

BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

April 27, 2012

IN RE:

PETITION OF TENNESSEE AMERICAN WATER
COMPANY FOR A GENERAL RATE INCREASE

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DOCKET NO.
10-00189

FINAL ORDER

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This matter came before Chairman Mary W. Freeman, Director Eddie Roberson and Director Sara Kyle of the Tennessee Regulatory Authority (the “Authority” or “TRA”), the voting panel assigned to this docket, at Authority Conferences held on April 4, 2011 and April 18, 2011, to consider the *Petition of Tennessee American Water Company for a General Rate Increase* (“*Petition*”) initially filed on September 17, 2010.¹ In addition, at the August 22, 2011 Authority Conference, the panel considered the appropriate method by which TAWC may recover \$275,000 in regulatory expenses, incurred during its previous rate case in Docket No. 08-00039, following reversal of the TRA’s decision in that docket by the Court of Appeals on June 7, 2011.² Upon consideration of the entire record, including all exhibits and the testimony of the witnesses, the panel concluded that the Company had a revenue deficiency of \$5,551,013, which should be recovered through increases in rates charged in all customer classes.³ These conclusions, as well as the TRA’s determinations concerning revenues, expenses, taxes and fees, Net Operating Income, Rate Base, Revenue Conversion Factor, and Rate of Return, are fully discussed below.

I. TRAVEL OF THE CASE

Tennessee American Water Company (“TAWC” or the “Company”) filed its *Petition* seeking TRA approval of its proposed increased rates, alleging that “[t]he Company’s existing rates and charges will not provide, and cannot be made to provide, sufficient revenues to cover all the costs incurred in providing adequate quality water service including its cost of capital.”⁴ The Company sought to put into effect “customer rates that will produce an overall rate of return

¹ The *Petition*, proposed tariffs and all pre-filed witness testimony of the Company were withdrawn and re-filed in this docket on September 23, 2010.

² The Court of Appeals issued its mandate in the appeal of *Tennessee American Water Co. v. Tenn. Regulatory Auth.*, 2011 WL 334678 (Tenn. Ct. App. Jan. 28, 2011) on June 7, 2011.

³ A majority of the panel determined that the revenue deficiency was in the amount of \$5,551,013 and Director Roberson voted against the majority on the following issues: Salaries and Wages, Utility Plant in Service, Rate of Return-Return on Equity, and Revenue Deficiency.

⁴ *Petition*, p. 2 (September 23, 2010).

of 8.38% on a rate base of \$125,472,973.”⁵ According to TAWC, its *Petition* would produce additional gross revenues of approximately \$9,984,463 for the attrition period ended December 31, 2011, amounting to a 26.77% increase.⁶ Following considerable discovery by the parties, and prior to the hearing, the Company amended the *Petition* to reflect a proposed revenue deficiency of \$11,580,683, which would equate to a 31% increase.⁷ Nevertheless, during the hearing on March 2, 2011, the Company stated that despite the updated numbers that were developed during the discovery process, “[t]he Company is not requesting more than the \$9.9 million that it originally filed for.”⁸ In support of the *Petition*, TAWC filed extensive exhibits along with the pre-filed testimony of John S. Watson, Michael A. Miller, Sheila A. Miller, James Vander Weide, Patrick Baryenbruch, Paul R. Herbert and Dr. Edward L. Spitznagel, Jr.

TAWC is a public utility as defined in Tenn. Code Ann. § 65-4-101 and is engaged in providing residential, commercial, industrial, and municipal water service, including public and private fire protection service, to the City of Chattanooga and surrounding areas, serving approximately 75,000 customers as of March 31, 2010. The rates of TAWC customers located in Georgia are not regulated by the Public Service Commission of the State of Georgia, but instead are set by the TRA.⁹ The Company is a wholly-owned subsidiary of American Water Works Company, Inc. (“AWWC”), which is headquartered in Voorhees, New Jersey. AWWC is the largest water holding company in the United States, providing water and wastewater services to sixteen million people in thirty-five states and two Canadian provinces.¹⁰

On September 21, 2010, the Consumer Advocate and Protection Division of the Office of the Attorney General (the “Consumer Advocate” or “CAPD”) filed a petition to intervene. At a regularly scheduled Authority Conference held on September 27, 2010, the panel voted

⁵ *Id.* at 11.

⁶ *Id.* at 8.

⁷ TAWC’s Supplemental Revised Exhibit No. 1, Schedule 1 (February 22, 2011).

⁸ Transcript of Proceedings, Vol. III B, p. 123 (March 2, 2011).

⁹ *Petition*, p. 1.

¹⁰ *Id.* at 2.

unanimously to convene a contested case proceeding, suspend the effective date of the tariffs, and appoint Chairman Freeman as Hearing Officer for the purpose of preparing this matter for hearing, including handling preliminary matters and establishing a procedural schedule to completion.¹¹ The Chattanooga Regional Manufacturers Association (the “CRMA”) and the City of Chattanooga (the “City”) filed petitions to intervene on October 4, 2010 and October 6, 2010, respectively. On October 12, 2010, the Hearing Officer issued an Order granting the interventions of the Consumer Advocate, the City, and the CRMA, and setting a status conference on October 18, 2010 to address any pending intervention petitions, identify issues, set a procedural schedule, and issue a Protective Order.¹²

On October 14, 2010, a petition to intervene was filed by the Utility Workers Union of America, AFL-CIO and UWUA Local 121 (“UWUA” or the “Union”), and on October 18, 2010, Walden’s Ridge Utility District (“Walden’s Ridge”) and the City of Signal Mountain (“Signal Mountain”), a municipality, also filed a joint petition to intervene in this docket. Pursuant to special contracts with TAWC, Walden’s Ridge and Signal Mountain purchase all of their water for distribution to their customers from TAWC.

A status conference was convened on October 18, 2010, at which time the parties submitted an agreed proposed protective order to the Hearing Officer. The Hearing Officer granted the UWUA’s petition to intervene, but the joint petition of Walden’s Ridge and Signal Mountain was filed too late to be considered during the status conference. Thereafter, motions were filed by the UWUA, the City, and the Consumer Advocate for permission to issue discovery requests exceeding the number set by TRA rule. In an Initial Order issued on November 12, 2010, the Hearing Officer established a preliminary procedural schedule, granted the joint petition of Walden’s Ridge and Signal Mountain, and limited the Consumer Advocate

¹¹ Transcript of Proceedings, pp. 42-43 (September 27, 2010).

¹² See *Order Granting Petitions to Intervene and Requiring the Parties to Submit a Proposed Procedural Schedule and Protective Order* (October 12, 2010).

to eighty initial requests, and the UWUA and the City to forty requests each, the limit set by TRA Rule 1220-1-2-.11(5)(a).¹³ On November 15, 2010, the Hearing Officer entered the proposed protective order, which was subsequently amended pursuant to TAWC's unopposed motion.

The CAPD, the City, the CRMA, and the UWUA (collectively, the "Intervenors") filed pre-filed direct testimony on January 5, 2011. The CAPD submitted the testimony of William H. Novak, John Hughes, Dr. Christopher C. Klein, and Terry Buckner. The City filed the testimony of Kimberly H. Dismukes. The CRMA filed the testimony of Michael Gorman, and the UWUA filed the testimony of James Lewis. The CAPD filed a correction to the pre-filed testimony of Dr. Klein on January 24, 2011 and amended testimony from Mr. Buckner on January 31, 2011. On February 8, 2011, the Company filed the pre-filed rebuttal testimony of Dr. Spitznagel, Bernard L. Uffelman, Ms. Miller, Mr. Vander Weide, James I. Warren, Mr. Baryenbruch, Mr. Watson, Mr. Herbert and Mr. Miller. Following additional discovery, the Company filed Revised Exhibits on February 14, 2011. In addition, the Company filed supplemental revised exhibits on February 16, 2011, the revised rebuttal testimony of Mr. Miller on February 17, 2011, and final supplemental revised exhibits on February 22, 2011. The City filed amended testimony of Ms. Dismukes, along with revised schedules KHD-15 and KHD-17, on February 10, 2011. The Consumer Advocate filed the rebuttal testimony of Mr. Buckner on February 24, 2011 and several revisions to the testimony of Mr. Hughes on March 1, 2011.

Various filings were made in this docket in accordance with the procedural schedule, and discovery responses were supplemented and updated by TAWC and the intervening parties throughout the course of the docket. TAWC also responded to data requests from the TRA staff. In addition, on February 14, 2011 and February 16, 2011, TAWC filed revised supplemental

¹³ Tenn. Comp. R. & Regs. 1220-1-2-.11(5)(a); *Order Granting Petitions to Intervene, Reflecting Action Taken at Status Conference and Establishing a Procedural Schedule*, p. 9 (November 12, 2010).

accounting exhibits and work papers to replace those that were submitted with earlier pre-filed testimony.

I. DISPUTED PRE-HEARING MATTERS

During the pre-hearing process, the Hearing Officer resolved a variety of disputed matters that emerged between the parties, the most significant of which included the following:

CITY'S MOTIONS TO COMPEL DISCOVERY

On November 18, 2010, the City filed a motion to compel, requesting that the Hearing Officer compel TAWC to respond to certain discovery requests. In this motion, the City asserted that TAWC refused to produce a log identifying the documents and information that TAWC had withheld from discovery based on a claim of privilege or protection, and the City asked that the Hearing Officer compel TAWC to comply with Tenn. R. Civ. P. 26.02(5).¹⁴ The City filed a subsequent motion to compel on December 6, 2010.¹⁵ The second motion, however, involved other discovery objections asserted by the City and did not relate to production of a privilege log.

On December 23, 2010, the Hearing Officer issued an Order finding that Tenn. R. Civ. P. 26.02(5) did not contain a provision that made the production of a "privilege log" mandatory.¹⁶ Therefore, the Hearing Officer did not require the parties to prepare "privilege logs," concluding instead that a party that claims a privilege or protection from discovery should provide specific information about the items it has withheld and set forth its reasons for doing so.¹⁷ Accordingly, the Hearing Officer ordered the parties to identify any information and/or documents withheld from discovery on grounds of privilege or protection, state the privilege or protection claimed,

¹⁴ *The City of Chattanooga's Motion to Compel Tennessee American Water Company to Respond to Discovery Requests*, pp. 3-4, § B (November 18, 2010).

¹⁵ *The City of Chattanooga's Second Motion to Compel Tennessee American Water Company to Respond to Discovery Requests* (December 6, 2010).

¹⁶ *Order on First Round Discovery Disputes*, pp. 18-19 (December 23, 2010).

¹⁷ *Id.*

and describe the withheld materials with sufficient specificity so as to enable the Authority to evaluate “the applicability of the claimed privilege or protection.”¹⁸

Thereafter, on December 30, 2010, TAWC filed its response, entitled *TAWC Privilege Log Document*. TAWC’s privilege log charted ninety-six written communications and materials that TAWC determined to be responsive to discovery requests on which it asserted the applicability of a privilege or protection.¹⁹ All of the communications and materials identified in TAWC’s privilege log related in some respect to the management audit that had been ordered by the TRA in Docket No. 08-00039. TAWC acknowledged that it had withheld these communications and materials, which were classified as internal e-mail messages, chains of internal e-mail exchanges, documents, and attachments, on grounds of attorney-client privilege or work product, or both.²⁰

On January 7, 2011, the City filed with the Authority a third motion to compel, in which the City asserted that TAWC’s privilege log failed to comply with the Hearing Officer’s December 23, 2010 Order because the log did not describe the materials withheld in a manner that enabled the parties or the TRA to determine the factual basis of TAWC’s claims of attorney-client privilege and/or work product protection.²¹ On January 14, 2011, the Company filed its response to the City’s third motion to compel. In its response, TAWC contended that it had properly asserted its claims of attorney-client privilege and work product as to each item listed in its privilege log and that it had, in fact, gone beyond the requirements of the Hearing Officer’s ruling on discovery by producing a privilege log that identified the sender of the communication

¹⁸ *Id.* at 19.

¹⁹ *TAWC Privilege Log Document* (December 30, 2010).

²⁰ *Id.*

²¹ *The City of Chattanooga’s Third Motion to Compel Tennessee American Water Company to Respond to Discovery Requests*, pp. 4-5 (January 7, 2011).

and its recipients, provided the date and general subject matter, and set forth the privilege or protection asserted as its basis for withholding each item.²²

TAWC asserted that all of the materials not produced consisted of documents or written descriptions of communications that had been exchanged internally between TAWC employees, or between TAWC employees and TAWC's parent company, AWWC, its affiliated service company American Water Works Service Company ("AWWSC"), state affiliate companies, or legal counsel.²³ Further, TAWC asserted that the internal email communications and documents, which all related to some aspect of the management audit, were intended to be confidential and were created in the course of ongoing litigation or in reasonable anticipation of litigation.²⁴ TAWC further asserted that it had provided the parties with all of the discoverable, non-privileged communications that had been exchanged between TAWC and the auditor, Schumaker & Co.²⁵

TAWC stated that the sole purpose of the audit was to confirm or reject the reasonableness of the management fees sought by TAWC in contested litigation, and that any business-related purpose was incidental and ancillary.²⁶ According to TAWC, each item listed on its privilege log represented internal communication "about the TRA management audit, an audit that has little, if any, commercial or business purpose for the Company outside these contested rate cases."²⁷ For this reason, TAWC asserted that, under the work product doctrine, all of TAWC's internal correspondence relating to the Schumaker management audit would be protected from discovery.²⁸ Other documents withheld on grounds of attorney-client privilege,

²² *Tennessee American Water Company's Response to the City of Chattanooga's Third Motion to Compel*, pp. 3-4 (January 14, 2011).

²³ *Id.* at 7.

²⁴ *Id.* at 6.

²⁵ *Id.* at 4.

²⁶ *Id.* at 6.

²⁷ *Id.* at 8.

²⁸ *Id.* at 6.

according to TAWC, were confidential communications with in-house legal counsel concerning the audit and would also be exempt from disclosure.²⁹

In a motion for leave to reply filed on January 18, 2011, the City contended that by merely providing conclusory statements, TAWC had not met its burden, as the party opposing discovery, to demonstrate a factual basis for its nonproduction of the email communications and documents at issue.³⁰ Further, the City asserted that merely sending copies of documents to in-house counsel does not conclusively establish attorney-client privilege or protection from discovery.³¹ Rather, the party opposing discovery must demonstrate that the elements of the privilege or protection are present as to each item withheld.³² On January 24, 2011, TAWC filed an affidavit by Mr. Miller to provide evidentiary support for its privilege log and to bolster its assertions of the attorney-client privilege and work product protection.³³ During the Status Conference held on January 24, 2011, the parties presented extensive oral argument before the Hearing Officer on the City's third motion to compel.

On February 25, 2011, the Hearing Officer issued an Order setting forth an extensive discussion of the attorney-client privilege, the work product doctrine and the use of privilege logs in asserting those protections in response to discovery requests.³⁴ The Hearing Officer provided substantive analysis of TAWC's privilege log and concluded that TAWC did not sufficiently describe the nature of the information that it had withheld to enable the Authority to make a determination as to the applicability of the privileges or protections asserted by TAWC.³⁵

²⁹ *Id.* at 7-8.

³⁰ *City of Chattanooga's Motion for Leave to Reply in Support of Its Third Motion to Compel*, pp. 2-3 (January 18, 2011).

³¹ *Id.* at 3-4.

³² *Id.*

³³ Michael Miller, Affidavit (January 24, 2011).

³⁴ *Order Reflecting Hearing Officer's Ruling with Respect to City of Chattanooga's Third Motion to Compel* (February 25, 2011).

³⁵ *Id.* at 16-27.

Further, the Hearing Officer found that TAWC's descriptions of the materials withheld consisted of a general categorization of communications that were a part of the audit process and did not provide a factual basis from which the Hearing Officer could readily determine the applicability of privilege.³⁶ Because TAWC had the burden of demonstrating that the communication or document was covered by privilege or otherwise protected, the application of privilege had to be clearly shown.³⁷ Further, the Hearing Officer concluded that such application of privilege had to be construed narrowly.³⁸

Therefore, the Hearing Officer determined that for items as to which the attorney-client privilege was raised, TAWC was required to establish with objective facts or competent evidence that the communication was made in order to seek or give legal advice, and not for a business or other purpose, and was intended to be kept confidential, and the privilege had not been waived. Without such specificity, the Hearing Officer could not conclude, based on the subject matter descriptions that the items for which TAWC asserted attorney-client privilege or work product protection was, in fact, protected.³⁹ Nevertheless, recognizing the importance of maintaining a valid privilege or protection, the Hearing Officer ordered an *in camera* review of the communications and documentation listed in TAWC's privilege log to determine whether the attorney-client privilege or work product protection should attach to the materials.⁴⁰ The decision of the Hearing Officer was announced at a pre-hearing conference held on February 25, 2011. Counsel for TAWC agreed to meet with and provide the materials to the TRA's General Counsel for that purpose on February 27, 2011.

On February 27, 2011 and March 2, 2011, TRA General Counsel, accompanied by TRA Deputy General Counsel, conducted an *in camera* review of the materials referenced in TAWC's

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.* at 27.

⁴⁰ *Id.*

privilege log. TRA counsel examined in detail all of the communications and documents noted or otherwise referred to in the privilege log. Mr. Miller, who serves as TAWC's Treasurer/Comptroller was present with TRA counsel on March 2, 2011 and responded to questions and provided clarification as requested. Upon completion of the *in camera* review, TRA counsel concluded that the communications and documents identified in the privilege log had either been produced to the parties in discovery already or qualified for protection from discovery. The TRA's General Counsel subsequently conveyed those conclusions to counsel for TAWC and the City.

Deposition and Testimony of Patricia Schumaker

On January 12, 2011, TAWC filed a motion stating that as Schumaker & Company had prepared the comprehensive independent management audit ordered by the TRA, it requested that the TRA call Patricia H. Schumaker to present testimony in this case.⁴¹ Specifically, TAWC wanted Ms. Schumaker to address the procedures, methodology and facts that support the conclusions contained in the audit because the intervening parties had indicated that they intended to call those same components of the audit into question.⁴²

In addition, on January 18, 2011, the City filed its own motion requesting the setting of a deposition of Ms. Schumaker.⁴³ Both motions were addressed by the Hearing Officer during a status conference held on January 24, 2011. Subsequently, by letter dated January 28, 2011, the parties agreed on a procedure for taking Ms. Schumaker's deposition.⁴⁴ After ascertaining the availability of Ms. Schumaker and the parties, on February 11, 2011, the Hearing Officer issued an Order setting Ms. Schumaker's deposition for February 18, 2011,⁴⁵ in the Hearing Room of the TRA with General Counsel presiding over the deposition. The deposition of Ms. Schumaker

⁴¹ *Motion to Call Schumaker & Company to Present Testimony Regarding Its Affiliate Audit Report of Tennessee American Water Company for the Tennessee Regulatory Authority*, p. 1 (January 12, 2011).

⁴² *Id.* at 3.

⁴³ *City of Chattanooga's Motion That Witness Be Ordered to Appear for Deposition*, p.1 (January 18, 2011).

⁴⁴ *Letter from Henry Walker to Chairman Mary W. Freeman* (January 28, 2011).

⁴⁵ *Order Setting the Deposition of Patricia H. Schumaker*, p. 2 (February 11, 2011).

was taken on February 18, 2011, with the City, the Consumer Advocate and TAWC participating in the questioning.

Following her deposition, the parties agreed that Ms. Schumaker would appear and provide testimony during the Hearing in Chattanooga on Tuesday, March 1, 2011. During the Pre-Hearing Conference held on February 25, 2011, the parties requested clarification as to the manner in which Ms. Schumaker would offer her testimony during the Hearing. Based on the parties' agreement, it was determined that counsel for TAWC would initially question Ms. Schumaker as an independent witness, followed by questioning by counsel for the intervening parties consistent with the order established during the Pre-Hearing Conference.⁴⁶

UWUA's MOTION TO SUBSTITUTE AFFIANT AND TAWC's MOTION IN LIMINE

On February 7, 2011, the UWUA filed a motion requesting permission to substitute the sworn statement of Martin R. Blevins for that of Jerry Haddock, which had been attached to Mr. Lewis's pre-filed testimony.⁴⁷ Stating that Mr. Haddock's current job made it difficult for him to be available, the UWUA requested permission to present Mr. Blevins for examination during the hearing and include his testimony in the record.⁴⁸ According to the UWUA, Mr. Blevins was familiar with TAWC's valve maintenance program and could attest to the accuracy of Mr. Haddock's descriptions.⁴⁹ UWUA stated that it had only recently become aware of Mr. Blevins's availability and, thus, had acted in as timely a manner as possible in obtaining his sworn statement.⁵⁰

In a response filed on February 14, 2011, TAWC contended that the UWUA's motion to substitute should be denied as improper and without any basis under the Tennessee Rules of

⁴⁶ See *Order Establishing Procedure for Testimony of Patricia H. Schumaker*, p. 3 (February 28, 2011).

⁴⁷ *Motion to Substitute Affiant*, p. 1 (February 7, 2011).

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.* at 2.

Civil Procedure, the Tennessee Rules of Evidence, or the TRA's Rules.⁵¹ TAWC asserted that, as the Intervenor's pre-filed testimony was due by January 5, 2011, Mr. Blevins's statement was untimely under the November 12, 2010 procedural schedule.⁵² TAWC also noted that, in fact, the UWUA had previously stated that it did not intend to call Mr. Haddock.⁵³ Nevertheless, less than three weeks before the Hearing, the UWUA had offered Mr. Blevins to provide testimony through the adoption of Mr. Haddock's statement.⁵⁴ TAWC further asserted that there was no legal basis for allowing a witness to "adopt" the affidavit of another individual; such adoption would constitute hearsay on three levels.⁵⁵ TAWC further noted that Mr. Haddock's written statement was not an affidavit as it was unsworn.⁵⁶

The Hearing Officer denied the UWUA's motion to substitute, finding that Mr. Haddock's statement was not confirmed by oath or affirmation but was merely submitted as a signed statement attached to Mr. Lewis's pre-filed testimony.⁵⁷ The Hearing Officer also found that because Mr. Haddock had not been designated as a witness and the UWUA had not pre-filed any testimony from him, Mr. Blevins could not adopt Mr. Haddock's statement and then testify in person.⁵⁸ The Hearing Officer further determined that the UWUA's request was both prejudicial and improper.⁵⁹

In conjunction with its response to the UWUA's motion, TAWC filed a motion in limine

⁵¹ *Tennessee American Water Company's Response in Opposition to the Utility Workers Union of America, AFL-CIO and UWUA Local 121's Motion to Substitute Affiant*, p. 1 (February 14, 2011).

⁵² *Id.* The only pre-filed testimony filed by the UWUA was that of Mr. Lewis, which included a statement signed by Mr. Haddock in support of certain portions of Mr. Lewis's testimony. Mr. Haddock did not submit pre-filed testimony, and the UWUA never indicated that Mr. Haddock was intended to be a witness or provide testimony. *Id.* at 2.

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *Id.* at 2-3. First, Mr. Lewis was reciting his conversation with Mr. Haddock; second, Mr. Blevins was attesting to Mr. Haddock's statement; and, third, Mr. Haddock's unsworn statement was an out-of-court statement inadmissible as hearsay. *Id.*

⁵⁶ *Id.*

⁵⁷ *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*, pp. 3-4 (February 25, 2011).

⁵⁸ *Id.*

⁵⁹ *Id.*

on February 14, 2011 asking the Authority to strike both Mr. Haddock's unsworn statement and portions of Mr. Lewis's testimony.⁶⁰ TAWC also moved to exclude Mr. Blevins's testimony.⁶¹ Stating that Mr. Lewis's testimony about its valve operations and maintenance was based solely on Mr. Haddock's unsworn statement, TAWC asked that Mr. Haddock's statement be stricken.⁶² TAWC asserted that attaching it to Mr. Lewis's pre-filed testimony did not convert Mr. Haddock's statement into pre-filed testimony.⁶³ TAWC contended that Mr. Lewis did not have personal knowledge of valve operations and maintenance and merely relied on a conversation with Mr. Haddock.⁶⁴ TAWC also argued that Mr. Blevins's testimony should be excluded as hearsay and untimely.⁶⁵

On February 25, 2011, the Hearing Officer issued an Order striking, as inadmissible hearsay, the portions of Mr. Lewis's pre-filed testimony that recounted his discussion with Mr. Haddock concerning valve operations and maintenance; the Hearing Officer further ruled that Mr. Lewis would not be permitted to adopt Mr. Haddock's statement or testify at the hearing.⁶⁶ Relying on Tenn. R. Evid. Rule 602, the Hearing Officer found that Mr. Lewis could not testify about TAWC's valve maintenance and operation for lack of personal knowledge.⁶⁷ The Hearing Officer struck Mr. Haddock's statement and ruled that Mr. Blevins would not be permitted to adopt Mr. Haddock's statement or testify, since the UWUA had not identified or pre-filed testimony from him.⁶⁸

⁶⁰ *Tennessee American Water Company's Motion In Limine to Strike the Statement of Jerry Haddock, Strike Certain Testimony of James Lewis, and to Exclude the Testimony of Marvin Blevins*, p. 1 (February 14, 2011).

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *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*, pp. 6-7 (February 25, 2011).

⁶⁷ *Id.* at 6.

⁶⁸ *Id.* at 7.

On February 28, 2011, the UWUA filed a request to appeal the Initial Order.⁶⁹ Also that day, the parties presented oral argument on the Union's reconsideration request before the full panel prior to the hearing.⁷⁰ The Union explained that Mr. Haddock's statement was an exhibit to Mr. Lewis's testimony, and Mr. Haddock would not be available to attend the hearing.⁷¹ Therefore, the Union asserted, it was necessary to replace Mr. Haddock with Mr. Blevins, who was also a former TAWC employee and had been Mr. Haddock's direct supervisor in valve maintenance.⁷² The Union stated that Mr. Blevins would attest to Mr. Haddock's statement and was available to participate in the hearing.⁷³ The Union acknowledged that Mr. Haddock's statement was not notarized but stated that it included the representation, "I swear and affirm this statement is true to the best of my knowledge," and Mr. Blevins's statement adopting Mr. Haddock's statement was notarized.⁷⁴

In addition, the Union contended that variances in the form of an affidavit are allowed when necessary to prevent injustice and urged the panel to consider the circumstances under which Mr. Haddock's statement was prepared.⁷⁵ Because of his new job as a truck driver, Mr. Haddock was not able to get a notary public to witness his statement.⁷⁶ The UWUA asserted that Mr. Haddock was merely a retired former TAWC employee and, under the circumstances, his statement should be accepted.⁷⁷ In addition, UWUA stated that Mr. Blevins was able to attest to Mr. Haddock's statements on the important issue of valve maintenance at TAWC.⁷⁸ The UWUA further stated that Mr. Blevins had been directly involved in the Company's valve maintenance

⁶⁹ *Petition for Appeal of the Hearing Officer's Initial Order Granting the City of Chattanooga's First Motion in Limine* (February 28, 2011).

⁷⁰ Transcript of Proceedings, Vol. I A, pp. 49-69 (February 28, 2011).

⁷¹ *Id.* at 50.

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.* at 49-50.

⁷⁵ *Id.* at 51.

⁷⁶ *Id.*

⁷⁷ *Id.* at 51-52.

⁷⁸ *Id.* at 52.

activities, could speak from personal knowledge, and had been Mr. Haddock's direct supervisor.⁷⁹ The UWUA also stated that the substance of the testimony had been made available to the Company in a timely manner.⁸⁰

TAWC responded that it would be highly improper to allow Mr. Blevins to "adopt" the statement of Mr. Haddock because it constituted multiple levels of hearsay.⁸¹ Further, TAWC asserted that Mr. Haddock's unsworn statement did not meet the requirements of Tennessee law and would not be allowed into evidence in court.⁸² TAWC reiterated that Mr. Blevins's testimony was untimely filed.⁸³ TAWC also noted that Mr. Lewis was not an expert on valves and his current job duties were to handle arbitrations, negotiate contracts, and handle grievance procedures.⁸⁴ The inclusion of a signed statement of a former TAWC employee was clearly the Union's attempt to use an exception that applies only to expert testimony, but Mr. Lewis was not testifying as an expert.⁸⁵ Finally, the Company argued that it was highly prejudicial to bring Mr. Blevins into the proceeding only two and half weeks before the hearing, as it had not had an opportunity to conduct discovery in response to his testimony.⁸⁶

The panel questioned the parties at length about Mr. Haddock's possible unavailability, the basis of Mr. Blevins's personal knowledge, the importance of the issues, and the potential prejudice to TAWC.⁸⁷ The panel voted to uphold, but modify, the Hearing Officer's Order.⁸⁸ The panel directed the UWUA to produce Mr. Haddock to testify and be cross-examined on the valve issues.⁸⁹ In the event Mr. Haddock was not available, the question of whether Mr. Blevins

⁷⁹ *Id.* at 52-53.

⁸⁰ *Id.* at 54-55.

⁸¹ *Id.* at 55.

⁸² *Id.*

⁸³ *Id.* at 56.

⁸⁴ *Id.* at 57.

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.* at 59-68.

⁸⁸ *Id.*

⁸⁹ *Id.*

would be permitted to testify was left open due to the importance of the valve maintenance issue and its possible impact on the setting of rates.⁹⁰

TAWC'S MOTION TO STRIKE CONSUMER ADVOCATE'S REBUTTAL TESTIMONY

On February 24, 2011, the Consumer Advocate filed rebuttal testimony from Mr. Buckner in response to certain testimony presented during Ms. Schumaker's deposition on February 18, 2011, and also to address the revised tax position of TAWC and an audit report prepared concerning New Jersey American Water Company.⁹¹ In a motion in limine filed on February 25, 2011, TAWC moved to strike Mr. Buckner's rebuttal testimony including the attached audit of New Jersey American Water Company.⁹²

The parties presented oral argument on this motion in limine during a Pre-Hearing Conference held on February 25, 2011. TAWC asserted that, contrary to the permissible scope of rebuttal testimony set forth following the deposition of Ms. Schumaker, the rebuttal testimony of Mr. Buckner, filed by the Consumer Advocate, was an improper attempt to put forth testimony concerning unrelated tax issues.⁹³ TAWC further asked that the audit report of New Jersey American Water Company be stricken as unreliable hearsay because it had not yet been considered, much less approved, by the New Jersey Board of Public Utilities and was not similar to the type of audit ordered by the TRA.⁹⁴ In response, the Consumer Advocate asserted that the New Jersey American Water Company audit was not being offered for the truth of the matters asserted therein, but instead was provided as an example for comparison with the audit of TAWC performed by Ms. Schumaker.⁹⁵ According to the Consumer Advocate, Mr. Buckner's testimony concerning the tax issues was filed due to the Company's change in position on those

⁹⁰ *Id.*

⁹¹ Terry Buckner, Pre-filed Rebuttal Testimony (February 24, 2011).

⁹² *Tennessee American Water Company's Motion in Limine to Strike the Rebuttal Testimony of Terry Buckner and Attachment* (February 25, 2011).

⁹³ *See Order Granting, in Part, and Denying, in Part, Tennessee American Water Company's Motion in Limine to Strike Testimony of Terry Buckner and Attachment*, p. 1 (February 25, 2011).

⁹⁴ *Id.*

⁹⁵ *Id.*

issues as set forth in the pre-filed rebuttal testimony of Michael A. Miller filed on February 17, 2011.⁹⁶

Based on the Company's second motion in limine and the arguments presented by the parties, the Hearing Officer determined that the New Jersey American Water Company audit and the rebuttal testimony of Mr. Buckner with respect to that audit should not be considered as evidence in this proceeding or be filed as part of the record.⁹⁷ Nevertheless, the Hearing Officer ruled that because the audit was not being offered for the truth of the matters asserted therein, the audit of New Jersey American Water Company could be used during cross-examination of witnesses but not filed as evidence.⁹⁸ The Hearing Officer also ruled that the rebuttal testimony of Mr. Buckner with respect to the tax issues should not have been filed with testimony to rebut the deposition testimony of Ms. Schumaker, but would be permitted as testimony offered to rebut TAWC's change in position.⁹⁹

THE CITY'S MOTION TO EXCLUDE TAWC'S REGULATORY EXPENSES ARISING FROM DOCKET NO. 08-00039

On January 28, 2011, the Tennessee Court of Appeals issued its decision in *Tennessee American Water Co. v. Tennessee Regulatory Authority*, Case No. M2009-00553-COA-R12-CV, in which it affirmed in part, and reversed in part, the TRA's Final Order in TAWC's rate case filed in TRA Docket No. 08-00039. In its Opinion, the Court reversed the TRA's decision to limit TAWC to a recovery of one half, or \$275,000, of its projected rate case expenses requested in Docket No. 08-00039, and ruled that TAWC should instead recover "the full amount of its proposed rate case expenses."¹⁰⁰ Thereafter, on February 8, 2010, TAWC amended its request for recovery of rate case expenses in this rate case proceeding (Docket No. 10-00189) to include

⁹⁶ *Id.* at 2.

⁹⁷ *Id.* at 2-3.

⁹⁸ *Id.* at 3.

⁹⁹ *Id.* at 3.

¹⁰⁰ *Tennessee American Water Co. v. Tenn. Regulatory Auth.*, 2011 WL 334678, at *30 (Tenn. Ct. App. Jan. 28, 2011).

the rate case expenses previously denied in Docket No. 08-00039.¹⁰¹ In a motion in limine filed on February 24, 2011, the City asserted that the rate case expenses associated with the Company's previous rate case in Docket No. 08-00039 were not properly before the Authority because the Authority's subject matter jurisdiction would not be reinstated until transmission of the mandate by the Court of Appeals, which had not yet been received as of February 8, 2010.¹⁰²

Due to timing, TAWC did not have an opportunity to file a written response, but the Company presented oral argument before the Hearing Officer during the Pre-Hearing Conference held on February 25, 2011. In responding to the City's motion in limine, TAWC stated that the Authority should take judicial notice of the Court of Appeals' January 28, 2011 Opinion so as to include and expedite the Company's recovery of the unrecovered portion of its regulatory expenses incurred in Docket No. 08-00039.¹⁰³ TAWC argued that including in this rate case the regulatory expenses related to Docket No. 08-00039 was more efficient for the Company and the Authority, and that it would not be improper for the Authority to consider TAWC's accumulated deferred regulatory expenses with its current projected expenses, as a whole.¹⁰⁴ According to TAWC, the Authority's consideration in this docket of the Company's regulatory expenses, including those not recovered previously as part of Docket No. 08-00039, would not violate the jurisdictional parameters of the TRA.¹⁰⁵

During the Pre-Hearing Conference held on February 25, 2011, the Hearing Officer informed the parties that the City's motion in limine was well-founded and, therefore, was granted. On February 25, 2011, the Hearing Officer issued an Order granting the City's motion

¹⁰¹ Michael A. Miller, Pre-Filed Rebuttal Testimony, pp. 75-79 (February 8, 2011).

