr. 5:5-8 (March 7, 2011) (correcting typographical errors in her Rebuttal Testimony).

<sup>39</sup> See Dr. Edward Spitznagel, Pre-Filed Direct Testimony, at 3 (Sept. 17, 2010); Dr. Edward Spitznagel, Rebuttal Testimony, at 1-2 (Feb. 8, 2011); Spitznagel Rebuttal Ex. ELS-1 & ELS-2; *see generally* Dr. Edward Spitznagel Testimony, Tr. Vol. III B (March 2, 2011).

<sup>40</sup> William H. Novak, Vol. VII A, Tr. 31:25-32:5 (March 8, 2011); Michael Gorman, Direct Testimony, at 9:10-11 (Jan. 5, 2011) (recognizing a decline in usage, but contesting the level of decline without any scientific support).

Accordingly, any revenue projection must properly reflect the long-term decline in customer water consumption.

The Company presented testimony and evidence from Dr. Edward Spitznagel, a professional mathematician, statistician, and professor at Washington University in St. Louis, Missouri who analyzed all available actual water consumption data (25 years of available data for residential and 20 years for commercial) and concluded that water consumption undoubtedly has been declining for more than 20 years at an average decline of greater than one gallon per customer day (“gcd”) per year for residential and nearly 10 gcd per year for commercial.<sup>41</sup> Dr. Spitznagel also testified at the Hearing that the residential decline has actually steepened in latter years to approximately a 2 gcd per year reduction.<sup>42</sup> This decline is due to a myriad of reasons, chief among them being the gradual replacement of household appliances with newer low-flow devices.<sup>43</sup>

Conversely, the recent dismal economy has “no effect whatsoever” on water usage.<sup>44</sup> Dr. Spitznagel reached this conclusion after conducting a separate study on the effect of the economy on water usage, which utilized 25 years worth of historical data, and testified to this fact during the Hearing when the City inquired on the subject.<sup>45</sup> This demonstrates that the decline in usage will not reverse in the attrition year simply because the economy *might* pick up, which the Intervenors attempted to suggest (but provided no credible evidence to support this innuendo) during the Hearing. This study also directly refutes Mr. Novak’s statement that the recession

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<sup>41</sup> Dr. Edward Spitznagel, Rebuttal Testimony, at 1:25-2:12 (Feb. 8, 2011).

<sup>42</sup> Dr. Edward Spitznagel, Vol. III B, Tr. 143:10-14 (March 2, 2011).

<sup>43</sup> Dr. Edward Spitznagel, Vol. III B, Tr. 151:10-24 (March 2, 2011).

<sup>44</sup> Dr. Edward Spitznagel, Vol. III B, Tr. 156:19-20 (March 2, 2011).

<sup>45</sup> Dr. Edward Spitznagel, Vol. III B, Tr. 156:10-157:25 (March 2, 2011).

caused a decrease in water consumption.<sup>46</sup> Mr. Novak did not perform any study or analysis to support his statement or contradict the scientific study Dr. Spitznagel testified to at the Hearing. Finally, Mr. Novak's opinion that the allegedly "much more expensive" cost of water might be an additional reason consumption is waning has no scientific or logical support and is based on a faulty premise. The average Chattanooga's water utility bill is dramatically less expensive than all other similar monthly utility bills, except for stormwater charges.<sup>47</sup> Moreover, a Chattanooga's charge for water service is currently less than what is charged by 70% of other Tennessee water utilities.<sup>48</sup> To suggest that water consumption was reduced because of the economy, when water bills are among consumers' least expensive monthly costs and when the decline has continued during times of economic boom, does not square with the facts or with logic.

## **2. The Company's Revenue Forecasts Consistently Have Been the Most Accurate Predictor of Actual Revenue Levels**

The Company normalized its test year revenues to that of a normal weather year, based on the statistical study conducted by Dr. Spitznagel, which the Company has done in the last several rates cases. Although the Company's weather normalized revenue forecasts have been included in the rates set by the TRA in prior cases<sup>49</sup>, the Company is not requesting that the TRA formally adopt weather normalization in this case. Indeed, the Authority can adopt the Company's normalized revenue projection for the attrition year without having to formally adopt weather normalization. In this regard, the Company urges the Authority to ask itself one simple question when determining which revenue projection to use when setting rates – which party's

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<sup>46</sup> William H. Novak, Vol. VII A, Tr. 32:14-25 (March 8, 2011).

<sup>47</sup> Trial Ex. 1, at 45.

<sup>48</sup> John Watson, Rebuttal Testimony, at 25 (Feb. 8, 2011); Watson Rebuttal Exhibit 3.

<sup>49</sup> See Michael A. Miller, Pre-Filed Direct Testimony, at 50 (Sept. 17, 2010).

forecast has proven to be the most accurate over the years? This is the same suggestion posited by the Court of Appeals in its opinion in the 2008 Rate Case.<sup>50</sup>

Mr. Miller, in his rebuttal testimony and exhibits, graphed the water consumption forecasts of Dr. Spitznagel, the CRMA, the CAPD, and the TRA from the period of 2004-2010 alongside the actual consumption data for those years to answer this very question.<sup>51</sup> The comparison shows what would have happened had the TRA set revenues at the levels predicted by the various parties in the 2004, 2006, and 2008 rate cases. Rightfully, no Intervenor contested the results of Mr. Miller's comparison, because the data speaks for itself and irrefutably shows that Dr. Spitznagel's model forecasts have consistently been the closest to the actual levels of consumption in the attrition years for the various rate cases. The only exception for residential per customer per day forecasts was in 2007, one of the hottest and driest years on record, where the CAPD's 2006 rate case projection was immaterially closer to actual consumption levels.<sup>52</sup> Other than 2007, the CAPD and other intervenor models grossly overstated revenues. For commercial per customer per day usage, Dr. Spitznagel's forecasts also have been closer to the actual consumption levels than the Intervenor's forecasts.<sup>53</sup>

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<sup>50</sup> *Tenn. Am. Water Co. v. Tenn. Regulatory Auth.*, No. M2009-00553-COA-R12-CV, 2011 Tenn. App. LEXIS 51, at \*69 (Jan. 28, 2011) ("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.").

<sup>51</sup> Michael A. Miller, Rebuttal Exhibit MAM-10. For Dr. Spitznagel's forecast for 2010, the pink line should be at the same level as that of 2009, resulting in a straight line between 2009 and 2010, similar to the other parties' projections. Had the Authority adopted the Company's 2008 rate case forecast for 2009, necessarily this forecast level would have continued to be level used for 2010. This correction can be seen in Trial Ex. 1, at 35. This correction does not change the data and still demonstrates that Dr. Spitznagel's 2008 rate case projections, had they been adopted, would have been closer to the actual consumption levels than either the Intervenor's or Authority's projections.

<sup>52</sup> Michael A. Miller, Rebuttal Exhibit MAM-10, at 1 of 5.

<sup>53</sup> Michael A. Miller, Rebuttal Exhibit MAM-10, at 3 of 5.

As the graphs demonstrate, the CAPD's trending method and the CRMA's simple historical average have not been the most accurate forecasts, but rather, have greatly overestimated water usage to the detriment of the Company.<sup>54</sup>

Actual residential water usage levels also were much less than that forecasted and used by the Authority in setting rates in the 2008 rate case.<sup>55</sup> In 2008, the TRA departed from the Company's revenue projections and used its own forecasting methodology to set rates. Because water usage and revenues turned out to be far below (\$3.2 million below<sup>56</sup>) the level forecasted and used by the TRA to set rates in the 2008 rate case, the Company has not been able to achieve its authorized rate of return in part due to this decreased revenue stream.<sup>57</sup>

The Authority should adopt the Company's revenue forecast for the attrition year in this case because *the Company's forecast has consistently been the most accurate when compared to actual historical data*. No one can predict future water consumption to the gallon; accordingly, the goal is to set going-level revenues at a level that gives an equal chance that the projected revenues in any year will be higher or lower than actual revenues.<sup>58</sup> The Company's revenue forecast model has historically accomplished this goal, balancing the interests of both the customers and the Company.

### **3. TAWC Demonstrated that the CAPD and CRMA's Revenue Projections will Not Accurately Predict Going-Level Revenues**

Not only have the Intervenor's revenue projections historically been less accurate than the Company's revenue projections, as demonstrated in Rebuttal Exhibit MAM-10, but the

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<sup>54</sup> Michael A. Miller, Rebuttal Exhibit MAM-10.

<sup>55</sup> Michael A. Miller, Rebuttal Exhibit MAM-10, at 1 of 5.

<sup>56</sup> Michael A. Miller, Direct Testimony, at 9:15-17 (Sept. 17, 2010).

<sup>57</sup> Michael A. Miller, Pre-Filed Direct Testimony, at 2-3 (Sept. 17, 2010).

<sup>58</sup> Michael A. Miller, Rebuttal Testimony, at 65-69 (Feb. 8, 2011).

Intervenors' revenue projection methodologies in this case once again suffer from several fundamental flaws.

The CAPD used a "trending analysis" as presented by Mr. John Hughes. This is the same method used by the CAPD in the 2008 rate case<sup>59</sup>, which the TRA rejected.<sup>60</sup> Mr. Hughes freely admitted at the Hearing that his "statistical" trending analysis methodology required nothing more than inputting data into an Excel program and pressing a button.<sup>61</sup> Despite claiming that trending analysis was a superior statistical method for predicting revenues, Mr. Hughes admitted multiple times that he was not a statistician and also admitted that he did not know how the CAPD's trending analysis actually worked.<sup>62</sup> The CAPD also claimed that trending analysis is superior because Mr. Hughes imputed seven years of usage and "seven years is a pretty long time".<sup>63</sup> Dr. Spitznagel, however, used 30 years of PMDI data and 10 years of historical usage data in creating his revenue projection model.<sup>64</sup> Finally, the CAPD's trending analysis did not normalize the test year data in making their attrition year projection.<sup>65</sup>

Further, even if trending analysis as a methodology was appropriate, which it is not here, the CAPD's application and presentation of its methodology in this case were rife with errors, rendering it wholly unreliable as a basis for setting going-level revenues in this case. Sheila Miller testified, and the Company demonstrated during the Hearing, that the CAPD's trend analysis was applied inconsistently and that it contained numerous errors including incorrect entry of actual data, the exclusion of available information, and multiple incorrect calculations.

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<sup>59</sup> John Hughes, Vol. IV B, Tr. 112:17-20 (March 3, 2011).

<sup>60</sup> Final Order, Docket No. 08-00039, at 10 (Jan. 13, 2009).

<sup>61</sup> John Hughes, Vol. IV B, Tr. 123:10-124:14 (March 3, 2011).

<sup>62</sup> John Hughes, Vol. IV B, Tr. 123:10-125:6 (March 3, 2011).

<sup>63</sup> John Hughes, Vol. IV B, Tr. 125:24-126:1 (March 3, 2011).

<sup>64</sup> Dr. Edward Spitznagel, Pre-Filed Direct Testimony, at 5-6 (Sept. 17, 2010).

<sup>65</sup> Michael A. Miller, Rebuttal Testimony, at 63 (Feb. 8, 2011).



Sheila Miller pointed out many of these errors in her rebuttal testimony<sup>66</sup> and the CAPD subsequently revised its testimony twice, each time noting that it was revising the testimony due to errors.<sup>67</sup> However, the “final” version of the CAPD’s testimony still contained numerous errors, a few of which were pointed out during Mr. Hughes’ cross-examination.<sup>68</sup>

The written testimony of Mr. Michael Gorman suffers from a very fundamental error. He uses a five-year historical average to project revenues. Not only does this method utilize relatively little historical data, but it will consistently overestimate revenues because it does not take into account the downward trend in water consumption, even though Mr. Gorman acknowledged the existence of a continuous decline in usage.<sup>69</sup> To demonstrate the extent of Mr. Gorman’s overestimation, Dr. Spitznagel used Mr. Gorman’s 5-year rolling average method going back to the earliest available data, 1992, and from 1992 to 2010 this methodology leads to an average overestimation of 4.64 gcd per residential customer and 38.071 gcd per commercial customer.<sup>70</sup> Notably, the CAPD also agrees that use of a historical average is an improper method to project going-level revenues.<sup>71</sup>

#### **4. The Intervenors’ Criticisms of Dr. Spitznagel’s Model Have No Merit**

The CAPD’s only argument against using Dr. Spitznagel’s weather normalization method is found in the testimony of Mr. Hal Novak, who asserted that the weather normalization method has too low of a correlation to have predictive value.<sup>72</sup> This is completely without merit. Mr. Novak based this claim on a simple averaging of the 12 individual months’ models, which Dr.

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<sup>66</sup> See Sheila Miller, Rebuttal Testimony, at 7-13 (Feb. 8, 2011).

<sup>67</sup> See John Hughes, Revised Testimony, at 3-4 (Feb. 25, 2011); Revised Testimony, at 3 (March 1, 2011).

<sup>68</sup> See John Hughes, Vol. IV B, Tr. 142-152 (March 3, 2011).

<sup>69</sup> Dr. Edward Spitznagel, Rebuttal Testimony, at 1-5 (Feb. 8, 2011); Michael Gorman, Direct Testimony, at 9:10 (Jan. 5, 2011).

<sup>70</sup> Dr. Edward Spitznagel, Rebuttal Exhibit ELS-3.

<sup>71</sup> John Hughes, Revised Testimony, at 14:12-13 (March 1, 2011).

<sup>72</sup> William H. Novak, Direct Testimony, at 11:16-14:1 (January 5, 2011).

Spitznagel used for illustration purposes.<sup>73</sup> Dr. Spitznagel, a distinguished professional statistician, clearly explained that this averaging of the individual models' R-Squared values was a "fallacy" that "cannot be done".<sup>74</sup> None of the CAPD's witnesses are professional statisticians. The Intervenors may not like or understand why this simple averaging cannot be done, but the fact remains that the simple averaging of the R-squares does not reflect the statistical coefficient of Dr. Spitznagel's revenue projection and the intervening parties have offered no scientific or mathematical hypothesis to explain otherwise.<sup>75</sup>

Dr. Spitznagel did provide the R-Squared value of his weather normalization model advocated in this proceeding in his rebuttal testimony. Contrary to Mr. Novak's claims to the contrary, Dr. Spitznagel explained that determining the R-Squared value of his model "could be obtained just by running one command", which he fully displayed in Rebuttal Exhibit ELS-4. The R-Squared values of his full weather normalization models were 84.3% residential and 69.3% commercial. Dr. Spitznagel stated that "to explain 84 percent is phenomenal. To explain almost 70 percent is very, very, very, very good. So we really can estimate consumption."<sup>76</sup>

Mr. Gorman's claim that Dr. Spitznagel's model has underestimated revenues over the past 5 years is worthy of only a brief discussion because it is so fundamentally incorrect. In making this claim, Mr. Gorman compares Dr. Spitznagel's projection for **2011** to actual usage levels from 2005-2009. Obviously, when water consumption is in a decline, any future

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<sup>73</sup> William H. Novak, Direct Testimony, at 12-14 (January 5, 2011).

<sup>74</sup> Dr. Edward Spitznagel, Vol. III B, Tr. 133:11-14; 134:6-11; 163:8-13 (March 2, 2011).

<sup>75</sup> During Mr. Novak's cross examination he claimed that he did not believe Dr. Spitznagel's calculation of the R-Squared values of his full model, which were contained in Rebuttal Exhibit ELS-4, simply because he did not understand how Dr. Spitznagel calculated his R-Squares. Yet, Mr. Novak also admitted that he never asked Dr. Spitznagel to provide him additional data on Rebuttal Ex. ELS-4, even though he had reviewed Dr. Spitznagel's rebuttal exhibits before the CAPD issued the Company additional data requests in which he asked follow-up questions on other exhibits. William H. Novak, Vol. VII A, Tr. 23:9-24 (March 8, 2011). Clearly, Mr. Novak's opinion on the appropriateness of Dr. Spitznagel's R-Squared calculations contained in Rebuttal Exhibit ELS-4 has no basis and should be disregarded as mere conjecture.

<sup>76</sup> Dr. Edward Spitznagel, Vol. III B, Tr. 134:12-14 (March 2, 2011).

projection is almost certain to be lower than actual levels in prior years. Had Mr. Gorman looked at Dr. Spitznagel's projections in the 2004, 2006 and 2008 rate cases for the attrition years that match up with these cases, he would have seen that Dr. Spitznagel's projections were the most accurate compared to actual consumption levels.<sup>77</sup>

Consequently, Dr. Spitznagel's projection is both (1) the most accurate predictor of going-level revenues when comparing the parties' past projections with actual consumption data and (2) is the only analysis that withstands scientific, mathematical and statistical scrutiny.

The undeniable decline in residential and commercial per customer usage combined with stagnant or very mild growth in the number of customers means that there is no doubt that the Company's revenues will be lower than those projected by the Authority in the last case or those projected by the parties in this case. For these reasons, the Authority should adopt the Company's attrition year revenue at present rates of \$37,296,457<sup>78</sup> when setting fair and reasonable rates for this proceeding.

## **B. American Water Resources**

American Water Resources, Inc. ("AWR") is a non-regulated affiliate of American Water Works that offers customer protection plans to households across the country, including some customers of TAWC.<sup>79</sup> These plans provide protection and service for repair of water and plumbing lines that are the responsibility of individual customers. TAWC has a contractual relationship with AWR to provide billing services to customers of AWR who are also customers of TAWC.<sup>80</sup> AWR appropriately compensates TAWC for these billing services at the rate

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<sup>77</sup> See Michael A. Miller, Rebuttal Exhibit MAM-10.

<sup>78</sup> *Id.*, Footnote 16.

<sup>79</sup> Michael A. Miller, Pre-Filed Rebuttal Testimony, at 95 (Feb. 8, 2011).

<sup>80</sup> Michael A. Miller, Pre-Filed Rebuttal Testimony, at 95 (Feb. 8, 2011).

approved by the Authority for all third-party billing contracts, including TAWC's billing services to the City of Chattanooga Sanitary Board.<sup>81</sup>

Prior to entering into any contract with AWR, TAWC briefed the Authority on its proposed business relationship with AWR. After the briefing TAWC then sent a follow-up letter to the Authority's general counsel on October 17, 2001, again explaining that under the proposed agreement TAWC would, among other things, offer AWR's programs to TAWC's customers through mailings and billing inserts.<sup>82</sup> Specifically, the contract provided for TAWC to distribute informational and promotional materials about AWR's services.<sup>83</sup> TAWC also requested that the Authority advise as to whether Authority approval was needed prior to entering into the contract.<sup>84</sup> The Authority then responded by letter on October 31, 2001 stating that no Authority approval was required.<sup>85</sup> TAWC entered into the billing contract with AWR on May 1, 2004.<sup>86</sup>

The revenue TAWC generates from its contract with AWR benefits TAWC's customers in the form of regulated revenues.<sup>87</sup> If TAWC were to stop providing contract billing services to third parties then TAWC's customers would suffer because additional revenue would be required and customers' rates would increase.

For TAWC's customers, the revenue related to the third-party billing services for AWR that is credited to TAWC in setting rates is essentially a windfall. TAWC's customers receive no direct tangible benefit, yet these revenues are included in TAWC's revenues to offset expenses

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<sup>81</sup> Michael A. Miller, Pre-Filed Rebuttal Testimony, at 95 (Feb. 8, 2011); Michael A. Miller, Vol. VIA, Tr. 52:11 - 53:23 (March 7, 2011).

<sup>82</sup> Rebuttal Exhibit MAM-15, at 1 (Feb. 18, 2011).

<sup>83</sup> Michael A. Miller, Pre-Filed Rebuttal Testimony, at 95 (Feb. 8, 2011); Michael A. Miller, Vol. VIA, Tr. 52:11 - 53:23 (March 7, 2011).

<sup>84</sup> Rebuttal Exhibit MAM-15, at 2 (Feb. 18, 2011).

<sup>85</sup> Rebuttal Exhibit MAM-15, at 3 (Feb. 18, 2011).

<sup>86</sup> See TN-TRA-04-Q152-ATTACHMENT, at 4 (Feb. 18, 2011).

<sup>87</sup> Michael A. Miller, Revised Pre-Filed Rebuttal Testimony, at 97 (Feb. 18, 2011).

incurred in actually providing water service. The City's witness Ms. Dismukes alleges, however, that on top of the revenues TAWC receives for its billing services the Authority should also credit *all* of AWR's revenues from its Tennessee customers as TAWC's revenue.<sup>88</sup> Ms. Dismukes' proposal – without any analysis – is to arbitrarily increase TAWC's revenues by \$1,071,281.<sup>89</sup> Ms. Dismukes' proposal lacks any credibility and is simply grasping at straws in an effort to improperly reduce TAWC's revenue requirement.

There are, of course, numerous deficiencies in Ms. Dismukes' unsubstantiated argument. First, Ms. Dismukes recommends a specific dollar amount of revenue even though she has done no analysis whatsoever of the actual revenue from AWR's customers who are served by TAWC. Likewise, Ms. Dismukes has not attempted to analyze the profit, if any, attained by AWR for serving these customers. For example, it would be highly inappropriate to simply impute the phantom revenues as suggested by Ms. Dismukes without also allocating expenses incurred by AWR as an offset to the phantom revenues.

Second, Ms. Dismukes alleges that over a million dollars of AWR's revenue should be credited to TAWC, but this is based almost entirely on what she admits to be intangible benefits.<sup>90</sup> Ms. Dismukes testified that intangible assets are not included in rate base<sup>91</sup> and she points to nothing other than customer address lists, which can be obtained with minimal effort for less than \$3,000, and an endorsement letter. Recommending confiscation of over \$1 million in revenue based only on an endorsement letter is an extreme position, especially when AWR has

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<sup>88</sup> Kimberly Dismukes, Pre-Filed Testimony, at 3 (Jan. 5, 2011).

<sup>89</sup> Kimberly Dismukes, Pre-Filed Testimony, at 3 (Jan. 5, 2011).

<sup>90</sup> Kimberly Dismukes, Pre-Filed Testimony, at 16 (Jan. 5, 2011).

<sup>91</sup> Kimberly Dismukes, Vol. IIC, Tr. 290:3 – 290:7 (March 1, 2011).

not paid for other endorsements in the past.<sup>92</sup> Third, Ms. Dismukes ignores the fact that the independent management auditors examined the relationship between TAWC and AWR<sup>93</sup> and found nothing inappropriate.<sup>94</sup>

TAWC has incurred no costs associated with AWR's services other than incremental billing costs for its billing services.<sup>95</sup> TAWC does not bear any risk associated with the services AWR provides to TAWC's customers, including risk for the cost to repair service lines, sewer laterals or in-house plumbing for customer lines.<sup>96</sup> AWR pays for all repairs and paid all expenses related to the creation of the promotional material. Further, TAWC's customers have benefited both from the billing contract revenues and from TAWC's message informing them about their responsibilities for the water lines and sewer lines that they own.<sup>97</sup>

While the independent management auditors already have examined the relationship between TAWC and AWR, the Company would nonetheless not be opposed to a review of the AWR contract. Such a review will conclusively establish that TAWC's customers are not being disadvantaged by the contract and that no royalty or other confiscation of AWR's earnings is appropriate. However, if the Authority believes otherwise after the study, TAWC needs to be given the opportunity to cancel the contract to prevent having its rates inappropriately lowered.

Attributing the phantom revenues from AWR to TAWC as suggested by Ms. Dismukes would burden and detract from TAWC's ability to provide quality water service to its customers. Accordingly, should TAWC not be given the opportunity to cancel the contract before an

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<sup>92</sup> Michael A. Miller, Revised Pre-Filed Rebuttal Testimony, at 100 (Feb. 18, 2011) (noting the Mayor of Burlington, Iowa endorsed AWR's services in a similar letter but was not compensated for the endorsement).

<sup>93</sup> See Trial Ex. 29, at 30-31.

<sup>94</sup> Trial Ex. 29, at 42 ("Schumaker & Company also considers TAWC's methodology for charge (sic) AWR for billing of its home protection programs to TAWC customers to be a reasonable methodology.").

<sup>95</sup> Michael A. Miller, Revised Pre-Filed Rebuttal Testimony, at 98 (Feb. 18, 2011).

<sup>96</sup> Michael A. Miller, Revised Pre-Filed Rebuttal Testimony, at 101 (Feb. 18, 2011).

<sup>97</sup> Michael A. Miller, Vol. VIA, Tr. 52:11 - 53:23 (March 7, 2011).

inappropriate confiscation of revenues occurs, TAWC would be forced to simply cancel the contract after the fact and file a rate case to recoup the improperly imputed revenue.<sup>98</sup>

### **C. Expenses**

Despite the Company's best cost-savings efforts, the undeniable fact is that the Company's expenses have increased substantially since 2008. This increase is not surprising, as the aftermath of the economic recession has diluted the Company's pension investment funds for its employees – a major driver of the Company's increased expenses in this case. Moreover, the cost of fuel has risen dramatically since 2008, causing the price of goods and services to rise. The purchase of these goods and services and the funding of the Company's pension fund is not something that the Company can avoid, as it has to make certain purchases to provide water service and it has to adequately fund its pension accounts by law. Other expenses, such as the purchase of electricity, waste disposal costs, increased paving costs and increased property taxes and storm fees are similarly unavoidable and are controlled, ironically, by the City of Chattanooga, which now complains about the increased costs TAWC must pay. The increased cost of providing service is not unique to Tennessee American, but rather, is a reality affecting the water utility industry nationwide.<sup>99</sup> There is no question that these increases have occurred and are easily known and measurable, as shown by the evidence presented by TAWC.

Increased operations and maintenance expenses account for 40% of the Company's requested rate increase in this case, amounting to \$4.041 million. The combination of decreased water sales and increased operating expenses has caused TAWC to be unable to earn a fair rate

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<sup>98</sup> Michael A. Miller, Revised Pre-Filed Rebuttal Testimony, at 101-02 (Feb. 18, 2011); Michael A. Miller, Vol. VIA, Tr. 52:11 - 53:23 (March 7, 2011).

<sup>99</sup> See John Watson, Rebuttal Testimony, p. 23:25-28 (Feb. 8, 2011) (increased operating costs are being experienced by the water utility industry nationwide and are oftentimes costs beyond the Company's control); Michael A. Miller, Vol. VI A, Tr. 38:24-39:2 (March 7, 2011) (increased pension and OPEB costs are affecting many other utilities nationwide).

of return and is the primary reason that the Company has no choice but to seek a rate increase at this time.

### Cost Savings Measures

The Company presented the testimony of TAWC's President, John Watson, who explained that since the 2008 rate case the Company has had to carefully walk the tightrope of reducing operating expenses and capital expenditures due to increased costs and inadequate funding while simultaneously maintaining the high service levels that are required of a public utility.<sup>100</sup> Because there is absolutely no basis on which to do so, the Intervenor has not once questioned the quality of water service the Company provides to its customers and customer satisfaction remains high with an overall 86.7% satisfaction rate, an improvement since 2008.<sup>101</sup> TAWC also timely met 99.5% of its customer appointments and completed 98.7% of its service orders as scheduled during 2010.<sup>102</sup> Simultaneously, over the last six years the operations and maintenance costs within TAWC's control have increased only 2.5%, compared to an inflation rate of 2.59%.<sup>103</sup> Accordingly, it is clear that the Company has been successful in striking this balance and keeping costs down. However, as described throughout this section there are many costs that the Company cannot control, and when these costs rise, so do the Company's expenses.

Mr. Watson described some of the cost-savings measures the Company has taken in his testimony. For example, Mr. Watson and TAWC management actively review and monitor the

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<sup>100</sup> John Watson, Pre-Filed Direct Testimony, at 32:18-33:4 (Sept. 17, 2010).