¹⁰² *City of Chattanooga's First Motion in Limine* (February 24, 2011).

¹⁰³ *Order Granting City of Chattanooga's First Motion in Limine*, p. 3 (February 25, 2011).

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

in limine, which reflected that ruling.¹⁰⁶ Later, TAWC raised the issue of rate case expense in Docket No. 08-00039 before the panel during the Hearing.

Thereafter, on March 16, 2011, the City filed with the Tennessee Supreme Court a request for permission to appeal the decision of the Court of Appeals. In light of this development, the panel remained firm in its decision and did not consider the \$275,000 recovery in its initial deliberations. On May 25, 2011, the City's request for permission to appeal was denied by the Supreme Court, and the Court of Appeals issued its mandate to the Authority on June 7, 2011. On August 3, 2011, the Hearing Officer in this docket issued a notice of filing and deliberations, stating that the Authority would consider the method by which to allow TAWC to recover the unrecovered \$275,000 rate case expense during the Authority Conference on August 22, 2011.¹⁰⁷ On August 22, 2011, a majority of the panel voted to allow recovery of the regulatory expense through a separate line item charge on customers' bills that will discontinue once the full amount was recovered.¹⁰⁸ A majority of the panel further directed that the amount should be recovered over a six-month period and be collected from all customer classes, resulting in a uniform surcharge of approximately \$0.62 monthly.¹⁰⁹ The Company was directed to file tariffs implementing the surcharge, including all supporting calculations, within ten days and to work with TRA Staff on the line item language that would be acceptable to include in customers' bills.¹¹⁰

II. THE HEARING AND POST-HEARING FILINGS

On January 31, 2011, the Authority issued a Notice of Hearing reflecting the panel's

¹⁰⁶ *Id.*

¹⁰⁷ *Notice of Filing and Deliberations*, p. 1 (August 3, 2011).

¹⁰⁸ Transcript of Authority Conference, pp. 79, 82 (August 22, 2011). Director Kyle, who voted against the prevailing motion, made a motion instead to allow TAWC to recover the \$275,000 through an increase in fixed monthly service charges and usage rates, as proposed by the Company, and to direct the Company to reduce the rates to current levels when the Company had collected the \$275,000 and to file all documentation for the new rates up to \$275,000 and work with David Foster and Pat Murphy of the TRA Staff. *Id.* at 79-81. This motion failed for lack of a second.

¹⁰⁹ *Id.* at 79.

¹¹⁰ *Id.*

decision to hold the hearing in Chattanooga, Tennessee, during the week of February 28, 2011 through March 4, 2011.¹¹¹ On February 14, 2011, TAWC published the required notice of the Hearing in the *Chattanooga Times Free Press* and filed proof of publication with the Authority on February 23, 2011. The Hearing was held in Chattanooga, Tennessee, beginning February 28, 2011 through March 4, 2011, and reconvened in Nashville on March 7 and March 8, 2011. Participating in the Hearing were the following parties and their respective counsel:

Tennessee American Water Company – R. Dale Grimes, Esq., E. Steele Clayton, IV, Esq., David Killion, Esq., and Chad Jarboe, Esq., Bass, Berry & Sims, PLC, 150 Third Avenue South, Suite 2800, Nashville, TN 37201.

Consumer Advocate and Protection Division – Ryan L. McGehee, Esq., Mary L. White, Esq., and Scott Jackson, Esq., Office of the Attorney General, 425 5th Ave. N., John Sevier Building, P.O. Box 20207, Nashville, TN 37202.

City of Chattanooga, Tennessee – Frederick L. Hitchcock, Esq. and Willa B. Kalaidjian, Esq., Chambliss, Bahner & Stophel, P.C., 1000 Tallan Building, Two Union Square, Chattanooga, TN 37402; and **Michael A. McMahan, Esq.,** Office of the City Attorney, 100 East 11th Street, Suite 200, Chattanooga, TN 37402.

Chattanooga Regional Manufacturers Association – Henry M. Walker, Esq., Bradley, Arant, Boulton, Cummings, PLC, 1600 Division Street, Suite 700, P.O. Box 340025, Nashville, TN 37203; and **David C. Higney, Esq.,** Grant, Konvalinka & Harrison, P.C., 9th Floor, Republic Centre, 633 Chestnut Street, Chattanooga, TN 37450-0900.

Utility Workers Union of America, AFL-CIO and UWUA Local 121 – Scott H. Strauss, Esq. and Katherine M. Mapes, Esq., Spiegel & McDiarmid LLP, 1333 New Hampshire Ave., NW, Washington, D.C. 20036.

During the Hearing, the Company presented the following witnesses: John Watson, Michael A. Miller, Sheila A. Miller, James Vander Weide, Patrick Baryenbruch, Paul R. Herbert, and Dr. Edward Spitznagel. Witnesses for the Consumer Advocate included Terry Buckner, John Hughes, Dr. Christopher C. Klein, and Hal Novak. Kimberly Dismukes testified on behalf of the City. The Union presented James Lewis and Marvin Blevins as witnesses. The CRMA

¹¹¹ Upon consideration of the CRMA's request to hold the Hearing in this matter in Chattanooga, Tennessee (Letter, October 20, 2010), which was supported by all intervening parties and the Hamilton County Commission (Resolution No. 1110-13, October 4, 2010) and duly noting the concerns of the Petitioner (Letters, October 22, 2010 and November 12, 2010) *see also*, Transcript of Proceedings (January 24, 2011), during the regularly scheduled Authority Conference on January 24, 2011, the panel voted unanimously to convene the Hearing on the Merits in Chattanooga, Tennessee. *Id.* at 34-43.

presented the testimony of Michael Gorman based on its proposed agreement with the Company. Public Hearings were held at various times during the Hearing to give TAWC customers and members of the public an opportunity to address the panel. Though several hours were set aside specifically for public comment, a limited number of comments were provided.

Additionally, there were three appeals to the full panel of initial orders issued by the Hearing Officer, two filed by TAWC and one by the UWUA. TAWC appealed to the panel the Hearing Officer's granting of the City's February 24, 2011 motion in limine.¹¹² The panel unanimously affirmed the Hearing Officer's decision and ruled that, upon receipt of the mandate from the Court of Appeals, the TRA would act swiftly and take the necessary action.¹¹³

Further, TAWC appealed to the panel the Hearing Officer's February 25, 2011 ruling on the City's third motion to compel.¹¹⁴ This matter was resolved off the record between the first and second days of the Hearing, and the panel did not take it up again during the Hearing.

Finally, the Union appealed the Hearing Officer's February 25, 2011 initial order on its motion to substitute affiant.¹¹⁵ After hearing arguments of counsel on this issue, the panel voted to uphold the Hearing Officer's ruling, with the understanding that Mr. Blevins could be heard on matters about which he had personal knowledge, and Mr. Haddock would be heard if he became available.¹¹⁶

At the conclusion of the Hearing, Director Roberson expressed concern that the Authority should have a complete record on rate case expenses and moved that the Company be required to provide detailed evidence of rate case expenses in a separate hearing that would be held on March 28, 2011. The motion was approved unanimously by the panel. On March 16, 2011, the

¹¹² *Petition for Appeal of the Hearing Officer's Initial Order Granting the City of Chattanooga's First Motion in Limine* (February 28, 2011).

¹¹³ Transcript of Proceedings, Vol. I A, pp. 47-49 (February 28, 2011).

¹¹⁴ *Tennessee American Water Company's Petition for Appeal of the Hearing Officer's Initial Order Granting the City of Chattanooga's Third Motion to Compel* (February 28, 2011).

¹¹⁵ *Petition for Appeal of the Hearing Officer's Initial Order* (February 28, 2011).

¹¹⁶ Transcript of Proceedings, Vol. I A, pp. 67-69 (February 28, 2011).

parties filed a joint motion in which the parties expressed their agreement to limit the amount of rate case expenses in this docket to the \$645,000, the amount originally filed in the Company's *Petition*.¹¹⁷ The agreement was reached in order to expedite the completion of the case within the statutory time required under Tenn. Code Ann. § 65-5-103. As part of the parties' agreement, TAWC further agreed to forego implementing its requested rates under bond until April 5, 2011 as provided in Tenn. Code Ann. § 65-5-103(b)(1).

On March 21, 2011, the parties filed post-hearing briefs. On March 22, 2011, the Hearing Officer issued an Order concluding that it was not necessary to proceed to hearing on the issue of rate case expense in light of the filing of the March 16, 2011 joint motion, which acted as a stipulation between the parties with respect to the necessity, reasonableness, and prudence of rate case expenses incurred by TAWC in this docket, and therefore, no additional evidence was necessary on the issue of rate case expense.¹¹⁸ In addition, the Hearing Officer re-suspended the Company's tariffs through April 4, 2011.¹¹⁹

On March 28, 2011, the CRMA and TAWC filed a joint summary detailing the settlement they had announced during the hearing in Chattanooga on February 28, 2011.¹²⁰ In the settlement, the CRMA and TAWC agreed that all three classes of customers would receive an equal percentage of any rate increase.¹²¹ TAWC explained that while the larger industrial customers would receive lower rate increases than smaller industrial customers, the result would be larger plant expansion and more economic growth in the Chattanooga area.¹²² However, the settlement agreement between CRMA and TAWC affected only the rates within the industrial

¹¹⁷ *Joint Motion for Approval of Rate Case Expenses* (March 16, 2011).

¹¹⁸ *Initial Order of the Hearing Officer Relating to Proof on Rate Case Expenses and the Joint Motion Filed by the Parties*, pp. 5-6 (March 21, 2011).

¹¹⁹ *Id.* at 6.

¹²⁰ *Summary of Settlement between CRMA and TAWC* (March 28, 2011).

¹²¹ *Id.* at 1.

¹²² *Id.* at 1-2.

class.¹²³

On April 4, 2011, this docket was convened for consideration of the settlement agreement filed by CRMA and TAWC. The panel directed TAWC to file two sets of tariffs; one set was to reflect an across-the-board increase on all customer classes and individual rates, and the other was to spread the revenue increase proportionately across all customer classes, including industrial customers.¹²⁴

On April 7, 2011 the UWUA filed its objection to the tariffs filed by TAWC asserting that neither tariff incorporated reporting conditions with respect to staffing and valve maintenance issues, which had been placed on the Company by the Authority at the April 4, 2011 Authority Conference.¹²⁵ On April 14, 2011, TAWC responded in opposition to the Union's objection.¹²⁶

During the regularly scheduled Authority Conference held on April 18, 2011, the panel voted to deny the Union's objections concerning TAWC's failure to incorporate staffing and valve maintenance reporting requirements into its tariffs, on the condition of TAWC's agreement to submit semi-annual reports concerning its staffing levels and valve operation and maintenance programs to the Utilities Division Chief on April 5th and October 5th of each year.¹²⁷ In addition, the panel reconsidered the settlement agreement that had been previously filed by CRMA and TAWC.¹²⁸ Thereafter, a majority of the panel voted to approve the settlement agreement of the CRMA and TAWC, and tariffs filed on April 6, 2011 reflecting an across-the-board increase.¹²⁹

¹²³ *Notice of Filing Amended Tariffs*, p. 2 (April 6, 2011).

¹²⁴ *Transcript of Proceedings*, p. 65 (April 4, 2011).

¹²⁵ *Objection to "Notice of Filing Amended Tariffs"* (April 7, 2011).

¹²⁶ *Tennessee American Water Company's Response in Opposition to UWUA's Objection to Notice of Filing Amended Tariffs* (April 14, 2011).

¹²⁷ *Transcript of Proceedings*, p. 10 (April 18, 2011).

¹²⁸ *Id.* at 11-12.

¹²⁹ Director Sara Kyle voted against the settlement agreement and moved to adopt the tariff to reflect an across-the-board increase to all customer classes and individual rates. Her motion failed for lack of a second. *Id.*

III. CRITERIA FOR ESTABLISHING JUST AND REASONABLE RATES

In carrying out its ratemaking function, the Authority is obligated to balance the interests of the utilities subject to its jurisdiction with the interests of Tennessee consumers; it is obligated to fix just and reasonable rates.¹³⁰ The Authority must also approve rates that provide regulated utilities the opportunity to earn a just and reasonable return on their investments.¹³¹

The TRA is not bound to follow rate-making methodology that it has employed in the past.¹³² Further, the Uniform Administrative Procedures Act authorizes the TRA to take notice of “generally recognized technical and scientific facts within the agency’s specialized knowledge,” and in the evaluation of evidence the agency is specifically authorized to utilize its “experience, technical competence, and specialized knowledge.”¹³³ The TRA is not to be “hamstrung by the naked record” and can consider all relevant circumstances shown by the record, all recognized technical and scientific facts pertinent to the issue under consideration and may superimpose upon the entire transaction its own expertise, technical competence and specialized knowledge.¹³⁴

The Authority considers a petition for a rate increase filed pursuant to Tenn. Code Ann. § 65-5-103 (2004) in light of the following criteria:

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

¹³⁰ Tenn. Code Ann. § 65-5-101 (Supp. 2011).

¹³¹ See *Bluefield Water Works and Improvement Company v. Public Service Comm’n of West Virginia*, 262 U.S. 679 (1923).

¹³² *Tennessee American Water Co. v. Tenn. Regulatory Auth.*, 2011 WL 334678, at *25 (Tenn. Ct. App. Jan. 28, 2011); *CF Indus. v. Tennessee Pub. Serv. Comm’n*, 599 S.W.2d 536, 542-45 (Tenn. 1980).

¹³³ Tenn. Code Ann. §4-5-314 (2011).

¹³⁴ *Tennessee American*, 2011 WL 334678, at *26.

It is settled law that the TRA has discretion with regard to setting rates and may exercise this discretion in selecting among the test periods proposed or the use of different test periods altogether.¹³⁵ The TRA is not limited to adopting a single test period in order to make known and measurable adjustments to produce just and reasonable rates.¹³⁶

The TRA has the discretion to use a historical test period, a forecast period, a combination of these where necessary, or any other accepted method of rate-making necessary to arrive at a fair rate of return.¹³⁷ The Tennessee Supreme Court has noted in this regard:

[T]here is no statutory nor decisional law that specifies any particular approach that must be followed by the Commission. Fundamentally, the establishment of just and reasonable rates is a value judgment to be made by the Commission in the exercise of its sound regulatory judgment and discretion.¹³⁸

There is no single, precise measure of the fair rate of return a utility is allowed an opportunity to earn. Therefore, the TRA must exercise its judgment in making an appropriate determination. The Authority, however, is not without guidance in exercising its judgment:

A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.¹³⁹

In addition, the United States Supreme Court has determined that regulated firms are

¹³⁵ *Tennessee American*, 2011 WL 334678, at * 20, citing *Powell Tel. Co. v. Tennessee Pub. Serv. Comm'n*, 660 S.W.2d 44, 46 (Tenn. 1983); *Am. Ass'n of Retired Persons v. Tennessee Pub. Serv. Comm'n*, 896 S.W.2d 127, 133 (Tenn. Ct. App. 1994).

¹³⁶ *Tennessee American*, 2011 WL 334678 at *3.

¹³⁷ *Id.* at *20.

¹³⁸ *Powell Tel. Co. v. Tenn. Pub. Serv. Comm'n*, 660 S.W.2d 44, 46 (Tenn. 1983); citing *CF Industries v. Tennessee Pub. Serv. Comm'n*, 599 S.W.2d 536 (Tenn. 1980).

¹³⁹ *Bluefield Water Works & Improvement Company v. Public Service Commission*, 262 U.S. 679, 692-93 (1923); see also *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 310 (1989).

entitled to a return that is “just and reasonable.”¹⁴⁰ The rate a firm is permitted to charge should enable it “to operate successfully, to maintain its financial integrity, to attract capital, and to compensate investors for the risks assumed.”¹⁴¹

The general standards to be considered in establishing the fair rate of return for a public utility are financial integrity, capital attraction and setting a return on equity that is commensurate with returns investors could achieve by investing in other enterprises of corresponding risk.¹⁴² The utility’s fair rate of return is the minimum return investors expect, or require, in order to make an investment in the utility.¹⁴³ The proper level of return on the Company’s capital, including equity capital, must be commensurate with returns on investment in other enterprises having corresponding risk.¹⁴⁴

Applying these criteria, and upon consideration of the entire record, including all exhibits and the testimony of the witnesses, the panel makes the following findings and conclusions.

IV. TEST PERIOD AND ATTRITION PERIOD

Establishing a “test period,” or “test year,” allows the Authority to measure a utility’s financial operations and investments over a specific twelve-month period. The test period is used to develop an “attrition year,” which is the forecast period used to set rates. The test period takes into consideration revenues, expenses, and investments.

The Company used a normalized historical test period of the twelve months ended March 31, 2010 to forecast attrition period results.¹⁴⁵ The Company made normalizing adjustments to the test period to forecast the results for the attrition period of the twelve months ended December 31, 2011.¹⁴⁶ The CAPD, however, used the twelve months ended September

¹⁴⁰ *Federal Power Comm’n v. Hope Natural Gas Co.*, 320 U.S. 591, 605 (1944).

¹⁴¹ *Id.*

¹⁴² *Id.* at 603.

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ Sheila A. Miller, Pre-Filed Direct Testimony, p. 4 (September 23, 2010).

¹⁴⁶ *Id.*

30, 2010 as its test period for residential, commercial and all other revenue categories, with adjustments for known and reasonably anticipated changes through the attrition year ended December 31, 2011.¹⁴⁷

The panel finds that both the normalized test period for the twelve months ended March 31, 2010, as proposed by TAWC, and the September 30, 2010 normalized test period, as proposed by Consumer Advocate, are acceptable test periods that best fit each of the individual items being forecasted.¹⁴⁸ Both the Company and the Consumer Advocate are in agreement as to the attrition period, and a majority of the panel votes to adopt the twelve months ended December 31, 2011 as the attrition period.¹⁴⁹

V. CONTESTED ISSUES

The positions of the parties and the determinations of the voting panel are set out below for each of the following contested issues related to the determination of a fair rate of return: Section V(A) – Revenues; Section V(B) – Expenses; Section V(C) – Taxes and Fees; Section V(D) - Net Operating Income; Section V(E) – Rate Base; Section V(F) – Revenue Conversion Factor; Section V(G) – Rate of Return; Section V(H) – Revenue Deficiency; and Section V(I) – Rate Design.

V(A). REVENUE

In order to accurately calculate overall revenues, TAWC's revenues must be calculated for each class of service. This is a two-step process. First, the number of customers must be determined and thereafter, a growth factor is applied to the number of bills for the test period (typically based on historical trend) to arrive at a forecasted number of bills for the attrition period. The forecasted bills are then multiplied by the current rate for each location and class. The next step in the process is to calculate water usage revenue for the attrition period.

¹⁴⁷ John Hughes, Pre-Filed Direct Testimony, pp. 6,8 (January 5, 2011).

¹⁴⁸ Transcript of Proceedings, p. 63 (April 4, 2011).

¹⁴⁹ *Id.* at 63-65.

Generally, usage is forecasted for the attrition period in much the same way as the number of bills. The water usage is then multiplied by the tariffed usage rates to calculate usage revenue. The flat rate revenue amounts and water usage revenue amounts are added together along with any other revenues, such as forfeited discounts, to arrive at the total amount of revenue forecasted for the attrition period for a particular class of service. The goal in forecasting the number of billing determinants is to develop a forecast that reflects what can be reasonably expected to occur in the future, or the attrition period.

TAWC receives revenue from six customer classes: (1) residential; (2) commercial; (3) industrial; (4) other public authority; (5) other water utility; and (6) public and private fire service. TAWC serves the cities of Chattanooga, Lookout Mountain, Lakeview, Suck Creek, and Lone Oak, Tennessee and sells water to Fort Oglethorpe, Catoosa Utility District, Signal Mountain and Walden's Ridge, Tennessee. Other TAWC operating revenues include service fees, late payment penalties, rent sewer revenues, connection fees and miscellaneous fees.

TAWC projected revenues by starting with billing determinants for the test year ended March 31, 2010. Thereafter, five normalizing adjustments were made: "(1) normalized test year adjustments which include annualizing the rate increase for the following: Walden's Ridge effective June 1, 2009, Signal Mountain effective July 1, 2009, Fort Oglethorpe effective November 1, 2009 and a rate decrease for the commercial classification effective September 1, 2009; (2) weather normalization adjustment for the residential and commercial customer classes; (3) eliminating the net change in accrued revenues; (4) adjusting for a duplicate miscellaneous invoice sent March 2010 to one commercial customer; and (5) including revenue for the estimated number of new customers to be added during the attrition year."¹⁵⁰ TAWC estimated the number of new customers based on twenty-three years of historical data. Based on this data, the Company projected an annual growth rate for residential customers of twenty-six additional

¹⁵⁰ Sheila A. Miller, Pre-Filed Direct Testimony, p. 6 (September 23, 2010).

customers monthly.¹⁵¹ For commercial customers, the Company projected an additional five customers per month. The Company's forecasted total by class was \$37,296,457.¹⁵²

The Company's expert, Dr. Edward L. Spitznagel, Jr., provided testimony on weather normalization usage per customer per day for both the residential and commercial customer classes in the attrition year.¹⁵³ Dr. Spitznagel stated that temperature and precipitation cause changes in water consumption and more water would be used in hotter and drier periods.¹⁵⁴ Dr. Spitznagel also pointed to the gradual introduction of water saving appliances that reduce water consumption as affecting usage.¹⁵⁵ He rejected temperature as a variable to use in his predictive models and instead, relied on the Palmer Modified Drought Index ("PMDI").¹⁵⁶

The Company used a bill analysis that reflects the actual billing determinants for the historical test year and is adjusted to normalize any new customers, loss of customers, or changes in usage (for large users) that occurred in the historical test-year, including customer growth through the attrition year, and an adjustment in residential and commercial usage using weather normalized usage per customer per day.¹⁵⁷

In rebuttal, on the question of weather normalized daily customer usage during the attrition year, Dr. Spitznagel criticized the CRMA's expert for using the previous five-year averages since it would result in an over-statement of future water consumption by failing to take into account declining water consumption trends.¹⁵⁸ Dr. Spitznagel also called into question the CRMA's expert's methodology and usage estimates.¹⁵⁹ Dr. Spitznagel performed various computations to demonstrate that CRMA witness Mr. Gorman's proposal was an inaccurate

¹⁵¹ TAWC's Responses to the TRA's Data Requests Dated September 20, 2010, Question 13, TN-TRA-01-Q013-REVENUES, p. 47 (September 24, 2010).

¹⁵² *Petition*, Exhibit No. 4, Schedule 1 (September 23, 2010).

¹⁵³ Dr. Edward L. Spitznagel, Jr., Pre-Filed Direct Testimony, p. 5 (September 23, 2010).

¹⁵⁴ *Id.* at 2.

¹⁵⁵ *Id.* at 3.

¹⁵⁶ *Id.* at 4.

¹⁵⁷ Sheila A. Miller, Pre-Filed Direct Testimony, pp. 5-6 (September 23, 2010).

¹⁵⁸ Dr. Edward L. Spitznagel, Jr., Pre-Filed Rebuttal Testimony, pp. 1-2 (February 8, 2011).

¹⁵⁹ *Id.* at 1-2.

predictor of future water consumption because it used data from the period 2005 through 2009 and claimed that residential and commercial consumption are declining.¹⁶⁰

Dr. Spitznagel criticized Mr. Novak for simply averaging the R-squares, which could be misleading and would not produce the appropriate measure of variation explained by his model.¹⁶¹ Disputing Dr. Klein's contention that he was unfamiliar with and had ignored considerable literature on estimating water demand, Dr. Spitznagel stated that he has reviewed more than one hundred papers on water demand and found that few pertain precisely to weather normalization.¹⁶² Dr. Spitznagel contended that the papers cited by Dr. Klein are not useful for normalizing average monthly water usage.¹⁶³

CAPD expert Mr. Novak stated that he assisted in developing the current Weather Normalization Adjustment ("WNA") rules for gas utilities in Tennessee and had presented testimony on the development of the first ever-approved WNA for a public utility in the state of Virginia.¹⁶⁴ Mr. Novak also stated that he developed the TRA Staff's WNA model and has testified on WNA issues in numerous rate cases.¹⁶⁵ Mr. Novak testified that neither the TRA nor its predecessor, the Tennessee Public Service Commission ("TPSC"), has ever directly addressed or approved a WNA for TAWC and the Company's statements and conclusions on this issue are incorrect.¹⁶⁶ Mr. Novak stated that he adapted the Staff's WNA model for gas utilities to fully examine the impact of weather on the Company's rate case in TPSC Docket No. 89-15388 and used it to consider the impact of heating and cooling degree-days and rainfall on the residential and commercial sales volumes using linear regressions.¹⁶⁷ Mr. Novak concluded the correlation

¹⁶⁰ *Id.* at 2-4.

¹⁶¹ *Id.* at 5-6.

¹⁶² *Id.* at 7.

¹⁶³ *Id.*

¹⁶⁴ William H. Novak, Pre-Filed Direct Testimony, p. 7 (January 5, 2011).

¹⁶⁵ *Id.*

¹⁶⁶ *Id.* at 8.

¹⁶⁷ *Id.* at 9.

factors he used were too poor to suggest a direct causal relationship between weather and water use; therefore, he disregarded the results.¹⁶⁸

Mr. Novak stated that in TPSC Docket Nos. 91-05224, 93-02943, and 96-00969, all of which involved TAWC, the Company accepted the WNA model that he had proposed in the 1989 rate case.¹⁶⁹ Mr. Novak stated that to the best of his recollection, allowance for the impact of weather was excluded because there was no demonstrated direct causal relationship between weather and water sales.¹⁷⁰ The issues in those three cases were settled between the parties without any allowance for weather normalization.¹⁷¹ He noted that in testimony before the Kentucky Public Service Commission the Company stated that it has been allowed to use a WNA in Tennessee since 1989.¹⁷² While it is possible that TAWC has included a WNA in each of its petitions for rate increases since 1991, all of those rate cases except the last two were resolved through “black box” settlements with no specific resolution of any weather normalization issue.¹⁷³ Mr. Novak stated that the 2006 and 2008 rate cases, however, were fully litigated, with the Company’s proposed WNA adjustments never being explicitly adopted by the TRA.¹⁷⁴

Dr. Klein did not agree with Dr. Spitznagel’s weather normalization study.¹⁷⁵ Dr. Klein contended that there is considerable literature on estimating water demand that Dr. Spitznagel was either unfamiliar with or had ignored.¹⁷⁶ Dr. Klein pointed out that Dr. Spitznagel included only weather as measured by the PMDI, but none of the studies cited in Dr. Spitznagel’s

¹⁶⁸ *Id.*

¹⁶⁹ *Id.* at 10.

¹⁷⁰ *Id.* at 11.

¹⁷¹ *Id.* at 10.

¹⁷² *Id.*

¹⁷³ *Id.* at 10-11.

¹⁷⁴ *Id.*

¹⁷⁵ Dr. Chris Klein, Pre-filed Direct Testimony, p. 19 (January 5, 2011).

¹⁷⁶ *Id.*

testimony made use of the index.¹⁷⁷ Thus, Dr. Spitznagel's results could be biased due to the failure to include all relevant variables.¹⁷⁸ Dr. Klein stated that Dr. Spitznagel used very little data, looking at only ten data points for each month, and that measures of good fit and statistical significance are generally unreliable for such small samples.¹⁷⁹

The CAPD used the actual billing determinates reported for the twelve months ended September 30, 2010 as a basis to project forecasted attrition period revenues.¹⁸⁰ The CAPD's forecasted revenues listed by class totaled \$38,399,479.¹⁸¹ The CAPD disagreed with two areas of the Company forecasted operating revenue.¹⁸² First, the CAPD argued that the WNA proposed by the Company should be disregarded in calculating operating revenue.¹⁸³ The total WNA adjustment calculated by TAWC for the year ended December 31, 2011 was \$318,523.¹⁸⁴

In forecasting residential revenues, the CAPD compiled monthly billing determinants for that class.¹⁸⁵ These billing determinants were then combined with data from previous TAWC rate cases filed in 2004 (Docket No. 04-00288), 2006 (Docket No. 06-00290), and 2008 (Docket No. 08-00039) because, in the CAPD's view, the data provided in those cases furnished an excellent history of billing determinants for use in trend analysis.¹⁸⁶ The CAPD's calculation of residential operating revenue, which excluded the Company's WNA revenue reduction, exceeded the Company's calculation by \$867,880.¹⁸⁷

In projecting commercial revenue, the CAPD established billing determinants by trending the number of meters and water usage history from the twelve month period beginning August

¹⁷⁷ *Id.* at 20.

¹⁷⁸ *Id.*

¹⁷⁹ *Id.*

¹⁸⁰ John Hughes, Pre-Filed Direct Testimony, pp. 6,8 (January 5, 2011).

¹⁸¹ *Id.* at 3.

¹⁸² *Id.* at 3-4.

¹⁸³ *Id.*

¹⁸⁴ *Id.*

¹⁸⁵ *Id.* at 6-7.

¹⁸⁶ *Id.*

¹⁸⁷ *Id.* at 8.

2003 through the twelve months ended September 2010 for Chattanooga, Lookout Mountain, Lakeview, and Suck Creek.¹⁸⁸ For Lone Oak, the CAPD used billing determinants from the twelve-month period beginning August 2006 through September 2010.¹⁸⁹ The CAPD's calculation for commercial operating revenue, which excluded the Company's proposed WNA, exceeded the Company's calculation by \$147,361.¹⁹⁰

In projecting industrial revenues, the CAPD established billing determinants by trending the number of meters and water usage history from January 2004 through the twelve months ended September 30, 2010.¹⁹¹ The CAPD's calculation of industrial operating revenue exceeded that of the Company by \$118,733.¹⁹² The CAPD forecasted industrial revenues of \$3,520,697 for the attrition period at current rates.¹⁹³

In forecasting Other Public Authority Revenues, the CAPD applied the current rates to its test year billing determinates to arrive at its forecasted attrition period amount.¹⁹⁴ The CAPD contended that the volumetric billing determinants for other public authority revenues in the Chattanooga area have declined from a total of 1,216,889 cubic feet at the beginning of 2004 to a total of 1,025,432 cubic feet in 2009.¹⁹⁵ By using trend analysis on the historical billing determinants, the CAPD detected a decline in volumes and a resulting decline in other public authority revenues.¹⁹⁶ The CAPD forecasted Other Public Authority Revenues of \$2,549,888 for the attrition period at current rates.¹⁹⁷

¹⁸⁸ *Id.*

¹⁸⁹ *Id.*

¹⁹⁰ *Id.* at 8-9.

¹⁹¹ *Id.* at 4.

¹⁹² *Id.* at 10.

¹⁹³ *Id.* at 9.

¹⁹⁴ *Id.* at 10-11.

¹⁹⁵ *Id.*

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

The CAPD predicted a decline in Other Water Utility Revenue¹⁹⁸ to \$1,293,805 during the attrition year ended December 31, 2011,¹⁹⁹ while TAWC estimated that this revenue would remain constant during the attrition period at the test period amount of \$1,308,493, which was calculated for the twelve months ended March 31, 2010.²⁰⁰ The CAPD used the more recent test year data for the year ended September 30, 2010.²⁰¹

The CAPD noted a sharp decline in volumetric usage by Catoosa County during the test year ended September 30, 2010.²⁰² Based upon this decline, the CAPD forecasted Other Water Utility Revenue would decline by at least \$14,688 during the attrition year, noting that the Catoosa Utility District Authority stopped purchasing water from TAWC in 2008.²⁰³

TAWC calculated Private Fire Service Operating Revenues of \$1,735,066 for the attrition period while the CAPD projected \$1,719,717.²⁰⁴ Consistent with the methodology used for other classes of service, the CAPD used historical billing determinants.²⁰⁵ The CAPD used the trend analysis technique for each pipe size to determine whether any attrition year estimates should be changed.²⁰⁶ As a result, the CAPD determined that, although the total billing determinants are the same as those in TAWC's forecast, different pipe sizes produced different forecasted revenues.²⁰⁷ Therefore, the CAPD's trend analysis of Private Fire Service Operating Revenues was \$14,688 lower than the amount calculated by TAWC.²⁰⁸ However, no testimony was offered on Public Fire Service Revenues or Other Operating Revenues. For these categories, the Company projected \$1,517,135, and the CAPD projected \$1,522,545, for the attrition period of

¹⁹⁸ The class "Other Water Utility Operating Revenues" included the utility districts of Fort Oglethorpe, Catoosa, Signal Mountain, and Walden's Ridge.

¹⁹⁹ John Hughes, Pre-Filed Direct Testimony, pp. 6,8 (January 5, 2011).

²⁰⁰ *Id.* at 11-12.

²⁰¹ *Id.*

²⁰² *Id.*

²⁰³ *Id.*

²⁰⁴ *Id.* at 12-13.

²⁰⁵ *Id.*

²⁰⁶ *Id.*

²⁰⁷ *Id.*

²⁰⁸ *Id.* at 12-13.

the twelve months ended December 31, 2011.²⁰⁹ The CAPD amount is greater by an immaterial amount of \$5,410.

Mr. Gorman, testifying for the CRMA, attested that Dr. Spitznagel's estimates of 135.93 gallons per customer per day for residential usage and 989.64 gallons per customer per day for commercial usage were simply too low.²¹⁰ In fact, the Company's own actual data indicated that Dr. Spitznagel had underestimated daily volume.²¹¹ The CRMA contended that a normal residential consumption estimate of 144.2 gallons per customer per day more reasonably projected actual usage for a residential customer based on historical usage patterns yet still reflected continued water conservation gains.²¹² To project the residential usage for Lookout Mountain and Lakeview, the CRMA calculated the percentage change between Mr. Gorman's residential usage estimate and Dr. Spitznagel's for the Chattanooga district and applied that percentage change to volumes that Dr. Spitznagel estimated for Lookout Mountain and Lakeview.²¹³ Mr. Gorman stated that TAWC's projection of 989.64 gallons per customer per day was not reasonable when compared to the Company's historical data.²¹⁴ CRMA recommended that attrition period commercial usage be based on the five-year average of 1,033.6 gallons per day per commercial customer because it was more reasonable and consistent with actual sales volume of commercial customers over the last ten years than the daily volume estimate of 989.64 gallons used by Dr. Spitznagel.²¹⁵ Additionally, over the last sixteen years, with the exception of 2009, the actual commercial usage substantially exceeded the estimate proposed by Dr. Spitznagel.²¹⁶ Additionally, CRMA pointed out that TAWC's expert used the

²⁰⁹ John Hughes, Pre-Filed Direct Testimony, Workpaper R-Revenue Comparative Summary (January 5, 2011).

²¹⁰ Michael Gorman, Pre-Filed Direct Testimony, pp. 7-8 (January 5, 2011).

²¹¹ *Id.*

²¹² *Id.* at 9.

²¹³ *Id.*

²¹⁴ *Id.*

²¹⁵ *Id.*

²¹⁶ *Id.* at 9-10.

same database and analyzed data for the months of May to September 2009, which was the wettest year since 1895.²¹⁷

TAWC claimed that it did not meet the TRA's revenue forecast adopted in the last rate case, Docket No. 08-00039, and that its revenues have actually decreased by \$3.293 million.²¹⁸ TAWC claimed that this reduction in revenue accounts for 33.3% of the overall requested rate increase.²¹⁹ Nevertheless, in Docket No. 08-00039, the Company had forecasted revenues of \$37,142,460 for the attrition period ended August 31, 2009.²²⁰ The CAPD forecasted revenues of \$39,492,768. The TRA adopted a revenue forecast of \$38,934,309. A comparison of the actual results from TAWC's 3.06 report for the year ended August 31, 2009 (the attrition period used in Docket No. 08-00039) with the revenue figures forecasted by the parties and the TRA showed that the forecast prepared by the TRA was the most accurate. After performing several trend calculations on this historical data and an analysis of the past five years of residential and commercial customer accounts, the Authority accepts as reasonable four of TAWC's normalizing adjustments but excluded weather normalization, as further discussed below.

The Authority rejects the CAPD's projection of meters for the attrition period. During cross-examination, it was unclear which specific information the CAPD relied upon to make its projections, although there was some discussion of data from the 3.06 Monthly Reports. Further, during cross-examination by the Company, the CAPD's witness admitted to having made numerous errors²²¹ and inappropriate assumptions, and that recognition of these errors had prompted the CAPD to file amended testimony on February 25, 2011, March 1, 2011 and March 8, 2011. The CAPD's projections were found to contain numerous errors and could not be relied

²¹⁷ *Id.* at 10.

²¹⁸ Michael A. Miller, Pre-Filed Direct Testimony, p. 6 (September 23, 2010).

²¹⁹ *Id.*

²²⁰ *In re: Petition of Tennessee American Water Company to Change and Increase Certain Rates and Charges so as to Permit It to Earn a Fair and Adequate Rate of Return on Its Property Used and Useful in Furnishing Water Service to Its Customers*, Docket No. 08-00039, *Final Order*, p. 9 (January 13, 2009).

²²¹ Transcript of Proceedings, Vol. IV B, pp. 133-134 (March 3, 2011).

upon with any degree of certainty. Therefore, the Authority declines to adopt the CAPD's revenue forecast.

The Company's forecast for residential and commercial usage relied on Dr. Spitznagel's WNA model. In the previous rate case for TAWC, Docket No. 08-00039, the Authority made it clear that it had not previously adopted the Company's WNA mechanism.²²² The panel again rejects Dr. Spitznagel's WNA model as it was applied to the residential and commercial classes because the monthly regressions employed in the model have too few observations to be statistically reliable.

The CRMA's witness, Mr. Gorman, testified that the Company underestimated the level of revenues that it would earn at its current rates by overestimating the effect of a reduction in sales due to conservation.²²³ He further stated that sales projections would be \$1,217,115 more for the attrition period at current rates than forecasted by the Company.²²⁴ However, the CMRA presented little evidence in the form of supporting schedules or workpapers to demonstrate or justify this assertion. For this reason, the Authority has been unable to verify Mr. Gorman's assertions and does not accept the forecast of revenues presented by CRMA.

The TRA determines that the most reasonable historical data upon which to base usage forecasts is contained in the Company's Rebuttal Exhibit MAM-10, Page 5. The moderate decline in usage per customer from 2005 through 2009 was demonstrated by data the Company provided; however, the TRA further notes that this decline has started to level off. This conclusion is based on what the TRA deems to be the most reliable data in the record for determining the future average residential and commercial usage per customer. The TRA's analysis is based on its calculations applying several methodologies used to examine probable future usage per customer, as well as an examination of the historical volumetric usage provided

²²² *Final Order*, Docket No. 08-00039, p. 11 (January 13, 2009).

²²³ Michael Gorman, Pre-Filed Direct Testimony, p. 7 (January 5, 2011).

²²⁴ *Id.*

by TAWC in its Rebuttal Exhibit MAM-10. This data clearly demonstrates only a moderate decline in customer usage in recent years. While, as TAWC points out, the data may show usage declining substantially over the entire period 1986 through 2010, usage for residential customers has declined by only one-half gallon per day for the more recent period 2004 through September 2009.

The Company's test period usage was determined from the twelve months ended March 31, 2010 based on a review and analysis of five-year customer counts. The residential and commercial usage, as normalized and adjusted for the attrition period, represented reasonable usage for the test period. Again, the TRA declines to adopt weather normalized adjustments to revenue in forecasting usage.

TAWC and the CAPD both projected a small increase in the Industrial, Other Public Authority, Other Water Utilities, Public/Private Fire Service and Other Operating Revenues classifications from the test period to the attrition period. Little or no testimony was provided by either party on these revenues; however, the projected increases were immaterial. Further, the CAPD's revenue projections have been found to be unreliable in this rate case, having been revised by the CAPD's witness three times during the course of the docket. Therefore, the TRA adopts the projection of TAWC for these revenue classes.

Based on the foregoing, the TRA adopts an estimate of \$37,614,978 for total operating revenues for the attrition period consisting of the following: (1) residential revenue of \$15,555,318; (2) commercial revenue of \$11,540,748; (3) industrial revenue of \$3,401,964; (4) other public authority revenue of \$2,556,253; (5) other water utility revenue of \$1,308,493; (6) private fire service revenue of \$1,735,066; (7) public fire service revenue of \$0; and (8) other operating revenue of \$1,517,135.

V(A)1. AMERICAN WATER RESOURCES (“AWR”) WATER AND SEWER PROTECTION PROGRAMS

During the course of the proceedings, the City raised certain issues concerning the Company’s relationship, subsidization, and transfer of utility assets and benefits without compensation to its non-regulated affiliate company American Water Resources (“AWR”).²²⁵ AWR provides homeowner protection plans to TAWC customers and other AWWC utility customers.²²⁶ These specialized protection programs include water line protection,²²⁷ sewer line protection,²²⁸ and in-home plumbing emergency protection services, which cover certain repairs to the water and/or sewer lines running from a home to the street and for plumbing repairs that occur within the home (lateral water and wastewater lines/facilities owned by the customer, not TAWC), and are designed to insulate homeowners from the unexpectedly high costs that can be associated with water or sewer line failures and in-home plumbing repairs.²²⁹

Under the *Agreement for Support Services between American Water Resources, Inc. and Tennessee American Water Company (“Service Agreement”)* executed on May 1, 2004, TAWC bills to and collects from its mutual customers AWR protection plan charges, distributes AWR promotional marketing materials and customer surveys, and notifies AWR of claims and/or initiates repair services,²³⁰ as follows:

Billing and Collection. AWR shall provide [TAWC] with a list of enrolled customers in its Programs who have chosen to have charges from AWR included on their bill from [TAWC], and shall keep such list up to date. [TAWC] shall

²²⁵ Like TAWC, AWR is a wholly-owned subsidiary of AWWC.

²²⁶ Kimberly H. Dismukes, Pre-filed Direct Testimony, pp. 10-11 (January 5, 2011); *see also* Michael A. Miller, Pre-filed Direct Testimony, Exhibit MAM-8, p. 26 of 143 (February 17, 2011).

²²⁷ The Water Line Protection Program offered to TAWC customers, subject to its terms and conditions, provides a service to repair customer-owned water lines that leak or break due to normal wear and tear. TAWC’s Responses to The TRA’s Fourth Set of Data Requests, Question 152, TN-TRA-04-Q152-ATTACHMENT, p. 23 of 24 (*Service Agreement*, Appendix A) (February 18, 2011).

²²⁸ The Sewer Line Protection Program offered to TAWC customers, subject to its terms and conditions, provides a service to clear or repair blocked customer-owned sewer lines that become clogged or blocked due to normal wear and usage. *Id.*

²²⁹ Kimberly H. Dismukes, Pre-filed Direct Testimony, pp. 10-11 (January 5, 2011); *see also* Michael A. Miller, Pre-filed Direct Testimony, Exhibit MAM-8, p. 26 of 143 (February 17, 2011).

²³⁰ TAWC’s Responses to The TRA’s Fourth Set of Data Requests, Question 152, TN-TRA-04-Q152-ATTACHMENT, pp. 11-13 & 24 of 24 (February 18, 2011) (*Service Agreement* § 6, pp. 8-10 & Exhibit 1).

include such charges on the customer's bill and collect such charges from the customer until such time as the customer or AWR notifies [TAWC] that the customer is no longer receiving services from AWR or has elected a different payment option. [TAWC] shall forward collected payments from enrolled customers to AWR within fifteen days following the end of each calendar month for amounts collected during such month. . . . AWR shall be responsible for all collection efforts for non-payment by [TAWC] customers for AWR Programs.²³¹

In performing its duty to provide billing and collections services, TAWC includes AWR protection plan charges on its regular bill to the customer, collects payments for such charges, along with its own charges for service, and forwards the payments to AWR.²³² Payments are applied first to utility services, and any remainder is thereafter credited to amounts owed to AWR.²³³ Utility service will not be interrupted, stopped, or refused, as a result of non-payment of amounts owed to AWR, and AWR is responsible for all collection efforts necessary due to non-payment by TAWC customers for AWR programs.²³⁴

In addition, AWR is responsible for the administrative activities of the programs,²³⁵ but TAWC agreed to manage and direct the distribution of materials related to the protection plan programs for its customers:

Distribution of Promotional Materials. Upon request of AWR, [TAWC] shall manage and direct the distribution of informational and promotional materials regarding the Program to its customers. Such materials shall be developed by AWR and provided to [TAWC] in sufficient quantities and in a timely manner so as not to impede any planned distribution efforts by [TAWC]. The materials shall be distributed as a part of [TAWC]'s normal billing process, unless arrangements are made, at least sixty (60) days in advance, for a special mailing. The materials provided by AWR must be satisfactory in form and content to [TAWC], and nothing in this Agreement shall require [TAWC] to distribute any materials that are not satisfactory to [TAWC]. [TAWC] shall make all reasonable efforts to promptly notify AWR when additional quantities of promotional materials are

²³¹ *Id.* at 12-13 of 24 (*Service Agreement*, § 6.1.3, pp. 9-10 & Exhibit 1).

²³² *Id.*

²³³ *Id.*

²³⁴ *Id.*

²³⁵ Under § 10.4 of the *Service Agreement*, administration of the AWR protection plan programs include activities such as enrollment, billings, accounting, marketing, financial analysis and reporting. *See*, TAWC's Responses to The TRA's Fourth Set of Data Requests, TN-TRA-04-Q152-ATTACHMENT, p. 17 of 24 (February 18, 2011) (*Service Agreement* § 10.4, p. 14).

needed. [TAWC] shall have the sole discretion to determine the customers who will receive the informational and promotional materials for the Program.²³⁶

All promotional and informational materials will be developed, produced, printed and supplied to TAWC, by AWR.²³⁷ Further, AWR provides TAWC with the opportunity to review and approve of all materials in advance of distribution to customers.²³⁸ All materials must be satisfactory to TAWC in form and content and TAWC is not compelled to distribute any materials that it does not determine to be satisfactory. TAWC retains control over the form and content of the AWR materials it distributes, and has discretion to determine which customers will receive these materials. In addition, TAWC reviews and has input as to AWR customer surveys prior to distributing such surveys to its customers.²³⁹

Finally, under the *Service Agreement*, TAWC has also agreed to provide AWR notification of possible claims:

Notification of Claim. Should a [TAWC] associate, as a part of his/her normal duties, determine that a [TAWC] customer has a covered occurrence with the Customer's water or sewer service line, the [TAWC] associate shall notify AWR by calling a toll-free telephone number to be supplied by AWR. AWR shall then engage a qualified contractor to provide the covered services to the customer. AWR shall timely provide that necessary information to cause [TAWC]'s customer records to reflect when coverage is available.²⁴⁰

Thus, TAWC employees who determine, as part of their duties, that a customer has a covered water or sewer line occurrence are required to notify AWR, who then engages a qualified contractor to provide service in accordance with the protection plan.²⁴¹

In its fee provision, the *Service Agreement* distinguishes the fee paid for billing and collection services from other services:

4.1 Fee. The fee paid to Utility by AWR for Services rendered pursuant to this Agreement shall be equal to one hundred and fifteen (115%) percent of the Fully

²³⁶ *Id.* at 11-12 of 24 (*Service Agreement*, § 6.1.1, pp. 8-9).

²³⁷ *Id.* at 16 of 24 (*Service Agreement*, § 10.1, p. 13).

²³⁸ *Id.*

²³⁹ *Id.* at 24 of 24 (*Service Agreement*, § 6.1.4, p. 10, Exhibit 1(3)).

²⁴⁰ *Id.* at 12 of 24 (*Service Agreement*, § 6.1.2, p. 9).

²⁴¹ *Id.*

Distributed Costs incurred by Utility in providing the Services *except* for billing and collection services. The Fee for billing and collection services rendered by Utility as set forth in Paragraph 6.1.3 below shall be at a rate of \$.405 per customer per billing period and apply in the aggregate to customers participating in one or more of AWR's Programs. The \$.405 rate may be adjusted from time to time as determined by the agency having regulatory authority over Utility to be consistent with any other such billing and collection service rates charged by Utility, under tariff, to others.²⁴²

As noted, TAWC receives 40.5¢ per customer per billing period for the billing and collection services it renders on behalf of AWR. The *Service Agreement* allows for adjustment of this fee by the TRA in order maintain consistency with any other third-party billing and collection fee arrangements extended to others under the Company's tariff. Other, non-billing and collection, services performed by TAWC, as described in the *Service Agreement*, are to be paid at 115% of the Fully Distributed Costs.²⁴³ The *Service Agreement* defines "Fully Distributed Costs" as follows:

"Fully Distributed Costs" means costs determined in a manner that complies with the standards and procedures for the apportionment of special, joint, and common costs between the [TAWC] and any non-regulated entity in accordance with applicable regulations of the State commission or board having jurisdiction over the operations of [TAWC], except taxes as discussed in Section 5. A fully distributed costing methodology apportions the total costs of a group of services of products, including the authorized rate of return, among the individual services or products in that group.²⁴⁴

Thus, TAWC agreed, in summary, to provide billing and collection "at a rate of \$.405 per customer per billing period" **and** to provide services other than billing and collection for "one hundred and fifteen (115%) percent of the Fully Distributed Costs incurred" by it.

Through the testimony of its expert witness, Ms. Kimberly H. Dismukes, the City asserted that AWR receives significant tangible and intangible benefits as a result of its affiliate relationship and association with TAWC and made specific recommendations:

²⁴² *Id.* at 10 of 24 (*Service Agreement*, § 4.1, p. 7).

²⁴³ For ratemaking purposes, the costs incurred and revenue received by TAWC as a result of providing service(s) are proper considerations for the TRA in setting just and reasonable rates.

²⁴⁴ *Id.* at 8 of 24 (*Service Agreement*, § 1, p. 5).

AWR receives significant benefits as a result of its relationship with TAWC. I recommend that the TRA increase test year revenue by \$1,071,281 for representing the revenue earned by AWR from the Protection Programs provided to TAWC customers. I also recommend that the TRA order a thorough examination of this affiliate relationship. Two areas need to be examined. First, procedures should be developed to ensure that costs are properly allocated to AWR to ensure that ratepayers do not subsidize this nonregulated affiliate. Second, the TRA should attribute revenue (through a royalty fee or other mechanism) to TAWC to ensure that ratepayers receive compensation for intangible and tangible benefits bestowed to the nonregulated Protection Programs offered to TAWC customers.²⁴⁵

As described in the *Service Agreement*, TAWC is to receive fee compensation for its billing and collection services²⁴⁶ and payment of 115% of fully distributed costs for other services. Nevertheless, the City asserted that TAWC provides certain services and intangible assets that benefit AWR, for which it is not compensated.²⁴⁷ These additional services include the use of TAWC's name and president's signature, logo, reputation, goodwill, corporate image, personnel, and customer names and addresses.²⁴⁸ Ms. Dismukes highlighted TAWC's efforts to promote AWR's services:

As shown on pages 6, 10, and 13 of Schedule KHD-3, the letters sent to potential customers offering these protection programs were sent on TAWC's letterhead. Moreover, the letters were signed by the President of Tennessee American Water Company. In addition, the letters make strong statements about the potential financial consequences associated with a line break without the program.²⁴⁹

The City contended that the transfer of intangible assets and provision of services to AWR, without compensation, demonstrates that "[c]learly there is no arms-length relationship between TAWC and AWR's sale of these Protection Programs."²⁵⁰ Ms. Dismukes stated:

There are substantial benefits to AWR for its affiliation with TAWC. These benefits include the use of TAWC's name and president's signature, logo, reputation, goodwill, and corporate image; being associated with a large, financially strong, well-entrenched water company; use of TAWC's personnel;

²⁴⁵ Kimberly H. Dismukes, Pre-Filed Direct Testimony, p. 3 (January 5, 2011).

²⁴⁶ The City noted that TAWC charged AWR \$52,617 in 2007, \$43,200 in 2008, \$39,365 in 2009, and \$40,900 for the twelve months ended September 30, 2010, for its provision of third-party billing services to AWR. *Id.* at 10.

²⁴⁷ *Id.* at 14-17.

²⁴⁸ *Id.* at 15.

²⁴⁹ *Id.* at 14.

²⁵⁰ *Id.* at 15.

and use of TAWC's customer names and addresses. All of these benefits were developed as a result of the regulated operations of TAWC. However, AWR obtains these significant benefits because of its association with the regulated utility operations at no cost.²⁵¹

Because of its unique association and direct affiliate relationship, AWR obtains free of charge the benefits of assets generated or developed through TAWC's regulated utility operations.²⁵² Further, TAWC's intangible assets, which are of significant value in the promotion and sale of AWR homeowner protection plans to TAWC customers, are not compensated under the *Service Agreement*. To compensate ratepayers, Ms. Dismukes recommended that TAWC's new rates reflect this relationship with AWR:

Because of this, I recommend that the TRA increase test year revenue to include the revenue earned by AWR for the provision of these services that is applicable to TAWC. To estimate this amount, I distributed the AWR Home Services revenue to TAWC based upon its proportion of customers to the total number of regulated customers. My recommendation indicates that test year revenue should be increased by \$1,071,281, as depicted on Exhibit KHD-4.

* * *

The TRA should require payment by AWR to TAWC of a royalty fee on the revenue of AWR attributable to tangible and intangible benefits bestowed by TAWC.²⁵³

Ms. Dismukes recommended that the Authority increase TAWC's test year revenue to include revenue earned by AWR, based upon the proportion of TAWC customers to AWR's total customer base.²⁵⁴ The City asserted that AWR has 11,129 water line protection contracts, 6,410 sewer line protection contracts and 2,490 home plumbing contracts in Tennessee,²⁵⁵ and that these programs were marketed through materials printed using TAWC's name and logo, and signed by the President of TAWC.²⁵⁶ Ms. Dismukes distributed AWR Home Services revenue

²⁵¹ *Id.*

²⁵² *Id.*

²⁵³ *Id.* at 16.

²⁵⁴ *Id.* at 16.

²⁵⁵ *Id.* at 11; *see also* TAWC's First Supplemental Responses To The First Discovery Request And First Responses to the Supplemental Discovery Request Of The CAPD, TN-CAPD-01-Q77 and Q78 (December 2, 2010).

²⁵⁶ *Id.* at 14 (Schedule KHD-3).

(\$47,532,000)²⁵⁷ to TAWC using the ratio (.0225381) of TAWC Customers (74,774) to the total number of AWWC regulated customers (3,317,672).²⁵⁸ As a result of this calculation, the City asserted that TAWC's test year revenue should be increased by \$1,071,281 to account for revenue earned by AWR from its lucrative marketing arrangement with TAWC.²⁵⁹ During cross-examination, Ms. Dismukes conceded that it would be appropriate to impute the earnings of AWR's Tennessee-specific operations to the revenues of TAWC to compensate the ratepayers.²⁶⁰

The City also asserted that the Authority should require AWR to pay a royalty fee to TAWC on the AWR revenue attributable to its use of TAWC's tangible and intangible assets.²⁶¹ Ms. Dismukes pointed out that payment of a royalty fee was consistent with the position taken by TAWC witness, Bernard L. Uffelman, in a book on cost allocation, in which Mr. Uffelman discusses the regulatory practice of requiring a non-regulated affiliate to pay a royalty or referral fee to its regulated utility affiliate for use of the utility's brand name and logo.²⁶² Finally, Ms. Dismukes recommended that the Authority order a thorough investigation of AWR operations and develop procedures to ensure that TAWC ratepayers do not subsidize AWR, an unregulated affiliate.²⁶³

The CAPD concurred with the City's assertion that additional revenue should be attributed to TAWC for certain services it performs on behalf of its affiliate, AWR.²⁶⁴ Specifically, the CAPD agreed that AWR receives considerable benefits as a result of its

²⁵⁷ As noted in footnote 20 in her pre-filed testimony, Ms. Dismukes obtained AWR Home Service revenue for 2008 from TAWC's response to Schumaker IR 02-39, Attachment 1. See Kimberly H. Dismukes, Pre-Filed Direct Testimony, Schedule KHD-4 (January 5, 2011).

²⁵⁸ *Id.* at 16 (Schedule KHD-4).

²⁵⁹ *Id.* at 3 (Schedules KHD-2, 3 and 4).

²⁶⁰ Transcript of Proceedings, Vol. II C, p. 292 (March 1, 2011).

²⁶¹ *Id.* at 232, 241-43; see also Kimberly H. Dismukes, Pre-Filed Direct Testimony, pp.16-17 (January 5, 2011).

²⁶² Transcript of Proceedings, Vol. II C, pp. 232, 241-43 (March 1, 2011); see also Transcript of Proceedings, Vol. IV B, pp. 81-83 and Hearing Exhibit 53, p. 19 (March 3, 2011).

²⁶³ Kimberly H. Dismukes, Pre-Filed Direct Testimony, p. 16 (January 5, 2011).

²⁶⁴ *Consumer Advocate and Protection Division's Post-Hearing Brief*, pp. 15-16 (March 21, 2011).

affiliation with TAWC and the use of intangible assets, including TAWC's logo, in the marketing and sale of its products to TAWC customers.²⁶⁵ Therefore, the CAPD joined with the City in urging the Authority to review the affiliate relationship between TAWC and AWR and consider imputing a portion of AWR's revenues to TAWC.²⁶⁶

In response to the City's and CAPD's contentions, the Company, through its witnesses, Mr. Michael A. Miller and Mr. John Watson, asserted that its only participation in the water line/service line protection programs was to provide third-party billing and collection services for AWR at the tariff rate approved by the TRA for such services, which is also the same rate charged to the City of Chattanooga Sanitary Board.²⁶⁷ Mr. Miller asserted that as TAWC already bills its customers for water service, aside from incremental printing costs, TAWC incurs little, if any, additional cost in providing billing services to AWR:

The Agreement indicates that TAWC will also bill AWR for any costs not covered by the billing fee at 115% of cost (Article 3.3.2 of the Affiliated Agreement). The Agreement also indicates that TAWC will distribute, upon the request of AWR, informational and promotional materials regarding the AWR programs to its customers through inserts in its billing envelopes, which is the same service TAWC would provide to its contract sewer billing customers upon request.

* * *

Other than incremental cost to print additional information on the bill and collect the fees there is little, if any, additional costs incurred by TAWC.²⁶⁸

Mr. Miller acknowledged that the Company is not compensated for AWR's use of the signature of TAWC's President used on its marketing materials, and asserted that, under the *Service Agreement*, TAWC is entitled to compensation only when it incurs an additional cost,

²⁶⁵ *Id.*

²⁶⁶ *Id.*

²⁶⁷ Michael A. Miller, Revised Rebuttal Testimony Amendment, p. 95 (February 17, 2011); Transcript of Proceedings, Vol. VI A, p. 52 (March 7, 2011); *see also* TAWC's First Supplemental Responses to City of Chattanooga's First Discovery Request, TN-COC-01-Q39 and TAWC's First Supplemental Responses To The First Discovery Request And First Responses to the Supplemental Discovery Request Of The CAPD, TN-CAPD-01-Q77 and Q78 (December 2, 2010).

²⁶⁸ Michael A. Miller, Pre-Filed Rebuttal Testimony, p. 96 (February 8, 2011).

and no such cost is incurred.²⁶⁹ Mr. Watson contended that his endorsement and approval, as TAWC President, has little value or benefit to AWR in the marketing and sale of the protection plans to TAWC customers.²⁷⁰ Rather, he asserted that the real benefits accrue to the customers in the important service they receive when, through the AWR marketing materials, they become educated of their responsibilities for certain water service/sewer lines and aware of the significant costs involved in maintaining and repairing those lines.²⁷¹

TAWC asserted that it provides no services to AWR that are not covered by the contract billing fee and that such fees “more than adequately compensate” TAWC for the services it provides to AWR.²⁷² Nevertheless, Mr. Miller’s contentions with Ms. Dismukes’s recommendations were founded primarily on the claim that TAWC incurs no additional costs in providing services to AWR over or above what TAWC incurs for the regulated services TAWC is already providing to its customers:

When any customer calls with a concern about a leak, TAWC employees respond initially. If the leak is identified on the customer’s service line, they are so advised. . . . Because the Company’s personnel always respond to a customer’s service issue regarding a high bill or leak, TAWC does not incur any additional costs when it instructs the customer that the leak appears to be on the customer owned line and they need to call AWR if they have the service line protection with AWR.

* * *

TAWC has borne no cost for producing or sending that information to its customers.

* * *

The regulatory process is a cost-based process. While Ms. Dismukes perceives value for these attributes, there is no rate base value or expense recognition allowed by the TRA for them. Thus, TAWC recovers nothing from its regulated customers for these attributes or intangible assets. Therefore, there is no value for

²⁶⁹ *Id.* at 99 (February 18, 2011).

²⁷⁰ Transcript of Proceedings, Vol. III A, pp. 83-84 (March 2, 2011).

²⁷¹ Michael A. Miller, Revised Pre-Filed Rebuttal Testimony Amendment, pp. 97-98 (February 17, 2011); *see also* Transcript of Proceedings, Vol. III A, pp. 83-84 (March 2, 2011).

²⁷² Michael A. Miller, Revised Pre-Filed Rebuttal Testimony Amendment, p. 101 (February 17, 2011).

those intangible assets recovered from the rate payers, and they should not, and are not entitled to a lower rate from assets to which they do not contribute.²⁷³

Moreover, TAWC asserted that as there is no overt rate base value or expense recognition in the ratemaking process for intangible assets or attributes, ratepayers have not contributed to the development of such utility assets and, thus, are not entitled to any benefits that the Company may enjoy as a result of intangible assets.²⁷⁴ Mr. Miller concluded:

Therefore, because the customers bear no risk for the costs of AWR in the rates of TAWC they are not entitled to any portion of the revenue generated by the contracts between AWR and the customers who elect to accept AWR services.²⁷⁵

The Company also disputed the necessity of an investigation concerning the affiliate relationship between TAWC and AWR.²⁷⁶ Relying on the Schumaker Audit Report, the Company asserted that the management auditors had already examined the relationship between TAWC and AWR and determined that the billing methodology was reasonable.²⁷⁷ On February 19, 2011, in response to Question 150 in the TRA's Fourth Set of Data Requests, the Company filed income statements related to the AWR Service Line Protection services overall and specifically to their operations in the state of Tennessee as of December 31, 2010.²⁷⁸

²⁷³ *Id.* at 98-99.

²⁷⁴ *Id.*

²⁷⁵ *Id.* at 101. Mr. Miller made similar statements in response to TRA data request Question 168:

Q. For the same years, what was the net effect on TAWC's financial results from the agreement with AWR?

A. The revenue from AWR is recorded in account number 403001.AW21 (above the line) and is included in the going-level revenue of this case. Therefore, the revenue from AWR serves to lower the amount of revenue required from the Company's regular water service tariffs. The Company does not track the incremental cost of billing and collecting services for AWR (or for any other third party billing customer, i.e. City of Chattanooga). Because TAWC would have to read the meters, print the bills, mail the bills, and collect the bills even if the third party billing contracts did not exist, other than the small incremental costs of third party billing and collecting (which is automated), the cost is well below the 40.5¢ charged for the service.

See TAWC's Responses to the TRA's Fifth Set of Data Requests, Question 168, TN-TRA-05-Q168 (February 22, 2011).

²⁷⁶ *Id.* at 102; see also *TAWC's Post-Hearing Brief in Support of Its Petition to Change and Increase Certain Rates and Charges*, p. 25 (March 21, 2011).

²⁷⁷ *Id.*

²⁷⁸ TAWC's Responses to the TRA's Fourth Set of Data Requests, Question 150, with attached schedules TN-TRA-04-Q150-ATTACHMENT (February 18, 2011).

In fixing just and reasonable rates, the Authority adheres to its precedent and longstanding regulatory policy of looking beyond its regulated utility to consider the impact of the unregulated operations of its affiliate and parent companies.²⁷⁹ Review of the record demonstrates that, contrary to TAWC's position, by contracting to provide its name and goodwill to AWR, TAWC transferred valuable intangible assets to an affiliate.²⁸⁰ The regulatory consequences of such a transfer have been broadly recognized: "Where a utility derives benefit from the use of a non-rate-based asset paid for by the ratepayers, [the regulatory commission] may allocate part of the cost borne by the ratepayers to the shareholders."²⁸¹ Therefore, "[i]nsofar as the ratepayers have borne the costs for creating value in [the utility's] name and reputation, the ratepayers are entitled to a prudent use of those assets."²⁸²

In addition, notably under the heading "Notification of Claim," TAWC provided the services of its employees to AWR apart from billing and collection. This type of practice carries with it similar opportunities for improper subsidy:

Regulated utilities also subsidize their subsidiaries and affiliates when the expertise and experience of the utilities' employees are placed at the disposal of the subsidiaries for consultation and advice. Since ratepayers have paid for these human resources through training, salaries, bonuses and other incentive programs, the diversion of employee resources on subsidiary and affiliate matters imposes costs on the ratepayers.²⁸³

Accordingly, it has been held that

it is in the public interest to require [an unregulated affiliate] to compensate [a regulated utility] for the many intangible benefits its receives, including, but not limited to the following: the use of the [utility's] name; the use of the [utility's]

²⁷⁹ See, e.g., *TPSC v. Nashville Gas Company*, 551 S.W.2d 315 (Tenn. 1977) (holding that Commission is not bound to observe corporate charters, form of corporate structure, or stock ownership in regulating a public utility and in fixing fair and reasonable rates for its operations).

²⁸⁰ See *In re: Affiliated Activities, Promotional Practices and Codes of Conduct of Regulated Gas and Electric Companies*, Maryland Pub. Serv. Comm'n, Case No. 8820, *Order* (July 1, 2000); *US West Communications, Inc. v. Washington Utils. and Transp. Comm'n*, 949 P.2d 1337, 1351 (Wash. 1997) (citing cases).

²⁸¹ *Rochester Tel. Corp. v. Pub. Serv. Comm'n of New York*, 660 N.E.2d 1112, 1117 (N.Y. 1995), cited in *BellSouth Advertising and Publ'g Corp. v. Tennessee Regulatory Auth.*, 2001 WL 134603, *42 (Tenn. Ct. App. Feb. 16, 2001) (Cottrell, J., dissenting), *rev'd* 79 S.W.3d 506 (Tenn. 2002).

²⁸² *Rochester Tel.*, 660 N.E.2d at 1117.

²⁸³ *Id.*

logo; reliance on the [utility's] reputation; immediate access to financing; and the ability to capitalize, through contractual arrangements, on a trained, skilled workforce.²⁸⁴

In setting TAWC's rates, the TRA is empowered to assess the adequacy of compensation for these benefits and to take steps to ensure that TAWC's customers are not being made to subsidize a non-regulated company without proper compensation. As stated by the Supreme Court of Washington, "[t]he general rationale for [a regulatory] Commission's authority to review transactions between affiliated companies is fear of collusion in the absence of arm's-length dealings."²⁸⁵ The Court further stated:

It does not matter . . . whether the utility paid the affiliate too much money for too little service or property, or whether . . . the utility gave the affiliate something of far greater value than the affiliate paid for in return. The effect in either situation is to give to the shareholders of the affiliate something of value at the expense of the ratepayers of the utility.²⁸⁶

These statements are consistent with Tennessee law, which recognizes the TRA's ability to exert jurisdiction over non-regulated affiliates of regulated utilities when necessary for proper ratemaking. As the Tennessee Supreme Court stated over thirty years ago, "a regulatory body, such as the Public Service Commission, is not bound in all instances to observe corporate charters and the form of corporate structure or stock ownership in regulating a public utility, and in fixing fair and reasonable rates for its operations."²⁸⁷

TAWC's implementation of the *Service Agreement* with AWR does not adequately compensate TAWC's customers for the disposition of intangible assets or for employee effort and expertise. First, TAWC's statement that it incurs no costs in providing its name and goodwill to AWR lacks credibility. Second, and more importantly, TAWC's implementation of the service contract deprives its customers of proper compensation. Although TAWC provides

²⁸⁴ *United Tel. Long Distance, Inc. v. Nichols*, 546 So.2d 717, 719 (Fla. 1989).

²⁸⁵ *US West*, 949 P.2d at 1348.

²⁸⁶ *Id.*

²⁸⁷ *Tennessee Pub. Serv. Comm'n v. Nashville Gas Co.*, 551 S.W.2d 315, 319 (Tenn. 1977), *quoted in BellSouth Advertising and Publ'g Corp. v. Tennessee Regulatory Auth.*, 79 S.W.3d 506, 516 (Tenn. 2002) (recognizing the potential detriment to ratepayers in dealings with non-regulated affiliates).

billing and collection services for which it receives compensation from AWR, TAWC plainly provides other services as well. For example, TAWC has contracted to “manage and direct the distribution of informational and promotional materials regarding the [AWR] Program to [TAWC’s] customers.” The *Service Agreement* also provides that “[s]hould a Utility associate, as a part of his/her normal duties, determine that a Utility customer has a covered occurrence with the Customer’s water or sewer service line, the Utility associate shall notify AWR by calling a toll-free telephone number to be supplied by AWR.”

The fact that the *Service Agreement* separates AWR’s compensation to TAWC into two components, a fee of \$.405 per bill and a fee of 115% of fully distributed costs, acknowledges that TAWC is providing something of value to AWR other than billing and collection. The use of a fully distributed cost method of allocating costs between a regulated utility and its non-regulated affiliate has been deemed acceptable.²⁸⁸ However, TAWC’s position that it “incurs no additional costs” to provide these services is inconsistent with the provision that the fee paid by AWR for services other than billing and collection—services that are clearly part of the *Service Agreement*—will be based on TAWC’s fully distributed costs of providing the service. Put simply, TAWC is not distributing the costs between itself and AWR as the *Service Agreement* requires.