<sup>101</sup> Michael A. Miller, Rebuttal Exhibit MAM-12 (p. 1 of 3).

<sup>102</sup> Michael A. Miller, Rebuttal Exhibit MAM-12 (p. 1 of 3).

<sup>103</sup> John Watson, Pre-Filed Direct Testimony, at 7:20-23 (Sept. 17, 2010); Michael A. Miller, Rebuttal Ex. MAM-12 (p. 2 & 3 of 3). Rebuttal Exhibit MAM-12 shows those operations and maintenance expenses that are subject to general inflation to create an accurate comparison. Accordingly, pensions, group insurance, one-time costs not recoverable in rates, and depreciation of capital costs embedded in the service company are excluded. Michael A. Miller, Vol. VI A, Tr. 49:13-18 (March 7, 2011).



Company's Business Plan and budget each month to monitor costs and revenue patterns, to identify efficiencies, and to ensure that necessary expenses needed to comply with applicable laws and regulations are met.<sup>104</sup> Capital expenditures also are reviewed to identify needed facilities and ensure that construction is completed timely and cost-effectively.<sup>105</sup> Mr. Watson also provided an example of some of the investments in technological advances that the Company has implemented over the years, which save costs over the long-term.<sup>106</sup> For example, the Company continues to install permalogger electronic surveillance devices to detect leaks and reduce unaccounted for water.<sup>107</sup>

Mr. Watson also testified that he has tried to control labor costs by limiting overtime work, which costs one and half times the normal pay rate, and by electing not to immediately fill vacancies and/or hire contractors to perform certain jobs when appropriate.<sup>108</sup> Employee travel also has been restricted and more fleet vehicles have been grounded to reduce expenses.<sup>109</sup>

As explained by Mr. Miller, the Company has saved costs over time by shifting certain functions to the service company, AWWSC, resulting in a net cost-savings of \$1,229,864.<sup>110</sup> Mr. Watson explained in his testimony and at the hearing that he and others at TAWC monitor bills from the service company and dispute charges when appropriate to ensure that the Company is

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<sup>104</sup> John Watson, Pre-Filed Direct Testimony, at 6:17-7:20 (Sept. 17, 2010).

<sup>105</sup> John Watson, Pre-Filed Direct Testimony, at 7:24-27 (Sept. 17, 2010).

<sup>106</sup> John Watson, Pre-Filed Direct Testimony, at 8-9 (Sept. 17, 2010). The Intervenor attempted to argue during Mr. Watson's cross-examination that these technological advances are some of the same ones listed in the 2008 rate case. Mr. Watson was simply using these to illustrate areas where cost-savings opportunities have been identified and implemented and was not suggesting that all these investments were included during the test year or attrition year in this case and included in the rate request.

<sup>107</sup> John Watson, Pre-Filed Direct Testimony, at 8:23-9:3 (Sept. 17, 2010).

<sup>108</sup> John Watson, Pre-Filed Direct Testimony, at 33:6-16; 34:26-35:15 (Sept. 17, 2010).

<sup>109</sup> John Watson, Vol. I B, Tr. 137:15 – 138:10 (Feb. 28, 2011).

<sup>110</sup> Michael A. Miller, Ex. MAM-11, at 1 of 2.

not being billed improperly.<sup>111</sup> Mr. Watson, as TAWC's President, performs a high level review of the electronic copy of the charges and the actual invoice and identifies any particular charges or timekeepers that appear out of the ordinary and then performs a more in-depth review.<sup>112</sup> Mr. Watson works with the Manager of Finance in this process, who also reviews in detail and directly disputes any questionable charges with AWWSC as well.<sup>113</sup> During cross-examination, the Intervenors attempted to use the Company's response to City Data Request No. 13 (Trial Ex. 11) to suggest that TAWC only disputed one charge from the service company. Mr. Watson explained however – as is plain from the face of the document – that the Company's response to that data request was simply an *example* of the Company's disputed charges, that there were in fact additional disputes, and that it would be quite cumbersome to go back and attempt to list every single dispute because many were handled by phone, rather than in writing.<sup>114</sup>

Mr. Watson's testimony on the Company's cost savings measures refutes Mr. Buckner's unsupported claim that TAWC has elected to forego cost-savings and simply seek a rate increase instead. Although the Company cannot offset all revenue losses by controlling costs, Mr. Watson and his management have offset losses through these various cost-savings measures when and where they could, and have done their best to identify and implement efficiencies as best as possible.<sup>115</sup> Moreover, as described more thoroughly below, many of the increased costs are beyond the Company's control.

Unfortunately, despite the short-term success of these various cost-savings measures, Mr. Watson testified that TAWC has reached the point where the continued rise in operating

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<sup>111</sup> John Watson, Rebuttal Testimony, at 16:6-17 (Sept. 17, 2010); John Watson, Vol. III A, Tr. 103:19 – 105:20 (March 2, 2011).

<sup>112</sup> John Watson, Vol. I B, Tr. 202:17 – 203:20 (Feb. 28, 2011); Vol. III A, Tr. 103:19 – 105:20 (March 2, 2011).

<sup>113</sup> *Id.*

<sup>114</sup> John Watson, Vol. I B, Tr. 203:21 – 205:19 (Feb. 28, 2011); Vol. III A, 105:21 – 108:1 (March 2, 2011).

<sup>115</sup> John Watson, Vol. I B, Tr. 138:11-19 (Feb. 28, 2011).

expenses and decrease in water consumption make it difficult, if not impossible, to strike the necessary balance without a rate increase.<sup>116</sup>

Finally, the Union and other Intervenors attempted to insinuate during cross-examination that the Company should have foregone the payment of dividends in 2009 and 2010. They provide no analysis or basis for their position. First, dividend payments on its preferred stock are contractual and paid at a set rate.<sup>117</sup> With respect to dividends paid on its common stock, Mr. Watson testified that in fact TAWC only made two dividend payments on its common stock in 2010 (and only three in 2009), rather than four.<sup>118</sup> In fact, in the limited instances that the Company paid dividends on its common stock in 2010, it did so only when it had earnings from which to pay these dividends and it only paid a portion of those earnings as dividends. In addition to the fact that the Company was only able to pay dividends in two quarters in 2010, those dividend payments were made on an insufficient level of earnings that generated an unacceptable 2.66% rate of return. As the evidence from the Hearing confirms, this level of return is wholly inadequate to attract additional capital.

#### Increased Operations & Maintenance Expenses

The Company presented the testimony of Ms. Sheila Miller, Mr. Miller, and Mr. Watson to describe the known and measurable increases in the Company's operations and maintenance expenses that were included in the Company's test year and attrition year. Ironically, the increases in power, waste disposal, paving and restoration, and certain tax increases are all costs that are controlled by Intervenor City of Chattanooga. The Company has no control over these

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<sup>116</sup> John Watson, Pre-Filed Direct Testimony, at 32:25-33:4 (Sept. 17, 2010).

<sup>117</sup> John Watson, Vol. III A, Tr. 65:24-66:5 (March 2, 2011); Email from S. Clayton to parties and TRA dated March 18, 2011.

<sup>118</sup> John Watson, Vol. III A, Tr. 97:24-98:8 (March 2, 2011); Email from S. Clayton to parties and TRA dated March 18, 2011.

increased expenses. In the limited circumstances where TAWC does have some degree of control over an expense item, it has worked to minimize these expenses, as described above.

Despite the irrefutable evidence of the Company's increased operations and maintenance expenses, the City of Chattanooga attempted to argue during the cross-examination of Mr. Watson and Mr. Miller that TAWC has somehow not incurred the level of increased operations and maintenance expenses it claims. Mr. Hitchcock attempted to introduce Exhibits 15 and 18, *demonstrative exhibits he created*, showing a comparison of the Company's operations and maintenance costs since 2007.<sup>119</sup> The Company objected during the Hearing after having had an opportunity to review Mr. Hitchcock's calculations. The Company found numerous errors in the amounts portrayed and in the calculation of percentage increases, which the Company fully described in its March 11, 2011 "Notice of Filing Corrected Hearing Exhibits 15 and 18". The Authority should give no weight to the City's demonstrative exhibit because of these numerous errors.

Even if Exhibits 15 and 18 were correct, the City's argument misses its mark. For example, the City attempted to show that the Company's operations and maintenance costs increased by a lower percentage than the "more than 33%" increase in purchased power costs the Company described in its opening and in Mr. Watson's testimony.<sup>120</sup> Clearly, the "more than 33%" increase in electric power costs is the total increase in the *rates* for these goods. This increase is undeniable. However, the level of actual operations and maintenance percentage increases reflected in the Company's accounting statements will depend on the level of purchases the Company makes – thus, the percentage increase in the Company's operation and maintenance expenses is not going to be the exact same as the increased percentage in rates. Mr.

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<sup>119</sup> John Watson (cross examination), Vol. I C, Tr. 233-258 (Feb. 28, 2011).

<sup>120</sup> See John Watson (Cross Examination), Vol. I C, Tr. 245:4-10 (Feb. 28, 2011).

Watson explained this difference during cross-examination.<sup>121</sup> As described throughout this section, the Company has fully detailed the increase in operations and maintenance expenses that the Company has incurred and will continue to incur in the attrition year. The City's argument in this regard is nothing more than smoke and mirrors, devoid of any substance.

## **1. Fuel & Power**

The total attrition year fuel and power costs amount to \$2,511,238, a \$195,105 increase over the historical test year<sup>122</sup> and are costs entirely outside the control of TAWC. The Company gets its electric power from the Electric Power Board of Chattanooga ("EPB"). TAWC is one of EPB's largest customers, due to the massive amounts of power needed to operate the Citico treatment plant and pumping and booster stations and to otherwise provide water service to its customers.<sup>123</sup> Since the Company's 2008 rate case filing, EPB has repeatedly raised its rates. In 2008, rates were raised 20%, in 2009 they were raised an additional 13%, in 2010 an additional 6%, and, according to EPB, an additional 6% increase is planned for October 2011.<sup>124</sup> This 2011 expected increase was included in the Company's attrition year calculation. ***The City of Chattanooga is solely responsible for these increases in power costs.*** The City has suggested that its rate increases were caused by the higher TVA fuel charges that it incurs, but this argument proves the Company's point – there are charges incurred by TAWC, which it must pay, that are completely outside of its control. The City has raised its rates to compensate for these uncontrollable costs (assuming it is true that TVA is the culprit) just as the Company must

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<sup>121</sup> John Watson, Vol. I C, Tr. 245:11-19; 247:2-4 (Feb. 28, 2011).

<sup>122</sup> Shelia Miller, Pre-Filed Direct Testimony, at 9:3-10:4; (Sept. 17, 2010); Sheila Miller, Ex. 2, Schedule 3; Michael A. Miller, Rebuttal Ex. MAM-12, at 3 of 3.

<sup>123</sup> John Watson, Vol. I B, Tr. 130:15 – 131:3 (Feb. 28, 2011); John Watson, Pre-Filed Direct Testimony, at 25-26 (Sept. 17, 2010).

<sup>124</sup> John Watson, Pre-Filed Direct Testimony, at 26:20 – 27:7 (Sept. 17, 2010); John Watson, Ex. JSW-2.

now raise its rates. The difference is that the City can raise its rates whenever and however it chooses, unlike TAWC, which must submit rate increases to the TRA for full review.

In addition, increased fuel costs have been responsible, to some degree, for cost increases on all products and services the Company purchases. The Company provided updated information showing how fuel prices have risen since 2009 and have continued to rise even subsequent to the filing of this rate case, resulting in greater fuel expense in 2011.<sup>125</sup> The Company has no choice but to pay these increased fuel and power expenses and seek recovery through higher rates.

## **2. Chemicals**

The Company requires chemicals to treat its water because, unlike places such as Memphis that gets its water from groundwater sources, TAWC gets its water from the Tennessee River, which must be treated to be safe for human consumption.<sup>126</sup> Although the Company is able to utilize its size and purchasing power to negotiate for discounted bulk prices on chemicals, costs have risen since 2008 and have led to increased expenses that TAWC must pay.<sup>127</sup> Zinc Orthophosphate, a corrosion inhibitor, rose 41.3% in price since 2010.<sup>128</sup> Chlorine is a necessary disinfectant used to kill bacteria and ensure drinking water quality, but its cost has risen 15.9% since 2010.<sup>129</sup> Polyaluminum chloride, the chemical used in the most quantity, is up 3.7% from 2010. The total attrition year chemical expense is \$1,069,369. The Company, however, was able to obtain more favorable contract prices in 2011, which are reflected in the attrition year

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<sup>125</sup> Sheila Miller, Rebuttal Testimony, at 6:5-7:7 (Feb. 8, 2011); Rebuttal Ex. SAM-2.

<sup>126</sup> John Watson, Rebuttal Testimony, at 26:12-19 (Feb. 8, 2011).

<sup>127</sup> John Watson, Vol. I B, Tr.131:4 – 132:2 (Feb. 28, 2011). TAWC calculates the needed dosage levels based on the average historical dosage required at the Citico treatment plant during the test year.

<sup>128</sup> Trial Ex. 3, at 6 (Watson PowerPoint Presentation); John Watson, Vol. I B, Tr. 131:11-15 (Feb. 28, 2011).

<sup>129</sup> Trial Ex. 3, at 6 (Watson PowerPoint Presentation); John Watson, Vol. I B, Tr. 131:16-20 (Feb. 28, 2011).

adjustment to create a *decrease* of \$70,290 from the historical test year.<sup>130</sup> Nevertheless, chemical costs are still greater overall from the levels experienced in 2008 due to these cost increases.

### **3. Waste Disposal**

Waste disposal is another necessarily incurred expense whose cost is controlled by the City of Chattanooga. TAWC's treatment plant operations require the disposal of water used in filter backwash, sediment basin cleaning and water treatment residuals.<sup>131</sup> TAWC discharges this water into the sewer system under an approved permit with the City.<sup>132</sup> Since the 2008 rate case, the City of Chattanooga Sanitary Board has issued at least five (5) rate increases through the passage of several City ordinances.<sup>133</sup> The Company's test year waste disposal expenses were adjusted to reflect the 3% increase effective January 1, 2010, the 2.75% increase on October 1, 2010 and an additional 2.75% increase that will occur on April 1, 2011.<sup>134</sup> The Company revised its original attrition year waste disposal expense calculation with the updated data available through the CAPD's test year ending September 30, 2010, resulting in a total attrition year cost of \$194,401.<sup>135</sup>

The CAPD improperly uses a growth and inflation adjustment to come to an attrition year cost of \$172,338, rather than adjusting for the known and measurable increases in waste disposal

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<sup>130</sup> Sheila Miller, Pre-Filed Direct Testimony, at 10:6-24 (Sept. 17, 2010); Sheila Miller, Ex. 2, Schedule 3; Michael A. Miller, Rebuttal Ex. MAM-12, at 3 of 3.

<sup>131</sup> John Watson, Pre-Filed Direct Testimony, at 28:12-18 (Sept. 17, 2010).

<sup>132</sup> *Id.*

<sup>133</sup> John Watson, Pre-Filed Direct Testimony, at 28:17 – 29:11 (Sept. 17, 2010); John Watson, Exhibit JSW-3.

<sup>134</sup> Sheila Miller, Pre-Filed Direct Testimony, at 11:1-7 (Sept. 17, 2010); Sheila Miller, Ex. 2, Schedule 3; Michael A. Miller, Rebuttal Ex. MAM-12, at 3 of 3.

<sup>135</sup> CAPD Data Request 1, Part 3, Question 31; Sheila Miller, Rebuttal Testimony, at 4 (Feb. 8, 2011).

rates that have *already been approved* by the Sanitation Board.<sup>136</sup> TAWC provided these ordinances in response to TRA Data Request 2, Question 119.<sup>137</sup> Accordingly, it would be improper to adopt the CAPD's projection over TAWC's projection, which utilized a properly normalized test-year adjusted for known and measurable changes in the attrition year.

#### **4. Labor Costs**

The Company's labor expenses include costs for wages and other benefits and labor-related expense costs. As has been done in previous filings, TAWC calculated labor expense by individual employee, using each employee's wages during the historical test year and making adjustments to account for the wage level that will be in effect during the attrition year.<sup>138</sup>

In accordance with accounting principles, the Company properly eliminated the 15.83% of labor expenses (including group insurance, pensions, OPEBs, Defined Contribution Plan, Retirees' medical expenses and payroll taxes) that are capitalized from its operations and maintenance expenses.<sup>139</sup> The CAPD, on the other hand, used a 20.57% capitalization figure based on the faulty premise that labor capitalization was correlated to plant additions.<sup>140</sup> Ms. Miller explained why this was wrong in her rebuttal testimony. Labor charges are actually incurred as CWIP is expended during construction, not just when plant additions are put into

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<sup>136</sup> Sheila Miller, Rebuttal Testimony, at 4:7-5:16 (Feb. 8, 2011); Trial Ex. 76, at 7 (Sheila Miller PowerPoint presentation).

<sup>137</sup> Sheila Miller, Rebuttal Testimony, at 5:6-16 (Feb. 8, 2011).

<sup>138</sup> Sheila Miller, Direct Testimony, at 7 (Feb. 8, 2011). Adjustments were made to overtime hours for hourly employees to restate those hours to a level equivalent to the employee's hourly pay rate. Similar adjustments were made for premium overtime hours. The Company based its attrition year wage rates of its union employees on historical union contracts which are effective through October 31, 2011. An adjustment commensurate to prior increases was used for the final two months of the attrition year. For non-union hourly employees, the Company used the 3% pay increase that was effective January 1, 2011. Salaried employees were similarly adjusted for their January 1, 2011 increase. Sheila Miller, Direct Testimony, at 7:16 – 9:1 (Sept. 7, 2010).

<sup>139</sup> Sheila Miller, Direct Testimony, at 7:6-14 (Sept. 7, 2011).

<sup>140</sup> Sheila Miller, Rebuttal Testimony, at 1:26 – 3:9 (Feb. 8, 2011); Sheila Miller, Vol. VI A, Tr. 8:11 – 9:1 (March 7, 2011).



service, so there is no correlation with plant additions.<sup>141</sup> Moreover, if Mr. Buckner had looked at the individual budgeted items and projects, he would have seen that only \$2.948 million of the \$13.151 million attrition year capital budget will require internal labor, which affects the level of capital labor.<sup>142</sup> Mr. Buckner's 20.57% estimate is not in line with the level of capital labor that was actually expended in 2009/2010 or in line with what will actually be expended in 2011 and therefore should be rejected.

**a. Pensions & OPEBs**

The financial market crash in the Fall of 2008 and ensuing recession greatly diluted the Company's pension and Other Post Retirement Employee Benefits Costs ("OPEB") investment funds. TAWC, however, is required by law to fund these investments and therefore had to replenish these accounts with Company capital. As a result, pension costs have risen 42% since the 2008 rate case.<sup>143</sup> As testified to by Mr. Miller, the Company updated the pension expense contained in its original filing with the latest available pension expense information for 2011 from Towers/Watson, which was included in the Company's response to TN-CAPD-Part III-Q48-CONFIDENTIAL ATTACHMENT.<sup>144</sup> The result was an increase in expense from \$1,645,113 per the original filing to \$2,062,140 using the most recent available data.<sup>145</sup>

Shockingly, the CAPD takes the position that the Authority should *not* use the most recent available pension information even though they simultaneously argue in this case in favor

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<sup>141</sup> Sheila Miller, Rebuttal Testimony, at 1:26 – 3:9 (Feb. 8, 2011); Sheila Miller, Vol. VI A, Tr. 8:11 – 9:1 (March 7, 2011); Rebuttal Ex. SAM-1.

<sup>142</sup> *Id.*

<sup>143</sup> Michael A. Miller, Vol. VI A, Tr.32:12-19 (March 7, 2011).

<sup>144</sup> Michael A. Miller, Rebuttal Testimony, at 89 (Feb. 8, 2011).

<sup>145</sup> Michael A. Miller, Rebuttal Ex. MAM-13. The Company's labor expenses also include Defined Contribution Plan costs associated with pensions for those union employees hired after January 1, 2001 and non-union employees hired after January 1, 2006, totaling \$101,147. Employees hired after January 1, 2006 do not receive OPEBs, but rather receive defined contribution payments for health costs, totaling \$7,576 in costs to TAWC. Michael A. Miller, Direct Testimony, at 55-57 (Sept. 17, 2010); Exhibit MAM-10.

of using the most recent available data on other items. In fact, Mr. Buckner argued the exact opposite in the 2006 rate case – advocating that the most recent available Pension Evaluation Report should be used to set the Company’s pension expense, a position that the Authority adopted.<sup>146</sup> The CAPD’s explanation for its erroneous position in this case is that there will be a new Pension Evaluation Report available in August 2011, and that the market might improve by that time. This is hardly a defensible position because (1) Mr. Buckner cannot predict the stock market (2) recent events in the Middle East and Japan have demonstrated the market is currently in a decline and is highly volatile, and (3) this position ignores the most recent available data in favor of Mr. Buckner’s mere speculation of what might happen with the market in 2011.<sup>147</sup>

The Company similarly updated its OPEB expenses with the most recent available OPEB Evaluation Report information, which increase the expense from \$959,573 to \$1,174,215.<sup>148</sup> Just as it does with pension expense, the CAPD ignores the latest and best available data and opts to apply an inflation factor to determine attrition year OPEB expenses. For the same reasons as above, the CAPD’s argument fails. Importantly, both the pension and OPEB costs the Company has paid in January 2011 have been consistent with the latest Towers/Watson evaluation reports, further demonstrating that these latest available reports best reflect the Company’s actual expenses it will incur in 2011.

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<sup>146</sup> Michael A. Miller, Rebuttal Testimony, at 89:28 – 90:4 (Feb. 8, 2011); Final Order, Docket No. 06-00290, at 28.

<sup>147</sup> An additional error in the CAPD’s pension expense calculation is a \$92,701 reduction in costs attributable to the CAPD’s faulty labor capitalization rate of 20.57%. Michael A. Miller, Rebuttal Testimony, at 88:19-24 (Feb. 8, 2011).

<sup>148</sup> Michael A. Miller, Rebuttal Testimony, at 91:22-28 (Feb. 8, 2011); Michael A. Miller, Rebuttal Ex. MAM-13.

## **b. Group Insurance**

As a result of market conditions and increasing health care costs, group insurance premiums have risen 22%.<sup>149</sup> Ms. Miller's testimony explains that the Company's annualized group insurance cost was calculated by applying the group insurance rates effective March 31, 2010 to the employee complement and salary/wage information in the attrition year.<sup>150</sup> Employee contributions for healthcare coverage are not included. Total annual group insurance cost for the attrition year is \$1,260,708, which includes the updated data through October 2010 that the Company provided in this case in response to TRA Data Request, Question 121.<sup>151</sup> The CAPD did use this updated information, but only applied the employee reimbursement credit contained in the Company's response to 104 employees, rather than the 110 included in the response, leading to a \$1,569 understatement of group insurance expense.<sup>152</sup>

## **c. The Need for 110 Employees**

The Company has requested recovery for a complement of 110 full time employees. Currently, the Company has 108 employees. John Watson provided ample testimony that 110 employees are needed to continue providing quality water service and maintain and operate the Company's water system.<sup>153</sup> This number was determined after careful consideration of the Company's needs, practices, planned capital investments, and many additional factors affecting the work level of Tennessee American.<sup>154</sup> This number represents the *actual* level of employees

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<sup>149</sup> Michael A. Miller, Vol. VI A, Tr.32:12-19 (March 7, 2011).

<sup>150</sup> Sheila Miller, Direct Testimony, at 11 (Sept. 17, 2010).

<sup>151</sup> TN-TRA-02-Q121-ATTACHMENT 1 & 2.

<sup>152</sup> Sheila Miller, Rebuttal Testimony, at 5:18-6:2 (Feb. 8, 2011).

<sup>153</sup> John Watson, Pre-Filed Direct Testimony, at 21 (Sept. 17, 2010); Rebuttal Testimony, at 7:22 – 8:2 (Feb. 8, 2011).

<sup>154</sup> John Watson, Rebuttal Testimony, at 3:12-20 (Feb. 8, 2011).

needed in the attrition year.<sup>155</sup> Intervenor UWUA supports the Company's request for 110 full time employees.<sup>156</sup>

The CAPD, on the other hand, argues for a *reduction* of employees to 104, calling for the elimination of several positions that, if eliminated, would seriously hamper the Company's ability to provide service and maintain and operate its assets.<sup>157</sup> The CAPD ignores the fact that someone has to perform these functions, so if those positions were eliminated service could be harmed and the Company would need to either increase overtime pay or hire outside contractors to perform the tasks associated with these positions; the Company doubts that this alternative would please the CAPD or customers. Mr. Buckner performed no analysis of TAWC's job functions or operations to support the claim that TAWC can continue to perform its public service obligation with this level of employees.<sup>158</sup> As Mr. Watson testified, TAWC has been able to make do in the short term by using overtime and contracting services, but it cannot continue to do so in the long term and maintain required service levels.<sup>159</sup>

The CAPD only supports its position by arguing that TAWC has not maintained a full complement of employees compared to levels authorized in prior rate cases.<sup>160</sup> This argument ignores the fact that (1) the Company has experienced a significant level of turnover due to retirements and an aging workforce, (2) the Company had no choice but to terminate 10 employees recently for cause, (3) vacancies cannot be filled instantly, and (4) needs are increased

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<sup>155</sup> John Watson, Rebuttal Testimony, at 7:1-18 (Feb. 8, 2011).

<sup>156</sup> James Lewis, Direct Testimony, at 2:18-19 (Feb. 8, 2011).

<sup>157</sup> John Watson, Rebuttal Testimony, at 4 (Feb. 8, 2011). These positions include a professional engineer project manager, the Field Service Superintendent, and a Master Maintenance Mechanic.

<sup>158</sup> John Watson, Rebuttal Testimony, at 7:9-18 (Feb. 8, 2011).

<sup>159</sup> See John Watson, Rebuttal Testimony, at 5:1-14; 6:15-7:7; 11-12 (Feb. 8, 2011); Vol. I B, Tr. 140:18 – 141:6 (Feb. 28, 2011).

<sup>160</sup> See Terry Buckner, Direct Testimony, at 4:15-19 (Jan. 5, 2011).

in the attrition year.<sup>161</sup> Mr. Buckner's argument simply ignores the realities of operating a major business. Additionally, by disallowing any labor costs associated with the difference between the 110 employees and Mr. Buckner's 104 employee level, the CAPD ignores the fact that the Company incurs labor expenses even when it has employee vacancies because it costs money to pay for overtime labor, contracted labor, the cost of delaying projects, recruiting and hiring expenses, and other similar costs that emerge when unplanned vacancies arise.<sup>162</sup>

However, when questioned on cross-examination, Mr. Buckner admitted that the Company should be able to recover its known and measurable salaries and wages, including the costs of the Company's 108 employees (less the Government Affairs Specialist) because at the time of submitting his Direct Testimony, Mr. Buckner did not know of the full 108 employees.<sup>163</sup> The Company, during the Hearing, also proposed that it would be amenable to providing the TRA a report on its employee levels. Mr. Buckner, on cross-examination, agreed that this was a better alternative than simply disallowing the cost of employees.<sup>164</sup> Accordingly, if the Authority has a concern about maintenance of the 110 employee level, the Company suggests that this be an alternative to disallowing recovery of the costs for the 110 employees needed to effectively operate and adequately maintain service to its customers.

The Company does, however, adamantly oppose the UWUA's proposal that TAWC be **required** to maintain 110 employees at all times. Imposing such an onerous restriction blatantly ignores the realities of operating a business and would be almost impossible to follow, given that employee turnover is inevitable and outside the Company's control. Moreover, it would be

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<sup>161</sup> John Watson, Rebuttal Testimony, at 8:4-20; 10:10-14; 11-12 (Feb. 8, 2011); Vol. III A, Tr. 100:3 – 102:9 (March 2, 2011).