More than one option exists for the appropriate regulatory treatment of a utility’s disposition of a regulatory asset. One is the imputation of a royalty, an approach suggested by Ms. Dismukes and adopted in some instances.²⁸⁹ Another may be the use of a contract calling for payment of fully distributed costs, properly applied.²⁹⁰ TAWC’s position, namely, that it incurs no additional costs and therefore has no costs to report, leaves the TRA without sufficient

²⁸⁸ See, e.g., *In re: Affiliated Transactions*, 183 P.U.R.4th 277 (Md. P.S.C. February 23, 1998).

²⁸⁹ See, e.g., *In re: St. Lawrence Gas Co., Inc.*, 183 P.U.R.4th 457, New York Pub. Serv. Comm’n, Case No. 97-G-0409, Order (January 22, 1998).

²⁹⁰ This is the approach endorsed by the National Association of Regulatory Utility Commissioners (“NARUC”) for allocating indirect costs: “The general method for charging indirect costs should be on a fully allocated cost basis.” ROBERT L. HAHNE & GREGORY ALIFF, ACCOUNTING FOR PUBLIC UTILITIES, § 19.03[4][d] (2011).

information upon which to base a royalty. At the same time, this position denies TAWC's customers adequate compensation for the intangible assets.

Faced with the Company's broad dismissal of the AWR issue, the panel decided to impute to TAWC the net income generated from AWR's Tennessee water and sewer line protection programs.²⁹¹ This will insure that TAWC's regulated customers are adequately compensated for establishing the value of the asset TAWC transferred. While Ms. Dismukes's conception of this issue is basically sound, the TRA cannot accept her recommendation to impute \$1,071,281, as this figure is based upon the total revenue of AWR from all water systems, not just those related to TAWC. Moreover, during cross-examination, Ms. Dismukes admitted that imputing the earnings of AWR's Tennessee-specific operations to the regulated side would be appropriate.²⁹² Accordingly, the panel concluded that the \$306,611 net income generated from AWR's Tennessee water and sewer line protection programs shall be imputed to TAWC.

V(B) EXPENSES

V(B)1. SALARIES AND WAGES

The Company forecasted Salaries and Wages Expense of \$5,680,299.²⁹³ For current employees, wages for the twelve months ended March 31, 2010 were adjusted to account for the wage level to be paid during the attrition year.²⁹⁴ The Company calculated the attrition year wage levels by prorating known wage rate increases that will occur during the attrition period.²⁹⁵ For TAWC Union employees, whose current contract expires on October 31, 2011, the Company assumed a 3% increase effective November 1, 2011 consistent with the Union contract for the

²⁹¹ The use of imputation of income is broadly supported in regulatory decisions. See *US West*, 949 P.2d at 1351 and n. 9 (citing cases).

²⁹² Transcript of Proceedings, Vol. II C, p. 292 (March 1, 2011).

²⁹³ *Petition*, Exhibit No. 2, Schedule 3 (September 23, 2010).

²⁹⁴ *Id.* at 7.

²⁹⁵ *Id.*

last five years.²⁹⁶ For non-Union employees and current salaried employees, the Company calculated the rate based on a 3% wage increase to take effect on January 1, 2011.²⁹⁷

The Company sought to expand its employee level from the 109 employees accepted for ratemaking purposes in Docket No. 08-00039 to 110 employees.²⁹⁸ According to TAWC witness Mr. Watson, the employee level of 110 reflects the number needed and required to meet the expected service levels during the attrition year.²⁹⁹ Mr. Watson stated that each position had particular responsibilities that played an integral role within the Company; however, due to natural workforce turnover and a recently unplanned termination of ten employees, there were vacant positions.³⁰⁰ These factors brought TAWC's actual employee numbers down, but TAWC was working diligently to fill the remaining positions.³⁰¹ Mr. Watson testified that as of the week of the hearing in this rate case TAWC's employee count was 108.³⁰²

The Company used a capitalization rate³⁰³ of 15.83% to determine the amount of Salaries and Wages charged to operations and maintenance ("O&M") expense, based on the actual twelve-month average of capitalized labor as of March 2010 (the end of the test period used by TAWC).³⁰⁴ The Company included Annual Incentive Plan ("AIP") costs of \$146,640 in Salaries and Wages Expense. The Company stated that its AIP was changed in 2009 to make the entire individual employee AIP award applicable to each eligible employee's individual goals, which are not tied to the financial performance of TAWC or AWW.³⁰⁵ The Company also stated that its incentive compensation program is part of its overall compensation plan and was established

²⁹⁶ *Id.* at 8.

²⁹⁷ *Id.*

²⁹⁸ John S. Watson, Pre-Filed Direct Testimony, p. 21 (September 23, 2010).

²⁹⁹ John S. Watson, Pre-Filed Rebuttal Testimony, pp. 5-6 (February 8, 2011).

³⁰⁰ *Id.* at 6.

³⁰¹ *Id.* at 6-7.

³⁰² Transcript of Proceedings, Vol. III A, p. 76 (March 2, 2011).

³⁰³ The capitalization percentage represents the actual time charged to capital projects. The amount of capitalized salaries and wages removed from salaries and wages expense is accounted for (recovered) in rate base.

³⁰⁴ TAWC's Responses to the TRA's Data Requests Dated September 20, 2010, TRA-01-Q031-ATTACHMENT, p. 2 (September 24, 2010).

³⁰⁵ Michael A. Miller, Pre-Filed Rebuttal Testimony, p. 80 (February 8, 2011).

to motivate better employee performance. The overall compensation plan is claimed to be market-driven to result in benefits to TAWC's customers. Mr. Miller stated that a "performance based culture does benefit the customer, the employee (who meets high performance goals) and the shareholder."³⁰⁶

The CAPD forecasted Salaries and Wages Expense of \$4,915,111 for the attrition period.³⁰⁷ The CAPD argued that TAWC historically has not achieved or maintained the employment levels it forecasted.³⁰⁸ The CAPD, therefore, opted to use the actual employee level of 104.³⁰⁹ The CAPD priced out Salaries and Wages Expense using actual wage rates per employee, actual overtime hours as of September 2010, prospective payroll increases as of January 1 of each year pursuant to the Company's policy for salary and non-Union employees, and a 3% annual pay increase on November 1 each year for Union employees, pursuant to their contract.³¹⁰ Secondly, the CAPD eliminated 70% (\$102,646) of the AIP costs from Salaries and Wages Expense.³¹¹ The CAPD stated that 70% of the incentive payroll claimed by TAWC is based on financial performance measures and opined that any increase in regulated earnings will benefit solely the employees and the shareholders at the expense of the ratepayer.³¹² The CAPD stated that it does not object to a mechanism that provides a reward for TAWC's employees for increasing earnings from regulated operations; however, the cost should be charged to those who reap the benefits, namely, the shareholders, and not the ratepayers.³¹³ The CAPD further noted that this treatment of incentive payroll is in accordance with established TRA precedent and decisions in several other States (Louisiana, Kentucky, Idaho, Connecticut, Illinois and

³⁰⁶ *Id.* at 81.

³⁰⁷ Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).

³⁰⁸ *Id.* at 4.

³⁰⁹ *Id.* at 17.

³¹⁰ *Id.* at 13.

³¹¹ *Id.* at 18.

³¹² *Id.* at 19.

³¹³ *Id.*

Oklahoma) which have recently disallowed or limited plans of this type.³¹⁴ Additionally, the CAPD used a capitalization percentage³¹⁵ of 20.57%, which the CAPD based on the actual average capitalization rate TAWC experienced for the twelve months ended December 31, 2008.

The Union supported TAWC's request for approval to recover the "fully loaded and labor-related expenses" associated with 110 full-time employees but conditioned its support on a requirement that the Company maintain its full-time employee workforce at the 110-person level at all times.³¹⁶ The Union based its position on the assertion that (1) the Company testified that it is unable to conduct short and long-term activities in an efficient and cost-effective manner; (2) information provided by the Company showed that the current workforce is composed of a lower number of employees than previously accepted by the Authority; (3) TAWC has not maintained a union-represented workforce that is consistent with the level authorized by the authority; and (4) TAWC acknowledged that its current workforce is insufficient for the cost-effective conduct of either short-term or long-term activities, including valve maintenance.³¹⁷

The Union further testified that TAWC's failure to conduct a valve operation and maintenance program could be significant in times of emergency situations, since the valve maintenance program helps to ensure easy valve location and proper functioning. A failure of this kind could have ripple effects leading to additional customer service disruptions in a larger area, continued water leakage, and considerable damage.³¹⁸ Moreover, the Union focused extensively on presenting evidence concerning the condition of valves and valve maintenance by TAWC and related these issues to employee levels at TAWC.

³¹⁴ *Id.*

³¹⁵ This represents the percentage of employee time spent working on capital projects.

³¹⁶ James Lewis, Pre-Filed Direct Testimony, pp. 2-4 (January 5, 2011).

³¹⁷ *Id.* at 3.

³¹⁸ *Id.* at 15-16.

As this discussion makes evident, the valve and valve maintenance issues brought by the Union became a central focus in this rate case in determining the proper employee levels at TAWC. Initially, these issues were raised by the Union through the Pre-filed Testimony of James Lewis, which was filed on January 5, 2011. Mr. Lewis, who is National Senior Representative for UWUA, Region II, is responsible for handling grievances, arbitrations, and contract negotiations in Florida, Maryland, Pennsylvania, Tennessee, Virginia and West Virginia, including in relation to the unionized portion of the workforce at TAWC.³¹⁹

Attached to Mr. Lewis's pre-filed testimony was a written statement by Mr. Haddock concerning employee levels, valves and valve maintenance at TAWC. As stated previously, this statement was signed by Mr. Haddock but not notarized, yet the Union referred to it as an "affidavit." Thereafter, the Union filed a *Motion to Substitute Affiant* on February 7, 2011 to have a former employee, Mr. Blevins, adopt Mr. Haddock's statements. Mr. Blevins was Field Operations Supervisor for TAWC from 1992 until November 2010. The Hearing Officer denied the Union's motion by Order issued on February 25, 2011, but the Union raised its objection again on February 28, 2011,³²⁰ the first day of the Hearing in Chattanooga, through a *Petition for Appeal of the Hearing Officer's Initial Order*.

The panel voted to uphold the Hearing Officer's Order denying the Union's motion to substitute Mr. Blevins for Mr. Haddock, but the panel allowed the UWUA to call Mr. Haddock as a witness to attest to his own statement regarding TAWC valves. However, the panel also stated that if Mr. Haddock was going to be unavailable, testimony on valves should be heard from Mr. Blevins, having been informed that he would be available during the hearing.³²¹ Mr. Haddock was subsequently discovered to be unavailable because he was in Washington State and could not return to Chattanooga in time for the hearing. Since TAWC witness Mr. Watson

³¹⁹ *Id.* at 1-2.

³²⁰ Transcript of Proceedings, Vol. I A, p. 49 (February 28, 2011).

³²¹ Transcript of Proceedings, Vol. II A, p. 6 (March 1, 2011).

had provided pre-filed rebuttal testimony on the valve issue, the panel determined that TAWC would not be unduly prejudiced³²² by the calling of Mr. Blevins, whom TAWC would have an opportunity to cross-examine. The panel upheld the Hearing Officer's ruling striking the portion of Mr. Lewis's statement that referred to Mr. Haddock's statement and excluding the signed statement of Mr. Haddock attached to Mr. Lewis's testimony (UWUA Exhibit 11).³²³

During the public comment period, Mr. Blevins offered comments specifically about a water main break that had occurred in Chattanooga the previous week and the problems TAWC has experienced with its valves.³²⁴ Mr. Blevins discussed TAWC's valve inspection program, staffing, and his knowledge concerning its valve problems.³²⁵ Additionally, as a result of the panel's determination that the valves and valve inspection program was important in this proceeding and testimony concerning this issue needed to be in the record, Mr. Blevins was permitted to testify on the record based on his own personal knowledge of TAWC's valve program. TAWC was also permitted to cross-examine Mr. Blevins.³²⁶

Also testifying for the Union, Mr. Lewis contended that TAWC's workforce level is not sufficient to continue to ensure safe, reliable, and high quality water services to customers³²⁷ and that even if the TRA approves the employee level TAWC was requesting, TAWC may not fully staff its operations in the future.³²⁸ Mr. Lewis suggested requiring TAWC to submit quarterly reports to the TRA showing both its authorized and its actual employment levels. Further, if TAWC should fail to maintain a workforce level consistent with the authorized number of employees, TAWC should be penalized.³²⁹ This would serve to ensure that TAWC actually

³²² *Id.* at 7.

³²³ Transcript of Proceedings, Vol. IV D, pp. 246-247 (March 3, 2011).

³²⁴ *Id.* at 281.

³²⁵ Transcript of Proceedings, Vol. I C, pp. 329-330 (February 28, 2011).

³²⁶ *Id.* at 331-332.

³²⁷ James Lewis, Pre-Filed Direct Testimony, p. 6 (January 5, 2011).

³²⁸ *Id.* at 4.

³²⁹ *Id.*

employs the number of employees that it has requested and, indeed, that it needs.³³⁰

Testifying for TAWC, Mr. Watson explained that workforce turnover had played a significant role in determining employee levels, and TAWC has been unable to avoid having unfilled positions.³³¹ Also, turnover at TAWC has been due to retirement, resignations, severance, terminations for cause, deaths, or other events beyond the Company's control, such as medical leave, military duty or personal relocations.³³² Mr. Watson stated that TAWC anticipated having employee levels of 110 full-time equivalents ("FTEs") for 2010-2011 on or about February 28, 2011.³³³ TAWC had hired five additional employees, and three additional candidates had accepted offers of employment and were to be hired the week of February 21, 2011.³³⁴

In his rebuttal testimony, Mr. Watson stated that TAWC has had an ongoing valve inspection program in Tennessee for the past twelve years.³³⁵ In addition, TAWC had invested in a new vehicle that was designed and equipped to provide a comprehensive approach to valve exercising and inspection, and employees have been trained on its use and operation,³³⁶ TAWC keeps an extensive paper records system that contains distribution system valve information, valve maps, valve numbers, construction records, and valve inspection records, similar to a fire hydrant database.³³⁷

TAWC indicated that it would be willing to provide the number of employees on a quarterly report to the Authority.³³⁸ The Consumer Advocate supported this idea.³³⁹ Mr. Watson also stated that TAWC performs preventive valve maintenance, having set specific goals for

³³⁰ *Id.*

³³¹ John S. Watson, Pre-Filed Rebuttal Testimony, p. 8 (February 8, 2011).

³³² *Id.*

³³³ *Id.*

³³⁴ *Id.*

³³⁵ John S. Watson, Pre-Filed Rebuttal Testimony, p. 26 (February 8, 2011).

³³⁶ *Id.*

³³⁷ Transcript of Proceedings, Vol. IV D, pp. 301-302 (March 3, 2011).

³³⁸ Transcript of Proceedings, Vol. III A, pp. 34-35 (March 2, 2011).

³³⁹ *Consumer Advocate and Protection Division's Post-Hearing Brief*, p. 22 (March 21, 2011).

2009 and 2010,³⁴⁰ and had met its valve inspection/operation goals in 2010 except for smaller valves. According to Mr. Watson, TAWC was close to meeting its goal fully but was prevented by an employee's retirement.³⁴¹ Mr. Watson testified that additional employees had been hired, and once employee levels were at 110 FTEs, TAWC would be able to meet its valve maintenance goals by the end of 2011.³⁴²

The Company argued that it had been able to maintain its valves effectively, but it could not continue to perform proper valve operation and maintenance in the longer term without the additional staff requested in its *Petition*.³⁴³ Until this point, TAWC had been able to sustain its valve maintenance program because of the weak economy and a decrease in housing starts in its service area and by shifting employees in other areas to valve maintenance functions.

During cross-examination, Mr. Watson agreed that TAWC's valve exercising, maintenance and inspection program is part of its obligation to operate its system in accordance with good utility practice and an appropriate program for a water utility.³⁴⁴ Mr. Watson stated that he was not aware of any federal or state mandates for valves or valve maintenance.³⁴⁵

Mr. Blevins testified that some valves in TAWC's system had been in disrepair for a number of years.³⁴⁶ He also stated that TAWC did not have enough employees handling valve maintenance, and often he had trouble finding valves that were sufficiently operational to allow TAWC to carry out a repair.³⁴⁷ He stated that on occasion he had to conduct repairs without reducing water pressure because he was unable to turn off an inoperable valve.³⁴⁸ He also testified that TAWC was aware that valves were inoperable and that valve issues had been

³⁴⁰ John S. Watson, Pre-Filed Rebuttal Testimony, pp. 26-27 (February 8, 2011).

³⁴¹ *Id.* at 27.

³⁴² *Id.* at 28.

³⁴³ *Id.* at 27.

³⁴⁴ Transcript of Proceedings, Vol. IV D, p. 319 (March 3, 2011).

³⁴⁵ *Id.* at 319.

³⁴⁶ *Id.* at 290-291.

³⁴⁷ *Id.* at 291.

³⁴⁸ *Id.* at 295.

discussed during TAWC departmental meetings and group discussions.³⁴⁹

In its post-hearing brief, TAWC claimed that the Intervenor was attempting to shift the focus to a variety of irrelevant topics during this rate case, such as TAWC's policies and procedures for inspecting and maintaining the valves.³⁵⁰ TAWC asserted that Mr. Watson's testimony had disproved the Intervenor's allegations of deficiencies in the valve maintenance program.³⁵¹

The Union replied in its post-hearing brief that the Company's alleged staffing and maintenance deficiencies compromise the quality of service it provides to its customers.³⁵² The Union stated that its main concern was the potential inclusion in rates of expenses associated with all eighty-two hourly employees being included in the Company's 110 FTE level.³⁵³

The Consumer Advocate recommended that TAWC be allowed only 104 employees, based on the average number of employees during the test period ended September 2010, because TAWC had a track record of not maintaining authorized employee levels.³⁵⁴ The Consumer Advocate later modified its position to state that the maximum number of employees should be 107, and the TRA should require a monthly report of employees by name and position.³⁵⁵

Tenn. Code Ann. § 65-4-103 provides, in pertinent part, that the TRA has an obligation in setting rates "to take into account the safety, adequacy and efficiency or lack thereof of the service or services furnished by the public utility." Tenn. Code Ann. § 65-4-115 further provides that no public utility shall "provide or maintain any service that is unsafe, improper, inadequate or withhold or refuse any service which can reasonably be demanded and furnished when

³⁴⁹ *Id.* at 296.

³⁵⁰ *Tennessee American Water Company's Post-Hearing Brief in Support of Its Petition to Change and Increase Certain Rates and Charges*, p. 118 (March 21, 2011).

³⁵¹ *Id.* at 171.

³⁵² *Id.*

³⁵³ *Id.*

³⁵⁴ *Consumer Advocate and Protection Division's Post-Hearing Brief*, p. 21 (March 21, 2011).

³⁵⁵ *Id.*

ordered by the Authority.” TRA Rule 1220-4-3-.42(2) requires that a utility “shall make all reasonable efforts to prevent interruptions of service and when such interruptions occur shall endeavor to re-establish service with the shortest possible delay consistent with the safety to its customers and the general public.” Both the noted uncertainties surrounding employee levels and the related issue of adequate valve maintenance implicate these regulatory requirements, and the TRA must necessarily consider these issues in setting TAWC’s rates for water service.

Based on the record and foregoing considerations, a majority of the panel sets \$5,279,477 for Salaries and Wages Expense during the attrition period.³⁵⁶ As further discussed below, the Salaries and Wages Expense amount that is calculated by the majority utilizes a price out that consists of 110 employees, reflects a deduction of 20% of the current salary of the newly created Government Affairs Specialist position, a 50% reduction (\$67,619) to AIP incentive payroll, the elimination in full of allocations to the Long Term Incentive Plan (“LTIP”) (\$11,403), and a 20.57% capitalization rate.

The Authority agrees that the calculation of Salaries and Wages Expense appropriately begins with 110 employees, but deducts the portion of the current salary of the Government Affairs Specialist that correlates to time spent performing the job function of political lobbying or legislative/governmental actions advocacy.³⁵⁷ The Company’s witness, Mr. Watson, TAWC President, testified that the Government Affairs Specialist position was a newly created position, which replaced a previously contracted service position, filled by the Company on August 30,

³⁵⁶ Director Roberson did not vote with the majority and files a separate opinion explaining his position. Additionally, Director Roberson voted to exclude from the calculation the position of Finance Manager because that employee’s functions duplicate a portion of the function for finance services that are provided to TAWC by AWWSC. This would reduce TAWC’s revenue requirement by \$120,333. Transcript of Proceedings, p. 71 (April 4, 2011).

³⁵⁷ Agreeing with the CAPD’s position, Director Roberson moved to amend the pre-filed motion filed by Chairman Freeman to reflect a maximum allocation of 107 employees. Director Roberson derived this employee allocation based on the actual number of current TAWC employees (108) testified by Mr. Watson, President of TAWC, excluding the Government Affairs Specialist position and full salary paid to Mr. Kino Becton, TAWC’s newly hired Government Affairs Specialist, who is a registered lobbyist in the State of Tennessee. The results of Director Roberson’s amendment, had it succeeded, would have been to reduce the Salary & Wages Expense by an additional \$163,944. *See*, Transcript of Proceedings, pp. 68-69 (April 4, 2011).

2010.³⁵⁸ The duties of the Government Affairs Specialist include working closely with municipal officials, customers, and constituents on local issues, building relationships with state officials concerning activities, plans, and projects of interest to the Company, improving the Company's management of local and state issues, and monitoring changes in municipal, county, state and federal laws and regulations.³⁵⁹ Mr. Watson estimated that 20% of the Government Affairs Specialist's time would be spent lobbying on behalf of TAWC and its customers.³⁶⁰

It is a well-established and long-standing policy of the TRA to disallow expenses related to lobbying when setting utility rates.³⁶¹ Consistent with its own policy and precedent, and that of most other state regulatory commissions throughout this country, the majority finds that expenses related to lobbying are expended for the benefit of the Company first and foremost, and are not necessary for the provision of safe and adequate service. Therefore, the majority concludes that insofar as 20% of the Governmental Affairs Specialist's time will be spent lobbying, it is reasonable for ratemaking purposes to deduct a proportional percentage of the current salary allocated to that position (20%).³⁶²

In addition, the Company testified that in 2009 and 2010, it scaled back some of its planned capital investment projects due to financial constraints following its last rate case order.³⁶³ In light of the reduced completion of capital investment projects, the calculations for plant additions appear unusually low in the test periods used by both the Company and the CAPD and the Company's capitalization rate does not accurately reflect typical activity in this

³⁵⁸ John S. Watson, Pre-Filed Direct Testimony, p. 23 (September 23, 2010).

³⁵⁹ *Id.* at 23-24.

³⁶⁰ TAWC's First Supplemental Responses To The First Discovery Request And First Responses To The Supplemental Discovery Request Of The CAD Questions 53-126, TN-CAPD-SUPPLEMENTAL-Q086 (December 2, 2010).

³⁶¹ Reaffirming its policy and practice of disallowing lobbying expenses in ratemaking, the Tennessee Public Service Commission, which was the predecessor agency of the TRA, stated, "We still believe that the first obligation of the company's lobbyist is to act in a manner that is beneficial to the company, which may or may not be beneficial to the company's customers. We will continue our position that this is an improper expense for rate-making purposes." *In re S. Cent. Bell Tel. Co.*, 22 P.U.R.4th 281, 297 (Dec. 30, 1977); *see also*, 48 P.U.R.4th 493, 496 (Sept. 20, 1982).

³⁶² TAWC's Responses to the TRA's Data Requests Dated September 20, 2010, TN-TRA-01-Q013, Workpaper Labor 12 months ended 2010 (September 24, 2010).

³⁶³ John S. Watson, Pre-Filed Direct Testimony, pp. 13-14 (September 23, 2010).

category. Therefore, the panel elects to use the CAPD's capitalization percentage of 20.57%. This percentage is the actual capitalization rate for the twelve months ended December 31, 2008, a period that better reflects normal plant additions.

The Company confirmed that its reported AIP amount of \$146,640 includes an LTIP of \$11,403 of Equity Compensation, leaving a balance of \$135,237 as the intended AIP amount. The TRA disagreed with the Company's position that the total of AIP and LTIP costs (\$146,640) should be included in Salaries & Wages Expense. However, the CAPD's proposal to remove 70% of these costs based on financial targets is also unsatisfactory because this is the overall amount of AIP available for payment in a given year, and once determined, employee performance is no longer tied to the overall financial goals of AWW.³⁶⁴

The TRA determined that one half of AIP (\$67,619) should be included in Salaries and Wages, since both TAWC and its customers benefit from AIP through higher financial returns for the Company. Regarding the LTIP plan, this program provides executive or director compensation based on the financial performance of AWWC's stock price. No just and reasonable basis exists for charging ratepayers this type of compensation, which rewards TAWC solely on the basis of financial performance. For ratemaking purposes, therefore, LTIP should be eliminated.

Further, the panel required TAWC to submit semi-annual reports of its staffing levels to the TRA's Utility Division Chief. Specifically, each such report should include (1) the actual number of full-time equivalent employees for the previous period, by month; (2) an explanation of any differences between authorized and actual FTEs; and (3) the date(s) TAWC expects to fill any vacant positions. The panel also required the Company to submit a semi-annual report to the Utility Division Chief regarding its Valve Operation and Maintenance Program. Each semi-annual report should also include (1) the number of employees assigned to the valve program, by

³⁶⁴ Michael A. Miller, Pre-Filed Rebuttal Testimony, pp. 80-81 (February 8, 2011).

month; (2) the target number of larger and smaller valves scheduled during the preceding period for inspection/operation and maintenance, by month; (3) the number of valves actually inspected/operated and maintained during the report period, by month; (4) the number of valves found to be in need of repair or replacement, by month; (5) the date for repair or replacement of such valves; and (6) if TAWC decided not to repair or replace those valves, the number of valves that were not repaired or replaced and the reason for not doing so.

V(B)2. PURCHASED WATER

The Company forecasted Purchased Water Expense of \$50,962. This amount represents the Company's 2011 purchased water budget.³⁶⁵ The CAPD originally forecasted \$47,708 for the attrition period.³⁶⁶ This amount is based upon the Company's Income Statements for the twelve months ended September 30, 2010³⁶⁷ and increased by the CAPD's growth/inflation factor of 1.51%,³⁶⁸ which was later corrected to 1.40% growth factor.³⁶⁹ The effect of this adjustment was to decrease Purchased Water Expense from \$47,708 to \$47,657.³⁷⁰ On March 1, 2011, the CAPD filed amended testimony changing the residential customer growth factor from 0.89% to 1.05% (utilized to project revenues)³⁷¹ and this caused the CAPD's growth/inflation factor to change from 1.40% to 1.48%.³⁷² The effect of this adjustment was to increase Purchased Water Expense from \$47,657 to \$47,692.³⁷³

³⁶⁵ TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, TN-TRA-02-Q092D-Purchase Water Summary, p. 1 of 28 (December 1, 2010).

³⁶⁶ Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).

³⁶⁷ Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-PW (January 5, 2011).

³⁶⁸ Terry Buckner, Pre-Filed Direct Testimony, p. 12 (January 5, 2011).

³⁶⁹ Terry Buckner, Non-Confidential Direct Testimony Amendment, Workpaper AMENDED E-PW (January 31, 2011).

³⁷⁰ *Id.*

³⁷¹ John Hughes, Amendment to Amended Testimony filed February 25, 2011, Workpaper R-CUSTOMER GROWTH (March 1, 2011).

³⁷² Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-PW (Hearing Exhibit 90) (March 8, 2011).

³⁷³ Terry Buckner, Second Amendment to Direct Testimony, Amended Exhibit 1, Schedule 5, p. 5 of 9 (Hearing Exhibit 90) (March 8, 2011).

The Authority adopts \$47,692 as the Purchased Water Expense projection for the attrition period. The panel reasons that the Company provided its budgeted amount but did not supply supporting documentation for its number, and the CAPD's projection is based upon known and measurable changes and accounts for inflation.

V(B)3. FUEL AND POWER

Fuel and Power Expense is the amount of fuel and power (electricity) necessary to pump TAWC's water to its customers. In order to calculate Fuel and Power Expense, the amount of water to be pumped, adjusted for an allowable water loss percentage, has to be determined. The Company projected total Fuel and Power Expense of \$2,511,238 for the attrition period.³⁷⁴ The calculation was based upon the expected volume of water pumped into the system during the attrition year, and the cost to pump and treat the water.³⁷⁵ The Company estimated attrition year water sales of 9,878,253,000 gallons (13,171,004 CCF)³⁷⁶ adjusted by a three year average of lost or unaccounted-for water of 22.70% to arrive at system delivery.³⁷⁷ The Company used Chattanooga Electric Power Board ("EPB") tariff rates effective on October 1, 2009 adjusted for expected increases for the attrition year as indicated by the EPB. The Company stated that it had contacted an EPB representative during the summer of 2010 to determine rates going forward and was advised to expect 6% increases on both October 1, 2010 and October 1, 2011, along with Fuel Cost Adjustments that would continue monthly in 2010 and could level off or slightly decrease.³⁷⁸ Later, the Company adjusted its projected attrition year Fuel and Power Expense

³⁷⁴ Sheila A. Miller, Pre-Filed Direct Testimony, p. 10 (September 23, 2010).

³⁷⁵ *Id.* at 9.

³⁷⁶ $13,171,004 \text{ CCF} \times 7.5 = 9,878,253,000 \text{ gallons}$

³⁷⁷ TAWC's Responses to the TRA's Data Requests Dated September 20, 2010, TN-TRA-01-Q013-Fuel and Power, p. 3 (September 24, 2010).

³⁷⁸ John S. Watson, Pre-Filed Direct Testimony, pp. 26-27 (September 23, 2010).

from \$2,511,238 to \$2,575,657. The Company increased Fuel and Power Expense by \$64,419, as a result of using the updated EPB November 2010 Fuel Cost Adjustment.³⁷⁹

The Consumer Advocate projected total attrition period Fuel and Power Expense of \$2,410,868.³⁸⁰ The CAPD calculated this cost based on water sales volumes of 13,582,557 CCF³⁸¹ for the attrition year. The CAPD incorporated the Fuel Cost Adjustment as of November 1, 2010 and capped the amount of lost or unaccounted-for water loss at 15%, as established by Authority Order in Docket No. 08-00039. The CAPD stated that the cap utilized for lost or unaccounted-for water was the primary difference between the Company and CAPD forecasts of Fuel and Power Expense.³⁸² On March 1, 2011, the CAPD filed amended expert witness testimony changing its calculation of water sales for the attrition period, utilized in projecting revenues, from 13,582,557 CCF to 13,508,335 CCF.³⁸³ This adjustment decreased the CAPD's calculation of Fuel and Power Expense from \$2,410,868 to \$2,397,694.³⁸⁴

Water that is lost or unaccounted for in the system is water that is still pumped and treated, and TAWC still incurs an expense for the fuel and power needed to pump it. Recovery of the cost of the fuel and power incurred to pump lost or unaccounted-for water is allowed through the setting of a percentage that is then applied to determine Fuel and Power Expense.

The CRMA proposed 15% as an acceptable lost and unaccounted-for water ("UFW") percentage for use in the calculation of both Chemicals Expense and Fuel and Power Expense.³⁸⁵ The CRMA chose 15% for the following reasons:

³⁷⁹ TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, Question 113, TN-TRA-02-Q113 (December 1, 2010).

³⁸⁰ Terry Buckner, Pre-Filed Direct Testimony, p. 20 (January 5, 2011).

³⁸¹ Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-FP (January 5, 2011).

³⁸² Terry Buckner, Pre-Filed Direct Testimony, p. 20 (January 5, 2011).

³⁸³ Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-FP (Hearing Exhibit 90) (March 8, 2011).

³⁸⁴ Terry Buckner, Second Amendment to Direct Testimony, Amended Exhibit 1, Schedule 5, p. 5 of 9 (Hearing Exhibit 90) (March 8, 2011).

³⁸⁵ Michael Gorman, Pre-Filed Direct Testimony, p. 4 (January 5, 2011).

1. The American Water Works Association "Survey of State Agency Water Loss Reporting Practices" indicates that a reasonable lost water factor is 15% or less;
2. The water loss factor is consistent with the Authority's ruling in Docket No. 08-00039; and
3. The cost of replacing transmission lines is included in this filing, which the CRMA believes will bring the lost water factor down to a more reasonable level.³⁸⁶

In contrast, the Company recorded an unaccounted-for water percentage of 22.93% for the twelve-month period ended March 31, 2010.

The Company's water loss increased from the 20.43% level requested in its last rate case (the twelve months ended March 2008) to the 22.70% requested in this rate case. In its testimony, the Company stated it delayed part of its scheduled investment due to its poor earnings. However, the Company included additional plant investment in this rate case. With the additional investment in plant, it is reasonable to expect a decrease in water loss from current levels. The Authority determined that the baseline water loss percentage of 15% for TAWC, the same percentage established in the 2008 rate case,³⁸⁷ remains viable, and TAWC should continue to strive to meet this goal. Also, the Authority agreed with the evidence put forth by the CRMA, and supported by the CAPD, that a 15% water loss was reasonable. Accordingly, the Authority determined the Fuel and Power Expense for the attrition period to be \$2,277,057. This calculation was based on the Company's normalized usage during the test period of 13,132,968 CCF,³⁸⁸ the rates in effect from the Chattanooga EPB plus the March 2011 Fuel Cost Adjustment, and a 15% water loss percentage.

The Authority uses the EPB's rates, as of October 2009, for the demand cost, energy cost, and the customer charge in the fuel and power calculation for the attrition year and did not include the Company's anticipated 6% increase in EPB rates that were forecasted, but unproven,

³⁸⁶ *Id.* at 4-5.

³⁸⁷ On appeal of this issue by TAWC, the Tennessee Court of Appeals affirmed the TRA's decision setting a 15% cap on UFW. *Tennessee Amer. Water Co. v. TRA*, 2011 WL 334678, * 27-28 (Jan. 28, 2011).

³⁸⁸ *Petition*, Exhibit No. 4, Schedule 2 (September 23, 2010).

for implementation on October 1, 2010. Rather, EPB's actual rate on October 1, 2010 was verified, and the TRA included that \$0.0063 current Fuel Cost Adjustment as of March 2011.

V(B)4. CHEMICALS

Chemical Expense is the cost of chemicals purchased by TAWC necessary to treat the water prior to consumption. The Company initially projected Chemical Expense for the attrition period of \$1,069,369. The Company used the attrition year water sales of 13,171,004 CCF,³⁸⁹ adjusted by a three-year average percentage of lost or unaccounted-for water of 22.70% to arrive at a system delivery amount. The Company used the estimated 2011 contract chemical prices to calculate its Chemical Expense.³⁹⁰ Later, the Company decreased projected attrition year Chemical Expense by \$97,447, as a result of obtaining lower actual 2011 contract prices for chlorine and sodium hydroxide (caustic soda) than originally anticipated.³⁹¹ The effect of the adjustment was to decrease Chemical Expense from \$1,069,369 to \$971,922.³⁹²

The CAPD forecasted Chemical Expense for the attrition period of \$930,961.³⁹³ The CAPD calculated this cost based on water sales volumes of 13,582,557 CCF³⁹⁴ and known contract prices for 2011.³⁹⁵ The CAPD capped the amount of lost and unaccounted-for water loss at 15% and stated that its treatment of this expense was consistent with the Authority's Order in Docket No. 08-00039.³⁹⁶ In amended testimony filed on March 8, 2011, the CAPD changed the water sales calculation for the attrition period that it used in projecting revenues from 13,582,557 CCF to 13,508,335 CCF³⁹⁷ and decreased its Chemical Expense forecast from

³⁸⁹ 13,171,004 CCF * 7.5 = 9,878,253,000 gallons.

³⁹⁰ Sheila A. Miller, Pre-Filed Direct Testimony, p. 10 (September 23, 2010).

³⁹¹ TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, TN-TRA-02-Q117-Attachment 3, p. 3 (December 1, 2010).

³⁹² *Id.*

³⁹³ Terry Buckner, Pre-Filed Direct Testimony, p. 21 (January 5, 2011).

³⁹⁴ Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-CHEM 2 (January 5, 2011).

³⁹⁵ Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-CHEM 1 (January 5, 2011).

³⁹⁶ Terry Buckner, Pre-Filed Direct Testimony, p. 20 (January 5, 2011).

³⁹⁷ Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-CHEM2 (Hearing Exhibit 90) (March 8, 2011).

\$930,961 to \$925,894.³⁹⁸ The CAPD priced out chemicals using known prices for 2011. The CRMA proposed that a 15% lost and unaccounted-for water percentage was reasonable to use in the calculation of both Chemicals Expense and Fuel and Power Expense for the reasons previously discussed.³⁹⁹

The panel determines the Chemicals Expense for the attrition period to be \$881,439. Because known and measurable changes are appropriately considered, it was necessary to include the new contract chemical prices in the calculation of the Chemicals Expense. The panel agreed with the CRMA and the CAPD that the Authority should maintain its precedent and set a lost and unaccounted-for water percentage no higher than 15%. Using 13,132,968 CCF as the Company's usage,⁴⁰⁰ adjusting for actual contract chemical prices, and applying a 15% capped lost water percentage, the panel finds that Chemicals Expense totals \$881,439 for the attrition period.

V(B)5. WASTE DISPOSAL

The Company forecasted an attrition period Waste Disposal Expense of \$197,386.⁴⁰¹ This amount is based upon the actual amount paid during the test period ended March 31, 2010. This amount (\$183,965) was adjusted to reflect a 3% rate increase from the City of Chattanooga Sanitary Board effective January 1, 2010, a 2.75% increase effective October 1, 2010, and a 2.75% increase to be effective April 1, 2011, resulting in an adjustment of \$13,421 for the attrition period.⁴⁰²

The CAPD projected an attrition period Waste Disposal Expense of \$172,338.⁴⁰³ The CAPD used actual book values of \$169,774 as of September 30, 2010, which was reported in

³⁹⁸ Terry Buckner, Second Amendment to Direct Testimony, Amended Exhibit 1, Schedule 5, p. 5 of 9 (Hearing Exhibit 90) (March 8, 2011).

³⁹⁹ Michael Gorman, Pre-Filed Direct Testimony, pp. 4-7 (January 5, 2011); *see also*, 8 V(B)3, Fuel and Power.

⁴⁰⁰ *Petition*, TAWC Test Period Normalized Billing Determinants, Exhibit No. 4, Schedule 2 (September 23, 2010).

⁴⁰¹ *Petition*, Exhibit No. 2, Schedule 3 (September 23, 2010).

⁴⁰² Sheila A. Miller, Pre-Filed Direct Testimony, p. 11 (September 23, 2010).

⁴⁰³ Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).

TAWC's Income Statements, as the test period Waste Disposal Expense.⁴⁰⁴ The CAPD increased the test period book value amount by one half of its calculated customer growth factor of .89% plus an inflation factor of .76%.⁴⁰⁵ The CAPD later amended its growth factor to 1.4%,⁴⁰⁶ and this decreased the CAPD's projected Waste Disposal Expense from \$172,338 to \$172,151.⁴⁰⁷ Thereafter, the CAPD's amended testimony filed on March 1, 2011 changed the residential customer growth factor to be utilized in projecting revenues from 0.89% to 1.05%⁴⁰⁸ and this caused the CAPD's growth/inflation factor to change from 1.40% to 1.48%.⁴⁰⁹ The effect of this adjustment increased the CAPD's Waste Disposal Expense projection from \$172,151 to \$172,279.⁴¹⁰

Considering the evidence in the record and adjusting for known and measurable changes in forecasting for the attrition period, the panel finds \$194,993 appropriate for Waste Disposal Expense.

V(B)6. MANAGEMENT FEES

The category of management fees consists of the charges incurred by TAWC for services provided to it by AWWSC in accordance with their 1989 Service Company Agreement. AWWSC is an affiliated service company established by AWWC to aid, assist, and advise the business operations of AWWC subsidiaries, which includes TAWC, by providing accounting, administration, communications, corporate secretarial, engineering, finance, human resources,

⁴⁰⁴ Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-WASTE (January 5, 2011).

⁴⁰⁵ Terry Buckner, Pre-Filed Direct Testimony, p. 12 (January 5, 2011).

⁴⁰⁶ Terry Buckner, Non-Confidential Direct Testimony Amendment, Workpaper AMENDED E-WASTE (January 31, 2011).

⁴⁰⁷ *Id.*

⁴⁰⁸ John Hughes, Amendment to Amended Testimony filed February 25, 2011, Workpaper R-CUSTOMER GROWTH (March 1, 2011).

⁴⁰⁹ Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-WASTE (Hearing Exhibit 90) (March 8, 2011).

⁴¹⁰ *Id.*

information systems, operations, rates and revenue, risk management, and water quality services.⁴¹¹ These services are billed to ratepayers at-cost to TAWC.⁴¹²

Relevant Background

On May 15, 2007, as part of its deliberations in TAWC's 2006 rate case, the Authority allocated recovery of management fees in the amount of \$3,979,825, which was an amount that was slightly lower than the \$4,064,421 that TAWC had requested in its petition.⁴¹³ Further, the Authority ordered TAWC to obtain a management audit that conformed to the mandates of the Sarbanes-Oxley ("SOX") regulation.⁴¹⁴ The stated purposes of the audit were two-fold: to obtain an independent assessment as to 1) whether the significantly increasing costs incurred by TAWC for management fees reflected prudent decisions on the part of management, and 2) whether the allocation methodology used to charge the costs of the services to TAWC was reasonable.⁴¹⁵

On March 14, 2008, along with a petition for a rate increase, TAWC filed with the Authority an audit report prepared by Booz Allen Hamilton ("BAH").⁴¹⁶ During the proceeding that followed, the City challenged the independence of the BAH auditor and report, and contended that the audit had not been conducted as the TRA had required, nor in compliance with SOX. After a thorough review and hearing, the Authority held that the BAH report had failed to adequately address the issue of whether the management fees at issue resulted from

⁴¹¹ See *In re: Tennessee American Water Company's Request for Proposal for a Management Audit*, Docket No. 09-00086, *Notice of Filing of Schumaker & Company's Affiliate Audit Report of Tennessee American Water Company for the Tennessee Regulatory Authority*, Schumaker & Company, Affiliate Audit Report ("Schumaker Audit Report"), p. 13 (September 10, 2010).

⁴¹² *Id.*

⁴¹³ See *In re: Petition of Tennessee American Water Company to Charge and Increase Certain Rates and Charges so as to Permit It to Earn a Fair and Adequate Rate of Return on Its Property Used and Useful in Furnishing Water Service to Its Customers*, Docket No. 06-00290, *Order*, p. 26 (June 10, 2008).

⁴¹⁴ *Id.*; See also 15 U.S.C 98 (2002) (Named after Senator Paul Sarbanes and Representative Michael Oxley, who were its main architects, the Sarbanes-Oxley Act of 2002 introduced major changes in the regulation of corporate governance and financial disclosure. Effective in 2006, all publicly-traded companies were required to implement and report internal accounting controls to the SEC for compliance.)

⁴¹⁵ *Id.* at 27.

⁴¹⁶ See *In re: Petition of Tennessee American Water Company to Change and Increase Certain Rates and Charges so as to Permit It to Earn a Fair and Adequate Rate of Return on Its Property Used and Useful in Furnishing Water Service to Its Customers*, Docket No. 08-00039, *Petition* (March 14, 2008).

prudent decisions made by TAWC management, and further, that the audit had not been conducted by an independent auditor in conformity with SOX and as ordered by the TRA in Docket No. 06-00290.⁴¹⁷ Therefore, the Authority determined that TAWC's request of \$4,335,190 in management fees was unsupported in the record, and instead allocated \$3,529,933 to attrition year expense.⁴¹⁸ Because the Authority concluded that the audit did not comply with the TRA's directive in the 2006 rate case, it further declined to include recovery of the costs of the BAH audit in the rate case. Further, the Authority ordered TAWC to develop and submit for Authority approval, a Request for Proposal ("RFP") for a comprehensive management audit by an independent certified public accountant and set certain minimum requirements and procedural deadlines concerning the RFP.⁴¹⁹

Following entry of the Authority's Order in Docket No. 08-00039, TAWC filed an appeal with the Tennessee Court of Appeals alleging, among other issues, that the TRA's decisions concerning the management audit and fees were arbitrary and capricious, an abuse of discretion, and erroneous. On January 28, 2011, the Court issued an Opinion in which it found that the decisions of the TRA were not in error, arbitrary, or capricious, but, rather, an appropriate exercise of the agency's discretion and affirmed the TRA's decisions on all of the challenges TAWC had raised concerning the management audit and fees.⁴²⁰ Finding that because TAWC had failed to meet its burden of proof to show that the charges it had requested were prudent, the Court affirmed the Authority's decision to allocate management fees in an amount that was lower than had been requested by TAWC as an appropriate exercise of the TRA's discretion.⁴²¹ Further, the Court affirmed the TRA's decisions concerning its choice of methodology used to

⁴¹⁷ See *In re: Petition of Tennessee American Water Company to Change and Increase Certain Rates and Charges so as to Permit It to Earn a Fair and Adequate Rate of Return on Its Property Used and Useful in Furnishing Water Service to Its Customers*, Docket No. 08-00039, Order, pp.18-22 (January 13, 2009).

⁴¹⁸ *Id.* at 18, 21.

⁴¹⁹ *Id.* at 21-22.

⁴²⁰ See *Tennessee American Water Co. v. Tenn. Regulatory Auth.*, 2011 WL 334678, at *18-21 (Tenn. Ct. App. Jan. 28, 2011).

⁴²¹ *Id.* at *18.

forecast the fees, determinations concerning the lack of independence of BAH, TAWC's chosen auditor, the TRA's subsequent disregard of the BAH report, and disallowance of the costs related to the BAH report.⁴²²

After announcing its decision in Docket No. 08-00039, the Authority opened Docket No. 09-00086 to accommodate all filings related to the RFP.⁴²³ The TRA Staff continued to work with TAWC in further developing the necessary parameters of the RFP throughout the audit proceedings, until the culmination and filing of the final report. On September 10, 2010, TAWC filed in Docket No. 09-00086 the final management audit report that had been prepared by Schumaker & Company.⁴²⁴ On September 23, 2010, following a request by TAWC, the Authority entered a protective order in the docket file.⁴²⁵ On September 27, 2010, TAWC filed the confidential Workpapers and Exhibits that Ms. Schumaker prepared and provided to TAWC in conjunction with the Schumaker Audit Report.⁴²⁶ Despite ongoing activity in the docket, a request for intervention was not filed in Docket No. 09-00086 until January 2011.⁴²⁷ On January 24, 2011, Chairman Freeman, acting as Hearing Officer, took official administrative notice in Docket No. 10-00189 of all filings that had been made in Docket No. 09-00086.

⁴²² *Id.* at *19-21.

⁴²³ See *In re: Petition of Tennessee American Water Company to Change and Increase Certain Rates and Charges so as to Permit It to Earn a Fair and Adequate Rate of Return on Its Property Used and Useful in Furnishing Water Service to Its Customers*, Docket No. 08-00039, *Order Moving Request for Proposal to New Docket* (July 16, 2009).

⁴²⁴ See *In re: Tennessee American Water Company's Request for Proposal for a Management Audit*, Docket No. 09-00086, *Notice of Filing of Schumaker & Company's Affiliate Audit Report of Tennessee American Water Company for the Tennessee Regulatory Authority* (September 10, 2010). On December 9, 2010, TAWC filed a replacement disk of the Schumaker Audit Report, originally filed on September 10, 2010, asserting that the originally filed disk contained certain confidential information.

⁴²⁵ See *In re: Tennessee American Water Company's Request for Proposal for a Management Audit*, Docket No. 09-00086, *Protective Order (As Modified)*, (September 23, 2010).

⁴²⁶ See *In re: Tennessee American Water Company's Request for Proposal for a Management Audit*, Docket No. 09-00086, *Notice of Filing of Confidential and Proprietary Portions of Workpapers Related to Schumaker & Company's Affiliate Audit Report of Tennessee American Water Company for the Tennessee Regulatory Authority* (September 27, 2010).

⁴²⁷ On January 6, 2011, following TAWC's filing of a *Motion to Approve and Adopt Schumaker & Company's Affiliate Audit Report of Tennessee American Water Company for the Tennessee Regulatory Authority*, the CAPD filed a petition to intervene in Docket No. 09-00086.

Positions of the Parties in Docket No. 10-00189

In the instant rate case, TAWC relied on the cost of service study, and the related testimony, of Mr. Patrick L. Baryenbruch, as well as, in part, upon the findings of the Schumaker Audit Report, to support its contentions that the \$5,226,034 it projected in attrition period management fees were reasonable, necessary, and the result of prudent management decisions made by TAWC.⁴²⁸ Through the study and testimony of Mr. Baryenbruch, the Company asserted that AWWSC's cost of \$59.00 per customer was reasonable as compared to an average cost of \$95.00 per customer for electric and combination electric/gas service companies.⁴²⁹ In addition, TAWC had been charged the lower of cost or market for the administrative and professional services, which were vital, efficiently procured, and absent of any profit markup, resulting in substantial savings to the ratepayers and Company.⁴³⁰ Further, the customer account services provided by the National Call Center are reasonable and fall below an average range of the study's electric comparison group.⁴³¹ Mr. Baryenbruch asserted that his study demonstrated that AWWSC's services are necessary, would be required even if TAWC were a stand-alone company, and that no redundancy or overlap exists in the services provided to TAWC.⁴³² Finally, Mr. Baryenbruch asserted that the Schumaker Audit Report affirmed his study's methodology as a reasonable approach to verifying that the service costs charged to TAWC do not harm ratepayers.⁴³³

TAWC also filed additional testimony prepared by Mr. Baryenbruch for the purpose of rebutting certain criticisms of Baryenbruch's study that were made by the City's witness, Ms.

⁴²⁸ Patrick Baryenbruch, Pre-filed Direct Testimony, attached Market Cost Comparison of Service Company Charges to Tennessee American Water Company 12-Months Ended March 31, 2010 (September 23, 2010).

⁴²⁹ *Id.* at 4 of 8.

⁴³⁰ *Id.* at 5-6 of 8.

⁴³¹ *Id.* at 6-7 of 8.

⁴³² *Id.* at 7 of 8.

⁴³³ *Id.* at 7 of 8.

Kimberly H. Dismukes.⁴³⁴ In response to Ms. Dismukes's criticisms concerning the use of electric and combination electric/gas companies, instead of water companies, as comparisons in analyzing the reasonableness of the service charges allocated to TAWC, Mr. Baryenbruch asserts that his methodology is reasonable because there is no publicly available cost information for water service companies.⁴³⁵ In addition, very few water companies have a centralized service company arrangement, and those that do are not overseen by a single regulatory agency that requires a standard filing.⁴³⁶ Further, Mr. Baryenbruch asserted that the differences in the operating and maintenance processes or functions between electric companies and water companies does not result in unreliable results because the study compares administrative and general expenses, rather than O&M expenses, which are similar across utility types.⁴³⁷

To calculate its projected management fees, the Company started with historical test-year expenses of \$5.008 million, then eliminated a total of \$46,230 in non-recurring and other properly excluded expenses to arrive at a normalized historical test-year amount of \$4.962 million.⁴³⁸ Next, the Company increased its normalized historical test-year amount using an annual inflation rate of 3% and adjusted the amount to account for the twenty-one (21) months remaining to the end of the attrition year.⁴³⁹ The resulting calculation of \$5.226 million in AWWSC charges for management fees was included in TAWC's rate case filing.⁴⁴⁰

TAWC's forecast of its 2011 attrition year management fees represented an increase of \$1,659,901, or 46.55%, over and above its 2005 management fee expenses.⁴⁴¹ The Company asserted that compelling and justifiable reasons existed for the increases, which had occurred

⁴³⁴ Patrick Baryenbruch, Rebuttal Testimony of Patrick Baryenbruch (February 8, 2011).

⁴³⁵ *Id.* at 4-5.

⁴³⁶ *Id.* at 5.

⁴³⁷ *Id.* at 5-16.

⁴³⁸ Michael A. Miller, Pre-Filed Direct Testimony, p. 40 (September 23, 2010). Also note, as discussed previously in this *Final Order*, the Company used a historical test period ending March 31, 2010, and forecasted an attrition period of twelve months ending December 31, 2011.

⁴³⁹ *Id.*

⁴⁴⁰ *Id.*

⁴⁴¹ *Id.* at Exhibit MAM-10.

primarily due to a shift in functions from TAWC to AWWSC and increases in pension and group insurance costs related to financial market conditions, over which TAWC had little control.⁴⁴² In addition, an accounting change, in which the costs of capital assets now on the books of AWWSC were offset by the avoidance of those costs on the books of TAWC, contributed significantly to the increase.⁴⁴³

The Company filed testimony asserting that, from 2005 until the 2011 attrition year, ratepayers have saved \$1.229 million because of the realignment and shifting of services from TAWC to AWWSC.⁴⁴⁴ TAWC also asserted that customers benefitted from having (1) round-the-clock call center availability; (2) convenient automated Interactive Voice Response (IVR) contact with the call center; (3) on-line access to TAWC service personnel, which permits the scheduling of service orders at convenient times for the customers; and (4) improved efficiencies in the tracking of service orders and service employees.⁴⁴⁵ Citing certain findings that were noted in section IV of the Schumaker Audit Report, the Company further maintained that the Schumaker Audit Report confirmed that the shifting of functions from TAWC to AWWSC had resulted in savings and service improvements to the benefit of TAWC's customers.⁴⁴⁶

Through its witness, Mr. Terry Buckner, the CAPD forecasted \$3,653,946 in management fees for the attrition period.⁴⁴⁷ In its calculations, the CAPD started with \$3,529,933 as its base amount, which had been the management fees amount approved previously in Docket No. 08-00039, then increased this amount by the annual customer growth and GDP rate of 0.54% in 2009; 1.70% in 2010; and 1.60% for 2011.⁴⁴⁸ The CAPD asserted that

⁴⁴² *Id.* at 46.

⁴⁴³ *Id.*

⁴⁴⁴ *Id.*

⁴⁴⁵ *Id.*

⁴⁴⁶ *Id.* at 47.

⁴⁴⁷ Terry Buckner, Second Amendment to Direct Testimony, Amended Exhibit 1, Schedule 5 (Hearing Exhibit 90) (March 8, 2011).

⁴⁴⁸ Terry Buckner, Non-Confidential Direct Testimony Amendment, p. 28 (January 31, 2011).

its calculation was consistent with the methodology adopted by the TRA in Docket No. 08-00039.⁴⁴⁹

Further, the CAPD asserted that TAWC's calculation of management fees was not just and reasonable because it included costs unnecessary for the provision of water service, including: (1) an over-allocation of charges to TAWC primarily based on non-cost causative factors; (2) AIP compensation, which is primarily based on financial goals; (3) Stock Based Compensation Expense, also known as LTIP compensation; (4) Business Development expense, which is devoted to non-regulated operations; (5) External Affairs expense, which is devoted to marketing, advertising, lobbying, and political influence; (6) contained non-recurring accounting charges for changes in financial reporting to the IRS; (7) double counted and overestimated payroll increases; (8) failed to comport with current economic conditions; and (9) included non-normalized salaries.⁴⁵⁰

Through its witness, Ms. Dismukes, the City recommended that three adjustments be applied to management fees. Ms. Dismukes testified that the study conducted by Mr. Baryenbruch, TAWC's witness, contained numerous flaws and failed to demonstrate that AWWSC's charges are necessary, just or reasonable. Ms. Dismukes asserted that just as the operations of electric and gas utilities are very different from water companies, likewise the expenses of electric and gas utilities are dissimilar and, therefore, not comparable to the service company charges of water companies.⁴⁵¹ She contended that Mr. Baryenbruch failed to provide evidence to support his comparative analysis of the service company charges of electric and gas utilities to the charges of AWWSC as appropriate or reliable.⁴⁵² Ms. Dismukes recommended a comparison of the AWWSC's charges with that of other water and combination

⁴⁴⁹ *Id.*

⁴⁵⁰ *Id.* at 29-30.

⁴⁵¹ Kimberly H. Dismukes, Pre-Filed Direct Testimony, pp. 4, 27-33 (January 5, 2011).

⁴⁵² *Id.* at 33-39.

water/wastewater utilities, and that the water company comparative analysis she had performed showed that the AWWSC charges were excessive.⁴⁵³ As a result, Ms. Dismukes recommended that test year management fees be reduced by \$4,089,360 in order to reflect a lower cost consistent with the costs incurred by comparable Class A water and combination water/wastewater companies.⁴⁵⁴

For these same reasons, Ms. Dismukes challenged Mr. Baryenbruch's comparison and findings concerning TAWC's customer service costs.⁴⁵⁵ She asserted that the inherent differences that exist between water companies and electric and gas utilities would indicate that customer service costs should be less for water companies.⁴⁵⁶ In keeping with her comparative approach and analysis using water companies, Ms. Dismukes recommended an additional reduction of \$464,661 to expenses for excessive customer costs charged to the Company by AWWSC.⁴⁵⁷ In addition, Ms. Dismukes asserted that the analysis employed in Schumaker Audit Report as to the reasonableness of the AWWSC charges in 2008, which compared the service charges of electric and electric/gas companies with AWWSC, an approach similar to that utilized by Mr. Baryenbruch, was similarly flawed and inappropriate and should be rejected by the TRA.⁴⁵⁸ Ms. Dismukes further asserted that the analysis contained within the Baryenbruch study did not reliably support a finding that AWWSC's services were provided at the lower of cost or market, nor that the level of services provided by the service company would be required if TAWC were a stand-alone water company.⁴⁵⁹

Finally, Ms. Dismukes recommended the removal of a combined \$94,658 for two categories of expenses, which she asserts the Company improperly included: business

⁴⁵³ *Id.* at 27-33.

⁴⁵⁴ *Id.* at 43.

⁴⁵⁵ *Id.* at 43-45.

⁴⁵⁶ *Id.* at 4, 43-44.

⁴⁵⁷ *Id.* at 4, 44-45; and *see* Transcript of Proceedings, Vol. II C, Hearing Exhibit 35 (March 1, 2011) (Ms. Dismukes revised her recommendation that customer account expenses be reduced from \$676,655 to \$464,661).

⁴⁵⁸ *Id.* at 45-46.

⁴⁵⁹ *Id.* at 46-49.

development and corporate government affairs.⁴⁶⁰ Business development expenses consist of expenses that the Company claims were incurred for the purpose of growing revenue and customer base.⁴⁶¹ Ms. Dismukes testified that, although TAWC failed to quantify the benefits that customers received from its business development efforts, she had examined the expenses incurred for business development activities at both the regional and national levels and found that the costs incurred by TAWC for business development have not resulted in significant enhancements in customer growth for the Company.⁴⁶² Further, Ms. Dismukes contended that TAWC had failed to demonstrate that the business development expenses charged to it by AWWSC are just and reasonable, cost effective, or necessary for the provision of safe and reliable service.⁴⁶³ Further, Ms. Dismukes asserted that both the Florida and California state regulatory commissions have disallowed expenses related to business development and acquisitions.⁴⁶⁴ Therefore, she recommended that \$82,861 in business development expenses should be removed from the expenses allocated for the attrition year.⁴⁶⁵

Ms. Dismukes further recommended that expenses related to legislative functions and advocacy performed by service company personnel in the Corporate Government Affairs unit should not be passed on to ratepayers. She asserted that regulators often disallow these types of expenses, and noted that both the Florida and California state commissions do not allow utilities to recover expenses of this type from ratepayers.⁴⁶⁶ Ms. Dismukes recommended that the \$11,797 charged for legislative functions of corporate government affairs be removed from expenses allocated for the attrition year.⁴⁶⁷

Michael Gorman, witness for CRMA, asserted that no witness for the Company has

⁴⁶⁰ *Id.* at 5, 49-55.

⁴⁶¹ *Id.* at 50.

⁴⁶² *Id.* at 51-52.

⁴⁶³ *Id.* at 52.

⁴⁶⁴ *Id.* at 53-54.

⁴⁶⁵ *Id.* at 53.

⁴⁶⁶ *Id.* at 54.

⁴⁶⁷ *Id.* at 54.

provided sufficient evidence to support the substantial increase requested in the rate petition and, therefore, the increase is not known and measurable and should be rejected.⁴⁶⁸

Findings and Conclusions

Previously, in Docket No. 08-00039, the TRA determined management fees using the amount forecasted by the Company for its 2005 management fees, as originally filed in Docket No. 04-00288, and applied a growth factor.⁴⁶⁹ Based on this methodology, in this case the CAPD utilized the management fees amount that was most recently ordered by the Authority in Docket No. 08-00039 as its base, then applied its recommended growth factor.⁴⁷⁰ The Authority disagrees with the CAPD's contention that the methodology used by the TRA to forecast management fees in Docket No. 08-00039 established precedent in this Docket. The method utilized by the Authority to forecast management fees in Docket No. 08-00039 was necessary as a result of the lack of sufficient evidence in the record to support TAWC's forecasted management fees, due in large part to the Company's failure to file a management audit that complied with the requirements ordered by the Authority. Nevertheless, the TRA is not bound to a previously employed methodology when determining the allocations appropriate in future cases. This is particularly true when better, more recent or accurate evidence is presented by the parties or otherwise made part of the record, which would allow the TRA to more accurately forecast future results.

In Docket No. 08-00039, the TRA ordered a comprehensive management audit be conducted by an independent certified public accountant for the primary purposes of investigating the management performance and decisions relating to internal processes and controls of AWWSC and to evaluate that the allocation methodology, factors, and resulting costs

⁴⁶⁸ Michael Gorman, Pre-filed Direct Testimony, p. 23 (January 5, 2011).

⁴⁶⁹ See *In re: Petition of Tennessee American Water Company to Change and Increase Certain Rates and Charges so as to Permit It to Earn a Fair and Adequate Rate of Return on Its Property Used and Useful in Furnishing Water Service to Its Customers*, Docket No. 08-00039, *Order*, p. 21 (January 13, 2009).

⁴⁷⁰ Terry Buckner, Non-Confidential Direct Testimony Amendment, p. 28 (January 31, 2011).

for services charged to TAWC were efficient, accurate, and reasonable.⁴⁷¹ To that end, the Authority initiated the proceedings in Docket No. 09-00086, and wherein, upon completion, was filed the Schumaker Audit Report.⁴⁷² In the instant case, both the CAPD and City offered testimony concerning the Schumaker Audit Report, its processes and results. Yet, while the CAPD noted certain concerns about the reliability of the audit, it does not completely reject the methodology utilized or credentials of the auditor.⁴⁷³ Rather, the CAPD's testimony focuses more on other, alternative methodologies that might have been utilized instead but does not critically analyze the methods and processes employed by Schumaker & Company in its preparation of the Schumaker Audit Report.⁴⁷⁴

In its recent opinion, the Court of Appeals held that the TRA's decision to use the 2005 management fees to forecast fees in Docket No. 08-00039 was a "reasonable, temporary, solution to the dilemma faced [by the TRA] until TAWC could submit a proper management audit."⁴⁷⁵ Here, the Authority acknowledges that a new management audit has been performed by Schumaker & Company in compliance with the requirements of the RFP, and that the findings set forth in detail in the Schumaker Audit Report state that the management fees and cost allocations charged to TAWC are reasonable and prudent. Even the City's witness, Ms. Dismukes, agreed that the use of customers to allocate costs to TAWC was acceptable, even though in her opinion other, more superior approaches could have been utilized.⁴⁷⁶

Further, despite the panel's agreement that Mr. Baryenbruch's study cannot be relied

⁴⁷¹ See *In re: Petition of Tennessee American Water Company to Change and Increase Certain Rates and Charges so as to Permit It to Earn a Fair and Adequate Rate of Return on Its Property Used and Useful in Furnishing Water Service to Its Customers*, Docket No. 08-00039, Order, pp. 21-22 (January 13, 2009).

⁴⁷² See *In re: Tennessee American Water Company's Request for Proposal for a Management Audit*, Docket No. 09-00086, Notice of Filing of Confidential and Proprietary Portions of Workpapers Related to Schumaker & Company's Affiliate Audit Report of Tennessee American Water Company for the Tennessee Regulatory Authority (September 27, 2010).

⁴⁷³ Terry Buckner, Non-Confidential Direct Testimony Amendment, pp. 23-25 (January 31, 2011).

⁴⁷⁴ *Id.*

⁴⁷⁵ See *Tennessee American Water Co. v. Tenn. Regulatory Auth.*, 2011 WL 334678, at *20 (Tenn. Ct. App. Jan. 28, 2011).

⁴⁷⁶ Kimberly H. Dismukes, Pre-Filed Direct Testimony, pp. 3, 18-20 (January 5, 2011).

upon to conclude that AWWSC provides services at less than the prevailing market rate, the Authority disagrees with the City's contention that \$4,089,360 of expenses in service costs should be eliminated from management fees. While the Authority agrees that there were flaws in Mr. Baryenbruch's study, especially as to the billed rates and number of hours billed to professionals, it cannot agree with the City's assertion that Mr. Baryenbruch's study, however flawed, thereby leads to the conclusion that there is no evidentiary basis upon which to allow recovery of a majority of the management fees requested by TAWC.

Therefore, upon consideration of the record, the Authority allocates recovery of \$4,741,068 in management fees for the attrition period. It determines this amount based on the Company's normalized amount of management fees of \$5,048,200⁴⁷⁷ for the twelve months ended September 30, 2010,⁴⁷⁸ then eliminates \$172,295 for External Affairs expense, \$89,720 for Business Development, 50% (\$89,734) of the AIP, and adjusts the residual amount by an annual inflation rate of .76% compounded for fifteen months (or .95%).

In its elimination of expenses related to corporate government affairs, the Authority determines that because lobbying expenses are not necessary to the provision of safe and reliable water service, such expenses are appropriately disallowed for rate making purposes. Further, because the Authority concludes that it is not reasonable to allow recovery of an expense that does not enhance customer growth, business development expenses in the amount of \$89,720 are eliminated from our calculations. The Authority agrees with TAWC's assertion that both the Company and its customers benefit from AIP through higher financial returns for the Company. For this reason, the Authority therefore approves recovery of one-half of the AIP and correspondingly eliminates 50% (\$89,734) of AIP. The elimination of 50% of AIP is consistent

⁴⁷⁷ TAWC's December 8th Supplemental Responses To The First Discovery Request And Supplemental Discovery Request Of The CAPD, Question 102, TN-CAPD-SUPPLEMENTAL2-Q102-ATTACHMENT 2 (December 8, 2010).

⁴⁷⁸ As noted previously in this *Final Order*, the twelve months ending September 30, 2010 is consistent with the test period recommended and utilized by the CAPD.

with the Authority's removal of 50% of AIP from employee benefits.

Following the aforementioned adjustments to management fees, the panel applies an inflation factor of .95%⁴⁷⁹ in order to calculate management fees for the attrition period. The panel utilizes an annual GDP Chained Price Deflator growth rate of .76% as of September 2010, divides this rate by twelve months, then multiplies by fifteen months to arrive at the December 2011 growth rate. The result of these calculations is \$4,741,068 for allocation to management fees in this case.

V(B)7. GROUP INSURANCE

The Company projected total Group Insurance Expense of \$2,034,757.⁴⁸⁰ This category included Group Insurance and Other Post Employment Benefits ("OPEB"). The Company forecasted Group Insurance expenses of \$1,075,184.⁴⁸¹ This amount was calculated by applying March 31, 2010 insurance rates to 109⁴⁸² anticipated employees. The Company forecasted OPEB of \$959,573 for the attrition period.⁴⁸³ The Company's actuary, Towers/Watson, provided a letter which projects \$1,140,000 for the total OPEBs.⁴⁸⁴ The Company applied a 15.83% capitalization rate to the OPEBs to remove the capitalized portion of OPEBS from O&M Expense.

Subsequently, the Company adjusted its projection of Group Insurance Expense from \$2,034,757 to \$2,220,281 for the attrition period.⁴⁸⁵ The Company updated the Group Insurance

⁴⁷⁹ The mathematic calculation is demonstrated as follows: \$5,048,200 - \$172,295 - \$89,720 - \$87,734 = \$4,696,451 (This number represents the balance of management fee calculation after the noted reductions, but before application of the growth factor).

⁴⁸⁰ *Petition*, Exhibit No. 2, Schedule 3 (September 23, 2010).

⁴⁸¹ *Petition*, Exhibit No. 1, Schedule 3, p. 3 of 6 (September 23, 2010).

⁴⁸² There are 110 forecasted employees as stated above in the discussion of Salaries and Wages. One employee, however, opted out of the Group Insurance plan.

⁴⁸³ *Petition*, Exhibit No. 1, Schedule 3, p. 3 of 6 (September 23, 2010).

⁴⁸⁴ TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, TN-TRA-02-Q92d-Attachment, p. 9 of 28 (December 1, 2010).

⁴⁸⁵ TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, TN-TRA-02-Q121-Attachment 2 (December 1, 2010).

portion to \$1,260,708 to reflect October 1, 2010 insurance rates.⁴⁸⁶ In rebuttal testimony, the Company further revised Group Insurance to \$2,434,923 for the attrition period.⁴⁸⁷ The Company then applied a capitalization factor of 15.83% to remove the capitalized portion from O&M Expenses.