<sup>162</sup> John Watson, Rebuttal Testimony, at 6:13-7:18 (Feb. 8, 2011).

<sup>163</sup> Terry Buckner, Vol. VII B, Tr. 80:4-16; 81:7-11 (March 8, 2011).

<sup>164</sup> Terry Buckner, Vol. VII B, Tr. 80:17 – 81:11 (March 8, 2011).

detrimental to both the Company and to customers if TAWC were forced to maintain a certain level of employees regardless of the Company's financial situation.

The CAPD also, ironically, complains that TAWC allegedly has not maintained the level of employees authorized in the 2008 rate case, yet simultaneously argues that TAWC has not tried to reduce costs even though Mr. Watson testified he was forced to maintain a reduced working force as an effort to deal with the difficult financial position the Company is in.<sup>165</sup>

Finally, several particular employee positions have become an issue in the case. The CAPD takes issue with the Company's hiring of a Government Affairs Specialist, although Mr. Buckner admitted that he performed no particular analysis of what that person's role was at TAWC.<sup>166</sup> The Company presented ample testimony that this position is essential because the Company is heavily regulated and must remain apprised of pending legislation in many fields, all of which could have a direct effect on the Company's operations.<sup>167</sup> The Government Affairs Specialist also works with the community and local government to ensure there is ample communication about the Company's water service.<sup>168</sup> The Company stated in its data request responses that it estimates that the Government Affairs Specialist will only spend approximately 20% of his time engaged in lobbying on behalf of TAWC and its customers.<sup>169</sup> Accordingly, should the Authority decide to disallow recovery for employee costs associated with lobbying activities, it should still allow recovery of 80% of the Government Affairs Specialist's labor costs.

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<sup>165</sup> John Watson, Pre-Filed Direct Testimony, at 33:6-16; 34:26-35:15 (Sept. 17, 2010)

<sup>166</sup> Terry Buckner, Vol. VII B, Tr. 85:9-15 (March 8, 2011).

<sup>167</sup> John Watson, Rebuttal Testimony, p. 13:20 – 14:4 (Feb. 8, 2011); John Watson, Vol. III A, Tr. 98:9 – 99:12 (March 2, 2011).

<sup>168</sup> *Id.*

<sup>169</sup> Response to CAPD Supplemental Data Request No. 86

Director Roberson also asked Mr. Watson about the External Affairs Manager and Mr. Watson explained that her role did not overlap with the Government Affairs position and explained the importance of her role to the Company.<sup>170</sup> The Intervenors also questioned the Company's recovery of business development expenses. However, other regulatory commissions have specifically rejected challenges to the recoverability of business development expenses.<sup>171</sup>

The current economic reality is that TAWC needs 110 employees to continue its public service obligation to its customers and the Company has submitted undisputable evidence to support the Authority's award of labor expenses for the full complement of 110 employees.

## **5. Management Fees**

TAWC seeks recovery of \$5.226 million for management services. These services are necessary to provide water services to TAWC's customers. While this is an increase of approximately \$800,000 over the amount of management fees requested by TAWC in Docket 08-00039, as the evidence clearly demonstrated, the most significant portions of the increase are the result of labor costs, payroll taxes, pension costs, group insurance & OPEB costs, and capital costs, the majority of which are driven by financial market fluctuations and other factors outside TAWC's control.<sup>172</sup> The Intervenors have contested the recovery of management fees paid to AWWSC, alleging: (1) the costs from the service company have increased over time; and (2) TAWC's management fees are purportedly not in line with comparable water companies. Of course, the Intervenors fail to provide any substantive or credible evidence to prove that the increase is improper, unwarranted, or unreasonable given TAWC and AWWSC's fixed costs.

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<sup>170</sup> John Watson, Vol. III A, 89:23 – 90:23 (March 2, 2011).

<sup>171</sup> Trial Ex. 92, p. 83 (*In re Petition of Indiana American Water Co.*, Cause No. 43680, Final Order, Apr. 30, 2010).

<sup>172</sup> Michael A. Miller, Pre-Filed Direct Testimony, at 41-42 (September 17, 2010).

Mr. Miller's testimony, Mr. Watson's testimony and TAWC's experts all establish that AWWSC's services are necessary for the provision of water service and that the services are provided by AWWSC at the lower of cost or market. TAWC has also proven that its management fees are in line with those charged by comparable utility service companies, as shown in the separate Cost Comparison studies completed by the independent management auditors Schumaker & Company and Work & Greer and Mr. Baryenbruch. In addition, the independent management auditors performed a comprehensive management audit in accordance with the directives of the Authority that confirms the reasonableness of the charges to TAWC from AWWSC.

**a. Management Fees Overview**

TAWC presented evidence that the savings to the customers of TAWC from the shifting of functions and costs away from TAWC and to AWWSC have resulted in a total savings to its customers of \$1,229,864.<sup>173</sup> AWWSC provides TAWC with a 24/7 customer call center as well as expert services in accounting, administration, communication, engineering, financial, human resources, information systems, operations, rates and revenue, risk management, water quality, and corporate governance.<sup>174</sup> Moreover, AWWSC *provides all of these services to TAWC at cost*.<sup>175</sup>

If not for its relationship with AWWSC, TAWC would still have to provide these required services. Shifting services from AWWSC to the local level would require more full-time employees and would result in much greater fees for outside contractors (who do not bill at cost). As many leading national utilities have done through the service company model, TAWC

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<sup>173</sup> See Michael A. Miller, Pre-Filed Direct Testimony, Exhibit MAM-11 (Sept. 17, 2010).

<sup>174</sup> Trial Ex. 29, at 17-18; see also Patrick Baryenbruch, Pre-Filed Direct Testimony, Ex. PLB-1 at 3 (Sept. 17, 2010).

<sup>175</sup> Trial Ex. 29, at 24.



has taken advantage of the expertise and economies of scale afforded by its relationship with AWWSC.<sup>176</sup> This model allows AWW subsidiaries to utilize highly qualified and specialized employees, while sharing in the cost of employing those personnel, some of whose services may not be needed on a full-time basis at each operating subsidiary.

Efficiency of services was a key focus of the Authority's ordered management audit. After studying TAWC's relationship with AWWSC, Schumaker & Company issued Finding IV-1 that states that the "composition and mix of responsibilities as identified by functions and associated services provided by the AWWSC and utility company organizations, such as TAWC, is reasonable."<sup>177</sup> The management auditors further explained that "[c]onsolidation and centralization of governance, strategy, policy development, and support functions is generally considered a cost effective way to provide such services. Schumaker & Company found no evidence to the contrary within the American Water organization."<sup>178</sup> The management audit confirmed what AWW had already determined in 2004 – that customers of the operating entities would benefit from reduced costs, greater efficiencies, and higher quality as the result of centralizing these services.<sup>179</sup>

With respect to the distribution of functions between TAWC and the various service company organizations, the management auditors found that "overlap and duplication do not exist with the current configuration/mix of American Water national, regional and operating

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<sup>176</sup> Patrick Baryenbruch, Pre-Filed Direct Testimony, Ex. PLB-1 at 3 (Sept. 17, 2010).

<sup>177</sup> Trial Ex. 29, at 106.

<sup>178</sup> Trial Ex. 29, at 112.

<sup>179</sup> Michael A. Miller, Vol. VIB, Tr. 142:3 – 142:20 (March 7, 2011) (explaining the extensive analysis that was preformed by AWW before the decision was made to centralize services).

company organizations.”<sup>180</sup> Moreover, Ms. Schumaker also testified that the allocation of functions between AWWSC and TAWC generally follows “best practices.”<sup>181</sup>

The Intervenor has alleged that the service company model is not efficient because overall management fees have increased since 2004. All that the Intervenor has done is to calculate the overall percentage increase since an arbitrary point in time and label the percentage unreasonable. This “analysis,” which fails to take into account any of the drivers behind the increase, is therefore completely invalid. The independent management auditors did study the issue of management fee cost increases and opined that “[i]n many cases, business services that an operating company had traditionally performed internally have been centralized to the service company to more effectively deploy newer technologies and improve the overall efficiency and effectiveness. As a result charges from the AWWSC to TAWC *would be expected to increase* as these services were centralized.”<sup>182</sup>

Mr. Miller testified as to the drivers behind the management fee cost increase and offered Exhibit MAM-10 to illustrate these drivers. He explained that the most significant portions of the increase are the result of labor costs, payroll taxes, pension costs, group insurance & OPEB costs, and capital costs, the majority of which are driven by financial market fluctuations and other factors outside TAWC’s control.<sup>183</sup> For example, pension costs have *increased 722%* due to market losses over the last few years which have resulted in required increases in pension contributions to meet and maintain ERISA funding requirements.<sup>184</sup> The market decline and resulting increased pension contributions are completely out of TAWC and AWWSC’s

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<sup>180</sup> Trial Ex. 29, at 112.

<sup>181</sup> Patricia Schumaker, Vol. IIB, Tr. 199:10 – 199:15 (March 1, 2011).

<sup>182</sup> Trial Ex. 29, at 85. (emphasis added)

<sup>183</sup> Michael A. Miller, Pre-Filed Direct Testimony, at 41-42 (September 17, 2010).

<sup>184</sup> Michael A. Miller, Pre-Filed Direct Testimony, at 42 (September 17, 2010).

control.<sup>185</sup> Likewise, group insurance costs have increased 87% primarily due to the cost of employee health insurance,<sup>186</sup> which has been recognized nationally as a major problem over which companies have little control. Mr. Miller presented an analysis that conclusively showed the remaining costs, many of which TAWC does have control over, have actually *decreased* by \$331,169 or 26% once labor costs, payroll taxes, pension costs, group insurance, OPEB and capital costs are eliminated.<sup>187</sup>

TAWC presented evidence establishing that the full amount of management fees included in its Petition are necessary to provide water service to its customers and should be included as part of a just and reasonable rate. TAWC has established that the services provided by AWWSC are essential for TAWC to meet its public service obligation and no Intervenor has provided any substantive credible evidence to the contrary. In fact, the evidence leads to the undeniable conclusion that the relationship with AWWSC benefits TAWC's customers.

**b. The Management Audit**

In addition to the management fee evidence directly submitted by TAWC in this docket, the management audit ordered in Docket No. 08-00039 and completed by Shumaker & Company and Work & Greer has been submitted to the Authority in Docket No. 09-00086. At the Authority's order Ms. Schumaker also provided testimony in this docket. As explained below, the management audit proves not only that AWWSC's services and fees promote efficiency, but also that AWWSC's fees to TAWC are based upon prudent allocation methodologies and management decisions. Therefore, the full amount of AWWSC's fees to TAWC should be included as part of a just and reasonable rate.

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<sup>185</sup> Michael A. Miller, Pre-Filed Direct Testimony, at 46 (September 17, 2010).

<sup>186</sup> Michael A. Miller, Pre-Filed Direct Testimony, at 42 (September 17, 2010).

<sup>187</sup> Michael A. Miller, Pre-Filed Direct Testimony, at 42-43; Ex. MAM-10 (September 17, 2010).

**i. Management Audit Issue History**

In the 2008 rate case filed in Docket No. 08-00039 the Authority awarded \$3,529,933 in management fees and ordered TAWC to develop a Request for Proposal (“RFP”) for a management audit. It is clear from the record in that case that the Authority did not intend that \$3,529,933 was the maximum amount of management fees that TAWC was entitled to recover. Instead, the Authority ordered a management audit process to be conducted under the Authority’s supervision and subject to its approval so that the Authority could determine whether the fees being allocated for services were prudent.<sup>188</sup> As Director Roberson noted in presenting the motion that was ultimately adopted as the majority position on management fees in Docket No. 08-00039:

Regarding the amount of management fees allowed, there is no doubt in my mind that legitimate expenses are incurred from the service company. The problem I had is in determining whether the amount requested by the company to pay its service company is a just and reasonable amount based on prudent expenditures.

The management audit ordered in 06-290 could have answered this important question if conducted properly....

I am anxious for the conclusion of the comprehensive audit ordered in 06-290 and restated in my motion for this docket. ***I want to stress that if the management audit ultimately shows that the fees being allocated for services are prudent, the authority can on its own motion or the motion of a party revisit the issue of management fees.***<sup>189</sup>

TAWC complied with the Authority’s Order to file a draft RFP on March 23, 2009. The Authority then oversaw each and every step of the audit procurement process, beginning on June 15, 2009, when the Authority first addressed TAWC’s draft RFP and opened Docket No. 09-00086 to oversee the management audit procurement process.

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<sup>188</sup> See Order at 21-22, Docket No. 08-00039. The Court of Appeals also noted the temporary nature of the TRA’s decision regarding management fees in the 2008 Order. See *Tenn. Am. Water Co. v. Tenn. Reg. Auth.*, Case No. M2009-00553-COA-R12-CV, 2011 Tenn. App. LEXIS, at \*56 (Jan. 28, 2011) (“Using the fees from 2005 was a reasonable, temporary solution to the dilemma until TAWC could submit a proper management audit.”).

<sup>189</sup> Hrg. Tr. at 8-9, Docket No. 08-00039 (Sept. 22, 2008) (emphasis added).

The Authority considered the management audit process at multiple Directors' Conferences in 2009 and made numerous revisions to the RFP originally submitted by TAWC before finally issuing an Order approving the final version of the RFP on September 8, 2009. The Authority next reviewed all responses to the RFP and reviewed TAWC's recommendation and rationale for selecting an auditing proposal. TAWC filed its request for approval of Schumaker & Company as the auditor on October 28, 2009. On December 14, 2009 the Authority approved Schumaker & Company and Work & Greer as the management auditors.<sup>190</sup> Thereafter, TAWC submitted to the Authority its draft contract with the management auditors and on January 25, 2010 the Authority revised the draft contract and then approved the contract. The contract set forth in detail all procedures, requirements, standards, terms, and conditions for the audit.<sup>191</sup>

## **ii. Management Audit Overview**

Schumaker & Company and Work & Greer began work on the audit shortly after their contract with TAWC was approved by the Authority. The management auditors completed 24 interviews with TAWC and AWWSC personnel, received information from TAWC in response to the over 100 data requests from Schumaker & Company, and spent more than six months completing the audit.<sup>192</sup> The management audit was completed in compliance with generally accepted auditing standards ("GAAS"), as contained in the United States General Accounting Office's "Yellow Book," and in accordance with the standards as defined in the RFP and set forth in NARUC's "Consultant Standards and Ethics for Performance of Management

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<sup>190</sup> The Authority later issued this written Order on March 12, 2010.

<sup>191</sup> See Trial Ex. 28. The Authority later issued a written Order on March 24, 2010 documenting its approval of the contract.

<sup>192</sup> Patricia Schumaker, Vol. IIA, Tr. 73:10 – 75:13 (March 1, 2011).

Analysis.”<sup>193</sup> Shortly after the completion of the audit TAWC filed a copy of the audit with the Authority on September 10, 2010.

The Authority’s Order in Docket No. 08-00039 explained that the management audit should include “an investigation of AWWSC’s management performance and decisions relating to internal processes and internal controls” and include recommendations of any needed management changes and implementation thereof.<sup>194</sup> The Order went on to require the management auditors to evaluate “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.”<sup>195</sup> The Authority ordered that ten specific scope items be included in the contract between the management auditors and TAWC.<sup>196</sup> The scope items were attached to the Authority’s Order of March 12, 2010 and were included in the contract as Exhibit E.<sup>197</sup>

The audit completed by Schumaker & Company and Work & Greer – and conducted pursuant to the RFP and contract approved by the Authority – met all of the Authority’s ten specific scope item requirements and confirmed that the fees charged by AWWSC are necessary to provide the level of quality service that both TAWC’s customers and the Authority expect. The audit found, among other things, that for each and every scope item that the contract required to be studied, TAWC’s performance was at or above adequate levels.<sup>198</sup>

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<sup>193</sup> Trial Ex. 29, at 4.

<sup>194</sup> Final Order, Docket No. 08-00039, at 22.

<sup>195</sup> *Id.*

<sup>196</sup> Order Approving Contractor to Perform Management Audit, Docket No. 09-00086, at 5 (March 12, 2010).

<sup>197</sup> Order Approving Contractor to Perform Management Audit, Docket No. 09-00086, at Ex. 1 (March 12, 2010); Trial Ex. 28, at Ex. E.

<sup>198</sup> Trial Ex. 29, at 10. (“The results of this report found no recommendations that should be in the significant improvement or major improvement category.”).

### **iii. Management Audit Findings**

In addressing the Authority's scope items, Schumaker & Company made a number of findings with respect to AWWSC's services in general, AWWSC's allocation methodologies, the reasonableness of AWWSC's costs compared to similar service companies, the relationships between TAWC and its non-regulated affiliates, and the numerous service improvements that AWWSC has provided in recent years for TAWC's customers. The management auditors' findings for the ten scope items were included on pages 10-11 of the audit:

<b>RFP Scope Item</b>	<b>Overall Evaluation</b>	<b>Applicable Findings</b>	<b>Applicable Recommendations</b>
Assessed the status and sufficiency of AWWSC's management performance and decisions relating to internal processes and internal controls.	Moderate improvements recommended	III-1, III-2, III-3, III-4, III-5, III-6, III-7	III-1, III-2, III-3, III-4 III-5
Assessed the efficiency of operating procedures and communication between TAWC and AWWSC.	Acceptable industry practice	II-7	N/A
Assessed the AWWSC performance with industry standards and best management practices.	Moderate improvements recommended	II-1, II-3, II-4, II-5, II-6, IV-2, IV-3, IV-4, IV-5, IV-6, IV-7, IV-8, IV-9, IV-10, IV-11, IV-12, IV-13	II-1, II-3, II-4, II-5, II-6 IV-1
Assessed the appropriateness of organizational structure of AWWSC/TAWC and reporting alignment.	Acceptable industry practice	IV-1	N/A
Assessed the development of AWWSC's long-range and short-range operational plans to assure the effective and efficient performance of the functions	Minor improvement recommended	II-3, II-7	II-3
Assessed the appropriateness of AWWSC's staffing and skill sets.	Acceptable industry practice	IV-1	N/A
Assessed TAWC's controls and systems to analyze and control costs from AWWSC.	Moderate improvements recommended	III-1, III-3, III-4, III-5, III-6, III-7	III-2, III-3, III-4, III-5
Evaluated the accuracy and reasonableness of total AWWSC charges (including expenses) allocated to TAWC.	Moderate improvements recommended	III-2, III-6, III-7, IV-1	III-1, III-4, III-5
Evaluated the necessity, reasonableness/prudency, and efficiency of processes and/or functions performed by AWWSC on behalf of TAWC.	Acceptable industry practice	IV-1	N/A
Evaluated the accuracy and reasonableness of the allocation factors utilized to allocate AWWSC charges to regulated and non-regulated subsidiaries, and allocated regulated AWWSC charges to TAWC, including a review of work previously performed regarding allocation methods.	Moderate improvement recommended	II-2 III-3, III-4	II-2 III-2, III-3



The associated evaluation categories were explained as follows:

- ***Acceptable industry practice*** – The area is functioning more than adequately and no recommendations were made.
- ***Minor improvement recommended*** – The area is generally functioning adequately, but minor improvements are recommended.
- ***Moderate improvement recommended*** – The area is generally functioning adequately, but some substantial opportunities for improvement were recommended.
- ***Significant improvement recommended*** – The areas is not functioning adequately and many recommendations, requiring considerable effort, need to be implemented to achieve adequate performance.
- ***Major improvement recommended*** – The area is not functioning effectively or efficiently and many recommendations need to be implemented to achieve adequate performance. Implementation of these recommendations will have a major effect on cost levels and performance for TAWC.<sup>199</sup>

The management auditors found that no scope item warranted significant improvement or major improvement.<sup>200</sup> Schumaker & Company explained in general that “[b]ecause the bulk of a management audit is focused on opportunities for improvement, it may give the reader the impression that the utility is seriously deficient. This is not so at TAWC with regard to its affiliate relationships, transactions, and associated internal controls, because many of the findings are of relatively minor or moderate in nature.”<sup>201</sup> In fact, each of the scope items was reported to be functioning adequately.

Aside from a small number of helpful recommendations for improvement, the management audit essentially presented a clean bill of health with respect to both the relationship between TAWC and AWWSC and the resulting fees from AWWSC to TAWC. The management audit confirmed TAWC’s position all along – that the fees from AWWSC to

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<sup>199</sup> Trial Ex. 29, at 10.

<sup>200</sup> Trial Ex. 29, at 10.

<sup>201</sup> Trial Ex. 29, at 10.

TAWC are the result of prudent management decisions and allocation methodologies. The Intervenor's argument that Schumaker & Company's audit is somehow not relevant to the consideration of TAWC's request for \$5.226 million in management fees in this case because the management auditors "looked at this from . . . a business perspective" is nothing more than a red herring.<sup>202</sup> The audit's test year overlapped significantly with TAWC's test year for this case and the audit proved that the fees studied, as well as the methodologies and internal controls implemented were reasonable, so all that is essentially left in this case is updating the test year numbers to arrive at the current reasonable level of management fees.

#### **A. Allocation Methodologies**

In Finding II-2 the management auditors found that the cost-allocation methodologies AWWSC uses to allocate costs to TAWC were generally reasonable.<sup>203</sup> With respect to Tier 1 charges, Schumaker & Company had no recommendations regarding AWWSC's direct charges to affiliates or AWWSC's Tier 1 allocations between regulated and non-regulated affiliates. With respect to Tier 2 charges allocated to the regulated affiliates, Schumaker & Company agreed that using the number of customers to make these allocations was reasonable. Schumaker & Company did recommend that TAWC verify that the use of customers to allocate Tier 2 charges reasonably approximates the use of cost-causative factors.<sup>204</sup> In response to the management auditors' recommendation, TAWC retained Mr. Uffelman, who completed a "Customer Based Cost Allocation Analysis," that confirmed that no change in allocating the Tier 2 charges was necessary.

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<sup>202</sup> Vol. IA, Tr. 94:6 - 94:8 (Feb. 28, 2011).

<sup>203</sup> Trial Ex. 29, at 40.

<sup>204</sup> Trial Ex. 29, at 51.

Mr. Uffelman has been in the utility industry for over 38 years, and his experience includes serving as chief accountant of the Illinois Commission and Director of Accounting for the Texas Commission.<sup>205</sup> Mr. Uffelman's analysis determined that the difference to TAWC between using customers and other cost-causative allocation factors versus number of customers was immaterial, resulting in a decrease of only 2.38% in the amount of allocated costs.<sup>206</sup> Accordingly, Mr. Uffelman concluded that "the use of the number of customers for allocating AWWSC costs reasonably approximates the use of cost-causative factors and does not justify changes in the current customer-based allocation methodology for allocating common costs."<sup>207</sup> When asked during the hearing whether Ms. Schumaker supports Mr. Uffelman's conclusion, Ms. Schumaker stated that a 2.38% difference means that allocating based on the number of customers reasonably approximates allocating based on cost causative factors.<sup>208</sup> Further, even the City's own witness, Ms. Dismukes, agreed that using the number of customers to allocate costs between regulated entities – as AWWSC does currently – is acceptable and not unreasonable.<sup>209</sup>

While the Intervenors attempted to discredit Mr. Uffelman's analysis based on the time he spent preparing the analysis for TAWC, Mr. Uffelman fully explained that much of the work for this study had already been completed while preparing a recent similar study for Pennsylvania American Water Company in which he spent significantly more time.<sup>210</sup> As a result, there was no need for Mr. Uffelman to recreate the wheel or his analysis and the TAWC study was able to be provided at a lower cost. Lower cost does not mean improper or

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<sup>205</sup> Bernard Uffelman, Vol. IIIB, Tr. 174:6 – 174:12 (March 2, 2011).

<sup>206</sup> Bernard Uffelman, Pre-Filed Rebuttal Testimony, Rebuttal Exhibit BLU-1, at 13 (Feb. 8, 2011).

<sup>207</sup> *Id.*

<sup>208</sup> Patricia Schumaker, Vol. IIA, Tr. 86:10 – 86:12 (March 1, 2011).

<sup>209</sup> Kimberly Dismukes, Pre-Filed Testimony, at 56:4 – 56:5 (Jan. 5, 2011); Vol. IIC, Tr. 279:17-18 (March 1, 2011).

<sup>210</sup> Bernard Uffelman, Vol. IVA, Tr. 6:8 - 6:16 (March 3, 2011).

incomplete. Mr. Uffelman testified to the validity of his study and none of the Intervenor presented any credible evidence, study or analysis contradicting Mr. Uffelman's analysis.

In direct contrast to Mr. Uffelman's study and testimony, the testimony and report of Ms. Schumaker and even the City's witness, Ms. Dismukes, the CAPD nevertheless recommended use of an alternative methodology for Tier 2 allocations. Mr. Buckner proposed that the Authority require AWWSC's Tier 2 allocations to be based on the same methodology as used by Atmos Energy, a Texas gas company.<sup>211</sup> Mr. Buckner's proposal is inappropriate for a number of reasons. First, Mr. Buckner did not perform any analysis or study to determine whether Atmos was an appropriate utility to compare to TAWC. Second, unlike Mr. Uffelman, Mr. Buckner did no analysis to determine whether a different allocation methodology was even needed. Third, Mr. Buckner did not take into account the significant costs that would be associated with completely changing AWWSC's allocation methodologies – the very same methodologies that have already been deemed reasonable by the independent management auditors.

## **B. Reasonableness of Charges**

With respect to the reasonableness of AWWSC's charges, Schumaker & Company stated in Finding II-3 that American Water had performed numerous cost-to-market comparisons in the past as a means to verify that AWWSC costs are equal to or lower than what they would be if outsourced to third-party organizations.<sup>212</sup> Schumaker & Company also issued a related recommendation that TAWC continue to do such studies in the future.<sup>213</sup> In addition, the independent management auditors completed their own service company operating cost comparison, which found AWWSC's operating expenses to be less than nineteen of the twenty-

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<sup>211</sup> Terry Buckner, Pre-Filed Amended Non-Confidential Testimony, at 30-31 (Jan. 5, 2011)

<sup>212</sup> Trial Ex. 29, at 42.

<sup>213</sup> Trial Ex. 29, at 52.

six comparable utilities.<sup>214</sup> If AWWSC's charges were not appropriate or were greater than cost or market, AWWSC's operating expenses would not have been less than nineteen of the twenty-six comparable utilities.

In the closing moments of the Hearing on the Merits the Consumer Advocate's witness Mr. Buckner alleged for the first time that the management auditors "relied on Mr. Baryenbruch in the report."<sup>215</sup> While this would not have been inappropriate, this is simply not the case. The contract between the management auditors and TAWC that was approved by the Authority included a requirement that the management auditors review "work previously performed regarding allocation methods, which will be supplied by AWW,"<sup>216</sup> and to consider the work and avoid duplicating the work, analysis, findings and/or certifications of PwC and E&Y to keep costs down. Accordingly, the management auditors requested all American Water studies, and after review of the studies the management auditors issued a finding that "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."<sup>217</sup> The management auditors explained that "[t]he use of studies by independent consultants is a reasonable approach to verify that ratepayers are not being harmed by charging these services at cost rather than market," and that "these studies have merit in providing hourly costs that TAWC may use in making decisions as to its continued use of specific AWWSC services."<sup>218</sup>

Accordingly, intervenors' allegations that the management auditors relied on any previous study to determine the reasonableness of AWWSC charges was proven completely

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<sup>214</sup> Trial Ex. 29, at 111-112.

<sup>215</sup> Terry Buckner, Vol. VIIB, Tr. 106:16 (March 8, 2011).

<sup>216</sup> Trial Ex. 28, at 3-4.

<sup>217</sup> Trial Ex. 29, at 42.