The CAPD originally forecasted attrition period Group Insurance Expense of \$2,166,396.⁴⁸⁸ Subsequently, the CAPD adjusted its growth factor and changed the projection of Group Insurance Expense to \$2,165,261,⁴⁸⁹ including Group Insurance of \$1,118,530 and OPEBs of \$1,046,730.⁴⁹⁰ Group Insurance of \$1,118,530 was priced out based on October 1, 2010 insurance rates and 104 Employees.⁴⁹¹ The CAPD used the actual book value listed in TAWC's Income Statements for its test period of the twelve months ended September 30, 2010 as a starting point for OPEBs and then increased its estimate of OPEBS by its inflation factor plus one-half of the customer growth.⁴⁹² The CAPD filed amended testimony on March 1, 2011 in which it changed the residential customer growth factor utilized to project revenues from 0.89% to 1.05%,⁴⁹³ and this caused the CAPD's growth/inflation factor to change from 1.40% to 1.48%.⁴⁹⁴ The effect of this adjustment was to increase the CAPD's figure for Group Insurance Expense from \$2,165,261 to \$2,166,035.⁴⁹⁵

⁴⁸⁶ *Id.*

⁴⁸⁷ TAWC's February 22nd Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 2, Schedule 3 (February 22, 2011).

⁴⁸⁸ Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).

⁴⁸⁹ Terry Buckner, Non-Confidential Direct Testimony Amendment, Amended Exhibit 1, Schedule 5, p. 5 of 9 (January 31, 2011).

⁴⁹⁰ Terry Buckner, Non-Confidential Direct Testimony Amendment, Workpaper AMENDED E-GI (January 31, 2011).

⁴⁹¹ Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-GIA (January 5, 2011).

⁴⁹² Terry Buckner, Non-Confidential Direct Testimony Amendment, Workpaper AMENDED E-GI (January 31, 2011).

⁴⁹³ John Hughes, Amendment to Amended Testimony filed February 25, 2011, Workpaper R-CUSTOMER GROWTH (March 1, 2011).

⁴⁹⁴ Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-GI (Hearing Exhibit 90) (March 8, 2011).

⁴⁹⁵ *Id.*

The TRA adopts an attrition period forecast of \$2,111,420 for Group Insurance Expense, after removing the capitalized amount using a 20.57% capitalization percentage, again consistent with the panel's treatment of Salaries and Wages Expenses. This forecast consisted of \$1,189,740 related to Group Insurance costs and \$921,680 related to OPEBs. This amount was calculated by using the 109 employees (out of the 110 anticipated employees) enrolling in the plan and the October 1, 2010 insurance rates to price out the Group Insurance and then applying the CAPD's capitalization percentage of 20.57% consistent with Salaries and Wages Expense. The OPEB amount for the attrition period was based on contribution under the funding policy amount of \$38,678,936 for AWWSC from the latest actuarial report. This amount was allocated from the service company to TAWC at 3%. The capitalized amount of TAWC's portion was then revised, using the CAPD's 20.57% capitalization percentage, again consistent with the treatment of Salaries and Wages Expenses.

V(B)8. PENSION EXPENSE

The Company initially forecasted Pension Expense of \$1,645,113 for the attrition period.⁴⁹⁶ This amount was taken from a letter written by the Company's actuary, instead of the annual actuarial report that has been used in past cases, which stated that the minimum ERISA contribution for the service company would be \$109.8 million for 2011.⁴⁹⁷ Based on this, the amount to be allocated to TAWC would be 1.78% or \$1,954,440.⁴⁹⁸ The Company then applied its capitalization factor of 15.83% to eliminate the capitalized portion from O&M Expenses to reach its initial forecast.⁴⁹⁹ Subsequently, the Company revised Pension Expense from \$1,645,113 to \$2,062,140. The revision was a result of a quarterly update from the actuary to the Company, which updated the forecast of minimum pension contributions for the service

⁴⁹⁶ *Petition*, Exhibit No.2, Schedule 3, p. 3 of 6 (September 23, 2010).

⁴⁹⁷ TAWC's Responses to the TRA's Data Requests Dated September 20, 2010, TN-TRA-01-Q013-Labor, p. 12 (September 24, 2010).

⁴⁹⁸ *Id.*

⁴⁹⁹ Sheila A. Miller, Pre-Filed Direct Testimony, p. 7 (September 23, 2010).

company to \$137.6 million. The Company revised Pension Expense and allocated TAWC's portion (1.78% of the minimum ERISA contribution, or \$2,449,880) then reduced that amount by the Company's capitalization percentage of 15.83%.⁵⁰⁰

The CAPD forecasted \$1,552,412 attrition period Pension Expense.⁵⁰¹ The CAPD adopted \$1,954,440, which was the 1.78% Tennessee portion of the original pension funding amount calculated by the Company and then applied its capitalization percentage of 20.57% to eliminate the capitalized portion from O&M Expenses.⁵⁰² The CAPD stated that the quarterly update from the actuary, which the Company relied upon, had a footnote stating that \$37 million is "[s]ubject to change pending the results of the July 1, 2011 valuation, which will be known in late August."⁵⁰³ The CAPD stated that it is reluctant to set rates on a pension contribution which is not known by the actuary and is subject to change.⁵⁰⁴

The Authority adopts an attrition period forecast of \$839,965 for Pension Expense. The Authority has historically included in rates the minimum required contribution as recommended in the latest actuarial report, rather than a preliminary estimate in a letter from the actuary. The actuarial report submitted by the Company recommended a minimum contribution of \$59,409,620 as of July 1, 2009.⁵⁰⁵ The Authority adopted Pension Expense for TAWC based on an allocation factor of 1.78% applied to recommended minimum contributions set forth in the latest actuary report. The Company's portion of ERISA minimum pension contribution was multiplied by the CAPD's capitalization percentage of 20.57% to arrive at attrition period Pension Expense of \$839,965.

⁵⁰⁰ TAWC's December 17th Supplemental Responses To The CAPD's Discovery Requests, TN-CAPD-01-PART III-Q48-Supplemental Confidential Attachment 3 (December 17, 2010).

⁵⁰¹ Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-PENSION (January 5, 2011).

⁵⁰² *Id.*

⁵⁰³ Terry Buckner, Pre-Filed Direct Testimony, pp. 41-42 (January 5, 2011).

⁵⁰⁴ *Id.* at 42.

⁵⁰⁵ TAWC's Responses to the TRA's Data Requests Dated September 20, 2010, TRA-01-Q36-ATTACHMENT, pp. 55, 60 (Actuarial Report April 2010) (September 24, 2010).

V(B)9. REGULATORY EXPENSE

The Company projected \$379,918 in Regulatory Expense for the attrition period. This amount represents the total of the amortization of various rate case expenses sought by the Company and included in this case. The Company stated in its testimony that it was seeking the following:

1. Estimated cost of this case (\$645,000) amortized over 3 years;
2. Estimated cost of service study for this case (\$42,500) amortized over 3 years; and
3. 12 months of amortization of 2006 rate case, 2008 rate case, 2008 cost of service, and the 2008 depreciation study totaling \$150,751.⁵⁰⁶

In rebuttal testimony, the Company projected \$847,368 in Regulatory Expense for the attrition period, which is \$467,450 higher than stated in the *Petition*.⁵⁰⁷ Part of the difference related to the Tennessee Court of Appeals' decision reversing the Authority's disallowance of \$275,000 in rate case expense from Docket No. 08-00039.⁵⁰⁸ The Company proposed to include that rate case expense, which the Company had absorbed since September 2008, in the attrition year. The Company also increased the expected cost of this case from the \$645,000 estimated in the *Petition* to a total of \$1,240,492.⁵⁰⁹ The Company updated the current rate case expense by (1) including the actual costs incurred to date as of January 31, 2011, (2) adding the estimated additional legal costs for the witnesses' rebuttal testimony, which included two new witnesses whose testimony was not originally anticipated, and (3) adding the estimated costs associated with conducting a full evidentiary hearing in Chattanooga.⁵¹⁰ The Company stated that these costs were reasonable based on the volume of discovery requests propounded by the Intervenor, the number of issues raised and addressed by the Intervenor in the testimony they presented, the

⁵⁰⁶ Sheila A. Miller, Pre-Filed Direct Testimony, pp. 12-13 (September 23, 2010).

⁵⁰⁷ TAWC's Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 2, Schedule 3 (February 14, 2011).

⁵⁰⁸ Michael A. Miller, Pre-Filed Rebuttal Testimony, p. 78 (February 8, 2011).

⁵⁰⁹ *Id.*

⁵¹⁰ *Id.*

number of discovery disputes, the increased number of Intervenor, and the cost of moving the evidentiary hearing to Chattanooga.⁵¹¹

The CAPD projected Regulatory Expense for the attrition period of \$195,284.⁵¹² The CAPD stated in its testimony that its calculation of Regulatory Expense included the following:

1. Amortization for the cost of service studies performed in Docket No. 06-00290 at \$8,004 per year and in Docket No. 08-00039 at \$3,204 per year;
2. Amortization of the depreciation study in Docket No. 08-00039 amounting to \$7,826 per year;
3. Amortization of rate case costs associated with Docket No. 08-00039 at \$68,750; and
4. Estimated cost of this case (\$322,500) amortized over three years at \$107,500 for the attrition period.⁵¹³

The CAPD did not include amounts for the cost of service study performed in the current docket. The CAPD eliminated this cost from its calculation of Regulatory Expenses asserting that (1) it is unacceptable to use "judgment factors" for a cost of service study because it would result in a cost of service study that cannot be independently verified or corroborated, and (2) the results of the cost of service study were not used by the Company in setting the proposed rates.⁵¹⁴ On March 8, 2011, the CAPD provided revised exhibits projecting Regulatory Expenses of \$298,884, which included the following:

1. Amortization for the cost of service studies performed in Docket No. 06-00290 at \$8,004 per year and in Docket No. 08-00039 at \$3,204 per year;
2. Amortization of the depreciation study expense in Docket No. 08-00039, amounting to \$7,826 per year;
3. Amortization of rate case costs associated with Docket No. 06-00290 (\$44,433);
4. Amortization of rate case costs associated with Docket No. 08-00039 (\$68,750); and
5. Amortization of the estimated cost of this case (\$500,000) over three years at \$166,667 for the attrition period.⁵¹⁵

⁵¹¹ *Id.*

⁵¹² Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).

⁵¹³ *Id.* at 41-43 (January 5, 2011).

⁵¹⁴ William H. Novak, Pre-Filed Direct Testimony, p. 6 (January 5, 2011).

⁵¹⁵ Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-REG (Hearing Exhibit 90) (March 8, 2011).

On March 8, 2011, prior to the close of the Hearing, the City motioned to exclude from the record certain exhibits consisting of revised schedules and rebuttal testimony filed or offered by TAWC that purported to increase TAWC's revenue requirement from the \$9.9 million originally petitioned to approximately \$11.5 million, of which a portion reflected an increase in rate case expense from \$645,000 to \$1.2 million, which TAWC asserted was properly considered by the Authority in setting rates.⁵¹⁶ Despite denial of the motion by Chairman Freeman, TAWC offered additional explanation of its position as to the appropriate use of the revenue information by the TRA.⁵¹⁷ The City objected, and reasserted its position that that such evidence should not be included or considered in the record.⁵¹⁸

Following the arguments of the parties, Director Roberson stated that over the years he had seen a significant and dramatic increase in the amount requested for rate case expenses and voiced his concern that in this case, the testimony, exhibits, and responses to data requests failed to provide a sufficient evidentiary record upon which the TRA could base a decision on the issue of rate case expense requested by the Company.⁵¹⁹ Citing the Court of Appeals recent Opinion in which it reversed the TRA's decision to cut in half the rate case expenses allowed in Docket No. 08-00039, finding that such decision was arbitrary due to a lack of specific evidence in the record and Final Order, Director Roberson moved that the Company provide detailed evidence of its rate case expenses, including itemized bills from experts, attorneys, and Company witnesses, to demonstrate that the rate case expenses being claimed are necessary, reasonable, and prudent.⁵²⁰ Director Roberson further moved to direct the Company to file this evidence through

⁵¹⁶ Transcript of Proceedings, Vol. VII B, pp. 114-115 and pp. 119-128 (March 8, 2011) (concerning City's "third item" for discussion).

⁵¹⁷ *Id.* at 119-121, 123-124.

⁵¹⁸ *Id.* at 121-123.

⁵¹⁹ *Id.* at 124-125, 127.

⁵²⁰ *Id.* at 125-126 (citing *Tennessee American Water Co. v. TRA*, 2011 WL 334678 *27 (January 28, 2011) (holding that the record and Final Order did not explain which specific expenses the TRA deemed unnecessary, improvident, or improper, or that the Authority closely examined the costs associated with the rate case to determine the portion

affidavits or supplemental testimony, which was to be accompanied by bills, invoices, or other supporting documentation, and to grant the Intervenor an opportunity to respond through affidavits, live testimony, or supporting documentation, if necessary, so that the TRA would have a complete record on rate case expenses on the basis of which the Authority would closely examine the costs associated with this rate case.⁵²¹ Finally, Director Roberson moved that the Authority hear limited testimony with the appropriate cross-examination of witnesses in an expedited hearing to be held on March 28, 2011 exclusively on the issue of rate case expense.⁵²² The motion was approved unanimously by the panel.

On March 16, 2011, the parties filed a *Joint Motion for Approval of Rate Case Expenses* in which the parties agreed to limit the amount of rate case expenses approved in this docket to \$645,000, as filed in the Company's original *Petition*. All of the parties in this docket asked that the Authority approve the agreed amount as the final rate case expenses to be recovered by TAWC without the necessity of further proof and in lieu of a separate proceeding on the issue. The parties' agreement reflected an effort to expedite the completion of the case and, thereby, avoid the possibility of TAWC implementing the full amount of its rate request under bond prior to April 5, 2011.⁵²³ On March 22, 2011, the Hearing Officer entered an Initial Order⁵²⁴ that found that the filing of the *Joint Motion* acted as a stipulation of the parties as to the issue of the rate case expense to be recovered in this case and concluded that no further proceedings, including the filing of testimony or convening of a hearing for the purpose of cross-examination

to be recovered by rate payers, and further admonishing that such examination should have taken place and its results included in the record and Final Order).

⁵²¹ *Id.* at 126-127.

⁵²² *Id.*

⁵²³ The Company would have been entitled to implement under bond the full amount of the requested rate increase under Tenn. Code Ann. § 65-5-103 (2004) in the event that the TRA did not render a final decision within six months of the Company's filing of its *Petition*.

⁵²⁴ *Initial Order of Hearing Officer Relating to Proof on Rate Case Expenses and the Joint Motion Filed by the Parties*, pp. 5-6 (March 22, 2011).

of evidence, were necessary.⁵²⁵ Furthermore, the decision to accept the amount proposed was within the purview of the voting panel assigned in this docket, and in light of this development, convening a separate proceeding on the issue of rate case expense at this time imposed an additional and unnecessary expense on the parties and, possibly, on the ratepayers of TAWC.⁵²⁶

During the hearing, the panel adopted an attrition period forecast of \$277,880 for regulatory expenses. This included:

1. Amortization of attrition year unamortized balance of rate case costs associated with Docket No. 08-00039 of \$146,139 for an annual cost of \$48,713;
2. Cost of this case (\$645,000) amortized over three years starting in April for an annual cost of \$215,000; and
3. Estimated cost of service study for this case (\$42,500) amortized over three years for an annual cost of \$14,167.

In addition, this matter came before the panel during the regularly scheduled Authority Conference held on August 22, 2011, for consideration of the method by which recovery of \$275,000 in regulatory fees due the Company following reversal of the TRA's decision in Docket No. 08-00039 by the Court of Appeals.⁵²⁷ A majority of the panel voted to allow recovery of the \$275,000 regulatory expense through a separate line item charge on customer bills, which will discontinue once the full amount has been recovered.⁵²⁸ The Company was directed to file tariffs to include the surcharge, including all supporting calculations, within ten days and to work with the TRA Staff on the acceptable line item language for inclusion in customers' bills.⁵²⁹

⁵²⁵ *Id.*

⁵²⁶ *Id.*

⁵²⁷ The Court of Appeals issued its mandate in that appeal on June 7, 2011.

⁵²⁸ Director Kyle moved to allow TAWC to recover the \$275,000 through a temporary increase in fixed monthly service charges and usage rates, as proposed by the Company, which would reduce to current levels when the Company had collected the \$275,000 in full, and directed that the Company file all documentation for the new rates and work with David Foster, Chief, and Pat Murphy, Deputy Chief, of the TRA's Utilities Division. This motion failed for lack of a second.

⁵²⁹ Transcript of Proceedings, p. 79 (August 22, 2011).

V(B)10. INSURANCE OTHER THAN GROUP

The Company proposed \$485,904 for the attrition period in Insurance Other than Group Expense.⁵³⁰ The attrition period expense is calculated using the Company's 2010 actual insurance premiums of \$477,086.92, less the Auto Liability Insurance of \$28,300.36, for a total premium amount of \$448,786.56 in 2010. The Company then adjusted the premiums for inflationary increases, which were provided by AWWC's insurance broker based upon the current commercial insurance market conditions.⁵³¹

The CAPD forecasted \$322,262 for the attrition period in Insurance Other than Group Expense.⁵³² The CAPD started its calculation using the September 30, 2010 income statement balances from Insurance General Liability, Insurance Workman's Compensation, and Insurance Other,⁵³³ then applied a growth factor of 1.51%.⁵³⁴ Later, the CAPD revised its growth factor to 1.40% and adjusted Insurance Other than Group Expense to \$321,913.⁵³⁵ The CAPD filed amended testimony on March 1, 2011, which changed the residential customer growth factor utilized in projecting revenues from 0.89% to 1.05%.⁵³⁶ This amendment caused the CAPD's growth/inflation factor to change from 1.40% to 1.48%,⁵³⁷ and increased Insurance Other than Group Expense from \$321,913 to \$322,151.⁵³⁸

The Authority adopts the CAPD's attrition period forecast of \$322,151 for Insurance Other than Group because it reflected a verified downward trend of actual insurance premiums

⁵³⁰ TAWC's Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 2, Schedule 3, p. 13 of 37 (February 16, 2011).

⁵³¹ TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, Question 125 (December 1, 2010).

⁵³² Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).

⁵³³ Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-OI (January 5, 2011).

⁵³⁴ Terry Buckner, Pre-Filed Direct Testimony, p. 12 (January 5, 2011).

⁵³⁵ Terry Buckner, Non-Confidential Direct Testimony Amendment, Workpaper AMENDED E-OI (January 31, 2011).

⁵³⁶ John Hughes, Amendment to Amended Testimony filed February 25, 2011, Workpaper R-Customer Growth (March 1, 2011).

⁵³⁷ Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-OI (Hearing Exhibit 90) (March 8, 2011).

⁵³⁸ *Id.*

over the last three years. It is also based upon a later test year amount and has been adjusted upwards for inflation. For these reasons, the Authority adopts \$322,151 for the attrition period in Insurance Other than Group Expense.

V(B)11. CUSTOMER ACCOUNTING

The Company projected \$857,278 for Customer Accounting Expense. Customer Accounting Expense for the historical test year was \$836,303. The Company applied an inflation factor of 3.58% to these expenses (excluding uncollectibles and normalizing adjustments for postage service totaling \$3,348) to arrive at an increase of \$17,627.⁵³⁹ The Company stated that the projected postage increase of \$3,348 is primarily the result of an increase in postage costs beginning May 2009.

The CAPD forecasted \$841,387 for the attrition period in Customer Accounting Expense.⁵⁴⁰ The CAPD adopted the general ledger balance for the twelve months ended September 30, 2010, made normalized adjustments for postage in the amount of \$3,809,⁵⁴¹ and increased the result by one half of the customer growth of 0.89% plus the annual GDP Chained Price Deflator growth rate of 0.76%.⁵⁴² The CAPD later corrected its growth factor to 1.4%.⁵⁴³ The effect of this adjustment was a decrease in Customer Accounting Expense from \$841,387 to \$840,475.⁵⁴⁴ In amended testimony, the CAPD adjusted the residential customer growth factor that it utilized in projecting revenues from 0.89% to 1.05%, which caused the CAPD's

⁵³⁹ TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, TN-TRA-02-Q92d-ATTACHMENT, p. 13 of 28 (December 1, 2010).

⁵⁴⁰ Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).

⁵⁴¹ Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-CA (January 5, 2011).

⁵⁴² Terry Buckner, Pre-Filed Direct Testimony, p. 12 (January 5, 2011).

⁵⁴³ Terry Buckner, Non-Confidential Direct Testimony Amendment, Workpaper AMENDED E-CA (January 31, 2011).

⁵⁴⁴ *Id.*

growth/inflation factor to change from 1.40% to 1.48%.⁵⁴⁵ This adjustment increased Customer Accounting Expense from \$840,475 to \$841,097.⁵⁴⁶

Thereafter, the panel adopted a Customer Accounting Expense projection in the amount of \$841,097 for the attrition year. This projection is based upon a later test period, including normalizing adjustments, and better reflects the proper amount for the attrition period.

V(B)12. UNCOLLECTIBLE EXPENSE

The Company projected Uncollectible Expense of \$198,122 for the attrition period at current rates. In its calculation, the Company started with its historical test period amount of \$202,677 and subtracted \$8,343 from this figure to arrive at a normalized test period expense of \$194,334. Then, the Company added \$3,788 of attrition year adjustments to arrive at a projected expense of \$198,122.⁵⁴⁷

The CAPD forecasted \$250,290 for Uncollectible Expense for the attrition period.⁵⁴⁸ This amount represented the actual uncollectible write-off balance for the twelve months ended September 30, 2010.⁵⁴⁹

The panel adopts an Uncollectible Expense amount at current rates of \$198,122. This amount is based upon the amount booked by the Company for the twelve months ended March 31, 2010, plus a normalizing adjustment and attrition year adjustment at current rates. Any incremental increase in Uncollectible Expense will be accounted for by the application of the Revenue Conversion Factor.

⁵⁴⁵ Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-CA (Hearing Exhibit 90) (March 8, 2011).

⁵⁴⁶ *Id.*

⁵⁴⁷ TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, Question 92, TN-TRA-02-Q092d-ATTACHMENT, p. 14 of 28 (December 1, 2010).

⁵⁴⁸ Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).

⁵⁴⁹ Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-UNC (January 5, 2011).

V(B)13. RENT EXPENSE

Rent Expense consisted of rental costs for such items as mobile radios, postage equipment, copiers, and land. The Company projected an attrition period Rent Expense of \$8,706.⁵⁵⁰ Rent Expense for the historical test year ended March 31, 2010, was \$9,799. The Company incorporated three adjustments within this category of expense. The first adjustment eliminated the Oce Imagistics copier lease cost. The second adjustment eliminated the rental at the Chattanooga Hotel, because this is a non-recurring expense.⁵⁵¹ The third and fourth adjustments normalized the ice machine rental and the Canon™ copier rental to include a full twelve month period, which resulted in a negative adjustment of \$1,093.⁵⁵²

The CAPD projected a Rent Expense of \$8,436 for the attrition period.⁵⁵³ The CAPD started with the general ledger balance for the twelve months ended September 30, 2010 for the Real Property Rent Expense and Equipment Rent Expense. Then the CAPD applied normalizing adjustments to Equipment Rent Expense, causing a reduction in the amount of \$408.⁵⁵⁴

The panel adopts \$8,436 for Rent Expense as it is based on a later test period and includes normalizing adjustments.

V(B)14. GENERAL OFFICE EXPENSE

The Company projected General Office Expense of \$217,933⁵⁵⁵ for the attrition period.⁵⁵⁶ The Company started with the test year amount of \$210,461⁵⁵⁷ and made three adjustments. The first adjustment annualized the sewer bill in the amount of a \$166 increase because the test

⁵⁵⁰ Sheila A. Miller, Pre-Filed Direct Testimony, p. 14 (September 23, 2010).

⁵⁵¹ *Id.*

⁵⁵² *Id.*

⁵⁵³ Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).

⁵⁵⁴ Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-RENT p. 41 (January 5, 2011).

⁵⁵⁵ This expense category includes costs associated with the general expenses for the office. These include 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.

⁵⁵⁶ Sheila A. Miller, Pre-Filed Direct Testimony, p. 15 (September 23, 2010).

⁵⁵⁷ *Id.* at 14.

period reflected only eleven months of the increase.⁵⁵⁸ The second was to eliminate a \$180 duplicate payment of membership dues.⁵⁵⁹ The third was to add \$52 for miscellaneous postage expense to reflect an increase that had been effective as of May 2009.⁵⁶⁰ Then the Company applied an inflation factor of 3.58% to all expenses excluding postage. The result of these adjustments was a net adjustment in General Office Expense of \$7,472.

The CAPD projected General Office Expense of \$218,450 for the attrition period.⁵⁶¹ The CAPD began its calculations using the book value General Office Expense as it is reported in TAWC's Income Statements as of September 30, 2010, and made two normalizing adjustments. The first normalizing adjustment eliminated duplicate payments of membership dues in the amount of \$80.⁵⁶² The second adjustment normalized Janitorial Expense to include an additional month of service in the amount of \$449.⁵⁶³ The CAPD then applied an inflation factor and a growth factor to the normalized test period for a net increase to the test period of \$3,249.⁵⁶⁴ The CAPD subsequently corrected and applied its growth factor to 1.40%.⁵⁶⁵ This adjustment caused General Office Expense to decrease from \$218,450 to \$218,213.⁵⁶⁶ In its amended testimony filed on March 1, 2011, the CAPD changed the residential customer growth factor it utilized in projecting revenues from 0.89% to 1.05%.⁵⁶⁷ This caused the CAPD's growth/inflation factor to

⁵⁵⁸ TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, Question 92, TN-TRA-02-Q092d, p. 18 of 28 (December 1, 2010).

⁵⁵⁹ *Id.*

⁵⁶⁰ *Id.*

⁵⁶¹ Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).

⁵⁶² Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-GO (January 5, 2011).

⁵⁶³ *Id.*

⁵⁶⁴ *Id.*

⁵⁶⁵ Terry Buckner, Non-Confidential Direct Testimony Amendment, Workpaper AMENDED E-GO (January 31, 2011).

⁵⁶⁶ *Id.*

⁵⁶⁷ John Hughes, Amendment to Amended Testimony filed February 25, 2011, Workpaper R-Customer Growth (March 1, 2011).

change from 1.40% to 1.48%⁵⁶⁸ and increased its figure for General Office Expense from \$218,213 to \$218,374.⁵⁶⁹

The panel adopts General Office Expense of \$218,374 for the attrition year because it is based upon a later test period, includes normalizing adjustments, and better reflects anticipated expenses incurred during the attrition period.

V(B)15. MISCELLANEOUS EXPENSE

The Company projected Miscellaneous Expense of \$2,005,675 for the attrition period. The Company started with its actual Miscellaneous Expense of \$1,945,947 as of March 31, 2010 and made six adjustments to this category.⁵⁷⁰ The Company's overall net adjustment to Miscellaneous Expense was \$59,728⁵⁷¹

The CAPD forecasted Miscellaneous Expense of \$1,956,125 for the attrition period.⁵⁷² The CAPD started by using the book values listed in TAWC's Income Statements for the twelve months ended September 30, 2010 and making five normalizing adjustments. The CAPD subsequently corrected its growth factor to 1.40%.⁵⁷³ The effect of this adjustment was to decrease Miscellaneous Expense from \$1,956,125 to \$1,954,046.⁵⁷⁴ The CAPD filed amended testimony on March 1, 2011, which changed the residential customer growth factor it utilized in projecting revenues from 0.89% to 1.05%.⁵⁷⁵ This resulted in a change in the CAPD's

⁵⁶⁸ Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-GO (Hearing Exhibit 90) (March 8, 2011).

⁵⁶⁹ *Id.*

⁵⁷⁰ Sheila A. Miller, Pre-Filed Direct Testimony, pp. 15-16 (September 23, 2010).

⁵⁷¹ TAWC's February 22nd Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 2, Schedule 3 (February 22, 2011).

⁵⁷² Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).

⁵⁷³ Terry Buckner, Non-Confidential Direct Testimony Amendment, Workpaper AMENDED E-MISC (January 31, 2011).

⁵⁷⁴ *Id.*

⁵⁷⁵ John Hughes, Amendment to Amended Testimony filed February 25, 2011, Workpaper R-Customer Growth (March 1, 2011).

growth/inflation factor from 1.40% to 1.48%,⁵⁷⁶ which increased Miscellaneous Expense from \$1,954,046 to \$1,955,463.⁵⁷⁷

The Authority, whenever possible, strives to use known and measurable information in forecasting for the attrition period. In calculating Miscellaneous Expense, the CAPD did not make normalizing adjustments for the increase in fuel cost. That being the case, the Company's forecast of \$2,005,675 forms a better basis for Miscellaneous Expense, as it reflects the actual increases in gasoline cost.

The Company and the CAPD proposed including amortization of the Management Audit of \$190,000 over five years (or \$38,000 per year) as part of their forecast of Miscellaneous Expense for the attrition period. The Company, the CAPD, and the City all agreed to split equally the \$6,960 deposition costs incurred in deposing Ms. Schumaker in preparation for the Hearing. The CRMA did not question the witness and did not agree to split the costs of the deposition.⁵⁷⁸ In addition, the costs of Ms. Schumaker's appearance at the Hearing totaled \$6,160.⁵⁷⁹ Accordingly, Miscellaneous Expense should include the actual cost of the Management Audit (\$184,964),⁵⁸⁰ the Company's portion of the deposition cost (\$2,320), and \$6,160 for Ms. Schumaker's hearing expenses, all of which are amortized over five years. Therefore, the panel adopts Miscellaneous Expense for the attrition period in the amount of \$2,006,364.

V(B)16. OTHER MAINTENANCE EXPENSE

The Other Maintenance Expense category includes costs associated with maintaining the property of the Company, including repair of parts and tools, maintenance supplies, contracted

⁵⁷⁶ Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-MISC (Hearing Exhibit 90) (March 8, 2011).

⁵⁷⁷ *Id.*

⁵⁷⁸ Transcript of Proceedings, Vol. VII B, p. 136 (March 08, 2011).

⁵⁷⁹ *Id.*

⁵⁸⁰ TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, TN-TRA-02-Q131-ATTACHMENT (December 1, 2010).

services, paving, maintenance agreements, and other miscellaneous maintenance expenses. The Company projected Other Maintenance Expense of \$1,110,317 for the attrition period. Maintenance Expense for the historical test year was \$1,042,628. The Company made one adjustment in the amount of \$44,838 for an anticipated increase in paving expenses due to new materials that are now required by the City. The Company then applied its inflation factor of 3.58% to the normalized test year balance, for an adjustment of \$22,851.⁵⁸¹

The CAPD forecasted \$1,143,925 in Other Maintenance Expense for the attrition period.⁵⁸² The CAPD started with the book balance of Other Maintenance Expense for the twelve months ended September 30, 2010⁵⁸³ and increased it by one half of the customer growth of 0.89% plus the annual GDP Chained Price Deflator growth rate of 0.76%.⁵⁸⁴ The CAPD subsequently adjusted its growth factor to 1.40%.⁵⁸⁵ The effect of this adjustment was a decrease in Other Maintenance Expense from \$1,143,925 to \$1,142,685.⁵⁸⁶ In amended testimony, the CAPD made a change to the residential customer growth factor it utilized to project revenues from 0.89% to 1.05%.⁵⁸⁷ This changed the CAPD's growth/inflation factor from 1.40% to 1.48%.⁵⁸⁸ The effect of this adjustment was an increase in General Office Expense from \$1,142,685 to \$1,143,531.⁵⁸⁹

Accordingly, the panel adopts \$1,143,531 for Other Maintenance Expense because this calculation is based upon a later test year and more accurately reflects inflation.

⁵⁸¹ Sheila A. Miller, Pre-Filed Direct Testimony, p. 16 (September 23, 2010).

⁵⁸² Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).

⁵⁸³ Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-MAINT (January 5, 2011).

⁵⁸⁴ Terry Buckner, Pre-Filed Direct Testimony, p. 12 (January 5, 2011).

⁵⁸⁵ Terry Buckner, Non-Confidential Direct Testimony Amendment, Workpaper AMENDED E-MAINT (January 31, 2011).

⁵⁸⁶ *Id.*

⁵⁸⁷ John Hughes, Amendment to Amended Testimony filed February 25, 2011, Workpaper R-Customer Growth (March 1, 2011).

⁵⁸⁸ Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-MAINT (Hearing Exhibit 90) (March 8, 2011).

⁵⁸⁹ *Id.*

V(B)17. DEPRECIATION EXPENSE

TAWC projected Depreciation and Amortization Expense for the attrition period of \$4,880,048.⁵⁹⁰ TAWC's projection was based upon its March 31, 2010 Plant in Service balances and forecasted additions and retirements through the attrition period, using current depreciation rates.

The CAPD projected Depreciation and Amortization Expense of \$4,703,804⁵⁹¹ for the attrition period. The CAPD's projection was based upon the Company's September 31, 2010 Plant in Service balances, forecasted additions and retirements through the attrition period,⁵⁹² and the current depreciation rates multiplied by a thirteen-month average of depreciable property through the end of the attrition year.⁵⁹³

The Authority adopts the CAPD's projected amount of \$4,703,804 for the attrition period Depreciation Expense because it is based upon more recent actual balances as of September 30, 2010, including forecasted additions and retirements provided by the Company through the attrition period and does not depreciate the fully depreciated accounts.

V(C). TAXES AND FEES

The category of Taxes other than Income includes the following: Gross Receipts Tax, TRA Inspection Fee, Property Tax, Franchise Tax, FICA Tax, and Unemployment Tax. These taxes are discussed in the following sections.

V(C)1. GROSS RECEIPTS TAX

The Company projected \$529,961 for the attrition period in Gross Receipts Tax.⁵⁹⁴ The Company stated that its Gross Receipts Tax was based on projected jurisdictional revenues for

⁵⁹⁰ TAWC's Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 2, Schedule 1 (February 22, 2010).

⁵⁹¹ Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-DEPRECIATION, p. 54 (January 5, 2011).

⁵⁹² Terry Buckner, Pre-Filed Direct Testimony, pp. 45-46 (January 5, 2011).

⁵⁹³ *Id.*

⁵⁹⁴ TAWC's Responses to the TRA's Data Requests Dated September 20, 2010, Question 13, TN-TRA-01-Q013-GENERAL TAXES, p. 8 (September 24, 2010).

TAWC including Other Operating revenues. The revenues, adjusted for the Franchise Tax, Excise Tax, and a \$5,000 exemption, were multiplied by the current 3% tax rate to arrive at the attrition year level. The forecasted amount was calculated using 50% of the Gross Receipts Tax Return based on 2009 revenues. This return was due July 2010 for the taxable period ended June 2011. The remaining 50% was based on 2010 budgeted revenues. This approach properly matched the Gross Receipts Tax with the attrition period in this case.⁵⁹⁵

The CAPD projected \$704,308 for the attrition period in Gross Receipts Tax.⁵⁹⁶ The CAPD based its calculation of gross receipts for the first half of the attrition period on state gross receipts tax paid in August 2010, which are derived from gross receipts for the fiscal year ended December 31, 2009.⁵⁹⁷ The CAPD forecasted the second half of the attrition period gross receipts based on actual gross receipts for the twelve months ended September 30, 2010, as stated on the Company's September 2010 TRA 3.06 Report. The CAPD then adjusted revenues by the \$5,000 exemption and multiplied the remaining taxable receipts by the current 3% tax rate. The CAPD adjusted taxes payable by deducting the amount of Franchise Tax, but did not apply any State Excise Tax. The CAPD calculated \$0 State Excise Taxes due in 2009, based on the effect of offsetting net operating losses from prior years.⁵⁹⁸

The panel adopts \$704,308 for the attrition period forecast for Gross Receipts tax, because this amount is calculated using the proper and most accurate methodology.