<sup>218</sup> Trial Ex. 29, at 52.

unfounded.<sup>219</sup> As explained above, the management auditors made no affirmative statements regarding the conclusions of any previous cost-to-market studies other than to state the irrefutable fact that those studies had previously been completed. The management auditors never stated they relied upon Mr. Baryenbruch or any other study TAWC had completed. In fact, contrary to Mr. Buckner's allegation, Ms. Schumaker stated earlier in her deposition that she *did not rely* on any previous reports:

A. I would say we didn't rely on any of these per se to make our conclusions. We used it as background information to get a better understanding of what had been done in the past. We looked at -- we wanted to see what the company had done with regard to this, and we did look at -- but I would say "rely" is probably the wrong word I would use.

Q. And what word would you use?

A. Again, we used most of these as background information to understand what had been done and to get a better understanding of the perspective from the company's basis.

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And we felt it was appropriate that the company try to look at what their costs were. We -- so in that sense there is a finding in here that talks about, you know, the fact that they have done these various kinds of studies and reports in the past.<sup>220</sup>

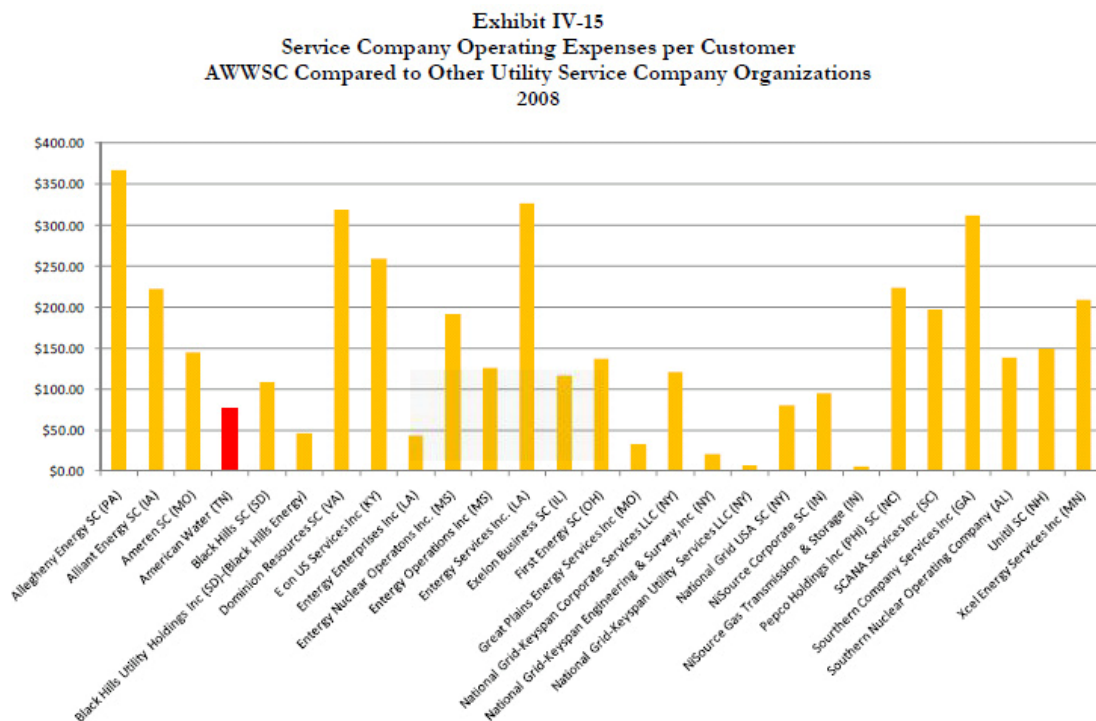
The management auditors certainly went further than simply reviewing the cost comparison studies that had previously been performed. The management auditors actually

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<sup>219</sup> Mr. Buckner also alleged for the first time during the closing moments of the hearing that Mr. Baryenbruch's independence was questionable because he was a witness in this rate case for TAWC. Terry Buckner, Vol. VIIB, Tr. 106:18 – 106:20 (March 8, 2011). However, Ms. Schumaker only stated in her report that Mr. Baryenbruch was an independent consultant. Trial Ex. 29, at 42. Furthermore, Mr. Schumaker testified that her definition of "independent" was that an individual was not an employee of American Water but was instead a consultant contracted by the American Water system to perform certain studies. Patricia Schumaker, Vol. IIA, Tr. 105:11 – 105:16 (March 1, 2011). Mr. Buckner did not allege Mr. Baryenbruch was an employee of any AWW-related entity, nor did he allege any facts upon which to question Mr. Baryenbruch's independence or objective judgment. Mr. Buckner's last second allegation against Mr. Baryenbruch was completely without foundation and was nothing more than last ditch attempt to discredit a management audit that turned out to be detrimental to the CAPD's position.

<sup>220</sup> Trial Ex. 34, 69:18 - 70:6, 70:16 - 70:20 (Feb. 18, 2011).

performed their own “sanity check to see where the American Water costs per customer were relative to these organizations to see if it was within sort of the realm of reasonableness.”<sup>221</sup> Ms. Schumaker indicated that the cost comparison was completed to determine AWWSC’s placement relative to other comparable utilities.<sup>222</sup> Of the twenty-six utility companies in the comparison group, nineteen had per customer costs that were higher than AWWSC, as shown on Exhibit IV-15 at page 112 of the management audit:



Source: Schumaker & Company Analysis based on FERC Forms, Annual Reports, and 10k Filings

This cost comparison was used as support for Finding IV-1, which states that the “composition and mix of responsibilities as identified by functions and associated services provided by the AWWSC and utility company organizations, such as TAWC, is reasonable.”<sup>223</sup> The management auditors explained that “[c]onsolidation and centralization of governance,

<sup>221</sup> Patricia Schumaker, Vol. IIA, Tr. 89:23 – 90:1 (March 1, 2011).

<sup>222</sup> Patricia Schumaker, Vol. IIA, Tr. 92:5 – 92:7 (March 1, 2011).

<sup>223</sup> Trial Ex. 29, at 106.

strategy, policy development, and support functions is generally considered a cost effective way to provide such services. Schumaker & Company found no evidence to the contrary within the American Water organization.”<sup>224</sup> With respect to the distribution of functions between TAWC and the various service company organizations, the management auditors also found that “overlap and duplication do not exist with the current configuration/mix of American Water national, regional and operating company organizations.”<sup>225</sup> This finding further supports the conclusion that AWWSC’s charges to TAWC are reasonable.

For purposes of their cost comparison the management auditors determined that the most appropriate comparison group was electric and gas utilities that were required to file FERC Form 60 and not other water utilities. When questioned why the management auditors had chosen this comparison group, Ms. Schumaker explained: “there’s no one source that the water companies have to provide that information to, much like the electric and gas have to provide it to FERC.”<sup>226</sup> It was Ms. Schumaker’s expert opinion that in order to compare AWWSC’s costs to only other water companies one would have to obtain not only the water company’s financial information but also the water company’s management fee information as well and “unless you’re usually in some kind of an audit proceeding where you can get that information from an organization, it’s difficult to get.”<sup>227</sup>

Finally, with respect to reasonableness of AWWSC charges, the management auditors also studied the nature of the support services provided by AWWSC. After completing this analysis, the management auditors issued a finding that AWWSC’s operating support services

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<sup>224</sup> Trial Ex. 29, at 112.

<sup>225</sup> Trial Ex. 29, at 112.

<sup>226</sup> Patricia Schumaker, Vol. IIB, Tr. 211:1 – 211:10 (March 1, 2011).

<sup>227</sup> Patricia Schumaker, Vol. IIB, Tr. 211:1 – 211:10 (March 1, 2011).



were generally reasonable.<sup>228</sup> The management auditors also tested AWWSC's internal controls and issued a finding that AWWSC's internal controls over affiliate transactions were appropriate.<sup>229</sup> As part of the internal controls testing, the management auditors sampled a number of transactions "to ensure that the actual practices were being followed or not being followed relative to the actual policies and procedures."<sup>230</sup>

### **C. Relationships with Non-Regulated Affiliates**

The audit report also looked at the relationships between TAWC and its non-regulated affiliates, including AWCC, ACS, and AWR. After examining the relationships between TAWC and these non-regulated affiliates, the management auditors found the methodology for charges between TAWC and its affiliates to be reasonable. Specifically, the management auditors found that the line of credit fees and interest paid on intercompany borrowings to AWCC, the purchase of GAC from ACS, and TAWC's charges to AWR for billing for AWR's home protection programs were all reasonable.<sup>231</sup> This finding was in sharp contrast to Ms. Dismukes' allegation – which was apparently based on little or no analysis – that the relationship between TAWC and AWR was somehow improper.<sup>232</sup>

### **D. Quality of Service**

Finally, the audit report contained numerous findings regarding the quality of service that AWWSC provides to TAWC's customers. The management auditors noted that service levels at the national call centers had improved since 2008,<sup>233</sup> that AWWSC had significantly improved

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<sup>228</sup> Trial Ex. 29, at 124.

<sup>229</sup> Trial Ex. 29, at 70.

<sup>230</sup> Patricia Schumaker, Vol. IIA, Tr. 72:10 – 72:13 (March 1, 2011).

<sup>231</sup> Trial Ex. 29, at 41-42.

<sup>232</sup> Kimberly Dismukes, Pre-Filed Testimony, at 3 (Jan. 5, 2011).

<sup>233</sup> Trial Ex. 29, at 114.

online access for TAWC's customers,<sup>234</sup> and that AWWSC had assisted TAWC in significantly reducing the number of estimated bills over the last five years.<sup>235</sup> In addition, the management auditors also noted TAWC's success at meeting service appointments has generally exceeded 99% in the last six years with only two exceptions,<sup>236</sup> emergency response rates had improved since 2008,<sup>237</sup> and TAWC had achieved its target on all types of service orders in the last two years.<sup>238</sup> Accordingly, the quality of services being provided by AWWSC to TAWC's customers was extremely high.

#### **iv. Independence of Schumaker & Company and Work & Greer**

Throughout the entire Hearing on the Merits no party directly questioned the independence of Schumaker & Company or Work & Greer. Independence was a clear requirement that was contained in the RFP for the management audit,<sup>239</sup> and Schumaker & Company and Work & Greer made an affirmative statement in their contract with TAWC that "Schumaker & Company and Work & Greer PC are and will remain 'independent' of the TRA, AWWSC, American Water Works Company ('AWWC'), any AWWC subsidiaries, and the parties to the 2008 TAWC Rate case, as the term 'independent' is defined by GAAS, until at least 18 months after the delivery of the completed management audit to TAWC."<sup>240</sup> Ms.

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<sup>234</sup> Trial Ex.29, at 116.

<sup>235</sup> Trial Ex. 29, at 120.

<sup>236</sup> Trial Ex. 29, at 121.

<sup>237</sup> Trial Ex. 29, at 121.

<sup>238</sup> Trial Ex. 29, at 122.

<sup>239</sup> See Trial Ex. 28, Ex. B, at 9 ("The firm, including any consultant used on this project, must provide an affirmative statement that it is independent of TAWC, AWWSC, AWW, the TRA, the Attorney General of Tennessee, the City of Chattanooga, and the Chattanooga Manufacturers Association as defined by Generally Accepted Auditing Standards (GAAS) and that firm will warrant in the engagement contract that they will not undertake an engagement that will impair their affirmation of independence during the term of the audit.").

<sup>240</sup> Trial Ex. 28, at 5.

Schumaker testified at trial that the definition of independence she used for herself when completing the management audit was as follows:

General standard of auditor independence is that an auditor's independence is impaired if the auditor is not, or a reasonable individual with knowledge of all of the facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgment on all issues encompassed within the audit engagement.<sup>241</sup>

The CAPD's witness Mr. Buckner testified that he had "great respect" for Work & Greer, but then testified with respect to Schumaker & Company that "I question her independence on the Baryenbruch thing."<sup>242</sup> Mr. Buckner's comment was ambiguous as to whether he questioned Ms. Schumaker's definition of "independent consultant" or whether he questioned Ms. Schumaker's actual independence.

Nevertheless, the unambiguous facts in this case prove that both Schumaker & Company's and Work and Greer's independence was beyond reproach throughout the entire management audit process. No party, including Mr. Buckner, presented any shred of evidence during the hearing to substantiate any claim that the management auditors were not completely independent. Any attempt to raise independence questions reflect nothing more than the Intervenors' desires to escape the results of a truly independent audit that refutes and defeats their agenda of trying to prevent TAWC from receiving the just and reasonable rate increase it deserves in this case. To even suggest the management auditors were not independent is completely unfounded and improper.

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<sup>241</sup> Patricia Schumaker, Vo. IIA, Tr. 70:1 - 70:8 (March 1, 2011).

<sup>242</sup> Terry Buckner, Vol. VIIB, Tr. 106:12 – 106:13; 107:11 – 107:12 (March 8, 2011).

**c. Cost to Market Study**

To further support the reasonableness of TAWC's management fee costs, TAWC submitted the testimony of Patrick Baryenbruch, a utility market cost expert with over 35 years experience as a consultant to the utility industry.<sup>243</sup> Mr. Baryenbruch has acted as an expert witness on the subject of utility-affiliate transactions in over 40 utility rate cases for 27 utility clients.<sup>244</sup> Mr. Baryenbruch testified that his market cost study methodology has been accepted by state commissions in Connecticut, Georgia, Illinois, Kentucky, Massachusetts, Missouri, New Mexico, New York, Ohio, Pennsylvania, Virginia, and West Virginia.<sup>245</sup>

**i. Study Methodology and Findings**

Mr. Baryenbruch examined four questions in his cost to market study, including the following: (1) Were the Service Company's charges to TAWC during the 12 months ended March 31, 2010 reasonable?;<sup>246</sup> (2) Was TAWC charged the lower of cost or market for managerial and professional services provided by the Service Company during the 12 months ended March 31, 2010?; (3) Were the 12 months ended March 31, 2010 costs of the Service Company's customer accounts services, including those of the National Call Centers, comparable to those of other utilities?; and (4) Are the services TAWC receives from Service Company necessary?<sup>247</sup>

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<sup>243</sup> Patrick Baryenbruch, Vol. IVC, Tr. 172:19 – 172:24 (March 3, 2011).

<sup>244</sup> Patrick Baryenbruch, Pre-Filed Direct Testimony, at 2 (Sept. 17, 2010).

<sup>245</sup> Patrick Baryenbruch, Pre-Filed Rebuttal Testimony, at 44-45 (Feb. 8, 2011).

<sup>246</sup> In TAWC's 2006 rate case the Authority expressed a desire for one metric to demonstrate that AWWSC's costs to TAWC were reasonable. In response, Mr. Baryenbruch modified his study methodology to add this first question. Patrick Baryenbruch, Vol. IVC, Tr. 177:18 – 178:3 (March 3, 2011).

<sup>247</sup> Patrick Baryenbruch, Pre-Filed Direct Testimony, at 3-4 (Sept. 17, 2010).

### A. Reasonableness of Charges

Mr. Baryenbruch's criteria to determine the reasonableness of AWWSC charges to TAWC was to determine whether the "costs fall into the range of an appropriate comparison group using metrics that are pertinent and the best available data."<sup>248</sup> Mr. Baryenbruch therefore calculated AWWSC's A&G-related services per TAWC customer by taking AWWSC's total charges to TAWC and removing non-A&G services, including capital charges and O&M function charges such as engineering, operations and water quality. The resulting calculation of AWWSC A&G-related services was \$59 per customer.<sup>249</sup>

Mr. Baryenbruch then determined whether these charges were reasonable by comparing them to the cost of the same services delivered by other utility service companies.<sup>250</sup> As with the Schumaker & Company comparison group, Mr. Baryenbruch's comparison group consisted of service companies for electric utilities and combination gas and electric utilities.<sup>251</sup> When questioned why Mr. Baryenbruch was not able to compare AWWSC's A&G-related charges to those of other water utilities, Mr. Baryenbruch explained:

If I could get service-company specific, water utility-specific service company charges, I would be benchmarking against them, ***but that information doesn't exist***. So I have to revert to using the next best alternative which comes from the FERC Form 60. And it's my experience that the services we're talking about here, administrative and general, are similar between utility types. When I go into an electric utility, for instance, I see the same type of functions as I do when I go into a water company.<sup>252</sup>

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<sup>248</sup> Patrick Baryenbruch, Vol. IVC, Tr. 177:12 – 177:17 (March 3, 2011).

<sup>249</sup> Trial Ex. 55, at 9.

<sup>250</sup> Patrick Baryenbruch, Vol. IVC, Tr. 175:13 – 175:16 (March 3, 2011).

<sup>251</sup> Patrick Baryenbruch, Vol. IVC, Tr. 175:16 – 175:18 (March 3, 2011).

<sup>252</sup> Patrick Baryenbruch, Vol. IVC, Tr. 176:24 – 177:10 (March 3, 2011) (emphasis added).

Mr. Baryenbruch's comparison group of utilities featured utilities with service companies that served an average of 3.11 million customers.<sup>253</sup> This group therefore provides a fair comparison to AWWSC, which serves 3.3 million American Water regulated retail customers.<sup>254</sup> Unlike any comparison group proposed by the Intervenor, Mr. Baryenbruch's comparison group actually included a utility with ties to Tennessee. Mr. Baryenbruch's group included AEP, which is the parent company of Kingsport Electric, a Tennessee retail electric company.<sup>255</sup> AEP had a service company A&G cost per customer of \$80, far in excess of TAWC's cost of \$59 per customer.<sup>256</sup>

Mr. Baryenbruch's cost comparison determined that AWWSC's charges to TAWC of \$59 per customer for the 12 months ended March 31, 2010 was considerably lower than the average of \$95 per customer for the comparison group service companies.<sup>257</sup> In fact, only four of the 24 comparison group service companies were able to attain a lower cost per customer than TAWC. The results of the cost comparison were presented in Exhibit 1 to Mr. Baryenbruch's report:<sup>258</sup>

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<sup>253</sup> Trial Ex. 56, at 3.

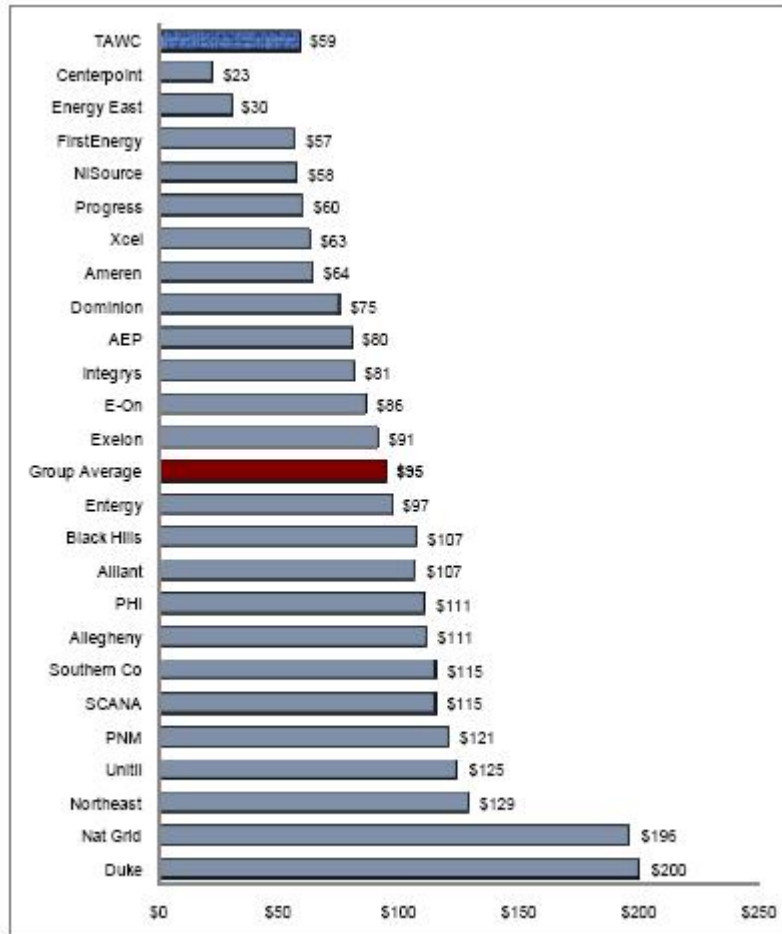
<sup>254</sup> *Id.*

<sup>255</sup> Patrick Baryenbruch, Vol. IVC, Tr. 176:5 – 176:10 (March 3, 2011).

<sup>256</sup> Trial Ex. 55, at 10.

<sup>257</sup> Trial Ex. 55, at 10.

<sup>258</sup> Trial Ex. 55, at 11.



As can be seen in the table, TAWC's costs were well below the group average of \$95 per customer. On the basis of this comparison Mr. Baryenbruch appropriately concluded that AWWSC's charges to TAWC for the 12 months ended March 31, 2010 were reasonable.<sup>259</sup>

### **B. Lower of Cost or Market**

To determine whether TAWC was charged the lower of cost or market, Mr. Baryenbruch compared the cost per hour for AWWSC's managerial and professional services to the cost of these functions if they were provided by outside companies.<sup>260</sup> Mr. Baryenbruch did this by first calculating AWWSC's hourly cost to provide management, legal, accounting, and engineering

<sup>259</sup> Trial Ex. 55, at 10.

<sup>260</sup> Trial Ex. 55, at 12.

services during the 12 months ended March 31, 2010.<sup>261</sup> The City attempted to mischaracterize Mr. Baryenbruch's report as representing the cost of a licensed attorney, an accountant with a CPA certification, an engineer with a P.E. accreditation, etc.<sup>262</sup> Mr. Baryenbruch made clear, however, that his analysis was designed to determine a blended cost instead for these general "categories of service,"<sup>263</sup> and the categories should be considered as law firm, accounting firm, management consulting firm and engineering firm.

The hourly rates were calculated by taking the entire amount of AWWSC charges and subtracting charges incurred from outside providers, travel expenses (which would be recovered from outside providers outside of normal hourly billing rates), and IT infrastructure expenses (which would be recovered by outside providers if they were to take over operations of the data center).<sup>264</sup> These totals were then divided by the number of hours charged for management, legal, accounting, and engineering services to determine AWWSC's average hourly charges to TAWC for these services.<sup>265</sup> Mr. Baryenbruch noted that the hourly rates calculated actually are overstated because AWWSC personnel do not charge overtime, so the hourly rates are based on a maximum of 8 hours per day even though many employees work more than 8 hours per day.<sup>266</sup>

After calculating AWWSC's average cost per hour for management, legal, accounting and engineering services Mr. Baryenbruch then calculated the approximate cost for equivalent services in the Chattanooga market. For attorneys, Mr. Baryenbruch used the best publicly-available source of information, which consisted of 2009 average billing rates for attorneys

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<sup>261</sup> Trial Ex. 55, at 13.

<sup>262</sup> Vol. VA, Tr. 29:21 - 32:12 (March 4, 2011).

<sup>263</sup> Trial Ex. 55, at 12; Patrick Baryenbruch, Vol. VA, Tr. 32:6 - 32:12 (March 4, 2011).

<sup>264</sup> Trial Ex. 55, at 12-13.

<sup>265</sup> Trial Ex. 55, at 13.

<sup>266</sup> Trial Ex. 55, at 12.



licensed in Michigan and Missouri as reported by Lawyers Weekly.<sup>267</sup> Mr. Baryenbruch took those average billing rates and applied a cost of living adjustment for Chattanooga to arrive at an approximate average billing rate of \$265 per hour.<sup>268</sup> This number was subjected to a “sanity check” of the few publicly available billing rates for Chattanooga attorneys – specifically two lawyers from the firm representing the City in this matter – which were reported to be \$260 and \$250 per hour.<sup>269</sup>

To calculate management consultant market fees, Mr. Baryenbruch used 2009 management consultant rates as reported by the Association of Management Consulting Firms to create a single weighted average hourly rate.<sup>270</sup> To calculate accountant hourly rates, Mr. Baryenbruch created a single weighted average hourly rate for Tennessee CPAs from the Tennessee version of a 2008 survey performed by the American Institute of Certified Public Accountants.<sup>271</sup> Finally, because no information regarding hourly rates for engineering services was publicly available, Mr. Baryenbruch used hourly rate information provided by the Company for outside engineering firms that could have been used by TAWC in 2009.<sup>272</sup>

The City of Chattanooga attempted to question Mr. Baryenbruch’s methodology by offering as a surprise exhibit on cross examination what the City alleged to be occupational employment and wage tables compiled by the Tennessee Department of Labor for Chattanooga, Tennessee.<sup>273</sup> However, the City offered no witnesses and presented no evidence regarding how the wage tables were compiled, the source of the data, how the data was relevant, or why the data

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<sup>267</sup> Trial Ex. 55, at 17.

<sup>268</sup> Trial Ex. 55, at 17.

<sup>269</sup> Patrick Baryenbruch, Vol. VA, Tr. 45:22 – 46:3 (March 4, 2011); Trial Ex. 55, at 17.

<sup>270</sup> Trial Ex. 55, at 18. Mr. Baryenbruch used national averages because consultants typically do not limit their practice to any one region. *Id.*

<sup>271</sup> Trial Ex. 55, at 18.

<sup>272</sup> Trial Ex. 55, at 18.

<sup>273</sup> Trial Ex. 60; Vol. VA, Tr. 47:3 – 47:9 (March 4, 2011).

appeared to be missing key information. For example, the 75<sup>th</sup> percentile wage information for lawyers was listed as “N/A” and the average experienced lawyer wage was not provided but merely noted that it was some unknown value greater than \$145,600.<sup>274</sup> The City also failed to offer any witness or explanation regarding the significance of the exhibit’s disclaimer that “[t]he OES survey does not collect information for entry or experienced workers.”<sup>275</sup> Moreover, the City also presented no evidence regarding the overheads associated with the wages presented in the tables. Perhaps more importantly, though, is that even if the wage tables were relevant, they still would not take into account the synergies present when one specialized entity containing all accountants, lawyers, managers and engineers all works cohesively on a daily basis to assist in the provision of water service. In other words, even if the data was meaningful, which it is not, it provides no insight on what expertise or ability one would obtain at that rate.

An issue was also raised during the hearing regarding whether Mr. Baryenbruch had based his market study on competitive bidding. In response, Mr. Baryenbruch testified that requiring a market cost comparison study to include prices based on competitive bidding would not be practical.<sup>276</sup> Mr. Baryenbruch stated that it would be difficult to get a competitive bid from a single entity for the outsourcing of all of AWWSC’s services.<sup>277</sup> He also stated that if potential bidders knew an RFP was being issued solely for benchmarking, then potential bidders would decline to submit bids. Also, putting out an RFP solely for purposes of benchmarking and not informing potential bidders of the purpose of the RFP would be misleading.<sup>278</sup>

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<sup>274</sup> Trial Ex. 60.

<sup>275</sup> Trial Ex. 60.

<sup>276</sup> Patrick Baryenbruch, Vol. VC, Tr. 138:2 – 138:23 (March 4, 2011).

<sup>277</sup> Patrick Baryenbruch, Vol. VC, Tr. 138:2 – 138:23 (March 4, 2011).

<sup>278</sup> Patrick Baryenbruch, Vol. VC, Tr. 138:2 – 138:23 (March 4, 2011).

In addition, it would be almost impossible to compare the quality of any bids in a false RFP process to AWWSC. Price alone could not possibly be rationalized as an appropriate basis. One would have to consider the experience and expertise of the bidders. No party has argued, nor could they, that a local Chattanooga provider would have the depth of experience or expertise in water service operations, for example, as the AWWSC personnel that work solely for water utility operating companies every single day.