V(C)2. TRA INSPECTION FEES

The panel determines that the TRA Inspection Fee for the attrition period revenue at current rates is \$116,262. This projection for the TRA Inspection Fee is based on forecasted

⁵⁹⁵ Sheila A. Miller, Pre-Filed Direct Testimony, p. 18 (September 23, 2011).

⁵⁹⁶ Terry Buckner, Pre-Filed Direct Testimony, Workpaper T-OTAX7 (January 5, 2011).

⁵⁹⁷ *Id.*

⁵⁹⁸ *Id.*

revenue of \$37,921,589 for the attrition period, reduced by uncollectibles of \$198,122 and a \$5,000 exemption to arrive at taxable revenues, and then multiplied by the statutory rate.

V(C)3. PROPERTY TAXES

The Company projected Property Taxes of \$2,936,068 for the attrition period.⁵⁹⁹ The Company started its calculation of Property Taxes for the test year in the amount of \$2,380,025. The Company then normalized the test period by increasing this figure by 19% to account for a known property tax increase enacted by the City of Chattanooga which is effective in the attrition year resulting in a normalized adjustment of \$242,895.⁶⁰⁰ The Company calculated an effective property tax, which included that increase, and applied the effective rate to the thirteen-month average attrition year Construction Work in Progress ("CWIP")⁶⁰¹ for the attrition period adjustment of \$313,148, to arrive at \$2,936,068 in property taxes for the attrition period.⁶⁰² In Rebuttal Testimony, the Company adjusted its 13-month average attrition year CWIP due to a retirement error in the original filing.⁶⁰³ This correction to CWIP changed Property Taxes for the attrition period from \$2,936,068 to \$2,800,043.⁶⁰⁴

The CAPD projected Property Taxes of \$2,572,725 for the attrition period.⁶⁰⁵ In its calculation, the CAPD used a ratio of 2009/2010 taxes paid for the Company's Georgia property and a ratio of 2009/2010 assessments for its Tennessee property, multiplied by the 2010 tax rates.⁶⁰⁶

The Authority adopts Property Taxes for the attrition period of \$2,572,725 as projected by the CAPD because it utilizes a later, more timely assessment period.

⁵⁹⁹ *Petition*, Exhibit No. 2, Schedule 5 (September 23, 2010).

⁶⁰⁰ Sheila A. Miller, Pre-Filed Direct Testimony, p. 17 (September 23, 2010).

⁶⁰¹ *Id.*

⁶⁰² *Id.*

⁶⁰³ Sheila A. Miller, Pre-Filed Rebuttal Testimony, pp. 14-15 (February 8, 2011).

⁶⁰⁴ TAWC's Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 2, Schedule 5 (February 16, 2011).

⁶⁰⁵ Terry Buckner, Pre-Filed Direct Testimony, p. 47 (January 5, 2011).

⁶⁰⁶ *Id.*

V(C)4. FRANCHISE TAXES

The Company projected Franchise Taxes of \$377,690 for the attrition year.⁶⁰⁷ The Company utilized its taxable basis as of December 2010 for five-sixths of the attrition year tax, and its projected taxable basis as of December 2011 for one sixth of the attrition year tax. Those values were then multiplied by the statutory rate of \$.25 per \$100.⁶⁰⁸

The CAPD projected Franchise Taxes of \$391,255 for the attrition period.⁶⁰⁹ The CAPD calculated Franchise Tax using a forecasted December 31, 2011 plant in service and accumulated depreciation net of forecasted plant additions and retirements.⁶¹⁰ The CAPD then multiplied its calculation for projected taxable basis by the statutory rate of \$.25 per \$100.

The Authority adopts Franchise Taxes of \$391,255 for the attrition period, as projected by the CAPD, because it is based upon more recent data.

V(C)5. FICA TAX

The Company projected FICA Tax of \$421,089⁶¹¹ utilizing applicable wages that are subject to payroll taxes, then applied the appropriate tax rates to arrive at its total for FICA Tax. A capitalization percentage of 15.83% was applied to the total FICA Tax to arrive at its normalized year FICA Tax.⁶¹²

The CAPD projected FICA Tax of \$370,627 by forecasting its attrition period FICA Tax and applying the current tax rates to its calculation of attrition period Salaries and Wages. The CAPD then applied a capitalization rate of 20.57%.⁶¹³

⁶⁰⁷ TAWC's Responses to the TRA's Data Requests Dated September 20, 2010, Question 13, TN-TRA-01-Q013-GENERAL TAXES, p. 2 (September 24, 2010).

⁶⁰⁸ *Id.*

⁶⁰⁹ Terry Buckner, Pre-Filed Direct Testimony, Workpaper T-OTAX8 (January 5, 2011).

⁶¹⁰ Terry Buckner, Pre-Filed Direct Testimony, p. 48 (January 5, 2011).

⁶¹¹ TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, TN-TRA-02-Q92f-ATTACHMENT, Exhibit No. 2, Schedule 5, p. 1 of 9 (December 1, 2010).

⁶¹² *Id.* at 9 of 9.

⁶¹³ Terry Buckner, Pre-Filed Direct Testimony, Workpaper T-OTAX3 (January 5, 2011).

The Authority adopts \$397,217 for FICA Tax for the attrition period because this forecast is consistent with the price-out calculation for Salaries and Wages Expense for 110 employees and applies a capitalization percentage of 20.57%.

V(C)6. UNEMPLOYMENT TAX

The Company projected Unemployment Tax of \$17,685.⁶¹⁴ The Company forecasted its attrition period Unemployment Tax by multiplying 110 employees by the appropriate tax base, and applying the current tax rate. The Company then applied a capitalization percentage of 15.83%.

The CAPD projected Unemployment Tax of \$15,778.⁶¹⁵ The CAPD performed empirical calculations on a forecasted average of 104 Tennessee employees for the test period ended September 2010. The CAPD multiplied 104 employees by the appropriate tax base and current tax rate, and applied a capitalization percentage of 20.57%.⁶¹⁶

The Authority adopts \$16,688 for Unemployment Tax for the attrition period. This forecast is consistent with the forecast of Salaries and Wages Expense for 110 employees and a capitalization percentage of 20.57%.

V(C)7. STATE EXCISE TAX

The Authority adopts an Excise Tax amount of \$223,534 for the attrition period. This amount is calculated using forecasted results from operations at current rates for the attrition period, and adjusted for interest expense, permanent differences, and applies the statutory tax rate of 6.5%. Additionally, the state excise tax was included on the amount of the projected revenue deficiency.

⁶¹⁴ *Petition*, Exhibit No. 2, Schedule 5 (September 23, 2011).

⁶¹⁵ Terry Buckner, Second Amendment to Direct Testimony, Amended Exhibit 1, Schedule 6, p. 6 of 9 (Hearing Exhibit 90) (March 8, 2011).

⁶¹⁶ Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-PAY-4A, p.7 (January 5, 2011).

V(C)8. FEDERAL INCOME TAX

The Authority adopts Federal Income Tax of \$1,672,871 for the attrition period. This amount is calculated using the forecasted results from operations at current rates for the attrition period, and adjusted for interest expense, permanent differences, excise tax, ITC amortization, then applies the statutory tax rate of 35%, and recognizes the reversal of the FAS 109 regulatory asset in the amount of \$623,832. The FIT tax is also included on the amount of the projected revenue deficiency.

V(C)9. ALLOWANCE FOR FUNDS USED DURING CONSTRUCTION (AFUDC)

CWIP may be appropriately included in utility rate base, and the Company is allowed to earn a return on this type of investment. The return, or income, generated by this investment, however, will not be realized until a future date, which is beyond the attrition period. Therefore, it is necessary to remove the return (the cost of debt) on CWIP from the attrition period so that current customers do not pay for expenses related to future income. Here, the Company's budgeted capital additions were used in its calculations of CWIP. As this is the case, the Company's associated budgeted AFUDC should also be adopted.

The Company proposed the amount of \$204,000 for AFUDC for the attrition period. This adjustment was made to reflect the AFUDC as an above the line item for ratemaking purposes.⁶¹⁷ The CAPD concurred with the Company's position.⁶¹⁸

Therefore, the TRA adopts \$204,000 for AFUDC for the attrition period, as proposed by both the Company and the CAPD.

⁶¹⁷ *Petition*, Exhibit No. 2, Schedule 3 (September 23, 2010).

⁶¹⁸ Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 3, p. 3 of 9 (January 5, 2011).

V(D). NET OPERATING INCOME

Based on the foregoing determinations, the Authority finds that TAWC's Net Operating Income is \$5,937,860 for the attrition period prior to the application of taxes for additional attrition period revenues.

V(E). RATE BASE

Rate base is the total of the investor funded or supplied plant, facilities, and other investments used by the utility in providing service to its customers. Rate base is the investment base to which a fair rate of return is applied in order to determine the Company's net operating income requirement. Relying on its revised accounting exhibits, TAWC proposed a rate base amount of \$120,967,931.⁶¹⁹ In its *Petition*, the Company stated that it used a test period ending March 31, 2010, made normalizing adjustments, and then projected the results to determine an attrition year of the twelve months ended December 31, 2011.⁶²⁰ The Consumer Advocate asserted that the Authority should approve an attrition year rate base of \$115,042,041.⁶²¹ For the reasons set forth below, the Authority adopts a rate base of \$118,459,808 for the attrition year ended December 31, 2011.

V(E)1. UTILITY PLANT IN SERVICE ("UPIS")

In direct testimony, the Company projected an average attrition period balance for Utility Plant in Service ("UPIS") of \$226,384,490.⁶²² TAWC President, Mr. Watson, testified that the projected UPIS will be used and useful and attributed the majority of the increase to two major projects. The first project is an upgrade of the Citico Treatment Plant that the Company states is necessary due to the Tennessee Department of Environment and Conservation's findings

⁶¹⁹ TAWC's February 22nd Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 1, Schedule 1 (February 22, 2011).

⁶²⁰ *Petition*, p. 4 (September 23, 2010).

⁶²¹ Terry Buckner, Second Amendment to Direct Testimony, Amended Exhibit 1, Schedule 1, p. 1 of 9 (Hearing Exhibit 90) (March 8, 2011).

⁶²² TAWC's February 22nd Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 1, Schedule 2, p. 1 of 3 (February 22, 2011).

regarding the need for a chemical off-loading facility. The second project consists of the replacement of one eight-inch steel water main and one twelve-inch water main in the Lookout Mountain service area. The total cost for both projects is \$8.3 million.⁶²³

To calculate its UPIS, TAWC used account balances as of March 31, 2010 and included projected net additions and retirements. The Company then utilized its projected monthly account balances for the period December 1, 2010 through December 31, 2011 to calculate a thirteen-month average and forecast an attrition year balance of \$226,384,490.⁶²⁴

The CAPD's calculation used test year balances as of September 30, 2010 and then applied the forecasted additions and retirements provided by TAWC in order to determine monthly amounts for plant in service through the attrition period ended December 31, 2011. The CAPD also used a thirteen-month average to arrive at a projected amount of \$225,496,165.⁶²⁵

Although TAWC is correct in its assertion that the use of an alternative test year, such as proposed by an Intervenor, requires more work on the part of the utility in providing more recent financial information, the Authority disagrees that differing test years, after application of the proper adjustments, would result in "essentially the same"⁶²⁶ attrition year amounts. In order for these amounts to be the same, all projections would have to be almost identical to the actual recorded amount, which is highly unlikely to occur for every account. The panel agrees with the CAPD that the use of more recent information often provides results that are a more accurate representation of what can be expected to occur on a going-forward basis.

For these reasons, the TRA finds that the later test period and normalizing adjustments made by the CAPD are likely to be more representative of future amounts for UPIS. Therefore,

⁶²³ John S. Watson, Pre-Filed Direct Testimony, pp. 5-6 (September 23, 2010).

⁶²⁴ Sheila A. Miller, Pre-Filed Direct Testimony, pp. 19-20 (September 23, 2010).

⁶²⁵ Terry Buckner, Non-Confidential Direct Testimony Amendment, p. 50 (January 31, 2011).

⁶²⁶ Michael A. Miller, Pre-Filed Direct Testimony, p. 18 (September 23, 2010).

the panel adopts UPIS in the amount of \$225,496,165 for the attrition period ending December 31, 2011.⁶²⁷

V(E)2. CONSTRUCTION WORK IN PROGRESS

TAWC initially reported CWIP as \$4,201,421, but later filed amended exhibits that decreased its CWIP amount by \$1,165,021 to account for certain retirements.⁶²⁸ Additional adjustments were made to CWIP expenditures in the amount of \$1,545,192 in order to reflect an accurate amount actually spent during the annual period.⁶²⁹ TAWC asserts that the CAPD did not appropriately consider the timing of the Company's capital spending throughout the year. Specifically, the CAPD utilized a later test period ending September 30, 2010, but failed to adjust for capital expenditures that had not taken place by the end of December 2010.

TAWC made adjustments to increase the capital expenditure amounts for CWIP by the difference between what TAWC projected would be spent by the end of December 2010 (\$11,974,692) and the actual expenditures made by the end of December 2010 (\$10,429,500) and spread the difference (\$1,545,192) over the twelve months ended December 31, 2011.⁶³⁰

The CAPD forecasted CWIP in the amount of \$2,681,318, using the later test period ending September 30, 2010.⁶³¹ In its post-hearing brief, the CAPD asserted that because of the interrelationship between CWIP and UPIS, capital spending projects should be accounted for in CWIP as they are being constructed and moved from CWIP to UPIS once the asset is placed into service.⁶³²

⁶²⁷ Director Roberson voted that the capital additions for the Citico treatment plant project of \$5,301,305 be removed from rate case calculations, and that such an adjustment will reduce the overall revenue requirement by \$753,736, including the reduced depreciation expense, accumulated depreciation, and the resulting tax effects (not including any adjustments to the accumulated deferred income taxes). He also stated that such projects will be allowed as it is implemented and a Hearing Officer will review and approve such requests by TAWC. Transcript of Proceedings, pp. 73-75 (April 4, 2011).

⁶²⁸ Sheila A. Miller, Pre-Filed Rebuttal Testimony, p. 14 (February 8, 2011).

⁶²⁹ *Id.*

⁶³⁰ *Id.*

⁶³¹ Terry Buckner, Pre-Filed Direct Testimony, p. 50 (January 5, 2011).

⁶³² *Consumer Advocate and Protection Division's Post-Hearing Brief*, pp. 61-62 (March 21, 2011).

After all of the final exhibits and testimony had been filed, the parties' use of different test periods and treatment of capital projects, which the Company stated had not yet occurred as of the end of December 2010, revealed that the difference between the parties amounted to approximately \$1.5 million. Upon review of the record, the TRA finds that TAWC did not provide any verifiable documentation to demonstrate that \$1.5 million was not spent and, therefore, should be added to CWIP during the attrition period. Therefore, the panel agrees with the CAPD that moving the amounts from CWIP to UPIS is not necessary to prevent double counting for this projected amount.⁶³³ Additionally, the Authority agrees that using a later test period as used by the CAPD is appropriate and adopts a CWIP balance of \$2,681,318.

V(E)3. UTILITY PLANT CAPITAL LEASE

The Company projected an average attrition period balance of \$1,590,500 for Utility Plant Capital Lease. TAWC's booked amounts for the period ended March 31, 2010, were adjusted to reflect through the end of the attrition period and averaged for the thirteen months ending December 31, 2011.⁶³⁴ As the known amount of annual leases does not fluctuate and would not be affected by using different test periods, no difference exists between the parties as to the calculation of Utility Plant Capital Lease. After reviewing the financial data, the TRA determines that Utility Plant Capital Lease for the attrition period is \$1,590,500.

V(E)4. WORKING CAPITAL

Working capital consists of the amount of funds needed to meet the Company's daily expenditures and a variety of non-plant investments. Working capital is necessary to sustain the ongoing operations of the utility until those expenditures can be recovered through revenues received from customers.

⁶³³ *Id.*

⁶³⁴ Sheila A. Miller, Pre-Filed Direct Testimony, pp. 21-22 (September 23, 2010).

TAWC included Prepaid Taxes, Materials and Supplies, Deferred Regulatory Expense, Unamortized Debt Expense, Other Deferred Debits, Lead-Lag Study and Incidental Collections in Working Capital.⁶³⁵ The following schedule shows the respective positions of the parties:

	TAWC ⁶³⁶	CAPD ⁶³⁷	Difference
Prepaid Taxes	284,235	414,322	(130,087)
Materials and Supplies	254,110	215,798	38,312
Deferred Regulatory Exp.	1,228,535	458,486	770,049
Unamortized Debt Exp.	460,845	460,842	3
Other Deferred Debits	280,983	280,997	(14)
Lead-Lag Study	987,000	640,976	346,024
Incidental Collections	(1,562,812)	(1,562,481)	(331)
Total Working Capital	1,932,896	908,940	1,023,955

TAWC projected Prepaid Taxes of \$284,235 based upon a thirteen-month average balance for the test year ending March 31, 2010.⁶³⁸ The CAPD projected Prepaid Taxes using a test period ended September 30, 2010 and a thirteen-month average, resulting in Prepaid Taxes of \$414,322.⁶³⁹

TAWC projected Material and Supplies based upon a thirteen-month average balance for the test year ended March 31, 2010, which resulted in \$254,110.⁶⁴⁰ The CAPD projected Materials and Supplies of \$215,798 using a test period ending September 30, 2010 and a thirteen-month average.⁶⁴¹

In rebuttal testimony, TAWC increased its Deferred Regulatory Expense to \$1,228,535⁶⁴² and asserted that this revised amount was a better projection and included the additional costs it anticipated incurring as a result of the Hearing having been located in Chattanooga. TAWC's

⁶³⁵ Sheila A. Miller, Pre-Filed Direct Testimony, pp. 20-21 (September 23, 2010).

⁶³⁶ TAWC's February 22nd Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 1, Schedule 3, p. 1 of 6 (February 22, 2011).

⁶³⁷ Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED RB-WORKING CAPITAL REQUIREMENT (Hearing Exhibit 90) (March 8, 2011).

⁶³⁸ TAWC's February 22nd Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 1, Schedule 3, p. 1 of 6 (February 22, 2011).

⁶³⁹ Terry Buckner, Pre-Filed Direct Testimony, Workpaper RB-PREPAID TAXES, p. 99 (January 5, 2011).

⁶⁴⁰ TAWC's February 22nd Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 1, Schedule 3, p. 1 of 6 (February 22, 2011).

⁶⁴¹ Terry Buckner, Pre-Filed Direct Testimony, Workpaper RB-M&S, p. 98 (January 5, 2011).

⁶⁴² TAWC's February 22nd Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 1, Schedule 3, p. 1 of 6 (February 22, 2011).

revised expense of \$1,228,535 reflected a thirteen month average of unamortized balances as of December 31, 2011. To calculate this amount, TAWC used \$1.2 million as the total cost for this rate case, and added \$275,000 from its prior rate case (Docket No. 08-00039),⁶⁴³ the unamortized balance of \$23,773 for its cost of service study, and \$3,010 for its depreciation study.⁶⁴⁴

In its amended schedules, Consumer Advocate projected \$458,486 for Deferred Regulatory Expense. Nevertheless, the supporting schedule it filed consisted of \$458,486 in Deferred Rate Case Expense, \$3,009 for the Deferred Depreciation Study, and \$12,533 for the Deferred Cost of Service Study, which totals \$474,028.⁶⁴⁵ The CAPD attributed the difference primarily to TAWC's having used \$1.2 million as the rate case cost for this docket and adding the \$275,000 rate case costs incurred in Docket No. 08-00039; whereas, the CAPD used the rate case costs approved by the Authority. The CAPD asserted that TAWC should not be allowed to include excessive rate case expenses that the TRA had not approved.⁶⁴⁶ TAWC responded that rate cases benefit shareholders as well as utilities.⁶⁴⁷

As noted above, Director Roberson expressed concern during the Hearing regarding regulatory fees and moved to require additional information be filed to substantiate TAWC's request in this case.⁶⁴⁸ Director Roberson further proposed that an expedited hearing be held on this matter, which was approved unanimously by the panel.⁶⁴⁹ Subsequently, on March 16, 2011, the parties filed a Joint Motion for Approval of Rate Case Expense stipulating to the Company's recovery of \$645,000 in rate case expense. This stipulated amount includes a total Deferred Regulatory Expense in the amount of \$630,897, which consists of \$589,165 for rate

⁶⁴³ Discussed supra; see *Tenn. Amer. Water Co. v. TRA*, 2011 WL 334678 (Tenn. Ct. App. Jan. 28, 2011).

⁶⁴⁴ TAWC's Responses To The TRA's Fifth Data Request Dated Feb. 15, 2011, Question 170, TN-TRA-05-Q170-ATTACHMENT (February 22, 2011).

⁶⁴⁵ Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED RB-DEFERRED REGULATORY (Hearing Exhibit 90) (March 8, 2011).

⁶⁴⁶ Terry Buckner, Pre-Filed Direct Testimony, p. 51 (January 5, 2011).

⁶⁴⁷ Michael A. Miller, Pre-Filed Rebuttal Testimony, pp. 76-79 (February 8, 2011).

⁶⁴⁸ Transcript of Proceedings, Vol. VII B, pp. 126-127 (March 8, 2011).

⁶⁴⁹ *Id.* at 127.

case expense, \$38,723 for the cost of service study expense, and \$3,010 for depreciation study expense.

TAWC projected its Unamortized Debt Expense based upon an account balance as of March 31, 2010, adding its new debt, and subtracting cumulative amortizations to arrive at monthly amounts for a thirteen-month average.⁶⁵⁰ The CAPD used the same methodology as the Company with a starting account balance as of September 30, 2010.⁶⁵¹

TAWC projected its Other Deferred Debits using a thirteen-month average of the unamortized monthly transition costs of the Customer Call Center, which totals \$204,399, and the Shared Services Center costs in the amount of \$76,584.⁶⁵² The CAPD projected close to the same amount of Other Deferred Debits using the actual booked amounts of the Company.⁶⁵³

Testifying for TAWC, Mr. Miller stated that Working Capital was calculated consistent with the Authority's ruling on this category in Docket No. 08-00039. He further noted that the amount projected included a provision based on the Lead-Lag Study performed by the Company in this case totaling \$987,000.⁶⁵⁴ The CAPD utilized the amount of the Lead-Lag Study provided by the Company but adjusted it to reflect a thirty-seven-day lag for the payment of state excise tax and federal income tax. The CAPD's witness, Mr. Buckner, stated that this methodology would align the payments with the corresponding statutory requirements. Using its forecasted revenue, expenses, and the tax lag adjustment, CAPD forecasted the Lead-Lag total to be \$640,976.⁶⁵⁵

⁶⁵⁰ Sheila A. Miller, Pre-Filed Direct Testimony, p. 21 (September 23, 2010).

⁶⁵¹ Terry Buckner, Pre-Filed Direct Testimony, Workpaper RB-UNAMORTIZED DEBT EXPENSE, p. 100 (January 5, 2011).

⁶⁵² Sheila A. Miller, Pre-Filed Direct Testimony, p. 21 (September 23, 2010).

⁶⁵³ Terry Buckner, Pre-Filed Direct Testimony, Workpaper RB-OTHER DEFERRED DEBITS, p. 97 (January 5, 2011).

⁶⁵⁴ TAWC's February 22nd Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 1, Schedule 3, p. 1 of 6 (February 22, 2011).

⁶⁵⁵ Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED RB-WORKING CAPITAL REQUIREMENT (Hearing Exhibit 90) (March 8, 2011).

Mr. Gorman, who testified for the City, asserted that Working Capital should be reduced by \$2 million because the adjustment is necessary to reflect the removal of the unamortized debt expense, elimination of the non-cash items, and the use of different expense lag for various expenses, including management fees, in the Lead-Lag Study. Further, Mr. Gorman asserted that the unamortized debt expense was already included in the debt interest, and thus, its inclusion in working capital would allow TAWC double recovery of this expense. Further, Mr. Gorman set the expense lag for Depreciation and Amortization, Deferred Taxes, Net Earnings, Amortizations and Uncollectibles equal to the revenue lag. He then used a different expense lag for Management Fees and Gross Receipts taxes, asserting that the charges from the parent company should not be prepaid. Finally, Mr. Gorman asserted that Depreciation and Amortization, Deferred Taxes, Net Earnings, Amortizations and Uncollectibles should be removed from the Lead-Lag study because they are not cash expenses and, therefore, do not create a Cash Working Capital requirement.⁶⁵⁶

In rebuttal, TAWC asserted that the CAPD's adjustments to the Lead-Lag for income tax payments were inaccurate because they were based upon textbook recommendations that do not reflect the Company's current payment schedule.⁶⁵⁷ TAWC also disagreed with Mr. Gorman's position, noting that its management contract with AWWSC requires advance payments. Further, TAWC asserted that Mr. Gorman failed to consider that if there were a lag in the payment to AWWSC, AWWSC would incur a lag in revenues that would then be passed back to TAWC. TAWC contended that the adjustment for uncollectibles that Mr. Gorman proposed was incorrect and represented the same position proposed by the CRMA in Docket No. 08-00039, which was not accepted by the TRA.⁶⁵⁸ In addition, TAWC stated that it outlays cash when it purchases the non-cash items for depreciation and amortization and, therefore, the depreciation and

⁶⁵⁶ Michael Gorman, Pre-Filed Direct Testimony, pp. 14-20 (January 5, 2011).

⁶⁵⁷ Michael A. Miller, Pre-Filed Rebuttal Testimony, p. 52 (February 8, 2011).

⁶⁵⁸ *Id.* at 53-54.

amortization allotment has already recovered the Company's initial cash investment. Finally, TAWC conceded that the gross receipts shown on the Lead-Lag were incorrect and corrected the service period in its rebuttal testimony.⁶⁵⁹

Considering the above, the panel adopts working capital in the amount of \$1,675,829, broken down as follows:

Prepaid Taxes	\$414,322
Materials and Supplies	215,798
Deferred Regulatory Expense ⁶⁶⁰	852,847
Unamortized Debt Exp.	460,842
Other Deferred Debits	280,997
Lead-Lag Study	1,013,504
Incidental Collections	<u>(1,562,481)</u>
Total Working Capital	\$1,675,829

With regard to these components, other than the Deferred Regulatory Expense and Lead-Lag amounts, the difference between the parties is attributable to the use of different test periods.

The category of Deferred Regulatory Expense consists of the unamortized balances of Regulatory Fees, Depreciation Study Expense, Management Audit Costs, deposition costs, and Cost of Service Studies. The panel finds that Regulatory Fees should be calculated using a thirteen-month average of the unamortized approved regulatory fees from Dockets No. 06-00290 and No. 08-00039, plus the thirteen-month average of the unamortized balance of the stipulated amount of \$645,000. The panel further finds that Depreciation Study Expense should be calculated using the thirteen-month average of the unamortized balances from Docket Nos. 06-00290, 08-00039, and this docket. The use of these methods results in the panel's adoption of \$852,847 for Deferred Regulatory Expenses within Working Capital.

Based upon the record, contrary to the CRMA's arguments, the panel finds that it is appropriate to include uncollectibles as an offset to revenues, the prepayment of Management charges, and Gross Receipt Taxes in the Lead-Lag Study. The panel does not agree that

⁶⁵⁹ *Id.* at 55-56.

⁶⁶⁰ This figure includes the cost of the management audit and the cost of Ms. Schumaker's deposition.

depreciation does not require a cash outlay and, therefore, should not be included in the Lead-Lag Study. Therefore, the panel adopts \$1,013,504 for the Lead-Lag Study expense within Working Capital.

V(E)5. ACCUMULATED DEPRECIATION

The Company projected \$72,578,044 for a thirteen-month average of Accumulated Depreciation. To calculate this amount, TAWC started with the historical balance of Accumulated Depreciation as of March 31, 2010 and applied actual depreciation rates to project monthly balances for the period ending December 31, 2011.⁶⁶¹

The CAPD used the historical booked Accumulated Depreciation as of September 30, 2010, then applied current depreciation rates to determine monthly amounts through December 31, 2011. A thirteen-month average was calculated resulting in \$73,137,622 as the final amount for Accumulated Depreciation.⁶⁶²

The differences between the parties as to Accumulated Depreciation are attributable to the use of different test periods. The Authority adopts the projection of \$73,137,622 for Accumulated Depreciation based upon the later test period used by the CAPD.

V(E)6. ACCUMULATED AMORTIZATION OF UTILITY CAPITAL LEASE

There was no difference calculated between the parties on Accumulated Amortization of Utility Plant Capital Lease. Just as with the Capital Lease amounts, this amount agrees because the lease amounts are known and do not fluctuate. Therefore, this amount is not affected as a result of the use of different test periods. After reviewing the financial data, the Authority adopts \$1,387,268 for the attrition period.

⁶⁶¹ Sheila A. Miller, Pre-Filed Direct Testimony, pp.21-22 (September 23, 2010).

⁶⁶² Terry Buckner, Pre-Filed Direct Testimony, Workpaper RB-ACCUMULATED DEPRECIATION, p. 102 (January 5, 2011).

V(E)7. ACCUMULATED DEFERRED INCOME TAXES (ADIT)

In its *Petition*, TAWC filed Accumulated Deferred Income Taxes (“ADIT”) on a non-SFAS 109 basis and asserted that the Authority recognized SFAS 109 accounting as to ADIT. Nonetheless, TAWC did not recognize the amortizations associated in calculating the federal income tax expense in the 2008 rate case. In addition, TAWC included a deferred expense and an expense related to the tax accounting treatment of “Capitalized Repairs” consistent with FIN 48.⁶⁶³ Subsequently, on February 22, 2011, TAWC revised its estimated ADIT amount to be consistent with SFAS 109. The subsequent filing resulted in two primary differences between TAWC and the CAPD related to ADIT: the treatment of SFAS 109⁶⁶⁴ and FIN 48⁶⁶⁵ recognition.

As summarized by TAWC, SFAS 109 addresses the flow-through rate recovery of pre-1981 property.⁶⁶⁶ The difference between straight-line method depreciation and the accelerated depreciation that is allowed by the IRS creates a timing difference.⁶⁶⁷ As the ratepayers received the benefit of accelerated depreciation, a regulatory asset must be established to account for the timing difference and to facilitate the appropriate reversal in subsequent years.⁶⁶⁸

Until the reversal of depreciation, SFAS 109 allows the Company to reduce its ADIT by the amount of the regulatory assets, which allows the Company to earn a return on the timing difference until reversal.⁶⁶⁹ As the timing difference reverses, the regulatory asset account steadily is reduced and the income tax expense steadily increases.⁶⁷⁰ Because the Company’s current taxes for rate recovery have always included the additional income taxes paid to the IRS

⁶⁶³ Michael Miller, Pre-Filed Direct Testimony, p. 58 (September 23, 2010).

⁶⁶⁴ Financial Accounting Standards Board (FASB) Statement No. 109.

⁶⁶⁵ Financial Accounting Standards Board Interpretation No. 48.

⁶⁶⁶ Michael A. Miller, Pre-Filed Rebuttal Testimony, p. 36 (February 8, 2011).

⁶⁶⁷ *Id.* at 35.

⁶⁶⁸ Accelerated depreciation temporarily reduces current income tax expense, thus reducing the expense that must be recovered from ratepayers. *Id.* at 39.

⁶⁶⁹ *Id.*

⁶⁷⁰ *Id.*

on the reversal of the pre-1981 property by the TRA under the APB11⁶⁷¹ approach to rate recovery, the Company established the SFAS 109 tax assets as regulatory assets under the provisions of SFAS 71, which allows regulatory assets to be established if future rate recovery is probable.⁶⁷²

In accordance with FIN 48, AWWC changed the accounting method it used for recording repairs and maintenance. Instead of capitalizing the costs, as it had previously done, TAWC deducted the costs in the current year.⁶⁷³ This change creates an uncertainty regarding the lawfulness of the deduction.⁶⁷⁴ FIN 48 allows the creation of a reserve for a portion of the capitalized repairs in order to allow payment of any future potential tax liability.⁶⁷⁵ FIN 48 requires the Company to identify any uncertain tax positions, evaluate them, and determine whether the IRS is likely to sustain a deduction.⁶⁷⁶ If uncertainty exists, FIN 48 allows the Company to exclude this amount as a deduction from rate base, thus earning a return on a potential repayment.⁶⁷⁷

The CAPD originally filed a calculation of ADIT that did not adjust the amount of regulatory assets or include capitalized repairs.⁶⁷⁸ Later, the CAPD amended its ADIT calculation to include the regulatory assets, but continued to include capitalized repairs in ADIT.⁶⁷⁹ Additionally, the CAPD included a timing difference for Capitalized Repairs and Post-80 depreciation in its calculations. The CAPD did not offer testimony to explain why these adjustments were necessary.

⁶⁷¹ Accounting Principles Board Opinion 11.

⁶⁷² Michael A. Miller, Pre-Filed Rebuttal Testimony, p. 39 (February 8, 2011).

⁶⁷³ *Id.* at 41.

⁶⁷⁴ FIN 48, § A26.

⁶⁷⁵ James I. Warren, Pre-Filed Rebuttal Testimony, p. 35 (February 8, 2011).

⁶⁷⁶ *Id.*

⁶⁷⁷ Michael A. Miller, Pre-Filed Rebuttal Testimony, p. 41 (February 8, 2011).

⁶⁷⁸ *Id.*

⁶⁷⁹ *Id.*

The TRA agrees with TAWC that the CAPD's amended filing appropriately reduced rate base by the total of the Company's ADITs (liabilities) as is reflected on the Company's financial statements using the SFAS 109 approach. Nevertheless, the CAPD failed to appropriately offset this amount by the SFAS 109 (regulatory) assets to account for reversal of the timing differences related to the pre-1981 flow-through property.

The TRA, therefore, agrees with both TAWC and the CAPD that, consistent with SFAS 109 and SFAS 71, regulatory asset accounts should be recognized when computing ADIT, and adopts the SFAS 109 approach to calculating income taxes, which recognizes regulatory assets in determining the ADIT balance. The TRA also agrees with TAWC that FIN 48 amounts represent a tax that the Company owes, with interest, as to previously filed tax returns. No documentation or justification was provided that the repairs deduction for federal income tax expense is uncertain or may not result in reversal. Further, there were no challenges made to the calculation of this FIN 48 amount. Therefore, the TRA concludes that the capitalized repairs deduction should not be used to reduce rate base. Thus, utilizing the regulatory assets in its determination of the ADIT balance and applying FIN 48, the TRA adopts Accumulated Deferred Income Tax in the amount of \$22,638,057.