The results of Mr. Baryenbruch's cost to market analysis showed that AWWSC currently provides legal services at \$136 less per hour than outside firms, management consulting services at \$103 less per hour than outside firms, accounting services at \$27 less per hour than outside firms, and engineering services at \$50 less per hour than outside firms.<sup>279</sup> When multiplied by the number of hours charged by AWWSC for these services in 2009, Mr. Baryenbruch calculated that AWWSC provided these services for ***\$1.83 million cheaper than their market cost*** for the 12 months ending March 31, 2010, as shown on the chart included in his report:<sup>280</sup>

12 Months Ended March 31, 2010			
Service Provider	Hourly Rate Difference-- Service Co. Greater(Less) Than Outside	Service Company Hours Charged	Dollar Difference
Attorney	\$ (136)	899	\$ (121,947)
Management Consultant	\$ (103)	6,118	\$ (630,010)
Certified Public Accountant	\$ (27)	24,293	\$ (650,038)
Professional Engineer	\$ (50)	8,664	\$ (436,675)
Service Company Less Than Outside Providers			\$ (1,838,669)

In addition to these cost-savings, Mr. Baryenbruch noted there are additional savings because AWWSC does not bill overtime hours and TAWC's relationship with AWWSC means that

<sup>279</sup> Trial Ex. 55, at 23.

<sup>280</sup> Trial Ex. 55, at 23.

TAWC does not have to employ an additional position to supervise outside firms.<sup>281</sup> None of the Intervenor presented any credible evidence, study or analysis to the contrary. Instead, and tellingly, the Intervenor attempted to confuse the Authority with bits of irrelevant hearsay that without explanation or testimony fails to shed any light on the issue.

### **C. Comparability of Customer Account Services**

To determine how AWWSC's customer account services compared to other service companies, Mr. Baryenbruch compared AWWSC's charges to those of neighboring utilities that make such data publicly and uniformly available.<sup>282</sup> As was the case with overall Service Company A&G costs, Service Company customer account cost data was not publicly and uniformly available for water companies, so Mr. Baryenbruch's comparison group was comprised of electric utilities that are required to file the FERC Form 1.<sup>283</sup> To account for the fact that electric utilities experience an average of 2.5 calls per customer compared to American Water's 1.32 calls per customer, Mr. Baryenbruch appropriately adjusted call center costs.<sup>284</sup>

AWWSC's customer account service charges were compared to those of utilities with regulated affiliates in Tennessee, North Carolina, Kentucky, Mississippi, Virginia, Georgia, Alabama, Arkansas and Missouri.<sup>285</sup> The results of Mr. Baryenbruch's customer account cost analysis showed that AWWSC had customer account services costs of \$29.08 per customer for TAWC, while the comparison group averaged \$32.01.<sup>286</sup> TAWC's customer account costs per customer were less than twelve out of the seventeen other comparable utilities.<sup>287</sup> Mr.

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<sup>281</sup> Trial Ex. 55, at 23.

<sup>282</sup> Trial Ex. 55, at 25.

<sup>283</sup> Trial Ex. 55, at 28.

<sup>284</sup> Trial Ex. 55, at 28.

<sup>285</sup> Trial Ex. 55, at 25.

<sup>286</sup> Trial Ex. 55, at 29.

<sup>287</sup> Trial Ex. 55, at 29.

Baryenbruch therefore appropriately concluded that TAWC's customer accounts-related expenses for the 12 months ended March 31, 2010 were comparable to those of other utilities.<sup>288</sup>

Finally, the City introduced a report titled "Benchmarking Performance Indicators for Water and Waste Water Utilities: Survey Data and Analyses Report" prepared by the American Water Works Association during the cross examination of Mr. Baryenbruch, purportedly as evidence of publicly available data regarding customer service account information for water utilities.<sup>289</sup> Notably, the City's witness Ms. Dismukes did not use or refer to this information in her testimony, either. Of course, the City provided no witness to authenticate what the hearsay report purported to represent, how the survey was compiled, what utilities were included, the purpose of the survey or even the date of the survey although the third page of the incomplete report indicates a copyright of 2005.<sup>290</sup> While the report is clearly suspect and the City only provided 9 pages out of 297 pages according to the table of contents provided, to the extent it represents anything, page 109 of the report conclusively confirms Mr. Baryenbruch's analysis and conclusion that TAWC's customer account service costs per customer are entirely appropriate.

Of course, if the customer account service costs set forth on page 109 are based on 2005 costs – over five years ago – those costs would be even higher today. Nevertheless, even comparing the 2010 customer service account costs for TAWC of \$29.08 to the 2005 customer account service costs in the survey, TAWC's customer account service costs per customer are

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<sup>288</sup> Trial Ex. 55, at 29.

<sup>289</sup> See Trial Ex. 64.

<sup>290</sup> Trial Ex. 64, at 3.

well below the median customer service cost per account reported on page 109 of the AWWA survey as follows:<sup>291</sup>

<b>Category</b>	<b>AWWA Survey Median Customer Service Cost Per Account</b>	<b>Customer Account Services Cost for TAWC</b>
<b>Region: South</b>	\$38.2	\$29.08
<b>Size: 50,001 to 100,000 customers</b>	\$37.1	\$29.08
<b>Type: Water</b>	\$34.8	\$29.08

#### **D. Necessity of Services**

The fourth portion of Mr. Baryenbruch's study examined whether the services provided to TAWC by AWWSC would be necessary if TAWC were a stand-alone water company.<sup>292</sup> Mr. Baryenbruch created a matrix of all utility functions necessary to run a water company, and then designated whether TAWC or one of the various locations or organizations of AWWSC was either primarily responsible for or provided support for each of these functions.<sup>293</sup> From this matrix, Mr. Baryenbruch confirmed that the services AWWSC provides are necessary and would be required if TAWC were a stand-alone water utility. Further, Mr. Baryenbruch confirmed that there was no redundancy or overlap in the services provided by AWWSC to TAWC, a finding that was identical to the management auditors' finding based on their own independent management audit.<sup>294</sup>

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<sup>291</sup> Trial Ex. 64, at 109.

<sup>292</sup> Trial Ex. 55, at 33.

<sup>293</sup> Patrick Baryenbruch, Vol. IVC, Tr. 182:1 – 184:11 (March 3, 2011); Trial Ex. 55, at 33-36.

<sup>294</sup> Trial Ex. 55, at 33-36.

## **ii. CAPD's Criticisms**

While the Consumer Advocate and Protection Division does not dispute that at least \$3,671,000.00 of management fees are necessary and reasonable,<sup>295</sup> CAPD witness Terry Buckner erroneously argues for certain items to be disallowed. Mr. Buckner's recommended disallowances, none of which are supported by any study or analysis, have all been rebutted by the evidence in the record from Mr. Miller, Mr. Watson, Mr. Baryenbruch, Mr. Uffelman and the independent findings and testimony from Schumaker & Company. This substantial evidence unquestionably establishes the reasonableness of TAWC's management fee expenses, and refutes Mr. Buckner's position.

The rebuttal testimony filed by Mr. Miller refuted each and every one of Mr. Buckner's proposed disallowances. For example, with respect to AIP costs, Mr. Buckner alleged that management fees should be reduced by \$142,610 because he alleged "70% of the compensation is based on financial metrics."<sup>296</sup> This is simply not true. Mr. Buckner fails to note that in response to concerns that AIP awards could be based on the financial performance of the Company, American Water's AIP plan was changed in 2009 to make the entirety of each individual AIP award based only on that individual employee's performance goals, which are in no way tied to the financial performance of TAWC or AWW.<sup>297</sup> Under the previous AIP plan 30% of an individual employee's award was actually tied to financial performance and under that plan the CAPD recommended disallowance of 30% of the costs in the 2008 rate case.<sup>298</sup> Accordingly, under that same reasoning the CAPD should now be recommending no

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<sup>295</sup> Terry Buckner, Pre-Filed Amended Non-Confidential Testimony, at 28 (Jan. 5, 2011).

<sup>296</sup> Terry Buckner, Pre-Filed Amended Non-Confidential Testimony, at 32 (Jan. 5, 2011).

<sup>297</sup> Michael A. Miller, Pre-Filed Rebuttal Testimony, at 80-81 (Feb. 8, 2011).

<sup>298</sup> Michael A. Miller, Pre-Filed Rebuttal Testimony, at 81 (Feb. 8, 2011).

disallowance in this case. Instead, Mr. Buckner provides no analysis of the AIP plan's changes and only bases his recommended disallowance on an erroneous premise.

Another example of Mr. Buckner's lack of any evidence or analysis to support his recommended disallowances can be seen in the area of business development expense. Mr. Buckner recommends disallowance of any business development portion of AWWSC's fees,<sup>299</sup> but fails to provide any analysis of why these fees are not appropriate other than to cite to two states in which apparently some of these fees have been disallowed.<sup>300</sup> Of course, Mr. Buckner does not note the myriad of states that do allow these fees and fails to note the plain logic that business development is advantageous for TAWC's customers because customer growth leads to revenue growth and the spreading of TAWC's fixed costs over a larger customer base, both of which offsets the need to increase rates.<sup>301</sup> Accordingly, because Mr. Buckner has provided no evidence or analysis to support his line-by-line recommended disallowances, they should be rejected.

### **iii. The City's Unfounded Criticisms**

The City of Chattanooga's witness Ms. Dismukes alleged that AWWSC's charges could not be compared to electric utility service company charges because water and electric utility A&G expenses are not comparable.<sup>302</sup> In response, Mr. Baryenbruch thoroughly discredited this allegation in his rebuttal testimony by testing each of Ms. Dismukes' allegations.<sup>303</sup> Mr. Baryenbruch proved that the differences Ms. Dismukes pointed to only affect non-service company O&M costs, which are not part of Mr. Baryenbruch's study, and that service company

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<sup>299</sup> Terry Buckner, Pre-Filed Amended Non-Confidential Testimony, at 33-34 (Jan. 5, 2011).

<sup>300</sup> Terry Buckner, Pre-Filed Amended Non-Confidential Testimony, at 33-34 (Jan. 5, 2011).

<sup>301</sup> Michael A. Miller, Pre-Filed Rebuttal Testimony, at 117 (Feb. 8, 2011).

<sup>302</sup> Kimberly Dismukes, Pre-filed Testimony, at 4 (Jan. 5, 2011).

<sup>303</sup> Patrick Baryenbruch, Pre-Filed Rebuttal Testimony, at 4-32 (Feb. 8, 2011).



A&G costs are similar between water and electric utilities, so using the only publicly-available source of information – FERC data – was the next best alternative to using comparable water company data, which does not exist.

For example, Ms. Dismukes erroneously alleged that electric companies are more highly regulated than water companies, so “it is unrealistic to think their A&G expenses would be in any way comparable.”<sup>304</sup> Mr. Baryenbruch, however, actually analyzed this issue and found that service company regulatory costs per customer for electric companies constituted less than 1% of overall service company charges, so any differences would not be material.<sup>305</sup> Ms. Dismukes also alleged that because electric utilities feature nuclear facilities that are more complex than water facilities, electric utility A&G expenses cannot be compared to water utilities.<sup>306</sup> Mr. Baryenbruch also debunked this myth by analyzing A&G costs per customer for nuclear vs. non-nuclear electric utilities and proving that non-nuclear utilities actually had a **higher** A&G cost per customer, contrary to Ms. Dismukes’ allegations.<sup>307</sup> At the end of the day, the only differences that Ms. Dismukes discussed were not related to A&G expenses, but were instead operational differences.

These operational differences had no bearing on the A&G costs per Mr. Baryenbruch who testified that he has performed numerous consulting engagements for electric, nuclear and water utilities and A&G costs are essentially the same across all of those utilities.<sup>308</sup> Further, as was conclusively shown, Ms. Dismukes’ “comparison group” did not compare the same charges as Mr. Baryenbruch’s analysis and was also plagued by numerous data aberrations and

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<sup>304</sup> Kimberly Dismukes, Pre-filed Testimony, at 29:25 – 29:26 (Jan. 5, 2011).

<sup>305</sup> Patrick Baryenbruch, Vol. VC, Tr. 132:21 – 133:25 (March 4, 2011); Trial Ex. 68.

<sup>306</sup> Kimberly Dismukes, Pre-filed Testimony, at 30:1 – 30:7 (Jan. 5, 2011).

<sup>307</sup> Patrick Baryenbruch, Vol. VC, Tr. 134:4 – 134:22 (March 4, 2011); Trial Ex. 69.

<sup>308</sup> Patrick Baryenbruch, Pre-Filed Rebuttal Testimony, at 7-8 (Feb. 8, 2011).

inconsistencies.<sup>309</sup> In short, Ms. Dismukes' comparison wholly lacks credibility and is useless in this case.

First, Ms. Dismukes did not compare the same charges that Mr. Baryenbruch analyzed. The scope of Mr. Baryenbruch's comparison was limited to AWWSC's A&G-related charges to TAWC.<sup>310</sup> Ms. Dismukes, however, included these charges but also lumped in all A&G expenses incurred directly by TAWC and that were recorded on the books of TAWC.<sup>311</sup> From the beginning, therefore, Ms. Dismukes' comparison group was not "apples to apples."

Second, Ms. Dismukes' used water company cost data that was obtained from annual reports filed with various state commissions, which is data that is not publicly available in a uniform or consistent format.<sup>312</sup> Both Ms. Schumaker and Mr. Baryenbruch testified that they did not create comparison groups consisting of water utilities because uniform, publicly-available comparison data did not exist.<sup>313</sup> The number of data aberrations and inconsistencies present in Ms. Dismukes' "comparison group" shows exactly why Ms. Schumaker and Mr. Baryenbruch considered the publicly available water utility cost data unreliable for comparison purposes. Just some of the many examples of data aberrations present in Ms. Dismukes' Schedules KHD-15 and 16 that were pointed out during the cross examination of Ms. Dismukes included:

- Calculation of only \$5 in annual A&G costs per customer for Water Service Corporation of Kentucky.<sup>314</sup>

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<sup>309</sup> Patrick Baryenbruch, Pre-Filed Rebuttal Testimony, at 25-30 (Feb. 8, 2011).

<sup>310</sup> Patrick Baryenbruch, Pre-Filed Rebuttal Testimony, at 25 (Feb. 8, 2011).

<sup>311</sup> Patrick Baryenbruch, Pre-Filed Rebuttal Testimony, at 25-26 (Feb. 8, 2011).

<sup>312</sup> Kimberly Dismukes, Pre-filed Testimony, at 40 (Jan. 5, 2011).

<sup>313</sup> See Patricia Schumaker, Vol. IIB, Tr. 211:1 – 211:10 (March 1, 2011); Patrick Baryenbruch, Vol. IVC, Tr. 176:23 – 177:10 (March 3, 2011).

<sup>314</sup> Kimberly Dismukes, Pre-filed Testimony, at Schedule KHD-15 (Jan. 5, 2011).

- Ms. Dismukes alleges the comparison group consists of “water companies of a similar size” to TAWC.<sup>315</sup> Ms. Dismukes’ schedules show TAWC with 74,625 customers but the comparison group companies with an average of only 6,115 customers.<sup>316</sup>
- In the most egregious example, Ms. Dismukes could not say whether a particular utility, Ni Florida LLC, included in her “comparison group” was merely a “developer system” that consisted of one subdivision or trailer park.<sup>317</sup> Nevertheless, she included this utility as a comparable utility even though it only had 744 customers versus TAWC’s 74,625.
- Multiple utilities with no salaries and wages but showing employee benefit costs, and utilities with salaries and wages but no benefits costs.<sup>318</sup>
- One utility, Utilities Inc. of Florida, showing \$1 of salaries and wages expenses and \$1 of materials and supplies expenses.<sup>319</sup>
- One utility, Carolina Water Services, reporting negative \$110,912 in salaries and wages expense.<sup>320</sup>
- Two utilities reporting negative amounts for contractual engineering services.<sup>321</sup>

What is perhaps even more troubling is the fact that Ms. Dismukes testified she did not bother to do any follow-up research or analysis to determine the source of any one of these multiple data aberrations and inconsistencies.<sup>322</sup> Also, Mr. Miller analyzed the water rates for Ms. Dismukes’ “comparison group” and showed that twenty-five of the utilities had rates higher than TAWC, while only six had lower rates, thereby undercutting any argument that these utilities are more

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<sup>315</sup> Kimberly Dismukes, Pre-filed Testimony, at 39 (Jan. 5, 2011).

<sup>316</sup> Kimberly Dismukes, Pre-filed Testimony, at Schedule KHD-15 (Jan. 5, 2011).

<sup>317</sup> Kimberly Dismukes, Vol. IIC, Tr. 254:19 – 255:11 (March 1, 2011).

<sup>318</sup> Kimberly Dismukes, Pre-filed Testimony, at Schedule KHD-15 (Jan. 5, 2011).

<sup>319</sup> Kimberly Dismukes, Pre-filed Testimony, at Schedule KHD-15 (Jan. 5, 2011).

<sup>320</sup> Kimberly Dismukes, Pre-filed Testimony, at Schedule KHD-15 (Jan. 5, 2011).

<sup>321</sup> Kimberly Dismukes, Pre-filed Testimony, at Schedule KHD-15 (Jan. 5, 2011).

<sup>322</sup> See Kimberly Dismukes, Vol. IIC, Tr. 264:6 - 264:10; 271:4 - 271:7; 272:12 - 272:15; 279:10 - 279:13 (March 1, 2011).

efficient than TAWC.<sup>323</sup> Furthermore, as can be seen by the numerous examples of data aberrations and inconsistencies, the “comparison group” that Ms. Dismukes offered simply cannot be taken seriously from an analytical standpoint.

In contrast to Ms. Dismukes testimony, the methodology employed by Mr. Baryenbruch’s cost to market analysis has been accepted by at least twelve state regulatory commissions. Accordingly, through the testimony of Mr. Miller, Mr. Baryenbruch and Mr. Uffelman, combined with the independent management audit and testimony of Ms. Schumaker, TAWC has more than met its burden to show that the \$5.226 million in management services provided by AWWSC is just and reasonable and necessary for the provision of water service to TAWC’s customers.

## **6. Insurance Other than Group**

For those categories of expenses with known and measurable changes in the attrition year, the Company adjusted its attrition year to include those changes. For those categories without any known or measurable changes, the Company adjusted its attrition year by adjusting the actual test year data for inflation, using Value Line’s CPI inflation rate information.<sup>324</sup> Insurance Other than Group, which includes costs for general liability, workers compensation, and property insurance, is an example of the latter.<sup>325</sup> Ms. Miller’s testimony shows that the Company’s attrition year expenses in this category totals \$485,904.<sup>326</sup>

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<sup>323</sup> Michael A. Miller, Pre-Filed Rebuttal Testimony, at Rebuttal Ex. MAM-14 (Feb. 8, 2011).

<sup>324</sup> Sheila Miller, Pre-Filed Direct Testimony, at 12:6-22 (Sept. 17, 2010) (the rate for April 1, 2010 to year end was 1.28% which, added to the 2011 rate of 2.3%, totals 3.58%).

<sup>325</sup> Sheila Miller, Pre-Filed Direct Testimony, at 13:10-15 (Sept. 17, 2010).

<sup>326</sup> Sheila Miller, Pre-Filed Direct Testimony, at 13:10-15 (Sept. 17, 2010); Sheila Miller, Ex. 2, Schedule 3.

## **7. Customer Accounting**

Customer Accounting includes the costs associated with the customer billing and collection function. It includes costs for office supplies, report forms, computer supplies, postage, collection agency fees, lock box expenses, janitorial service, telephone expense and other miscellaneous expenses. The Company applied an inflation factor to the test year expenses, excluding uncollectible customer account expense and postage.<sup>327</sup> Postage was increased by \$3,348 because this was a known and measurable change that happened when postage rates rose in May 2009, so the Company annualized this cost for the historical test year.<sup>328</sup> The net expense for the attrition year for this category totals \$857,278, an increase of \$17,627.<sup>329</sup>

## **8. Uncollectibles**

Similarly, the Company must account for uncollectible customer account expenses. The uncollectible percentage of 1.66% was derived by taking a three year average of the net charge offs, less recoveries as a percentage of total revenues. That percentage was applied to the proposed revenue increase of \$9,984,463 to arrive at the attrition year adjustment to uncollectible expense of \$165,769.<sup>330</sup>

## **9. Rents**

This category includes the costs associated with the renting of copiers, mobile radios, postage equipment and land. The total rent expense for the historical test year was \$9,799.<sup>331</sup> The Company annualized the cost of an ice machine rental for twelve months, annualized the

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<sup>327</sup> Sheila Miller, Pre-Filed Direct Testimony, at 13:17-14:3 (Sept. 17, 2010).

<sup>328</sup> *Id.*

<sup>329</sup> *Id.*; Sheila Miller, Ex. 2, Schedule 3.

<sup>330</sup> Sheila Miller, Pre-Filed Direct Testimony, at 14:5-11 (Sept. 17, 2010); Sheila Miller, Ex. 2, Schedule 3.

<sup>331</sup> Sheila Miller, Pre-Filed Direct Testimony, at 14:13-21 (Sept. 17, 2010).

costs of a Canon copier rental for its new lease, eliminated the Oce Imagistics copier lease cost, and eliminated its rental at the Chattanooga as this was a one-time non-recurring cost, which resulted in a decrease to the attrition year expense, for a total of \$8,706 in rent expense.<sup>332</sup>

## **10. General Office**

This expense category includes costs associated with the general expenses for the office such as report forms, office supplies, computer supplies, overnight mail expenses, janitorial services, telephone expense, electrical expense, employee expenses, credit line fees, bank service charges, and other miscellaneous general office expenses. The general office expenses for the test year totaled \$210,461.<sup>333</sup> The Company made adjustments to annualize the sewer billing, which only included eleven months in the historical test year, eliminated duplicate payments of membership dues, and adjusted miscellaneous postage expense for the increase that became effective in May 2009. The inflation factor of 3.58% was applied to the remaining expenses (excluding postage) to arrive at an attrition year expense of \$217,933.<sup>334</sup>

## **11. Miscellaneous**

The Company's miscellaneous expenses for the historical test year totaled \$1,945,947.

The Company proposes several adjustments to this category:

- Adjust for the 3.58% inflation factor, which results in an increase of \$60,617. (The Company did not apply the inflation factor to the 401K expense, Defined Contribution expense, or the Retiree Medical Reimbursement Plan);
- Adjust the 401K expense, Defined Contribution, and Retiree Medical Reimbursement. The net result of these adjustments is \$22,381;
- Eliminate non-recoverable costs including \$340 in lobbying expense, (\$50) in penalty expense, the lobbying portion of NAWC dues in the amount of \$3,768,

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<sup>332</sup> *Id.*; Sheila Miller, Ex. 2, Schedule 3.

<sup>333</sup> Sheila Miller, Pre-Filed Direct Testimony, at 14:23-15:9 (Sept. 17, 2010).

<sup>334</sup> *Id.*; Sheila Miller, Ex. 2, Schedule 3.

and transfer the institutional and promotional advertising expense below the line in the amount of \$15,666;

- Eliminate non-recurring costs of PWC contract services of \$29,960, and write off operations and maintenance variances of \$12,272 and temporary employment expenses of \$26,876;
- Annualize the Tennessee One-Call System expense to include the known and measurable increase in the cost of the service beginning January 2010 in the amount of \$3,705;
- Annualize the 2009 transportation fuel costs adjusted to current gasoline prices for an increase of \$23,856;
- Amortize the management audit expense over five years, resulting in an annual expense of \$38,000. No inflation factor was applied to this expense.

The proposed miscellaneous expense for the attrition year is \$2,005,675, which includes net adjustments totaling \$59,728.<sup>335</sup>

The CAPD improperly ignored rising gas prices and eliminated the transportation fuel cost adjustment in favor of using an inflation and growth factor. In her rebuttal testimony, Ms. Miller provided a schedule that includes the Company's total fuel purchases through the end of 2010 and the costs of gasoline for Chattanooga as of February 1, 2011.<sup>336</sup> Although the updated information shows a slight drop in purchases, the increase in costs still leads to a \$22,658 increase over the CAPD's calculation.<sup>337</sup> Indeed, the Company's figures likely underestimate the increased transportation fuel costs, given the recent events in the Middle East.

## **12. Maintenance**

This expense category includes costs associated with maintaining the Company's property such as costs for repair parts, tools, maintenance supplies, contracted services, paving, maintenance agreements, and other similar expenses. One adjustment was made to take into

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<sup>335</sup> Sheila Miller, Pre-Filed Direct Testimony, at 15:11-16:17 (Sept. 17, 2010); Sheila Miller, Ex. 2, Schedule 3.

<sup>336</sup> Sheila Miller, Rebuttal Ex. SAM-2; Sheila Miller, Rebuttal Testimony, at 6-7:7 (Feb. 8, 2011).

<sup>337</sup> Sheila Miller, Rebuttal Testimony, at 6-7:7 (Feb. 8, 2011).

account the known and measurable increases in paving expense due to the City of Chattanooga's new ordinance requiring the use of different, more expensive, paving materials – a \$44,838 increase.<sup>338</sup> The 3.58% inflation factor was applied to the remaining balance, for a total attrition year cost of \$1,110,317.<sup>339</sup>

### **13. Unaccounted for Water**

The Company has set for itself an aggressive long-term goal of reducing unaccounted water to 15% in accordance with AWW standards.<sup>340</sup> Mr. Watson testified to the many efforts Tennessee American has taken to address and reduce unaccounted for water including:

- Establishing a non-revenue water committee to monitor non-revenue water and identify improvements and having two full time employees dedicated to leak detection;
- Making significant capital investments in leak detection and survey equipment, purchasing over 1400 permalog leak detection devices which cover 80% of the distribution system, replacing water meters on a routine basis and beginning to replace small diameter water distribution mains;
- Conducting a 2007 Non-Revenue Water Study performed by Black & Veatch that identified capital investments needed to the system;
- Conducting several water audits.<sup>341</sup>

Unfortunately, unaccounted for water is a reality for all water systems, and is even more of a reality for systems operating in mountainous regions with aging infrastructures, such as TAWC.<sup>342</sup>

The Company also presented evidence showing that the Company's unaccounted for water levels are below those of many other utilities. In 2008, the legislature enacted a reporting

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<sup>338</sup> Sheila Miller, Pre-Filed Direct Testimony, at 16:19-26 (Sept. 17, 2010).

<sup>339</sup> *Id.*; Sheila Miller, Ex. 2, Schedule 3.

<sup>340</sup> John Watson, Rebuttal Testimony, at 20:24-30 (Feb. 8, 2011).

<sup>341</sup> John Watson, Pre-Filed Direct Testimony, at 38-44 (Sept. 17, 2010); John Watson, Rebuttal Testimony, at 18-21 (Feb. 8, 2011); Exhibits JSW-8 through 11 (JSW-11 contains the Black & Veatch Study).

<sup>342</sup> *See* John Watson, Rebuttal Testimony, at 21:1-10 (Feb. 8, 2011).



obligation for unaccounted for water, and the results show that TAWC's 22.93% level is below that of almost all major neighboring water systems.<sup>343</sup> Thus, the Company is currently making progress when it comes to unaccounted for water and is attempting to reduce unaccounted for water even further. To do this, however, the Company needs to invest capital. As an example, a major investment is needed for main replacement to reach this target.<sup>344</sup>

The CAPD and Mr. Gorman's proposal to continue to limit recovery of production costs to just 15% of the unaccounted for water is a counter-productive measure that will *not* result in a drop in unaccounted for water.<sup>345</sup> The Company is aware of the Authority's decision in the 2008 rate case, but respectfully asks the Authority to reconsider. The Company will not be able to bring unaccounted for water levels down to 15% (a long-term goal the Company has also set for itself) without spending additional capital to make the improvements to infrastructure and leak detection that are necessary to significantly reduce unaccounted for water levels. Capping the Company's production costs has a negative effect on rate of return and thus degrades the Company's ability to attract and spend the capital needed to make these improvements, placing the Company in an impossible situation.<sup>346</sup>

Capping unaccounted for water at 15% also ignores the impact this mandate will have on customers. Mr. Watson testified that he has been involved in several other states where unaccounted for water caps were addressed and that the capital expense required to drop unaccounted for water often surpasses the net savings in production costs.<sup>347</sup> For this reason and

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<sup>343</sup> John Watson, Rebuttal Testimony, at 17-18 (Feb. 8, 2011) (Mr. Watson obtained this information from the Annual Report of Utility District or Municipal System to TN Comptroller).

<sup>344</sup> Michael A. Miller, Rebuttal Testimony, at 72:4-10 (Feb. 8, 2011).

<sup>345</sup> Michael A. Miller, Vol. VI A, Tr. 51:15-22 (March 7, 2011); Michael A. Miller, Rebuttal Testimony, at 73:1-13 (Feb. 8, 2011).

<sup>346</sup> Michael A. Miller, Vol. VI A, Tr. 51:15-22 (March 7, 2011).

<sup>347</sup> Michael A. Miller, Vol. VI B, Tr. 129:1-10 (March 7, 2011).

the reasons stated above, the Company is recommending that the Authority order that a Water Loss Study be conducted that identifies the proper unaccounted for water level for TAWC's unique system and an appropriate remediation program that balances the costs of remediation and the impact on rates to the customers. Mr. Miller testified that this approach has been done in West Virginia and described the process in his rebuttal testimony for the Authority's consideration.<sup>348</sup> The Company proposes that the cost of the Study should be included as a regulatory asset in the next rate case. With this approach the interests of the Company and the customers will be balanced and meaningful progress can be made towards reducing unaccounted for water.

#### **14. Regulatory Expense**

TAWC respectfully submits that it should be allowed to recover the full amount of rate case expense costs in this case. TAWC submitted substantial evidence supporting its regulatory expense for the current rate case of \$645,000.<sup>349</sup> Pursuant to the Joint Motion for Approval of Rate Case Expense, the Intervenor do not oppose recovery of rate case expense in the amount of \$645,000 for the current case.<sup>350</sup> TAWC proposed an attrition year amortization expense of \$379,918. Included in this amount is amortization of the \$645,000 in expense associated with the current case, the unamortized balance of the cost of the 2006 rate case at the beginning of the attrition year of \$65,579, the unamortized balance of the 2008 rate case costs at the beginning of the attrition year of \$68,750, an estimate of the cost of service study for this case of \$42,500, the unamortized balance of the 2008 cost of service study at the beginning of the attrition year of

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<sup>348</sup> Michael A. Miller, Rebuttal Testimony, p. 73:15-75:12 (Feb. 8, 2011).

<sup>349</sup> See Sheila Miller, Pre-Filed Direct Testimony, at 12-13 (Sept. 17, 2010); Response to TRA Data Request No. 1, Question 13, "REGULATORY EXPENSE" (Oct. 1, 2010); Response to TRA Data Request No. 2, Question 123 (Nov. 29, 2010); Response to TRA Data Request No. 5, Question 159 (Feb. 22, 2011); Response to TRA Data Request No. 5, Question 170 (Feb. 22, 2011); Michael A. Miller, Pre-Filed Direct Testimony, at 53-55 (Sept. 17, 2010); Michael A. Miller, Pre-Filed Rebuttal Testimony, at 75-79 (Feb. 8, 2011).

<sup>350</sup> See Joint Motion for Approval of Rate Case Expense (March 16, 2011).

\$8,596, and the unamortized balance of the 2008 depreciation study at the beginning of the attrition year of \$7,826.<sup>351</sup> All of these expenses from the 2006 and 2008 cases, including the cost of service studies and the depreciation study expense, were authorized by the TRA to be amortized over three years with the effective date of the Order in docket number 08-00039.<sup>352</sup>

Even though TAWC has been vigilant in its efforts to decrease rate case expenses since the beginning of this case, for a variety of reasons outside of TAWC's control, the expenses have been significant. The Intervenor has asserted at times in this and past rate cases that the Authority should limit TAWC's recovery of regulatory expenses in rates. To limit TAWC's rate case cost recovery would be unjust, in light of the fact that most of the increased cost of this docket and past dockets has been attributable directly to the Intervenor's actions, to which the Company has had no choice but to respond.

TAWC has been forced to bear the cost of extensive and burdensome discovery. TAWC has also been forced to bear the costs associated with numerous Intervenor motions that could not have been anticipated, and was forced to retain an additional expert on rebuttal to explain the CAPD's tax errors. In addition, TAWC has had to litigate in this case a number of issues related to the management audit ordered by the Authority. Interestingly, the Intervenor protest that the Company is seeking to recover rate case expenses that the Intervenor deem too high, while it has been the Intervenor's actions that have dictated the cost and contentiousness of this docket.

In this rate case, the Company has faced the following: (1) no fewer than 497 discovery requests (*not* including subparts); (2) a total of 262 filings before the date of the Hearing on the Merits (compared to 119 and 137 *total* filings in the last Atmos Energy and Chattanooga Gas rate

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<sup>351</sup> Michael A. Miller, Rebuttal Testimony, at 75:18 – 76:5 (Feb. 8, 2011).

<sup>352</sup> See Final Order, Docket No. 06-00290, at 28-29 (June 10, 2008); Final Order, Docket No. 08-00039, at 24-25 (Jan. 13, 2009).

cases, respectively);<sup>353</sup> (3) multiple motions to compel; (4) numerous pre-hearing motions that were argued multiple times; (5) numerous discovery conferences; (6) numerous status conferences; and (7) a dispute over how the independent management auditors would present testimony in this case, ultimately resulting in a compromise that required a deposition. As all parties have noted in the past, rate case expenses necessarily increase when there are more complex contested issues.<sup>354</sup> On top of all of these complex contested issues in this case, however, is the fact that the number of intervenors doubled since the 2008 rate case.

TAWC's vigilance against increasing rate case expense was seen at each and every hearing in this case, as TAWC opposed multiple actions that inevitably lead to increased rate case expenses, including:

- The City's request for a privilege log.<sup>355</sup>
- The Union's request to intervene.<sup>356</sup>
- Intervenor attempts to unfairly compress TAWC's portion of the case schedule.<sup>357</sup>
- Intervenor requests for post-hearing briefing in lieu of closing arguments.<sup>358</sup>
- Intervenor requests to expand discovery limits.<sup>359</sup>

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<sup>353</sup> See Trial Ex. 1, at 27.

<sup>354</sup> See, e.g., Terry Buckner, Docket No. 08-00039, Vol. XVII, Tr. 1728:5-7 (Aug. 26, 2008).

<sup>355</sup> Discovery Conference, Tr. 26:4 - 26:5 (Nov. 22, 2010) ("It is the very kind of thing that makes rate case expense astronomical."); Discovery Conference, Tr. 34:10 - 34:15 (Nov. 22, 2010) ("State court litigation, federal court litigation, you know, there's not a concern about whether ratepayers are going to have to pay for the cost of regulatory expense. There is a concern here, and it's something that's got to be borne in mind.").

<sup>356</sup> Scheduling Conference, Tr. 8:1 - 8:3 (Oct. 18, 2010) ("[F]or every lawyer you bring in the case that just adds to the expense. So we are very concerned about that.").

<sup>357</sup> Scheduling Conference, Tr. 24:13 - 24:17 (Oct. 18, 2010) ("And what does that do to expense? What does that do to rate case expense? When you have got a short amount of time to conduct a lot of activity -- litigation activity, it's just going to be more expensive. So I would just note that.").

<sup>358</sup> Scheduling Conference, Tr. 28:19 - 28:23 (Oct. 18, 2010) ("We respectfully submit that the oral argument works just as well and that it's really not necessary to incur, again, the added expense and fairly tremendous expense of doing detailed briefs when the panel has just heard everything.").

- The City's request for detailed financial statements of 52 American Water affiliates.<sup>360</sup>
- The CRMA's request to move the entire evidentiary portion of the hearing to Chattanooga.<sup>361</sup>
- The City's request to depose Ms. Schumaker.<sup>362</sup>
- Intervenor requests to present witnesses before the close of TAWC's case.<sup>363</sup>

This onslaught of needlessly contentious litigation and flood of paper required the Company to respond to protect its rights. Litigation at this level requires resources, for which the Company has to pay. To be clear, TAWC has no desire to be confronted with this level of expense and difficulty. However, under the regulatory compact, TAWC has no choice but to petition this Authority for a rate increase when its revenues do not provide an adequate return on investment.

While the City continues to argue that legal fees are not recoverable as part of regulatory expense due to the American Rule, such an argument has been repeatedly rejected: by the Authority in the 2008 rate case;<sup>364</sup> by the Authority in other recent utility rate cases;<sup>365</sup> by the

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<sup>359</sup> Scheduling Conference, Tr. 50:11 - 50:15 (Oct. 18, 2010) ("You know, if we want to talk about rate case expense, discovery is where things get really out of control. And, you, know, I understand the Authority is concerned about regulatory expense -- the Company is concerned about regulatory expense. It's a serious matter.").

<sup>360</sup> Discovery Conference, Tr. 23:2 - 23:5 (Dec. 13, 2010) ("So this is unnecessary and just another example of something that's going to drive up the expense of this case if we have to go through a useless exercise.").

<sup>361</sup> Directors' Conference, Tr. 7:4 - 7:9 (Jan. 24, 2011) ("And so we think it's really counterintuitive to say, okay, we're concerned about rate case expense and we're not going to give you all the expenses that you actually are incurring in these cases, but let's all go down to Chattanooga for a week-long hearing.").

<sup>362</sup> Discovery Conference, Tr. 38:21 - 38:24 (Jan. 24, 2011) ("Rate case expense goes up, and we don't have time. They've got everything they need, and the schedule calls for rebuttal testimony on February the 8th.").

<sup>363</sup> Pre-Hearing Conference, Tr. 6:8 - 6:12 (Feb. 25, 2011) ("We have -- a lot of our witnesses are from out of town. There is an expense involved in having them sitting around waiting to see how quickly they need to be called . . .").

<sup>364</sup> Final Order, Docket No. 08-00039, at 25 (Jan. 13, 2009) (awarding TAWC a substantial portion of its legal fees as part of regulatory expense).

<sup>365</sup> See, e.g., Final order, Docket No. 09-00183, at 6 (Nov. 8, 2010) ("legal fees and regulatory expenses are regularly evaluated in the context of a rate case, and if considered valid and prudent, they are included in a portion of the overall cost of service for recovery through base rates.").

Authority in its arguments to the Court of Appeals;<sup>366</sup> and by the Court of Appeals itself.<sup>367</sup> TRA practice and precedent clearly allow regulated utilities to recover their rate case expenses in rates. There is no basis to depart from that established practice in this case.

For future rate cases in all utility industries, the Authority can take certain statutorily-authorized steps to limit the cost and inefficiency of proceedings. The Uniform Administrative Procedures Act gives this Authority the discretion to limit the involvement of Intervenor to ensure that the Intervenor's presence does not impair the "orderly and prompt conduct of the proceedings."<sup>368</sup> In this docket, as in Docket Nos. 08-00039 and 06-00290, the Intervenor was unable or unwilling to participate without significantly impairing the orderly and prompt resolution of the case, at least without a massive increase in the expected cost of the proceeding.

While it is the Authority's prerogative to permit rate cases to evolve into highly contested proceedings akin to federal court complex litigation, trying such cases is necessarily far more costly than presenting evidence with the lesser degree of detail and adversarial participation more typical of administrative proceedings. TAWC has justified recovery of the full amount of the requested rate case expense. Further, as set forth in the Joint Motion for Approval of Rate Case Expense, the Intervenor does not oppose the recovery of \$645,000 in rate case expense for this rate case. Accordingly, TAWC's rate case expense of \$645,000 for this case should be authorized for amortization over three years with the continued amortization of the 2006 and 2008 rate case expense authorized by the TRA in docket number 08-00039 and the amortization of the cost of service study for this case.

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<sup>366</sup> *Tenn. Am. Water Co. v. Tenn. Reg. Auth.*, Case No. M2009-00553-COA-R12-CV, 2011 Tenn. App. LEXIS at \*73 (Jan. 28, 2011) ("On appeal, the TRA does not dispute that reasonable and properly incurred expenses associated with a rate case should be recoverable by a utility.").

<sup>367</sup> *See Tenn. Am. Water Co. v. Tenn. Reg. Auth.*, Case No. M2009-00553-COA-R12-CV, 2011 Tenn. App. LEXIS at \*76 (Jan. 28, 2011) (awarding TAWC the full amount of its proposed rate case expenses).

<sup>368</sup> Tenn. Code Ann. § 4-5-310(a)(3) (2011).

#### **D. Rate of Return**

To establish a fair rate of return, the Authority should determine the cost of capital and an appropriate capital structure. The Company presented the testimony and exhibits of Mr. Miller and Dr. James Vander Weide, a distinguished finance and economics professor at Duke University's Fuqua School of Business, to present and support its proposed capital structure and return on equity. TAWC proposes an overall weighted cost of capital of 8.38% and an 11.5% return on equity.<sup>369</sup> TAWC proposes a "stand alone" capital structure consisting of: 3.453% short term debt, 51.386% long term debt, 1.126% preferred equity, and 44.035% common equity comprised of 24.345% common stock and 19.690% common equity in the form of retained earnings.<sup>370</sup>

The CAPD proposed a capital structure consisting of only 33.72% common equity on a double leverage basis and a return on equity of 9.0% with an overall weighed cost of capital of 6.831%.<sup>371</sup> No other party proposed a recommended cost of capital.

#### Capital Structure

##### **1. The Company's Proposed Capital Structure and the Historical Capital Structures of TAWC and AWWC**

The Company's proposed capital structure reflects the *actual* capital components that will exist in the attrition year to finance the rate base on which rates will be set in this case.<sup>372</sup> The Company used a forecasted capital structure for the thirteen month average of the attrition year ending December 2011.<sup>373</sup> This structure includes the permanent financings that will be

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<sup>369</sup> Exhibit MAM-5.

<sup>370</sup> Exhibit MAM-5.

<sup>371</sup> Trial Ex. 82.

<sup>372</sup> Michael A. Miller, Direct Testimony, at 20:18-20 (Sept. 17, 2010).

<sup>373</sup> Michael A. Miller, Direct Testimony, at 20:6-11 (Sept. 17, 2010).

consummated in the fourth quarters of 2010 and 2011, and the level of short-term debt that will be in place after the permanent debt financings are completed.<sup>374</sup>

All of the known and measurable changes that will occur to the capital structure in the attrition year are easily verifiable.<sup>375</sup> Accordingly, there is no need to even examine the historical capital structures to determine the attrition year structure. Nevertheless, the CAPD's witness, Dr. Klein, states that he relies on the historical structures of TAWC and AWWC to make his capital structure recommendation, which includes a 33.72% common equity component.<sup>376</sup>

Dr. Klein's 33.72% equity recommendation is a drastic reduction in the common equity component of Tennessee American. Even though Dr. Klein supposedly relies on the historical capital structures of TAWC and AWWC, the Company demonstrated during his cross-examination that when you examine the historical capital structure of TAWC and its parent AWWC, it is clear that neither has ever had a common equity component anywhere close to the level proposed by Dr. Klein.<sup>377</sup> Dr. Klein's own exhibits show that TAWC has had an average common equity component of 43.60%<sup>378</sup> and AWWC has had an average common equity of 43.99% on a consolidated basis.<sup>379</sup> Moreover, Dr. Klein's 33.72% equity recommendation is significantly lower than the equity component set by the TRA in the 2008 rate case (41.517%), even though the TRA also used double leverage in that case.<sup>380</sup> Interestingly, the 41.517% equity structure that the TRA used to set rates in the 2008 rate case, *after* having applied double

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<sup>374</sup> *Id.*

<sup>375</sup> Michael A. Miller, Rebuttal Testimony, at 25:17-18 (Feb. 8, 2011).

<sup>376</sup> Dr. Christopher Klein, Vol. VI C, Tr. 247:21 – 248:12 (March 7, 2011).

<sup>377</sup> See Dr. Christopher Klein, Vol. VI C, Tr. 264-267 (March 7, 2011).

<sup>378</sup> Klein Exhibit, at 3 of 19 (Trial Ex. 85).

<sup>379</sup> Klein Exhibit, at 4 of 19 (Trial Ex. 86).

<sup>380</sup> See Final Order, Docket No. 08-00039, at 49 (Jan. 13, 2009) (setting a 44.83% equity component and applying the parent supplied capital of 92.610% to TAWC's structure using double leverage).



leverage, actually was the CAPD's proposal in that case.<sup>381</sup> Finally, none of Dr. Klein's proxy companies – which he relies on to determine the appropriate return on equity percentage – have ever had an equity structure as low as 33.72%.<sup>382</sup> Rather, they have average equity structures of 48-50%.<sup>383</sup>

Clearly, there is no basis for setting TAWC's equity structure at such an unprecedented low percentage. As will be discussed more fully below, lowering the equity percentage of TAWC increases the financial risk associated with investing capital in TAWC. The CAPD, however, fails to make the proper adjustment to account for that increased risk.

## **2. Use of Double Leverage**

TAWC's recommendation of a "stand alone" capital structure is consistent with all of its rate case filings to date. The Company put forth evidence in the testimonies of Dr. Vander Weide and Mr. Miller demonstrating why double leverage should not be applied in regulatory rate making. Specifically, the double leverage approach violates three basic financial principles, leads to the same result as a stand alone structure when applied correctly, and is inappropriately premised on the belief that the source of funding affects market return.<sup>384</sup> Indeed, double leverage is only used in two of the 22 states in which AWWC operates (Iowa and Tennessee).<sup>385</sup> Accordingly, TAWC strongly believes that a stand alone structure is the best method on which to establish a fair cost of capital.

Nevertheless, the Company realizes that this Authority has chosen to use double leverage in the past. The Company submits that if the Authority chooses to use double leverage in this

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<sup>381</sup> Michael A. Miller, Vol. VI A, Tr. 41:18-24 (March 7, 2011).

<sup>382</sup> Dr. James Vander Weide, Rebuttal Ex. 3 (Trial Ex. 83).

<sup>383</sup> *Id.*; Dr. James Vander Weide, Vol. V C, Tr. 196:23 – 197:24 (March 4, 2011).

<sup>384</sup> See Dr. James Vander Weide, Rebuttal Testimony, at 24-31 (Feb. 8, 2011); Michael A. Miller, Rebuttal Testimony, at 19:8-21:8.

<sup>385</sup> Michael A. Miller, Vol. VI A, Tr. 82:1-4 (March 7, 2011).

case, that it should either (1) not apply double leverage to the Company's retained earnings because retained earnings are not funded by the parent's capital structure or (2) apply double leverage to all the capital obtained from AWWC as the Authority did in the 2008 rate case.<sup>386</sup> The former would result in a 38.484% equity structure and an 8.07% weighted cost of capital at an 11.5% return on equity.<sup>387</sup> The latter would result in a 40.994% equity structure and a 7.906% weighted cost of capital at an 11.5% return on equity.<sup>388</sup> Both these alternatives better reflect the actual capital structure that TAWC will have in the attrition year and better apply the principles of double leverage, compared to the double leverage application recommended by Dr. Klein.<sup>389</sup>

As articulated above, despite no real change to the capital structure of TAWC, AWWC, or change in the level of capital exchanged within the American Water Works organization, Dr. Klein's double leverage approach drops the equity percentage down to 33.72. This drop is *entirely* explained by the new methodology used by the CAPD in applying double leverage to TAWC.<sup>390</sup> Dr. Klein applied the parent, AWWC's, stand alone capital structure to just the equity portion of TAWC's capital, rather than applying it to all the capital obtained from the parent like the Authority did in the 2008 rate case.<sup>391</sup> This unwarranted change in methodology is a drastic departure from the Authority's historic application of double leverage and results in an equity component that (1) does not reflect the known and measurable attrition year capital structure of TAWC, (2) is not supported by the historical capital structures of TAWC or AWWC, and (3) is dramatically less than Dr. Klein's own proxy companies.

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<sup>386</sup> Miller, Rebuttal Testimony, at 23-24 (Feb. 8, 2011); Michael A. Miller, Rebuttal Ex. MAM-6; Michael A. Miller, Vol. VI A, Tr. 45 (March 7, 2011).

<sup>387</sup> Michael A. Miller, Vol. VI A, Tr. 45:10-16 (March 7, 2011).

<sup>388</sup> Michael A. Miller, Vol. VI A, Tr. 45:17-25 (March 7, 2011).

<sup>389</sup> See Michael A. Miller, Rebuttal Testimony, at 23-25 (Feb. 8, 2011).

<sup>390</sup> Michael A. Miller, Rebuttal Testimony, at 21:29-23:3 (Feb. 8, 2011).

<sup>391</sup> *Id.*

Accordingly, if the Authority chooses to apply double leverage, it should not use the application recommended by Dr. Klein.

### **3. Impact of the CAPD's Proposed 33.72% Common Equity Structure**

Dr. Klein's application of double leverage and the resulting capital structure creates a \$1.547 million difference in the revenue requirement due to capital structure alone.<sup>392</sup> This application leads to an automatic erosion of TAWC's earnings of 171 basis points, ensuring that TAWC would only have the opportunity to achieve a return on equity 1.71% less than whatever return the Authority sets in this case.<sup>393</sup>

Dr. Vander Weide testified at the hearing as to the impact of the 33.72% equity structure, to wit:

“33 percent equity is outside of the range of reasonableness for an equity ratio. There aren't -- at best, across the entire country, for utilities -- water utilities, electric utilities, natural gas utilities -- there are only one or two utilities that have equity ratios that low, and most of them are in troubled circumstances. So, one, that would be a highly risky capital structure.”<sup>394</sup>

When asked what bond rating a Company with a 33% equity ratio would have, Dr. Vander Weide answered:

“Well, the only -- it's somewhat hard to say because there are so few utilities that have 33 percent equity ratios. But for those that -- that have equity ratios like that, they are generally either BBB- or they're noninvestment grade.”<sup>395</sup>

The full danger of adopting Dr. Klein's capital structure, however, becomes evident when viewed in conjunction with his 9.0% return on equity recommendation.

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<sup>392</sup> Michael A. Miller, Rebuttal Ex. MAM-3.

<sup>393</sup> Michael A. Miller, Rebuttal Testimony, at 20 (Feb. 8, 2011).

<sup>394</sup> Dr. James Vander Weide, Vol. V C, Tr. 195:17-24 (March 4, 2011).

<sup>395</sup> Dr. James Vander Weide, Vol. V C, Tr. 196:18-22 (March 4, 2011).

## Return on Equity

Dr. Vander Weide, after conducting a detailed economic study utilizing similar utility companies, concluded that the appropriate return on equity for TAWC is 11.5% based on a 44.035% common equity structure. The CAPD, on the other hand, recommends a much lower return on equity of 9.0% on a much lower 33.72% equity structure. The CAPD's recommendation would give TAWC virtually no opportunity to attract capital and should be rejected by this Authority.

### **1. The Company's Proposed Return on Equity**

The Company asked Dr. Vander Weide to conduct an independent appraisal of TAWC's cost of equity based on the Company's recommended capital structure and to recommend an appropriate return on equity. In conducting this analysis, Dr. Vander Weide used two widely-accepted standard models for calculating cost of equity, the discounted cash flow ("DCF") model and the risk premium model.<sup>396</sup> Dr. Vander Weide applied these models to a group of comparable public water companies and a conservative proxy group of LDC gas companies. Dr. Vander Weide used strict criteria to ensure that the most comparable public water companies were included in the proxy group.<sup>397</sup> Because there are few publicly traded water companies, a comparable group of LDC gas utilities was also selected to ensure that the greatest and most accurate comparable data was used in the calculations. The proxy group of gas utilities was chosen using the same selection criteria as the water utilities and those chosen were also filtered to ensure they were of similar risk.<sup>398</sup> In fact, the LDC gas group provides a conservative

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<sup>396</sup> Dr. Vander Weide also used the capital asset pricing model ("CAPM") but did not give it equal weight because ample financial research supports the conclusion that the CAPM model underestimates the cost of equity for companies with a beta less than 1.0, which is the case with both AWWC and its proxy water companies. Dr. Vander Weide, Pre-Filed Direct Testimony, at 3-4 (Sept. 17, 2010).

<sup>397</sup> Dr. Vander Weide, Pre-Filed Direct Testimony, at 22-24 (Sept. 17, 2010).

<sup>398</sup> Dr. Vander Weide, Rebuttal Testimony, at 4-5 (Feb. 8, 2011).

estimate because their average riskiness is less than that of AWWC.<sup>399</sup> Dr. Klein took a similar approach, but he used less than the full amount of available comparable companies, decreasing the potential accuracy of his results.

The DCF model calculates the cost of capital by adding the future expected growth rate to the future expected dividend yield.<sup>400</sup> Dr. Vander Weide used the Quarterly DCF model because both AWWC and all the proxy companies pay dividends quarterly, and therefore use of the Annual DCF model would be inappropriate.<sup>401</sup> For the growth rate, he used analyst forecasts for earnings per share growth rates because ample studies and evidence suggest these are more accurate forecasters of growth compared to historical data and dividend growth estimates, respectively.<sup>402</sup> When applying the DCF model to the two proxy groups, the average return on equity for the gas proxy group was 10.9% and the water group was 12.3%.<sup>403</sup>

The risk premium model (both Ex Post and Ex Ante versions) calculates the cost of capital under the assumption that investors' expected earnings equal the return they would expect to get on a portfolio of long-term bonds plus a premium on top to account for the increased risk of owning stock.<sup>404</sup> For the Ex Post risk premium, Dr. Vander Weide used A-rated utility bonds and both the average annual return on an investment in the S&P 500 and S&P utility stocks, which resulted in a 10.6% to 11.2% range for the return on equity, for an average of 10.9%.<sup>405</sup> Dr. Vander Weide properly added 25 basis points to this average to account for the recovery of

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<sup>399</sup> Dr. Vander Weide, Pre-Filed Direct Testimony, at 26-28 (Sept. 17, 2010) (the LDC gas proxy group has an average Value Line Safety Rank of 2, whereas AWWC has a rank of 3).

<sup>400</sup> Dr. Vander Weide, Pre-Filed Direct Testimony, at 12-13 (Sept. 17, 2010).

<sup>401</sup> Dr. Vander Weide, Pre-Filed Direct Testimony, at 14-15 (Sept. 17, 2010).

<sup>402</sup> See Dr. Vander Weide, Rebuttal Testimony, at 10-15 (Feb. 8, 2010).

<sup>403</sup> Dr. Vander Weide, JVW Schedule 1 & Schedule 2. The 12.3% return for the water utility proxy group represents the simple average, rather than weighted average. Selecting the simple average results in a *more conservative* estimate, further buttressing the reasonableness of Dr. Vander Weide's recommendation.

<sup>404</sup> Dr. Vander Weide, Pre-Filed Direct Testimony, at 29 (Sept. 17, 2010).

<sup>405</sup> Dr. Vander Weide, Pre-Filed Direct Testimony, at 37 (Sept. 17, 2010).

flotation costs, which are incurred when issuing stock.<sup>406</sup> As explained at the Hearing, flotation costs are incurred at the time of issuance and are paid for out of the proceeds of the stock issuance, not on a rolling basis as suggested by the CAPD during cross-examination.<sup>407</sup> The final result is an 11.2% cost of equity risk premium calculation. For the Ex Ante risk premium, the result was an 11.3% cost of equity, which utilizes the average DCF of a portfolio of the proxy gas companies to the average interest rate on A-rated utility bonds and then applies this average spread to the forecasted yield to maturity on A-rated utility bonds.<sup>408</sup>

Dr. Vander Weide's professional financial assessment is that the proper and fair return on equity for TAWC is within the range of 10.9 to 12.3%, based on the returns of comparable utility companies using the widely-accepted models described above. Accordingly, the Company recommends that the Authority adopt a return on equity within this range.