V(E)8. CUSTOMER ADVANCES FOR CONSTRUCTION

Initially, TAWC and the CAPD disagreed as to the proper amount for Customer Advances for Construction. On February 8, 2011, although TAWC filed rebuttal testimony on its projected attrition period amount, which included exhibits, a discrepancy remained between TAWC's calculation and the CAPD's proposed amounts. On February 22, 2011, TAWC filed a revised exhibit that contained an updated amount of \$5,786,757 for Customer Advances for Construction, but did not include any testimony to support the change.⁶⁸⁰ Nevertheless these

⁶⁸⁰ TAWC's Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 1, Schedule 2, p. 1 (February 22, 2011).

revisions demonstrate an agreement between the TAWC and CAPD on the amount. Based on a review of the financial data, and considering that the parties are now in agreement, and the reasons noted previously concerning the appropriate test period, the Authority adopts \$5,786,757 as the total of Customer Advances for Construction.

V(E)9. CONTRIBUTIONS IN AID OF CONSTRUCTION

TAWC and the CAPD also initially disagreed regarding the amount to be used for Contributions in Aid of Construction ("CIAC"). On February 8, 2011, TAWC filed rebuttal testimony with exhibits, wherein TAWC's revised amount still differed from the amount projected by the CAPD. On February 22, 2011, TAWC filed a revised exhibit with an updated amount of \$9,932,550 for CIAC, without any testimony to support the change.⁶⁸¹ With the second revision, TAWC and the CAPD agree as to the projected total. Considering the financial data, the fact that the parties are now in agreement, and the reasons noted previously as to the appropriate test period, the Authority adopts \$9,932,550, as proposed by TAWC and the CAPD, for the CIAC amount.

V(E)10. UNAMORTIZED INVESTMENT TAX CREDIT ("UITC")

Initially, there was disagreement between TAWC and the CAPD regarding the proper amount to be used for Unamortized Investment Tax Credits. Nonetheless, on February 8, 2011, TAWC filed a rebuttal exhibit that contained an attrition period amount that is identical to that determined by the CAPD, but did not file supporting testimony.⁶⁸² Based on a review of the financial data, the fact that the parties are now in agreement, and reasons previously noted as to the appropriate test period, the TRA adopts \$26,899 for Unamortized Investment Tax Credits.

V(E)11. UTILITY PLANT ACQUISITION ADJUSTMENT

The differences between the parties as to the Utility Plant Acquisition Adjustment are due

⁶⁸¹ *Id.*

⁶⁸² Michael A. Miller, Pre-Filed Rebuttal Testimony, Exhibit MAM-9 (February 8, 2011).

to the use of different test periods. Upon review of the financial data and for the reasons previously noted regarding the appropriate test period, the Authority adopts \$74,850 for Utility Plant Acquisition Adjustment.

V(F). REVENUE CONVERSION FACTOR

Based upon the CAPD's methodology, the panel adopts an overall Revenue Conversion Factor of 1.643037 for the attrition year, a Forfeited Discount Factor of 0.0081 to reflect the CAPD's Normalized Test Year Late Payment Penalty/CAPD's Normalized Test Year Total Sales of Water, an Uncollectible Factor of 0.0066 to reflect the CAPD's Normalized Test Year Uncollectibles/CAPD's Normalized Test Year Total Sales of Water, a state excise tax of 6.5%, and an FIT of 35%.

V(G). RATE OF RETURN

To establish a fair rate of return, the following three steps are performed: (1) determination of an appropriate capital structure; (2) calculation of the cost rates of each component of the capital structure: (i) short-term debt, (ii) long-term debt, (iii) preferred equity, and (iv) common equity; and (3) computation of the overall cost of capital using a weighted average of the component rates to account for the proportion of each component.⁶⁸³

TAWC requested an overall rate of return of 8.38%.⁶⁸⁴ The Company's request was based upon the capital structure of TAWC. The Company proposed a capital structure for TAWC that consisted of: 51.386% long-term debt; 3.453% short-term debt; 1.126% preferred equity; 24.345% common equity in the form of common stock; and 19.690% common equity in the form of retained earnings.⁶⁸⁵ TAWC proposed a short-term debt cost of 1.9% based upon market forecasts for 2011 and recent short-term debt rates from American Water Capital

⁶⁸³ The legal basis on which the Authority determines a utility's fair rate of return is set forth in Section III, above.

⁶⁸⁴ Michael A. Miller, Pre-Filed Direct Testimony, Exhibit MAM-5 (September 23, 2010).

⁶⁸⁵ *Id.*

Corporation ("AWCC").⁶⁸⁶ The proposed cost of long-term debt is 6.2% and includes a proposed \$9 million debt offering at 6.212%, which is anticipated to be issued in late 2010, and an \$8.0 million issue at 6.612% targeted for November 2011.⁶⁸⁷

In deriving its recommended cost of capital of 8.38%, TAWC claimed that its return on equity should be set at 11.5%, as it is within the range of equity returns suggested by Company witness Dr. Vander Weide.⁶⁸⁸ Dr. Vander Weide used the Capital Asset Pricing Model ("CAPM") and the Discounted Cash Flow ("DCF") model to determine the appropriate cost of capital for TAWC.⁶⁸⁹ Dr. Vander Weide also employed risk premium models based upon the required spread above a fixed income instrument, like a utility bond, to form his cost of equity recommendation.⁶⁹⁰

When choosing growth rates for use in the DCF analysis, Dr. Vander Weide used forecasts by stock analysts, rather than historical measures, in reliance on economic research suggesting that analyst forecasts are the best estimates of investors' expectations.⁶⁹¹ He also included a 5% allowance for flotation costs in his DCF analysis.⁶⁹²

Dr. Vander Weide used a sample of water companies and found that the average DCF cost of equity is 12.3%,⁶⁹³ which was found to increase to 13.3% when the average is computed with weights based upon market capitalization.⁶⁹⁴ When the DCF model is applied to his sample of natural gas utilities, the average cost of equity is 11.1%, and falls to 10.9% when calculated on a market weighted basis.⁶⁹⁵ He proposed a cost of equity estimate of 11.2% using the ex post

⁶⁸⁶ *Id.*

⁶⁸⁷ *Id.*

⁶⁸⁸ *Id.*

⁶⁸⁹ Dr. James H. Vander Weide, Pre-Filed Direct Testimony, p.3 (September 23, 2010).

⁶⁹⁰ *Id.* at 29.

⁶⁹¹ *Id.* at 18.

⁶⁹² *Id.* at 20.

⁶⁹³ *Id.* at 25.

⁶⁹⁴ *Id.* at 25-26.

⁶⁹⁵ Dr. James H. Vander Weide, Pre-Filed Direct Testimony, p. 28 and Schedule 2-1 (September 23, 2010).

risk premium method.⁶⁹⁶ Based upon the results of his DCF analysis of water and natural gas companies, and using an ex ante risk premium and ex post risk premium analysis, Dr. Vander Weide determined a cost of equity for TAWC is in the range of 10.9% to 12.3%⁶⁹⁷

Dr. Vander Weide criticized CAPD witness Dr. Klein's DCF analysis and claimed that it is inappropriate to use an annual DCF model instead of a quarterly DCF model.⁶⁹⁸ Dr. Vander Weide further stated that the CAPD did not properly implement the DCF model because it did not adjust the current yield component of the calculation by the expected growth rate,⁶⁹⁹ which, in his view, leads to an understatement of the cost of equity of 25 basis points.⁷⁰⁰ He also criticized Dr. Klein's use of Value Line forecasts of dividend growth, asserting that they are inferior to analysts' estimates of earnings growth.⁷⁰¹ He argued that the CAPD should have used earnings growth estimates instead of dividend growth forecasts, claiming that earnings growth forecasts are more accurate.⁷⁰²

Dr. Vander Weide argued that the use of double-leverage is inconsistent with financial theory.⁷⁰³ Additionally, TAWC witness Mr. Miller asserted that the use of double-leverage is inappropriate and could prevent the Company from recovering its true cost of capital.⁷⁰⁴ Mr. Miller noted that Dr. Klein did not implement double leverage in the same way the TRA has done in previous TAWC rate cases.⁷⁰⁵ Mr. Miller asserted that Dr. Klein used the stand-alone capital structure for TAWC, adjusted to impose the cost of capital for AWW Parent (i.e. a non-consolidated entity) to total equity of TAWC,⁷⁰⁶ which, in Mr. Miller's opinion resulted in a

⁶⁹⁶ *Id.* at 37.

⁶⁹⁷ *Id.* at 44-45.

⁶⁹⁸ *Id.* at 7-8.

⁶⁹⁹ *Id.* at 8-9.

⁷⁰⁰ Dr. James H. Vander Weide, Pre-Filed Rebuttal Testimony, pp. 8-9 (February 8, 2011).

⁷⁰¹ *Id.* at 9.

⁷⁰² *Id.* at 9-10.

⁷⁰³ *Id.* at 24-30.

⁷⁰⁴ Michael Miller, Revised Pre-Filed Rebuttal Testimony Amendment, p. 19 (February 17, 2011).

⁷⁰⁵ *Id.* at 21-22.

⁷⁰⁶ *Id.* at 18.

drastic decrease in the equity ratio of the capital structure relative to the approach adopted by the TRA in previous cases.⁷⁰⁷ Mr. Miller further stated that the CAPD's use of a historical average capital structure is inappropriate because it is not consistent with the known and measurable test,⁷⁰⁸ and that the CAPD's technique artificially inflates the impact of low-cost short term debt on TAWC's capital structure.⁷⁰⁹

As stated above, CAPD witness Dr. Chris Klein utilized a double-leverage methodology that imputed the capital structure and associated cost of capital of TAWC's parent AWWC to the equity portion of TAWC's capital structure.⁷¹⁰ Dr. Klein recommended using the historical capital structures of both TAWC and AWWC in his double-leverage calculation.⁷¹¹ Dr. Klein's historical capital structure for TAWC contains 6.45% short-term debt, 48.71% long-term debt, 1.24% preferred stock and 43.6% equity.

Dr. Klein adopted the costs of short-term debt, long-term debt, and preferred stock for TAWC, as was proposed by Company witness Mr. Miller,⁷¹² and posited the cost of long-term debt for TAWC's parent to be 6.27%.⁷¹³ The CAPD estimated the cost of equity for AWWC using the familiar DCF and CAPM models. Like TAWC witness Dr. Vander Weide, Dr. Klein used proxy groups from both the water and natural gas industry.⁷¹⁴

For his DCF estimates, Dr. Klein uses historical dividend data to estimate dividend growth of 5% for AWWC.⁷¹⁵ Using the dividend yield range of 3.5% to 3.7%, Dr. Klein computes DCF cost of equity estimates for AWWC with a range of 8.5% to 8.7%.⁷¹⁶ Dr. Klein

⁷⁰⁷ *Id.* at 21-22.

⁷⁰⁸ *Id.* at 25.

⁷⁰⁹ *Id.*

⁷¹⁰ Dr. Christopher C. Klein, Corrected Pre-Filed Direct Testimony, p. 5 (January 24, 2011).

⁷¹¹ *Id.*

⁷¹² *Id.*

⁷¹³ *Id.* at Corrected Exhibit p. 2 of 19; *see also* Dr. Christopher C. Klein, Corrected Pre-Filed Direct Testimony, p. 9 (January 24, 2011).

⁷¹⁴ Dr. Christopher C. Klein, Corrected Pre-Filed Direct Testimony, pp. 10-11 (January 24, 2011).

⁷¹⁵ *Id.* at 12.

⁷¹⁶ *Id.*

indicates that the "... minimum DCF cost of equity for AWWC is approximately 8.6%. This is similar to the midpoint of the DCF range for natural gas utilities (8.65%) and just lower than the midpoint for large water companies (9.1%)."⁷¹⁷

For the CAPM, Dr. Klein selects his proxy for risk-free interest rates to be the yield on 5 year Treasury bonds which was 2.1% at the time his testimony was filed.⁷¹⁸ Dr. Klein sets the market risk premium at 7.1% using data taken from the familiar 2010 Ibbotson SBBI Stocks, Bonds, Bills and Inflation Valuation Yearbook. Dr. Klein indicates that the BETA statistic of AWWC, as reported by Value Line, is 0.65.⁷¹⁹ Using this data, Dr. Klein calculates an equity return of 6.72% for AWWC. Dr. Klein notes that "... the comparable water and natural gas utilities all have very similar CAPM cost of equity estimates between 6.36% and 7.78%."⁷²⁰ Dr. Klein notes that current low interest rates may lead to an understatement of the required equity return.⁷²¹ Dr. Klein further notes that there is some evidence that the CAPM may underestimate the cost of equity for firms, like utilities, that have BETA statistic less than one.⁷²² Dr. Klein observes that it is reasonable to expect that the cost of equity for utilities is still less than the market portfolio (BETA =1) which he calculates as 9.2%.⁷²³

Dr. Klein ultimately recommends a 9.0% ROE for AWWC as it is the midpoint of the range his CAPM and DCF estimates taken as a group.⁷²⁴ Dr. Klein also notes that his 9.0% equity return recommendation is within the bounds of his DCF estimates for water utilities (9.1%) and natural gas utilities (8.65%).⁷²⁵

⁷¹⁷ *Id.*

⁷¹⁸ *Id.* at 14-15.

⁷¹⁹ *Id.* at 7 of 19.

⁷²⁰ *Id.* at 15.

⁷²¹ *Id.*

⁷²² *Id.*

⁷²³ *Id.* at 14-15.

⁷²⁴ *Id.* at 15-16.

⁷²⁵ *Id.*

Dr. Klein disputed several of the conclusions reached by Dr. Vander Weide. First, Dr. Klein stated that some of the companies used in TAWC's comparison group were not representative of TAWC or AWWC.⁷²⁶ He also took issue with the risk premium analysis that formed the basis of TAWC's CAPM estimates. He questioned TAWC's reliance on long-term Treasury bonds, which, he stated introduces interest rate risk and, thus, cannot be risk free.⁷²⁷ Finally, Dr. Klein criticized TAWC's use of quarterly dividend payments and flotation costs.

CRMA Witness, Mr. Gorman, noted that the TRA has a long-standing practice of using a double-leveraged capital structure in setting TAWC's overall cost of capital.⁷²⁸ Mr. Gorman argued that TAWC's requested 11.5% equity return is not reasonable relative to the 10.2% equity return awarded in the last rate case.⁷²⁹ To support his argument, Mr. Gorman provided data to show that authorized returns on equity for electric and gas utilities, as well as utility bond yields on "A" and "Baa" rated instruments, have decreased since TAWC's last rate filing.⁷³⁰

The Union suggested that TAWC's equity return should be penalized if it does not maintain the staffing levels established by the TRA. Mr. Lewis opined, ". . . [if] the Company fails to maintain a workforce level consistent with its authorized level, absent a showing of exigent circumstances, TAWC should be subject to a penalty. The penalty, could, for example, take the form of a reduction in the return on equity component of its rates."⁷³¹

V(G)1. CAPITAL STRUCTURE

The TRA traditionally recognizes the importance of the parent-subsidary relationship when determining capital structure. To reflect the relationship between TAWC and its parent company, the panel uses double-leverage capital structure methodology. The TRA was not persuaded by the Company's witnesses, Dr. Vander Weide's and Mr. Miller's, criticism of the

⁷²⁶ *Id.* at 16-17.

⁷²⁷ *Id.* at 17-18.

⁷²⁸ Michael Gorman, Pre-Filed Direct Testimony, p. 22 (January 5, 2011).

⁷²⁹ *Id.*

⁷³⁰ *Id.*

⁷³¹ James Lewis, Pre-filed Direct Testimony (Public Version), p. 20 (January 5, 2011).

use of the double-leverage methodology. The Company failed to offer any new arguments in this case that would persuade the Authority to depart from its well-established precedent.

To implement the double-leverage calculation, it is necessary to determine the elements of TAWC's capitalization that are held by AWWC and those held by outside parties. In making these calculations, the TRA adopts the calculation of Mr. Miller that 6.81% of TAWC's capitalization is debt held by entities outside the AWWC corporate family. The next step in implementing the double-leverage methodology is to determine the capital structure of the TAWC's parent company, AWWC. The calculated historical capital structure for AWWC, set forth by CAPD Witness Dr. Klein, is deemed to be the appropriate structure to use in this proceeding.⁷³² Therefore, the TRA finds that the capital structure for AWWC is composed of 2.63% short-term debt, 53.13% long-term debt, 0.25% preferred stock, and 43.99% common equity. Given the impact of the crisis in the financial markets, the use of a historical capital structure for AWWC will be more reflective of its long run capital structure than using a single point in time to determine its capital structure.

V(G)2. COST OF DEBT

TAWC witness Mr. Miller's approach of measuring spreads between the Federal Funds rate and rates for outstanding short-term debt and then applying those spreads to forecasts of the Federal Funds rate, is inherently reasonable and provides a mechanism for incorporating prospective changes in often volatile short-term interest rates into the rate-setting process. Mr. Miller used the same approach in forecasting short-term debt rates as was used in the previous TAWC rate case. CAPD witness Dr. Klein deemed Mr. Miller's estimates to be reasonable for use in his own analysis. Thus, the TRA adopts a short-term debt rate of 1.9% for use in this proceeding. Additionally, the panel adopts a long-term debt rate of 6.27% as proposed by Dr. Klein, who concluded that this percentage represents that 6.27% is the embedded cost of

⁷³² Dr. Christopher C. Klein, Corrected Pre-filed Direct Testimony, Corrected Exhibit p. 4 of 19 (January 24, 2011).

AWWC's debt. The rate is very similar to the 6.2% figure for the subsidiary, TAWC, which would be expected to have a cost of debt that is very similar to that of its parent.

V(G)3. RETURN ON EQUITY

Finally, the last piece of information needed to determine the weighted cost of capital for AWWC is the appropriate equity return. TAWC requested an 11.5% equity return. CAPD witness Dr. Klein proposed a 9% equity return. CRMA witness Mr. Gorman does not make a specific recommendation, but he argued that the Company's requested return is unreasonable. There is no simple single-step process for setting the appropriate equity return. Therefore, the TRA looks at the results of the parties' models, prevailing economic conditions, and other factors that may provide evidence about the risk of investing in either AWWC or TAWC.

The TRA considered the CAPM result for AWWC. For its CAPM calculation, the Authority adopts a risk-free return of 4.75% for use in the CAPM calculation as proposed by Dr. Vander Weide and used in his CAPM analysis. For the market risk premium, the Authority uses the 7.1% long-run risk premium produced by Ibbotson Associates and referenced by Dr. Klein. This risk premium statistic is slightly below the mid-point of the two risk premium statistics, 6.7% and 7.75%, used by Dr. Vander Weide in his CAPM analysis. Finally, the Authority uses the Beta value of 0.65 for AWWC found in Dr. Klein's testimony. With the information described above, the result is an equity return for TAWC's parent of 9.4%, which is 80 basis points below the 10.2% equity return adopted by the TRA in the last TAWC rate case. This figure increases to 9.8% when using the Beta statistic used in Dr. Vander Weide's analysis. The TRA considers the 9.4% equity return estimate to be a useful floor in setting the equity return in this proceeding.

The TRA disagrees with Dr. Vander Weide's complete rejection of the CAPM and finds that the low Beta statistics associated with comparable companies and AWWC, provides useful information as to the risk of water companies relative to the market. While both witnesses assert

that the CAPM may underestimate the cost of equity for firms with low Beta statistics, the TRA has used the CAPM with such values in the past and no new theory or empirical evidence has been presented to discourage the TRA from adopting the practice again in this case.

The Authority does not adopt Dr. Vander Weide's use of the quarterly DCF model, and instead uses the simple annual DCF model because unlike the quarterly model, the annual model does not inflate the implied cost of equity. The Authority does not adopt the ex ante and ex post risk premium results reached by Dr. Vander Weide because they are not specific to AWWC, the water proxy group, or the natural gas proxy group upon which he based his analysis. The TRA and its predecessor, the Tennessee Public Service Commission, have rejected adding flotation costs to the return on equity when there is no accompanying stock issuance.⁷³³ During the hearing, TAWC witness Mr. Miller indicated that he is unaware of an offering by AWW.⁷³⁴ According to TAWC, it planned to issue \$0.622 million and \$2 million in equity in both 2011 and 2012, respectively.⁷³⁵ Since AWW holds the common stock of TAWC, the equity issuance is an internal transaction and, therefore, it is not necessary to include flotation costs.

The Authority does not agree with the CAPD's CAPM calculations because CAPD used short-term interest rates as a proxy for risk-free return. Instead, the Authority prefers to use longer-term interest rates as a proxy for risk-free return as it more closely matches the expected life of a security, such as a stock or an investment in utility plant. Further, short-term interest rates are likely to increase from the current unprecedented low levels that have been set by the Federal Reserve to combat the recent economic downturn.

TAWC witness Mr. Miller suggested that there has been a predictable spread between A-rate utility bonds and equity returns awarded by state commissions. Using this relationship,

⁷³³ See *In re: Petition of Chattanooga Gas Company for Approval of Adjustment of its Rates and Charges and Revised Tariff*, Docket No. 04-00034, *Order*, pp. 57-58 (October 20, 2004).

⁷³⁴ Transcript of Proceedings, Vol. VI B, pp.171-172 (March 7, 2011).

⁷³⁵ TAWC's Responses to the TRA's Data Requests Dated September 20, 2010, Question 82 (October 4, 2010).

based on current bond rates, Mr. Miller calculated a 10.36% equity return if the average spread is maintained.⁷³⁶ The Authority finds Mr. Miller's testimony to be useful in setting the equity return, as it provided useful information on equity returns awarded to comparable companies. Mr. Miller calculated the average equity return awarded since June 2009 to AWWC subsidiaries to be 10.36%.⁷³⁷ When restricting Mr. Miller's analysis to decisions with orders issued in 2010, the average awarded equity return decreased to 9.95%. In the most recent decision listed in Mr. Miller's exhibit, Kentucky American was awarded a 9.7% return on December 14, 2010.⁷³⁸

Given the range of equity estimates provided by the witness and recent decisions reached by other state regulatory commission, the Authority adopts a 10% equity return in this proceeding. Relative to the last TAWC rate proceeding, AWWC has become less risky as measured by its Beta statistic, thus implying that the required equity return has decreased since the last case. While the most recent decision in the Kentucky American case was a 9.7% equity return, the TRA is concerned that interest rates will generally be increasing as government monetary policy normalizes.

The Authority rejects the Union's suggestion that equity return be adjusted if employment levels fall below the level authorized by the TRA. First, many factors outside the control of TAWC, such as retirements, can alter employment levels. The Company demonstrated at the Hearing that a lengthy process is required to hire for union positions, which can result in vacancies and could result in further delays in meeting authorized employment levels. Secondly, altering base rates to account for employment levels will be costly to implement. Finally, the Authority was concerned that implementing an equity return adjustment

⁷³⁶ Michael A. Miller, Pre-Filed Rebuttal Testimony, Rebuttal Exhibit MAM-5 (February 8, 2011).

⁷³⁷ *Id.*

⁷³⁸ *Application of Kentucky-American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year*, Case No. 2010-00036, Kentucky Public Service Commission, *Order*, p. 71 (December 14, 2010).

to employment levels might introduce inefficiencies into the operations of TAWC by requiring the Company to maintain specific employment levels even when not warranted.

Based on its analysis of relevant debt and equity costs, The Authority determines that an equity return of 10% and overall cost of capital of 7.83% based upon a double-leveraged capital structure is just and reasonable.⁷³⁹

V(H). REVENUE DEFICIENCY

Based upon the preceding findings, a majority of the panel⁷⁴⁰ determines that the Revenue Deficiency is \$5,551,013 for the attrition period.⁷⁴¹

V(I). RATE DESIGN

The Company requested a \$9.984 million increase in annual revenues, which is approximately equal to a 26.77% increase in rates. The requested rates would increase the Chattanooga tariff rates, the Lakeview tariff rates, and the Lookout Mountain tariff rates.⁷⁴² With few exceptions, the base rate for these areas would increase approximately 27% to 28%. The Company also recommended merging the mountain-serving areas into one tariff to reflect the similar characteristics of those areas.⁷⁴³ The proposed volumetric usage increases vary greatly for these three locations depending on the service area and rate band.⁷⁴⁴ The Company requested that tariff rates be established for Suck Creek and Lone Oak.⁷⁴⁵ In addition, the Company recommended that it be allowed to merge the tariffs for Lone Oak and Suck Creek into the Mountain Tariff by adopting the basic blocking structure and volumetric rates.⁷⁴⁶

⁷³⁹ Director Roberson dissented and voted that the return on equity be set at 9.65% and an overall rate of return of 7.68%. This would reduce the revenue increase necessary by \$282,961. Transcript of Proceedings, p. 76 (April 4, 2011).

⁷⁴⁰ Director Roberson dissented from the majority's calculation of the dollar amount, but agrees with the methodology used to perform the calculation.

⁷⁴¹ Director Roberson voted to adopt a revenue deficiency for the Company of \$4,242,134, thereby reducing the total rate increase from 14.76% to 11.29% for customers. Transcript of Proceedings, p. 76 (April 4, 2011).

⁷⁴² John S. Watson, Pre-Filed Direct Testimony, p. 4 (September 23, 2010).

⁷⁴³ Paul R. Herbert, Pre-Filed Direct Testimony, p. 11 (September 23, 2010).

⁷⁴⁴ *Petition*, Exhibit No. 4, Schedule 2 (September 23, 2010).

⁷⁴⁵ John S. Watson, Pre-Filed Direct Testimony, p. 4 (September 23, 2010).

⁷⁴⁶ Paul R. Herbert, Pre-Filed Direct Testimony, p. 11 (September 23, 2010).

Further, the Company requested that individual rates be set for four large resale customers that receive service under special contracts approved by the TRA. The sale for resale customers are the Town of Signal Mountain, Tennessee, Walden's Ridge Utility District, Tennessee, City of Fort Oglethorpe, Georgia, and the Catoosa Utility District Authority, Catoosa County, Georgia.⁷⁴⁷ The CAPD asserted that “. . . any change in revenue requirements ordered by the TRA in this docket [should] be spread uniformly to all customer classes and customer locations.”⁷⁴⁸

Following the initial announcement by TAWC and the CRMA on February 28, 2011 that a settlement had been reached between them, the CRMA later submitted a summary of the proposed settlement agreement during the conclusion of the hearing on March 8, 2011, a copy of which was attached to that day's transcript.⁷⁴⁹ The settlement agreement proposed to increase the meter charges and volumetric rates of TAWC's small industrial customers, while, in turn, decreasing the meter charges and volumetric rates of larger industrial customers. The settlement affirmed that the other parties actively involved in this case do not object to the proposed settlement. As proposed, the settlement agreement applied exclusively between TAWC and the members of the CRMA. In its petition to intervene, the CRMA stated that it represents “. . . 250 manufacturers and businesses supporting and servicing the local area's manufacturing sector.”⁷⁵⁰

On March 25, 2011, a *Notice of Convening Panel* was issued, providing public notice that the panel would be convening on April 4, 2011 to deliberate the merits of the *Petition*.⁷⁵¹ During the proceedings held on April 4, 2011, as to the proposed settlement agreement, the panel determined that not all industrial customers of TAWC were also members of the CRMA, and that filing the proposed settlement during the hearing did not provide adequate notice or

⁷⁴⁷ John S. Watson, Pre-Filed Direct Testimony, p. 3 (September 23, 2010).

⁷⁴⁸ Terry Buckner, Pre-Filed Direct Testimony, pp. 62-63 (January 5, 2011).

⁷⁴⁹ *Summary of Settlement between CRMA and TAWC* (March 28, 2011).

⁷⁵⁰ *Petition to Intervene by the Chattanooga Manufacturers Association* (October 4, 2010).

⁷⁵¹ *Notice of Convening Panel* (March 25, 2011).

opportunity for response to non-members. In addition, the settlement was submitted late during the hearing proceedings, and neither party had presented a witness to testify as to the terms and conditions of the settlement, thereby preempting an opportunity for the Authority to ask questions concerning the proposed settlement agreement.⁷⁵²

While it appeared that the proposed settlement would likely be revenue neutral within the industrial class of consumers, except insofar as it seems that smaller users will absorb a higher percentage of the revenue increase than larger users, the panel was not able to determine its effects on individual users within the class. This issue had not been discussed by the parties, and the proposals included within the settlement were not raised during the discovery process. TAWC is the only party that provided testimony as to possible rate designs, but its testimony related more to what a minimal impact its requested rate increase would have on existing customers and did not provide a comparison of rates or a proper distribution of any potential revenue changes.

After due consideration and review of the record, the Authority declined to approve the proposed settlement because it was filed improperly as an exhibit, failed to include necessary information as to the structure and impacts of the proposals therein, and was designed to affect only rates within the industrial customer class.⁷⁵³ As a result, the Authority requested that the Company file two separate price-out tariffs that reflected the impacts of the proposed rate results and approved revenue changes: one tariff that demonstrated the impacts to rates in the event that the settlement agreement was denied, and one tariff that showed the impacts to rates should the panel approve the settlement agreement.⁷⁵⁴ On April 6, 2011, TAWC filed both price-out tariffs as ordered by the Authority.

⁷⁵² The parties later filed a *Summary of Settlement between CRMA and TAWC* in the docket file on March 28, 2011.

⁷⁵³ Transcript of Proceedings, pp. 8-9 (April 4, 2011).

⁷⁵⁴ *Id.* at 84.

On April 7, 2011, the UWUA filed an objection to the tariffs and asserted that both of the proposed tariffs failed to incorporate the reporting conditions related to staffing and valve maintenance issues that had been previously ordered by the Authority during its April 4, 2011, Authority Conference. On April 14, 2011, TAWC filed its response in opposition to the UWUA's objection. During its regularly scheduled Authority Conference held on April 18, 2011, the Authority overruled the UWUA's objection to the tariffs with regard to TAWC's failure to incorporate staffing and valve maintenance reporting requirements, and based on TAWC's agreement with a request by the UWUA, the panel ordered that the semiannual staffing and valve maintenance reports be filed on April 5th and October 5th of each year. The panel reasoned that the reporting requirements will be included in the Final Order and it is inappropriate and contrary to past practices of the TRA to include such terms in the tariff. Subsequently, the Authority approved the proposed settlement agreement filed by the CRMA and TAWC and the filed tariff that reflected the terms of the settlement agreement.⁷⁵⁵

Next, the Authority denied the Company's originally proposed tariff and ordered the Company to file a new tariff within thirty (30) days with new rates sufficient to produce incremental revenues in the amount of the revenue deficiency, as noted above. The Authority ordered that the tariff filing must be accompanied by a detailed price-out reflecting the new rates based upon attrition year billing determinates and accurately producing incremental revenues in the amount of the revenue deficiency approved by the Authority when compared to attrition year billing determinates at current rates.

IT IS THEREFORE ORDERED THAT:

1. The rates filed by the Tennessee American Water Company on September 23, 2010, are denied.

⁷⁵⁵ Director Kyle voted against the settlement agreement and moved to adopt the tariff to reflect an across-the-board increase to all customer classes and individual rates. Transcript of Proceedings, p. 12 (April 18, 2011).

2. For purposes of the rates set forth herein:

(a) The test period utilized shall vary according to the Authority's determinations herein as to the period that best fits each of the individual items being forecasted.

(b) The attrition period shall be for the twelve months ended December 31, 2011.

(c) The rate base is set at \$118,459,808 and the net operating income is \$5,937,860 at current rates.

(d) Capitalization of debt held by parties outside of the American Water Works Company, the corporate parent of Tennessee American Water Company, system is 6.81%, with a cost of 8.30%.

(e) The capital structure for American Water Works Company is composed of 43.99% common equity, 53.13% long-term debt, 2.63% short-term debt, and 0.25% preferred stock.

(f) An equity return of 10%⁷⁵⁶ and an overall rate of return of 7.83% based upon a double-leveraged capital structure, are just and reasonable and hereby set for Tennessee American Water Company.

3. The Revenue Conversion Factor is 1.643037, and results in a Revenue Deficiency of \$5,551,013, which allows the Company an opportunity to earn a fair return on its investment during the attrition year.⁷⁵⁷

4. The Revenue Deficiency shall be implemented by uniform percentage increases to base rates and volumetric rates for all customer classes.

5. (a) Tennessee American Water Company shall submit semi-annual staffing level reports to the Utility Division Chief on April 5th and October 5th of each year. Such reports shall include (1) the actual number of full-time equivalent employees for the previous period, by

⁷⁵⁶ Director Roberson dissented from the decision of the majority of the panel.

⁷⁵⁷ Director Roberson dissented from the decision of the majority of the panel.

month, (2) an explanation concerning any differences between the authorized and actual full-time equivalent employees, and (3) a date by which Tennessee American Water Company expects to fill any vacant positions.

(b) Tennessee American Water Company shall also semi-annually report to the Utility Division Chief concerning the progress of its valve operation and maintenance program. The report shall include (1) the current number of employees assigned to the valve program, by month, (2) the number of larger and smaller valves targeted for inspection, operation, and maintenance during the previous period, by month, (3) the number of valves actually inspected, operated, and maintained during the current period, by month, (4) the number of valves discovered or known to be in need of repair or replacement, by month, (5) the date of repair or replacement of such valves, and (6) in the event that Tennessee American Water Company did not to repair or replace certain valves, the number of valves that were not repaired or replaced and a detailed explanation of the reason(s) that action was not taken.

6. Tennessee American Water Company is hereby directed to file a tariff with the Authority that implements recovery of \$275,000 in regulatory expense through a separate line item charge that will be reflected on customer bills in all customer classes for a six-month period and will automatically cease upon full recovery.

7. Tennessee American Water Company is hereby directed to file with the Authority tariffs that produce an increase of \$5,551,013 in incremental revenues for service rendered, and any other tariffs necessary and consistent with this Order.

8. All tariffs shall be filed within thirty days.

9. Any party aggrieved by the decision of the Tennessee Regulatory Authority in this matter may file a Petition for Reconsideration within fifteen days of the date of this Order.

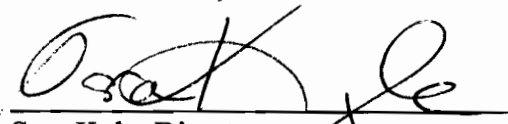
10. Any party aggrieved by the decision in this matter has the right to judicial review by filing a Petition for Review in the Tennessee Court of Appeals, Middle Section, within sixty

days of the date of this Order.


Mary W. Freeman, Chairman

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Eddie Roberson, Director⁷⁵⁸


Sara Kyle, Director

⁷⁵⁸ Director Roberson declined to vote with the majority in granting TAWC a revenue requirement in the amount of \$37,614,978 for the reasons set forth in his *Concurrence and Dissent of Director Eddie Roberson* filed herewith. Director Roberson voted with the majority in approving the rate design as set forth above.