## **2. Squaring TAWC's Proposed Return on Equity with the General Economy**

The Intervenor argued in their cross examinations and presentations that TAWC should not be allowed an 11.5% return on equity because the economy recently was in a major recession and is still in a state of recovery. This rhetoric has no place in the rate making context. As a regulated public utility, TAWC's rate of return is set by regulators, not the market place, and must remain at the level that attracts capital, insures the financial integrity of the utility, and provides the level of returns commensurate with investments of similar risk, regardless of the free market economy. This independence from the market means that when the economy is expansionary, TAWC is not allowed to achieve as high a return as it might if it were unregulated because its returns are capped through regulation. Simultaneously, however, TAWC is

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<sup>406</sup> Dr. Vander Weide, Pre-Filed Direct Testimony, at 20-21, 37 (Sept. 17, 2010).

<sup>407</sup> Dr. Vander Weide, Vol. V C, Tr. 151:8-12, 193:11-21 (March 4, 2011).

<sup>408</sup> Dr. Vander Weide, Pre-Filed Direct Testimony, at 29-31 (Sept. 17, 2010).

guaranteed under *Hope* and *Bluefield* the opportunity to earn a reasonable rate of return *at all times*. Accordingly, when the economy is not prospering, TAWC is still guaranteed the opportunity for a reasonable rate of return, which may in fact be larger than the return for the general market. To say that TAWC's return on equity should mirror the market is contrary to the very essence of public service utility regulation.

### **3. The CAPD Fails to Adjust its Return on Equity to Account for the Increased Financial Riskiness of a 33.72% Equity Structure**

The evidence has demonstrated that the Authority should reject the CAPD's cost of capital recommendation. Regardless of what methodology the CAPD used to create the capital structure and return on equity, if the CAPD's recommendation is adopted the reality will be that Tennessee American will have a 33.72% equity structure on which to earn a return for its investors. The CAPD is simultaneously recommending a 9.0% return on equity. The CAPD has lowered TAWC's equity structure but has also simultaneously lowered its return on equity. This combination violates the most basic fundamental principle of finance – the greater the risk, the greater the required return.<sup>409</sup> Dr. Vander Weide testified that another very fundamental financial principle is that a company with less equity and a greater debt percentage is more financially risky than a company with a higher equity percentage and less debt.<sup>410</sup> Accordingly, when the risk is increased (through a reduction in the equity portion of the capital structure) the required

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<sup>409</sup> Dr. James Vander Weide, Vol. V C, Tr. 196:3-6 (March 4, 2011).

<sup>410</sup> Dr. James Vander Weide, Rebuttal Testimony, at 3, 22-24 (Feb. 8, 2011). Although this is a very basic finance principle, Dr. Klein attempted to not agree with this statement during cross-examination, repeatedly adding the qualifier that the companies would have to have the same "operating risk" before eventually agreeing that two companies involved in the same operations, i.e. two utility companies, where one of those companies has a higher debt and lower equity structure than the other, the one with the higher debt and lower equity would be the riskier investment. See Dr. Christopher Klein, Vol. VI C, Tr. 292 (March 7, 2011).

return on equity also must increase to reflect this greater risk.<sup>411</sup> In this case the CAPD simply fails to adjust its return on equity.

Not only does the CAPD increase the risk and lower the return in relation to TAWC's historical capital structure and the return authorized by this Authority in 2008, but their recommendation also does not square with the capital structures and return on equity of their proxy utility companies. Dr. Klein used his group of proxy gas LDC utilities and water utilities to determine the appropriate return on equity for Tennessee American.<sup>412</sup> According to Dr. Klein's calculations, the return on equity range for these proxy companies is 8.6% to 9.6%, and therefore he assigns a 9.0% return on equity to TAWC. But, his proxy companies have an average equity capital structure percentage of 48-50%.<sup>413</sup> Dr. Klein has lowered TAWC's equity structure to 33.72%, making it a more risky investment, but has kept the same return on equity as a group of proxy companies with a much higher, less risky, equity percentage. As explained by Dr. Vander Weide at the hearing, assigning the same return to a company with a 33% equity ratio as one with a 48% equity ratio both violates the fundamental principles of finance and is patently unfair.<sup>414</sup>

#### **4. Additional Errors in the CAPD's Cost of Capital Recommendation**

Dr. Vander Weide in his testimony, and the Company during cross-examination, pointed out multiple errors in the CAPD's return on equity calculation. First, Dr. Klein selected a smaller proxy group, selecting only 3 comparable water utility companies rather than the 8 used

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<sup>411</sup> *Id.*

<sup>412</sup> Dr. Christopher Klein, Vol. VI C, Tr.254:9-13 (March 7, 2011).

<sup>413</sup> Vander Weide Rebuttal Ex. 3 (Trial Ex. 83).

<sup>414</sup> Dr. James Vander Weide, Vol. V C, Tr: 195:25-196:14 (March 4, 2011).



by Dr. Vander Weide; notably, the 3 selected companies had lower returns than the full group.<sup>415</sup> Selecting a larger group of companies with similar risk produces more reliable results.<sup>416</sup>

Second, the CAPD's growth estimates in its DCF calculation were seriously flawed. Dr. Klein improperly used the Annual DCF model even though AWWC and his proxy companies all pay dividends on a quarterly, not annual basis.<sup>417</sup> Dr. Klein also inserted a zero percent value for AWWC's earnings growth estimate even though Value Line simply stated that it did not have a growth value and even though other analyst reports (which should be in the toolbox of any cost of capital expert) reported an 11.57% and 8.8% earnings growth.<sup>418</sup> At the Hearing, Dr. Klein admitted that he did not look at this available data.<sup>419</sup> Inserting the zero percent value created the very low 3.5% lower bound of his DCF range for AWWC.

Dr. Klein also chose to ignore earnings growth and use dividend growth instead to determine his DCF range for both AWWC and his proxy companies<sup>420</sup>, even though Dr. Vander Weide testified that earnings growth is the better predictor of future growth.<sup>421</sup> Had Dr. Klein used the available earnings growth, rather than dividends growth, he would have gotten an average return on equity of 11.4% for his proxy water utilities, not 9.1%.<sup>422</sup>

Although Dr. Klein chose to look at dividend growth, he *did not even use* the dividend growth data reported by Value Line for AWWC (16%) because in his opinion this number was too high. He ignored the 16% reported value and instead "refined" his DCF estimate by

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<sup>415</sup> Dr. James Vander Weide, Rebuttal Testimony, at 5 (Feb. 8, 2011).

<sup>416</sup> Dr. James Vander Weide, Rebuttal Testimony, at 6-7 (Feb. 8, 2011).

<sup>417</sup> Dr. James Vander Weide, Rebuttal Testimony, at 8 (Feb. 8, 2011).

<sup>418</sup> Dr. James Vander Weide, Rebuttal Testimony, at 17 (Feb. 8, 2011). This zero value is also untenable given that Value Line reports a 16% dividend growth and, as Dr. Klein admits, dividends are based on earnings. *See* Dr. Christopher Klein, Direct Testimony, at 11:16-18 (Jan. 5, 2011).

<sup>419</sup> Dr. Christopher Klein, Vol. VI C, Tr. 270:15-16 (March 7, 2011).

<sup>420</sup> *See* Klein Exhibit Page 5 of 19 (Trial Ex. 87).

<sup>421</sup> Dr. James Vander Weide, Rebuttal Testimony, at 9-12 (Feb. 8, 2011).

<sup>422</sup> Dr. James Vander Weide, Rebuttal Testimony, at 12:1-5 (Feb. 8, 2011).

plugging in 5% for the dividend growth rate.<sup>423</sup> This 5% figure was based on only two years historical dividend growth data from AWWC.<sup>424</sup> The 5% historical growth figure ignores the reality that investors look at expected *future* returns when investing and ignores the 16% projected growth value predicted by Value Line.<sup>425</sup> It is clear that Dr. Klein's methodology in calculating his DCF is too subjective and inconsistent to be used to set the return on equity in this rate case.<sup>426</sup>

Finally, Dr. Klein uses the CAPM model to create the upper range of his return on equity recommendation. Dr. Vander Weide, however, pointed out in this testimony that the CAPM model should not be used because it underestimates returns for companies with a beta value of less than 1.0 – AWWC and the proxy utilities all have betas far less than 1.0.<sup>427</sup> Dr. Klein recognized this so he based his CAPM calculations on an average 1.0 beta stock, to generate a 9.2% return on equity.<sup>428</sup> In doing so, he used five-year Treasury bonds, which have an increased risk over long-term bonds (the CAPM model requires a risk-free investment) because the returns on these bonds have to be reinvested over the life of the utility every five years at uncertain interest rates.<sup>429</sup> Had Dr. Klein used less risky long-term Treasury bonds and used the actual

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<sup>423</sup> Dr. Christopher Klein, Vol. VI C, Tr. 277:17-21 (March 7, 2011).

<sup>424</sup> Dr. Vander Weide conducted an extensive independent study that confirmed that analyst growth forecasts are far more accurate predictors of actual growth rates than the use of historical growth data in estimating future growth. Dr. James Vander Weide, Rebuttal Testimony, at 12-15 (Feb. 8, 2011).

<sup>425</sup> Dr. James Vander Weide, Rebuttal Testimony, at 16,18 (Feb. 8, 2011).

<sup>426</sup> Interestingly, Dr. Klein's entire work can be found on one handwritten page of notebook paper (Trial Ex. 89) – the only work paper Dr. Klein created in calculating TAWC's return on equity. Dr. Christopher Klein, Vol. VI C, Tr. 293:18 – 294:4 (March 7, 2011). The Company questions whether it is appropriate to base such an important decision on the Company's future on work product of this nature.

<sup>427</sup> Dr. James Vander Weide, Pre-Filed Direct Testimony, at 40-44 (Sept. 17, 2010); Rebuttal Testimony, at 22 (Feb. 8, 2011).

<sup>428</sup> Klein Exhibit Page 7 of 19 (Trial Ex. 88); Dr. Christopher Klein, Vol. VI C, Tr. 250:18-23 (March 7, 2011).

<sup>429</sup> Dr. James Vander Weide, Rebuttal Testimony, at 19-20 (Feb. 8, 2011).

betas of the full cadre of comparable proxy utilities, his CAPM results would have been what Dr. Vander Weide calculated – 9.8% to 10.5%.<sup>430</sup>

**5. The CAPD's Return on Equity Recommendation is Manifestly Unjust and Would Be Impossible to Achieve, Even if Adopted, Given the CAPD's Recommendations in this Rate Case**

The manifest injustice of the CAPD's 9.0% return on equity recommendation can be seen when comparing the recent authorized returns on equity for other AWWC subsidiaries with the most recent interest rates on A-rated utility bonds. Mr. Miller presented this information in his testimony and exhibits and the results show that the average return on equity for AWWC subsidiaries in recent rate cases is 10.36% on the average spread over A-rated utility bonds<sup>431</sup>, far above the 9.0% recommended by the CAPD.

Finally, Mr. Miller illustrated in his Rebuttal Exhibit MAM-2 that TAWC will never be able to achieve the 9.0% return on equity recommended by the CAPD, even if it were adopted, because of the CAPD's recommended revenue requirement and cost of service in this case. When factoring in these reductions, TAWC would only be given the opportunity to achieve a return on equity of 1.12% in the attrition year on a U.S. GAAP basis.<sup>432</sup> As Mr. Miller testified at the Hearing, potential investors are only interested in actual returns achieved on a U.S. GAAP basis when they determine whether to invest in a company.<sup>433</sup> Accordingly, these comparisons should further illustrate the inadequacy of the CAPD's return on equity recommendation.

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<sup>430</sup> See Dr. James Vander Weide, Pre-Filed Direct Testimony, at 40 (Sept. 17, 2010).

<sup>431</sup> Michael A. Miller, Rebuttal Testimony, at 27-30 (Feb. 8, 2011); Rebuttal Ex. MAM-5.

<sup>432</sup> Michael A. Miller, Rebuttal Testimony, at 6-9, 27 (Feb. 8, 2011); Rebuttal Ex. MAM-2.

<sup>433</sup> Michael A. Miller, Vol. VI B, Tr.120:9 – 121:9 (March 7, 2011).

## **E. Taxes**

### Income Tax Expense

The Company has actual tax liabilities generating a revenue requirement deficiency of \$1.068 million that it is not recovering in rates because the 2008 rate case Order did not recognize the impact of the flow-through of the Company's pre-1981 assets and the required gross-up of AFUDC on its income tax expenses. The Company cannot continue absorbing a million dollars of lost revenue related to its IRS required tax liability without recovering this income tax amount in rates. Fortunately, the tax issue between the CAPD and Company in this case, albeit inherently complicated, is actually fundamentally simple – the Company has *actual tax liability* it must pay to the government, *which the CAPD has recognized*, yet simultaneously the CAPD has failed to adjust its tax expense amount to reflect these liabilities. Particularly, these liabilities are (1) the reversal of the flow-through benefits of the pre-1981 assets and (2) the tax that is imposed on the Company's equity Allowance for Funds Used During Construction (AFUDC) amounts. There is no doubt that the Company incurs these tax liabilities, which are recoverable in rates, so the only remaining issue is for the CAPD to properly adjust its tax expense calculation accordingly. When this difference – amounting to \$623,832 in additional income tax expense – is included in the CAPD's income tax calculation and grossed up through the revenue requirement calculation, the total tax revenue requirement becomes \$1.068 million.<sup>434</sup>

#### **1. Flow Through of the Pre-1981 Assets & AFUDC Gross Up**

Mr. James Warren, one of the nation's leading experts in this field, explained the concepts and mechanics behind the "two very basic mistakes" in Mr. Buckner's income tax

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<sup>434</sup> Michael A. Miller, Vol. 6 A, Tr.47:4-8 (March 7, 2011); Rebuttal Exhibit MAM-7.

expense proposal.<sup>435</sup> First, the Company already gave its customers a tax benefit for accelerated depreciation on its pre-1981 assets because it used “flow-through” accounting, which gave a tax benefit to the customers when the temporary tax/book difference occurred. At the point after the assets fully depreciate for tax purposes, the Company then is subject to repay the tax liability related to these assets, which then has to be passed along to customers in the form of income tax expense payment increases.<sup>436</sup> If the Company does not recover these income taxes on the back end, then essentially the customers get a double tax benefit, which is entirely improper.<sup>437</sup> The Company is now paying income taxes on the reversal of the timing differences for the pre-1981 flow-through property and needs to recover these taxes through rates.

Second, the Company’s total AFUDC amount incurs a tax liability that the Company must repay to the government. Mr. Buckner, however, only includes the actual equity AFUDC amount in his tax expense and revenue recovery without also including the income tax that the Company has to pay on its equity AFUDC (in order to fully recover the AFUDC in future rates the amount must be grossed-up). If not corrected, this guarantees that the Company will never have the opportunity to recover its equity AFUDC rate of return because the Company’s recovery will always be short 35% (the income tax rate).<sup>438</sup> Accordingly, Mr. Buckner needs to gross up the equity AFUDC amount to include this tax liability so that the Company can properly recover its income tax expense.

It is important to recognize that there is no disagreement about the policy or accounting behind flow-throughs or equity AFUDC as these are both standard, uncontroversial aspects of rate-making; instead, the only issue is the clear cut and fundamental error in the CAPD’s income

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<sup>435</sup> James Warren, Rebuttal Testimony, at 4:7 (Feb. 8, 2011).

<sup>436</sup> James Warren, Rebuttal Testimony, at 10-14 (Feb. 8, 2011).

<sup>437</sup> James Warren, Rebuttal Testimony, at 16, 18:7-13 (Feb. 8, 2011).

<sup>438</sup> James Warren, Rebuttal Testimony, at 7:17-22 (Feb. 8, 2011).

tax expense calculation.<sup>439</sup> Indeed, the TRA and its predecessor have recognized the flow-through method in all the Company's rate cases except for in 2008.<sup>440</sup> There is also no question that the CAPD has recognized both the reversal of the pre-1981 flow-through assets and the AFUDC gross up as SFAS 71 regulatory tax assets, as Mr. Buckner testified to this on the witness stand and included these as regulatory assets in his Revised Exhibit, Schedule 7.<sup>441</sup> Finally, and most importantly, *Mr. Buckner freely admitted at the Hearing that he did not include in his income tax calculation the reversal of the flow-through for the pre-1981 assets.*<sup>442</sup> If these two unquestionable errors are corrected, then there remains no issue between the parties on income tax expense. Accordingly, there is nothing to inhibit the Authority from correcting the error in the 2008 rate case order and include as part of the Company's revenue requirement \$1.068 million related to the actual tax liabilities it incurs on pre-1981 flow-through property and the AFUDC gross-up.

#### FIN 48

The Company adamantly disagrees with recording its uncertain tax position (FIN 48) amounts as ADITs, as suggested by Mr. Buckner. First, as explained by Mr. Miller, this suggestion fails to recognize that 30% of the Company's capitalized repairs deductions are not interest-free ADITs because there is a *high likelihood* that the IRS will not allow these deductions and will instead impose a tax liability on the Company.<sup>443</sup> ADITs only include interest-free capital and at this time these amounts are not interest free. It is improper to ignore

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<sup>439</sup> James Warren, Rebuttal Testimony, at 5:1-6; 14:12-14; 25:1-4 (Feb. 8, 2011).

<sup>440</sup> Michael A. Miller, Vol. VI C, Tr. 234:20 – 235:6 (March 7, 2011).

<sup>441</sup> Terry Buckner, Vol. VII B, Tr. 94:19 – 95:11; 97:5-17 (March 8, 2011).

<sup>442</sup> Terry Buckner, Vol. VII B, Tr. 98:20-99:8 (March 8, 2011) (“Q. So, on Exhibit 7, Mr. Buckner, can you show me on that schedule where you have accounted for the additional tax the company has to pay on the temporary difference now that these pre-’81 flow-throughs are reversing? A. It was not recorded on this schedule.”).

<sup>443</sup> Michael A. Miller, Rebuttal Testimony, at 45:22-46:6 (Feb. 8, 2011).

the formal opinions of the Company's independent tax auditors who have carefully evaluated the Company's tax positions and concluded that there will most likely be tax liability – making this amount non interest-free capital. The CAPD would rather have this Authority err on the side of choosing the *less* likely scenario, rather than the most likely scenario that has a basis in expert opinion. Furthermore, as fully explained in Mr. Warren's testimony, the CAPD's position creates a disincentive for the Company to file uncertain tax positions – a result that harms both customers and the Company.<sup>444</sup> It is in the customers' best interest because if the Company takes uncertain tax positions and is successful this results in cost-free capital, which means the Company needs less in the way of rates.<sup>445</sup> Indeed, three of the four commissions that have addressed FIN 48 agreed with the Company's recommendation.<sup>446</sup>

Finally, Mr. Buckner's support for his FIN 48 position contains several obvious errors and misinterpretations. Mr. Buckner misinterprets the Company's response to TRA Data Request 134, as the Company's response stated that the experts concluded that there was a high likelihood that 30% of capitalized repairs deductions will *not* be recognized by the IRS.<sup>447</sup> Mr. Buckner also incorrectly states that the statute of limitations will expire on the Company's capitalized repairs deduction in 2010. This is patently incorrect; these deductions were recorded on the Company's 2008 tax return, not its 2006 return, so they will expire in 2012.<sup>448</sup> Mr. Buckner also incorrectly states that the Company is not recording interest on its uncertain tax

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<sup>444</sup> James Warren, Rebuttal Testimony, at 33 (Feb. 8, 2011).

<sup>445</sup> James Warren, Rebuttal Testimony, at 33:7-15 (Feb. 8, 2011).

<sup>446</sup> See *In the Matter of Union Electric Company, d/b/a AmerenUE's Tariffs to Increase Its Annual Revenues for Electric Service*, Case No. ER-2008-0318, slip. op. at 55 (Mo. PSC Jan. 6, 2009); *Washington Utilities and Transp. Commission v. Puget Sound Energy, Inc.*, Case No. 2010-00036, slip op. at 70 (Wash. UTC April 2, 2010); *In re Petition of Kentucky American*, Final Order, Case No. 2010-00036, at 17-20 (Kentucky); but see *Application of Oncor Electric Delivery Company LLC for Authority to Change Rates*, Control No. 35717 (Order 2009).

<sup>447</sup> Michael A. Miller, Rebuttal Testimony, at 46:8-21 (Feb. 8, 2011).

<sup>448</sup> Michael A. Miller, Rebuttal Testimony, at 46:23-47:4 (Feb. 8, 2011). Mr. Buckner stated during cross-examination that he did think that 2012 would be the accurate statute of limitations date for a 2008 tax return. Terry Buckner, Vol. VII B, Tr. 90:25-91:15 (March 8, 2011).

liability, relying on the Company's 2009 Annual Report. The Company admitted that it had made an error but assured that this was corrected in the January 2010 accounting close and that these uncertain tax positions continue to be recorded on TAWC's financial statements along with the accrued IRS interest.<sup>449</sup>

#### Accumulated Deferred Income Taxes (ADITs)

As reflected on Mr. Miller's Rebuttal Exhibit MAM-7 and explained in his testimony, both the Company and CAPD, per its revised testimony, agree that the ADITs to be used for rate recovery total \$22,638,057, not including the FIN 48 amount.<sup>450</sup> As described above, it is entirely improper to include FIN 48 amounts in ADITs because at this time they are not interest-free capital. With FIN 48 amounts properly excluded from ADITs, the Company and Mr. Buckner are in agreement on the ADIT amount.

#### SFAS 109 vs. APB 11

Although the CAPD has repeatedly raised this issue, the SFAS 109 versus APB 11 discussion is a red herring that does not in any way affect the Company's revenue requirement. The Company originally filed the case using the APB 11 approach because it believed that the Authority's Order in docket number 08-00039 indicated that the Authority had a problem with the SFAS 109 approach utilized by the Company in that recovery was not allowed for the reversal of the flow-through of the pre-1981 assets.<sup>451</sup> The Company agrees with adopting and using the SFAS 109 approach utilized by Mr. Buckner in this case and amended its testimony to reflect income tax expense and ADITs using SFAS 109.<sup>452</sup> The reduction in the rate base amount due to the increased ADITs using SFAS 109 was reflected in Mr. Miller's Rebuttal Exhibit

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<sup>449</sup> Michael A. Miller, Rebuttal Testimony, at 47:6-17 (Feb. 8, 2011).

<sup>450</sup> See Michael A. Miller, Rebuttal Ex. MAM-7; Michael A. Miller, Vol. VI A 91:18-25 (March 7, 2011).

<sup>451</sup> Michael A. Miller, Rebuttal Testimony, at 39:19-29 (Feb. 8, 2011).

<sup>452</sup> See Michael A. Miller, Rebuttal Ex. MAM-7; Michael A. Miller, Rebuttal Testimony, at 39:19-29 (Feb. 8, 2011).



MAM-9 and is included in the Company's rate base recommendation, assuming the Authority adopts the SFAS 109 approach.

Mr. Warren explicitly stated at the Hearing that *the revenue requirement remains the same, regardless of whether the APB 11 or SFAS 109 methods are used* to calculate income tax and ADIT rate base, because the use of SFAS 109 or APB 11 is just a matter of "how you paint the picture" and "doesn't make any difference" in the level of tax expense.<sup>453</sup> Mr. Miller also unequivocally testified that amending the Company's filing using the SFAS 109 approach did *not* alter the Company's revenue requirement.<sup>454</sup> The CAPD raised the issue that Mr. Miller's Rebuttal Exhibit MAM-7 does not reflect identical revenue requirements, but Mr. Miller quickly explained that his exhibit was not meant to reflect the revenue requirement, just the difference in income tax expense and ADITs, and that the revenue requirement entry was made in error.<sup>455</sup> Accordingly, there is nothing in the record that otherwise changes the indisputable fact that the use of SFAS 109 or APB 11 makes no difference in the revenue requirement.

### Property Tax

Property taxes for the test year were \$2,380,025, which includes an adjustment for the 19% property tax increase the City of Chattanooga announced that will be effective in the attrition year.<sup>456</sup> This is yet another example of increased expenses that the Company has no control over. This normalized adjustment combined with the effective property tax rate based on the latest property tax returns was applied to the thirteen month average attrition year rate base to arrive at the attrition year adjustment of \$313,148.

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<sup>453</sup> James Warren, Vol. II A, Tr. 33:16 – 34:11 (March 1, 2011).

<sup>454</sup> Michael A. Miller, Vol. VI A, Tr. 84:20 – 85:16 (March 7, 2011).

<sup>455</sup> Michael A. Miller, Vol. VI A, Tr. 97:16-98:11 (March 7, 2011). This does not change the fact that the CAPD improperly excluded income tax expenses for the reversal of the flow through of the pre-1981 assets and equity AFUDC gross up. Once this is done, the Company's and CAPD's revenue requirement under SFAS 109 will be the same.

<sup>456</sup> Sheila Miller, Pre-Filed Direct Testimony, at 17:17-25 (Sept. 17, 2010).

## **F. Rate Base<sup>457</sup>**

### Capital Expenditures

Eleven percent (11%) of the Company's rate increase, \$1.137 million, is due to the continued need and obligation to undertake capital expenditures in the attrition year so that the Company's infrastructure remains operable and in good condition. The need for capital investment is of paramount importance because TAWC's infrastructure, unlike other water systems, is over 135 years old and faces unique stresses due to very high operating pressures needed to service the area's mountainous region. As explained elsewhere, the Company needs an actual opportunity to earn a fair and reasonable rate of return – in order for it to attract capital to make investments. An inability to attract capital would prevent the Company from being able to invest in necessary capital projects.

Until recently, the Company has been able to proactively invest in infrastructure replacement and construction, but that is no longer the case.<sup>458</sup> The 2008 rate case order did not allow the company the opportunity to earn a reasonable rate of return on its investments, resulting in very little capital investment funding for necessary capital projects.<sup>459</sup> The Company has been able to make do in the short term, but it cannot keep putting off capital investments – if it does, infrastructure could fail, increased service issues will result, and the repair and

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<sup>457</sup> The Company is recommending a rate base of **\$120,968,932**, as is reflected in Revised Rebuttal Exhibit MAM-9. As explained in Mr. Miller's rebuttal testimony, the Company updated its filing under the SFAS-109 approach, resulting in this revised rate base figure. This level of rate base is predicated on the assumption that the Authority will accept the ADIT balance of \$22,638,057 as determined on Rebuttal Exhibit MAM-7, line 3 under the SFAS 109 approach and not increase the ADITs for the FIN 48 amount related to the uncertain tax position resulting from the tax accounting change for capitalized repairs. This recommendation is also predicated on the assumption that the Authority will utilize the normalized pre-tax book income approach in this case as proposed on Exhibit 1, page 7 of 9 attached to the revised testimony of Mr. Buckner. In the alternative, if the Authority does not recognize the \$623,832 adjustment increasing income taxes under the CAPD's approach referenced above, the Company believes the Authority should insert an ADIT balance of \$17,153,815 into the ADIT line on Rebuttal Exhibit MAM-8, producing a rate base of \$126,753,124.

<sup>458</sup> John Watson, Pre-Filed Direct Testimony, at 19 (Sept. 17, 2010).

<sup>459</sup> John Watson, Pre-Filed Direct Testimony, at 19 (Sept. 17, 2010).

replacement work will become more expensive due to continued delay.<sup>460</sup> In fact, the Company has had to delay or defer many of its major capital projects due to inadequate earnings.<sup>461</sup> Just as you cannot continue to push off changing the oil in your car, the Company cannot continue pushing off these necessary projects that ensure its infrastructure can run properly. This is yet another reason why a rate increase at this time is an absolute necessity.

Mr. Watson, in his testimony, described the projects that the Company was able to undertake since the last rate case<sup>462</sup>:

- Fire protection upgrades and replacements at a cost of \$0.099 million
- Install and replace meters, services and equipment at a cost of \$1.589 million
- Lookout Mountain supply main replacement at a cost of \$1.6 million
- Citico Treatment Plant Phase 1A at a cost of \$6.5 million
- TDOT relocation work at a cost of approximately \$0.192 million

During the period of 2009 through the end of the attrition year, the Company will also have spent a total of \$1.15 million in 2” – 16” water main replacements.<sup>463</sup> The Company’s routine maintenance capital expenditures totals approximately \$4.9 million and will include water main installation, fire hydrant replacement/renewal and new construction of services and meters, amongst other routinely incurred maintenance projects.<sup>464</sup>

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<sup>460</sup> See John Watson, Pre-Filed Direct Testimony, at 17:1-13 (Sept. 17, 2010).

<sup>461</sup> John Watson, Pre-Filed Direct Testimony, at 14-16 (Sept. 17, 2010). Examples include: deferring phases of the Citico treatment plant improvements, the replacement of old iron and galvanized steel water mains, tank painting, the construction of a new storage tank for Missionary Ride, projects designed to reduce non-revenue water, delaying the Lookout Mountain supply main replacement by a year, amongst others.

<sup>462</sup> John Watson, Pre-Filed Direct Testimony, p. 13:13 – 14:11 (Sept. 17, 2010); John Watson, Vol. I B, Tr. 121:24 – 123:20 (Feb. 28, 2011). These are meant to illustrate projects undertaken in calendar years 2009 to 2010, not the test year necessarily. TAWC provided as late-filed Trial Exhibit 12 a copy of test year capital expenditures. Notably, projects such as the Citico Treatment plant incurred the vast majority of their spending after the test year, so these figures will not be in Exhibit 12.

<sup>463</sup> John Watson, Pre-Filed Direct Testimony, at 14:5-6 (Sept. 17, 2010).

<sup>464</sup> John Watson, Pre-Filed Direct Testimony, at 20:3-6 (Sept. 17, 2010).

Additionally, the Company has several major investment projects planned for the upcoming year, including:

- Phase II of the Citico Treatment Plant at a cost of \$2.49 million in 2011 and \$6.71 million in 2012
- East Ridge reservoir effluent valve additions at a cost of \$0.350 million
- Business transformation project at a cost of \$0.972 million
- Granular Activated Carbon filter replacement at Citico at a cost of \$1.0 million
- Non-revenue water reduction projects at a cost of \$1.0 million

The Company also estimates additional TDOT relocation expenses of approximately \$150,000, projects of which the Company often does not receive reimbursement.<sup>465</sup>

#### **1. Used and Usefulness**

The City, during its opening presentation, argued that TAWC has not proven that its rate base assets are used and useful. Once again, the City's argument misses the mark. Mr. Hitchcock questioned TAWC's response to City Data Request No. 8 that asked the Company to explain the used and usefulness of its plant additions. Mr. Watson properly responded that the Company had provided its accounting statements showing its additions to plant, forecasted additions to plant and construction work in progress ("CWIP"),<sup>466</sup> provided its auditor letters that represent that the Company's books reflect the status of existing property,<sup>467</sup> and responded that the Company had offered for the City to come and inspect its other documents regarding the Company's assets because the enormous volume of records (literally thousands of paper records filling two whole rooms) made it extremely difficult to produce.<sup>468</sup> Nevertheless, the City is not

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<sup>465</sup> John Watson, Pre-Filed Direct Testimony, at 12:6-13:12 (Sept. 17, 2010).

<sup>466</sup> John Watson, Vol. I C, Tr. 227:13 – 229:5 (Feb. 28, 2011); Vol. II C, Tr. 305:3-17 (March 1, 2011).

<sup>467</sup> John Watson, Vol. II C, Tr. 302:24 – 303:9 (March 1, 2011).

<sup>468</sup> John Watson, Vol. I C, Tr. 228:4-10 (Feb. 28, 2011).

satisfied and has tried to argue that somehow TAWC has failed to demonstrate the used and usefulness of its utility plant in place to serve its customers.

Under the City's preposterous view of the burden of proof, TAWC would have to literally dig up every single asset for inspection to determine if it was used and useful and properly included in rate base.<sup>469</sup> The cost and impossibility of doing this is obvious. More importantly, this is not a requirement imposed on any regulated utility. TAWC provided documents, as it always does, supporting its plant additions, retirements, and CWIP by way of its accounting exhibits. As Mr. Watson testified under oath at the Hearing, the assets reflected in the Company's accounting records are in use and are useful.<sup>470</sup> These accounting exhibits were provided in response to TRA Data Request Nos. 51-54 and are in Sheila Miller's Exhibit 1, Schedule 2 (as amended by Rebuttal MAM-9). The accounting records contain the Company's additions and retirements to rate base, and, if there was any issue with the Company's books not reflecting the actual assets of Tennessee American, its outside auditors would discover this and include that in their audit report. TAWC introduced into evidence the PriceWaterhouseCoopers Audit report, which found no such issue.<sup>471</sup> Additionally, the Company's two representation letters to its auditor, dated March 26, 2010 and March 30, 2009, respectively state as follows:

“We believe the utility plant in service accounts and accumulated depreciation as of December 31, 2009[8], and 2008[7], fairly represent the status of existing property in use at those respective dates.”<sup>472</sup>

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<sup>469</sup> Mr. Strauss also made the suggestion during Mr. Watson's cross examination that valves which are covered and not visible to inspection cannot be guaranteed to be used and useful. This argument fails for the same reasons as the City's arguments. To require the Company to dig up and inspect every single asset to prove it is used and useful is not a reasonable or required procedure in rate making. Further, the mere fact that the valves are in place makes the valves used and useful because without the valves there would be a water leak.

<sup>470</sup> John Watson, Vol. III B, Tr.116:17-21 (March 2, 2011). Contrary to the UWUA's suggestion, just because a valve may happen to be temporarily non-functioning does not prevent it from being used and useful and included in rate base. *See* John Watson, Vol. III A, Tr. 30 (March 2, 2011).

<sup>471</sup> Trial Ex. 46 (TAWC Response to TRA Data Request No. 5).

<sup>472</sup> Trial Ex. 36 (paragraph 52 of the 2010 audit letter). Paragraph 42 of the 2009 audit letter contains the same statement, with the dates 2008 and 2007 substituted for 2009 and 2008.

Clearly, the City's argument has no merit. Based on the overwhelming and undisputed evidence, there is no basis to deny the Company's recovery of its utility plant assets – especially on only the mere surmise that somewhere there might be an asset hidden from view that may not be useful.

#### Utility Plant in Service

As described in Ms. Sheila Miller's pre-filed testimony, Utility Plant includes the original cost of all land, land rights, easements, structures and improvements, together with equipment in service at March 31, 2010. Mr. Watson unambiguously testified that the plant additions contained in the Company's accounting are used and useful and described these additions in depth in his Pre-Filed Testimony.<sup>473</sup> There was not one shred of evidence presented by any Intervenor to the contrary or in any way proving that any component of the utility plant was not used and useful.

The Company determined the attrition year Utility Plant balance by adding net additions and retirements through the end of the attrition period, and calculating the 13-month average of the Utility Plant balances from December 1, 2010 through December 31, 2011.<sup>474</sup> The Utility Plant total for the attrition year is \$226,384,490.

#### Construction Work in Progress (CWIP)

The Company originally projected a \$4,201,421 CWIP balance by adjusting the actual balance on March 31, 2010 for construction expenditures and transfers to utility plant in the attrition year. The Company inadvertently included forecasted monthly retirement amounts as

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<sup>473</sup> See John Watson, Vol. III B, Tr. 116:17-21 (March 2, 2011); John Watson, Pre-Filed Direct Testimony, at 13-17, 20-21 (Sept. 17, 2010).

<sup>474</sup> Sheila Miller, Pre-Filed Direct Testimony, at 19:27 – 20:9 (Sept. 17, 2010).

an offset to the utility plant transfer additions, but corrected this error in Mrs. Miller's rebuttal testimony.<sup>475</sup>

The CAPD's CWIP balance adjusted the actual balance at the end of September 2010 by adding the capital spending from October 2010 through the end of the attrition year and subtracting additions to plant during that time. However, the CAPD left out \$1,545,192 in capital spending included in the Company's 2010 budget that it had not yet spent by the end of 2010, but that it will spend in the attrition year.<sup>476</sup> The completion and in-service dates for these projects has not changed, the only thing that has changed is when the money will be spent, which is now in 2011.<sup>477</sup> The CAPD does not dispute that this money will be spent. Accordingly, there has been absolutely no evidence that the Company's CWIP balance is anything other than what the Company projected and there is simply no basis to use a CWIP balance different than what the Company projects.

When adjusting for the \$1,545,192 in capital spending that will occur in the attrition year and correcting the inadvertent inclusion of the monthly retirement amounts, that total attrition year 13-month average included in rate base is \$3,463,575.<sup>478</sup>

#### Working Capital

This category includes Prepaid Taxes, Materials, & Supplies, and Deferred Regulatory Expense, Unamortized Debt Expense, Other Deferred Debts, the Lead-Lag Study and Incidental Collections. The Company originally calculated \$1,011,256 in working capital, supported by a lead/lag study that used the 12-month period ending March 2010 and the historical test year.<sup>479</sup>

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<sup>475</sup> Sheila Miller, Rebuttal Testimony, at 14:1-6 (Feb. 8, 2011).

<sup>476</sup> Sheila Miller, Rebuttal Testimony, at 14:8 – 15:10 (Feb. 8, 2011).

<sup>477</sup> Sheila Miller, Rebuttal Testimony, at 14:8-15:10 (Feb. 8, 2011).

<sup>478</sup> Sheila Miller, Rebuttal Exhibit SAM-5; Michael A. Miller, Revised Rebuttal Exhibit MAM-9.

<sup>479</sup> Michael A. Miller, Rebuttal Testimony, at 50:2-7 (Feb. 8, 2011).

The Company included average attrition year balances for prepaid taxes, materials and supplies, deferred regulatory expense, unamortized debt, and other deferred debits. For all other revenue and expense items the Company used the lead/lag method, based on the Company's lead/lag study. Cash, prepaid taxes and the 2006 management audit were not included.<sup>480</sup> The Company's method for calculating working capital is the same method used in the 2008 rate case, which the Authority approved. The Company amended its working capital calculation consistent with the updated filing provided at the request of the TRA staff, and included this revision in Rebuttal Exhibit MAM-8. The Company's final amended working capital total for the attrition year is \$1,932,896.<sup>481</sup>

### **1. Lead/Lag Study**

Both the CAPD and CRMA proposed adjustments to the lead/lag calculations without any credible argument to support their changes. The TRA rejected the intervenors' similar attempts in the last rate case to selectively change certain lead/lag items without conducting a full lead/lag study.<sup>482</sup>

The CAPD amended the lead days associated with federal and state income tax. The CAPD bases this recommendation by simply referring to a textbook.<sup>483</sup> The CAPD did not perform a lead/lag study to support this position and the textbook cited by Mr. Buckner does not reflect the current IRS schedule for estimated payments.<sup>484</sup> Conversely, the Company's lead and

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<sup>480</sup> Michael A. Miller, Rebuttal Testimony, at 50:1-16 (Feb. 8, 2011).

<sup>481</sup> Revised Accounting Ex. per Company Rebuttal Testimony, at 2 of 10 (Feb. 28, 2011)

<sup>482</sup> See Final Order, Docket No. 08-00039, at 41 (Jan. 13, 2009).

<sup>483</sup> Terry Buckner, Direct Testimony, at 52 n.137 (Jan. 5, 2011).

<sup>484</sup> Michael A. Miller, Rebuttal Testimony, at 52:7-15 (Feb. 8, 2011).



lag days reflect the *actual* payment dates for income taxes through March 2009 and conforms to the IRS payment guidelines.<sup>485</sup>

Mr. Gorman, although he conducted no lead/lag study of his own, made several inappropriate adjustments to lead and lag days, which Mr. Miller discussed in full in his rebuttal and revised rebuttal testimony.<sup>486</sup> For example, Mr. Gorman amended the expense lag for management fees to eliminate the fact that TAWC makes some pre-payments to AWWSC.<sup>487</sup> In doing so, Mr. Gorman simply took the expense lags that *TAWC* experiences and applies them to AWWSC. This completely ignores the expense lags that AWWSC *actually* experiences and simply imposes one company's expense lags upon another. Mr. Gorman also appears to have completely ignored the revenue lag, which, if he had applied it as well, would have led to the same lead/lag figures.<sup>488</sup> The Company, on the other hand, used the actual payments made during the historical test-year ending March 31, 2010.<sup>489</sup>

As he did in the last case, Mr. Gorman also assigned a zero revenue lag to uncollectibles, depreciation expense, amortization expense and deferred income tax expense in this case (effectively eliminating any working cash requirements for these expenses) – a position that the Authority did not accept in the 2008 rate case.<sup>490</sup> There was no basis for these adjustments in the last case and there is none now. Finally, Mr. Gorman amended the lead/lag days for Gross Receipts Tax using the prior year's revenues on which the current year's taxes will be based, which incorrectly assumes that the Company has received those gross receipts tax equivalents in revenue and he claims that overall revenue lag days should not apply to gross receipts taxes,

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<sup>485</sup> *Id.*

<sup>486</sup> Michael A. Miller Rebuttal (and Revised) Rebuttal, at 52-56 (Feb. 8, 2011).

<sup>487</sup> Michael Gorman, Direct Testimony, at 19:8-20 (Jan. 5, 2011).

<sup>488</sup> Michael A. Miller, Rebuttal Testimony, at 53:28 – 54:5 (Feb. 8, 2011).

<sup>489</sup> Michael A. Miller, Rebuttal Testimony, at 53:12-14 (Feb. 8, 2011).

<sup>490</sup> See Final Order at 41 (Dkt. No. 08-00039) (Jan. 13, 2009) (rejecting Mr. Gorman's similar adjustments).

which is also incorrect.<sup>491</sup> The one issue Mr. Gorman did correctly point out was an error in the Company's service period. The Company adjusted for this and the result of this correction was an increase to the Company's working capital of \$264,000, not a reduction of \$328,178 as was suggested by Mr. Gorman.<sup>492</sup>

## **2. Unamortized Debt Expense**

Unamortized debt expense was calculated by starting with the March 31, 2010, unamortized debt expense, adding new debt expense for proposed issues, and subtracting the cumulative amortizations to arrive at the balance at the end of the attrition year. The thirteen month average of these amounts results in a \$460,845 balance. Mr. Gorman eliminated this from working capital. The Company agrees with this position only if the Authority uses a stand alone capital structure. If the Authority uses a double leverage approach again to establish rates, then all of the debt (and unamortized debt expense) issued by TAWC may not be embedded in the capital structure used for rate recovery.<sup>493</sup>

### Accumulated Depreciation

The Company calculated the accumulated depreciation balance beginning with the historical test year balance as of March 31, 2010. Accumulated depreciation was calculated through the end of the attrition period utilizing current depreciation rates. A thirteen month average was then calculated using the month end accumulated depreciation balances from December 1, 2010 to December 31, 2011 to arrive at the accumulated depreciation at the end of the attrition period.<sup>494</sup>

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<sup>491</sup> Michael A. Miller, Rebuttal Testimony, at 56:3-7 (Feb. 8, 2011).

<sup>492</sup> Michael A. Miller, Rebuttal Ex. MAM-8; Michael A. Miller, Rebuttal Testimony, at 56-57:9 (Feb. 8, 2011).

<sup>493</sup> Michael A. Miller, Rebuttal Testimony, at 52:17-27 (Feb. 8, 2011).

<sup>494</sup> Sheila A. Miller, Pre-Filed Direct Testimony, at 21:24 – 22:4 (Sept. 17, 2010).

## **G. Valve Maintenance**

Though the purpose of this rate case is to set just and reasonable rates for TAWC, the Intervenor attempted to shift the focus to a variety of other topics, including TAWC's policies and procedures for inspecting and maintaining the valves that are part of its infrastructure.<sup>495</sup> The Intervenor alleged that valve maintenance topics were relevant to this rate case proceeding due to the Authority's obligation under Tenn. Code Ann. § 65-5-103 to "take into account the safety, adequacy and efficiency or lack thereof of the service or services furnished by the public utility."<sup>496</sup>

All of the Intervenor's allegations of deficiencies with respect to either valves or valve maintenance, however, were completely proven to be unfounded through the testimony of Mr. Watson and the Union's witness Mr. Blevins. Mr. Watson testified that TAWC has had a comprehensive ongoing valve inspection and maintenance program in place for at least twelve years.<sup>497</sup> Because there is no national or state requirement for valve maintenance and repair, TAWC has always implemented and operated its program voluntarily.<sup>498</sup> As part of the program TAWC maintains extensive records containing distribution system valve information, valve maps, valve numbers, construction records, and valve inspection reports.<sup>499</sup> Mr. Watson testified that while TAWC has been able to effectively maintain its valves, without the additional staff

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<sup>495</sup> Vol. IA Tr., 52:23 – 52:24 (Feb. 28, 2011).

<sup>496</sup> See UWUA's Response to TAWC's Second Set of Discovery Requests, No. 3 (Jan. 21, 2011).

<sup>497</sup> John Watson, Pre-Filed Rebuttal Testimony, at 26 (Feb. 8, 2011); John Watson, Vol. IVD, Tr. 318:24 – 319:2 (March 3, 2011).

<sup>498</sup> John Watson, Vol. IVD, Tr. 318:4 – 318:12; 319:7 – 319:12 (March 3, 2011).

<sup>499</sup> John Watson, Pre-Filed Rebuttal Testimony, at 26 (Feb. 8, 2011); John Watson, Vol. IVD, Tr. 321:24 – 322:2 (March 3, 2011).

requested in the Petition TAWC could not continue to perform valve operation and maintenance adequately in the long-term.<sup>500</sup>

Under TAWC's valve inspection and maintenance program TAWC sets goals to inspect a certain number of each type of valves each year.<sup>501</sup> For 2009 and 2010 almost all of these goals were not only met, but actually exceeded.<sup>502</sup> Mr. Watson also testified that in recent years fewer new housing units have been constructed in TAWC's service area, so TAWC has responded by shifting employees who normally perform new service installations to valve maintenance work.<sup>503</sup>

The testimony of the Union's witness Mr. Blevins was the subject of much controversy. On February 25, 2010 the Hearing Officer denied the Union's Motion to allow Mr. Blevins to submit testimony and granted TAWC's motion to exclude the testimony of Mr. Blevins.<sup>504</sup> Although Mr. Blevins had not filed pre-filed testimony and had been previously excluded as a witness the panel subsequently allowed Mr. Blevins to testify.<sup>505</sup> Despite the fact that Mr. Blevins had recently been terminated from TAWC for cause and is currently employed by the City of Chattanooga,<sup>506</sup> Mr. Blevins' *testimony confirmed almost all of Mr. Watson's testimony* regarding TAWC's valve inspection and maintenance program.<sup>507</sup> He explained that TAWC's

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<sup>500</sup> John Watson, Pre-Filed Rebuttal Testimony, at 27 (Feb. 8, 2011).

<sup>501</sup> John Watson, Pre-Filed Rebuttal Testimony, at 27 (Feb. 8, 2011).

<sup>502</sup> John Watson, Pre-Filed Rebuttal Testimony, at 27 (Feb. 8, 2011).

<sup>503</sup> John Watson, Pre-Filed Rebuttal Testimony, at 27 (Feb. 8, 2011).

<sup>504</sup> See Order Denying the UWUA's Motion to Substitute Affiant and Granting TAWC's Motion in Limine to Strike the Statement of Jerry Haddock, Strike Certain Testimony of James Lewis, and to Exclude the Testimony of Martin Blevins, at 4, 7-8 (Feb. 25, 2011). The Hearing Officer held that the Union's "request that Mr. Blevins provide witness testimony three weeks prior to the hearing is prejudicial because TAWC has not been made aware that Mr. Blevins was a possible witness and he has not filed any pre-filed testimony." *Id.* at 4.

<sup>505</sup> Vol. IIA, Tr. 6:15 - 8:11 (March 1, 2011).

<sup>506</sup> Martin Blevins, Vol. IVD, Tr. 282:12-25 (March 3, 2011).

<sup>507</sup> Martin Blevins, Vol. IVD, Tr. 300:15 - 301:1 (March 3, 2011).

system contains approximately 20,000 small and 500 large valves.<sup>508</sup> No, party, including Mr. Blevins, alleged that any significant portion of those valves were in a state of disrepair.<sup>509</sup> In fact, Mr. Watson testified that of the thousands of valves in the system there were only approximately 25 that he was currently aware of that were in need of repair.<sup>510</sup> Mr. Blevins testified that many of TAWC's inoperable valves could have been covered by third parties doing paving work or sidewalk repair work, and those valves were therefore made inoperable through no fault of TAWC.<sup>511</sup> Mr. Watson also testified that in his 34 years of experience in the industry he has never seen a water system that knew the exact location of every valve and had 100% of its valves functioning perfectly.<sup>512</sup>

Mr. Blevins was also asked about specific instances in which the Intervenors had alleged TAWC's repair efforts had been hampered by inoperable valves. First, with respect to the main break in downtown Chattanooga the week before the Hearing on the Merits, Mr. Blevins testified that "[p]ersonally, I think, given the situation that they had, that they did a really good job on that."<sup>513</sup> Mr. Watson also testified that the two valves involved in stopping the flow from this main break had previously been inspected as part of TAWC's valve inspection and maintenance program and both had been functioning adequately.<sup>514</sup>

Mr. Blevins was also asked about a specific leak repair on Lakeview Drive in Catoosa County, Georgia, and a separate leak repair in the Lookout Mountain area in 2010. Mr. Blevins

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<sup>508</sup> Martin Blevins, Vol. IVD, Tr. 288:9 – 288:14 (March 3, 2011).

<sup>509</sup> Martin Blevins, Vol. IVD, Tr. 290:13 – 290:15; 305:23 – 306:2 (March 3, 2011).

<sup>510</sup> John Watson, Vol. IVD, Tr. 324:22 – 325:3 (March 3, 2011).

<sup>511</sup> Martin Blevins, Vol. IVD, Tr. 301:11 – 302:14 (March 3, 2011).

<sup>512</sup> John Watson, Vol. IVD, Tr. 324:11 – 324:15 (March 3, 2011).

<sup>513</sup> Martin Blevins, Vol. IVD, Tr. 298:6 – 298:12 (March 3, 2011).

<sup>514</sup> John Watson, Vol. IVD, Tr. 328:7 – 328:15 (March 3, 2011).

testified, though, that he had no personal knowledge about the repair work done at either site.<sup>515</sup>

When asked whether the 250 gallons per minute that allegedly leaked from the Lookout Mountain site was a large or small leak, however, Mr. Blevins testified that it was “not a very bad leak.”<sup>516</sup>

Accordingly, no party submitted any proof that TAWC’s valve inspection and maintenance program was in any way deficient. To the contrary, TAWC submitted ample evidence that its voluntarily-implemented valve maintenance and inspection program was functioning adequately. Moreover, TAWC’s proof established that it was important that TAWC be allowed to continue to devote two to three full-time employees to this program.

## **H. Rate Structure**

The Company and CRMA reached an agreement on rate design before the Hearing and subsequently jointly submitted a summary of the agreement as Trial Exhibit 94. Each of the three classes of customers – residential, commercial, and industrial – will receive an equal percentage of any rate increase awarded in this case. The Company and CRMA have also agreed to make *revenue neutral* adjustments within the industrial customer class. The lower block industrial customers will receive a slightly higher-than-average increase to monthly meter charges and volumetric rates and the higher block industrial customers will receive a corresponding reduction equal to the level of increase for the lower block customers. The parties presented an illustrative example of the tariffs in Trial Exhibit 94, but the actual rate design will be calculated once the Authority reaches a decision on the appropriate increase. Mr. Gorman and the Company will work together to calculate the rate design (according to the principles in Trial Exhibit 94) and will share the results with the parties before filing. The other Intervenors in

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<sup>515</sup> Martin Blevins, Vol. IVD, Tr. 307:9 – 307:13 (March 3, 2011).

<sup>516</sup> Martin Blevins, Vol. IVD, Tr. 308:16 – 308:18 (March 3, 2011).

this matter have no objection to this settlement, subject to review of the final rate calculations. The Company and CRMA believe that this rate design appropriately addresses the needs and concerns of all the parties interested in this matter and respectfully request that the Authority adopt this proposed rate design.

## **VI. CONCLUSION**

Despite all the distractions, side arguments, and attempts by the Intervenors to confuse the issues, there is one simple question that the Authority must ask itself in reaching its decision – what is just and reasonable for both the Company and the customers? The Authority has a duty under state statute to establish a just and reasonable return for the Company, taking into consideration what is just and reasonable to the customers as well. The Company presented indisputable evidence that its return since the last rate case has been woefully short of just and reasonable. The danger of continuing to set rates at such a level is obvious – both the Company and the customers will suffer. Now is the time to correct those deficiencies.

Because the Company has met its burden of proving the reasonableness and prudence of its revenues, expenses, and rate of return, it is the Authority's duty to establish rates at a commensurate level. The Company has presented indisputable evidence establishing its actual expenses, projected revenues, upcoming necessary capital expenditures, the actual tax liability incurred by the Company, and has presented evidence showing the appropriate cost of capital. TAWC has clearly met its requisite burden of proof. As much as the Intervenors try to pick away at this mountain of evidence, at the end of the day, they are unable to do so and approval of the Company's rate request is the only just and reasonable result.

Conversely, the impact of this very important rate increase, if fully granted, is only \$4.68 per month, or about 15 cents per day for the average residential customer.<sup>517</sup> Currently, *TAWC's customers' average water bill is less than 70% of other water utilities in the state* and also is the second lowest monthly utility bill on average for TAWC's customers.<sup>518</sup> This is an incredible fact given the mountainous topography of the service area and the fact that the Company's river water source requires significant treatment, both of which make the cost of service more expensive. Even with the full increase, the cost of water service to TAWC's residential customers will still be just at the median compared to the cost of water service of 285 water utilities operating in Tennessee, demonstrating that this rate increase is reasonable and fair to customers.<sup>519</sup> Both the Company and its customers want it to continue providing quality water service and this goal is certainly worth 15 cents a day.

The Company demonstrated through its evidence that it needs a full rate increase of \$9.984 million for it to continue to be able to provide this service and simultaneously afford it the opportunity to earn a reasonable rate of return, which it is constitutionally guaranteed. Accordingly, the Company respectfully submits that its \$9.984 million rate increase should be approved in full by the Authority.

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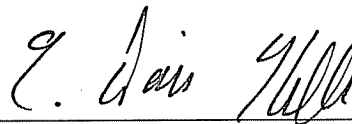
<sup>517</sup> Michael A. Miller, Pre-Filed Direct Testimony, at 2:20-23 (Sept. 17, 2010).

<sup>518</sup> John Watson, Rebuttal Ex. 3; Trial Ex. 1, at 43, 45.

<sup>519</sup> Trial Ex. 1, at 43.



Respectfully Submitted,

A handwritten signature in cursive script, appearing to read "R. Dale Grimes", written over a horizontal line.

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### CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing has been served by way of the method(s) indicated, on this the 21<sup>th</sup> day of March, 2011, upon the following:

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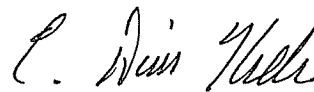
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