IN THE TENNESSEE REGULATORY AUTHORITY
AT NASHVILLE, TENNESSEE

IN RE:	)	
PETITION OF LAUREL HILLS	)	
CONDOMINIUMS PROPERTY OWNERS	)	**DOCKET NO. 12-00030**
ASSOCIATION FOR A CERTIFICATE	)	
OF PUBLIC CONVENIENCE AND	)	
NECESSITY	)	

POST-HEARING BRIEF OF THE CONSUMER ADVOCATE

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POST-HEARING BRIEF OF THE CONSUMER ADVOCATE

Robert E. Cooper, Jr., the Attorney General and Reporter for the State of Tennessee, through the Consumer Advocate and Protection Division ("Consumer Advocate"), respectfully submits this Post-Hearing Brief in Tennessee Regulatory Authority ("TRA" or "the Authority") Docket No. 12-00030, *Petition of Laurel Hills Condominiums Property Owners Association for a Certificate of Public Convenience and Necessity.*

I. INTRODUCTION

Laurel Hills Property Owners Association, LLC ("Laurel Hills") is a nonprofit located in Cumberland County on Renegade Mountain.[1] Since its incorporation in 1987, it has owned eight condominiums that have timeshares.[2] Laurel Hills has a three-member board: Mr. McClung, President and Director; Phillip Guettler, Secretary and Director; Darren Guettler, Director.[3]

In May 2011, Laurel Hills acquired the water system that serves all of Renegade Mountain from Moy Toy, LLC ("Moy Toy").[4] Philip Guettler, Secretary and Director of Laurel Hills, signed the Warranty Deed and Bill of Sale on behalf of Moy Toy, as Moy Toy's Managing

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[1] *Transcript of Proceedings*, Docket No. 12-00030, Ex. 1, tab 19, Feb. 13, 2013.
[2] *Id.* at 23.
[3] *Id.* at 1.
[4] *Petition of Laurel Hills*, Ex. 1 (April 10, 2012).

Member.[5] The most recent Secretary of State filings for Moy Toy shows it is a member-managed limited liability company and lists its Managing Member as of January 15, 2013 as Mr. McClung, who is also President of Laurel Hills.[6]

Prior to Laurel Hills filing its petition for a CCN in this Docket No. 12-00030, Laurel Hills shut off the water to 87 customers for almost six days and increased the water rates without approval from the Authority.[7] On or about February 1, 2012, Laurel Hills terminated the water service of customers.[8] The Customer Intervenors sought a declaratory order on February 3, 2012.[9] A hearing was conducted by the Chancery Court on February 14, 2012. On February 28, 2012, Chancellor Ronald Thurman issued a temporary injunction to prevent the shut-off of water to customers by Laurel Hills, set a rate of $43.20 per month for water service, and ordered the parties to contact the Authority to determine whether Laurel Hills was subject to the Authority's jurisdiction and regulation.[10]

A. <u>Docket 12-00030: First Petition of Laurel Hills</u>

On April 10, 2012, Laurel Hills petitioned the Authority for a Certificate of Public Convenience and Necessity ("CCN").[11] Laurel Hills further requested approval of proposed tariffs consisting of terms and conditions of service, including schedules for monthly water rates.[12] The Customer Intervenors filed a petition to intervene on May 1, 2012.[13] On May 7, 2012, less than a month after filing a petition to request a CCN, Laurel Hills filed a *Notice of*

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[5] *Id.* at 1, 7.
[6] *Transcript of Proceedings*, Docket No. 12-00030, Ex. 1, tab 18, p. 1, Feb. 13, 2013.
[7] *See supra* notes 78-85 and accompanying text.
[8] *Order Requiring Laurel Hills Condominiums Property Owners Association to Appear and Show Cause Why A Cease and Desist Order and Civil Penalties & Sanctions Should Not Be Imposed Against It For Violations of State Law*, p. 2, July 17, 2012.
[9] *Id.*
[10] *Petition of Laurel Hills*, p. 4; Ex. 6 (April 10, 2012).
[11] *Petition of Laurel Hills* (April 10, 2012).
[12] *Id.*
[13] *Petition to Intervene of Gary Haiser, et al*, May 1, 2012.

Voluntary Dismissal and Withdrawal, stating it would cease providing water service to the public and, therefore, would no longer be a public utility subject to the Authority's regulation.[14] On May 11, 2012, the Authority issued a *Notice to Appear at the Authority Conference* scheduled for May 21, 2012 to show cause why the Authority should not proceed to convene a proceeding to impose civil penalties for various violations of Tennessee law.[15] On May 18, 2012, Laurel Hills filed a response to the Authority's notice to appear indicating that on July 9, 2012, Laurel Hills would no longer provide water to the public and would not be a public utility.[16]

On June 28, 2012, the Consumer Advocate filed a petition to intervene.[17]

B. <u>Docket 12-00077: Authority Show-Cause</u>

Following the withdrawal of the CCN petition by Laurel Hills in Docket 12-00030 and the May 18, 2012 notice that it would cease water service on July 9, 2012, the Authority convened a docket on May 21, 2012 and appointed a Hearing Officer to determine whether the Show-Cause proceeding should go forward.[18] Laurel Hills did not appear before the Authority at the May 21, 2012 hearing. Accordingly, on July 17, 2012, the Authority issued a Show-Cause Order requiring Laurel Hills to appear for various violations of state law after Laurel Hills refused to appear before the Authority on May 21, 2012.[19] The Authority Investigation Staff became a party to Docket 12-00077. After Laurel Hills filed an amended CCN petition on August 3, 2012, Laurel Hills and the Authority Investigation Staff filed a joint motion to hold the

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[14] *Notice of Voluntary Dismissal and Withdrawal*, May 7, 2012.
[15] *Notice to Appear*, May 11, 2012.
[16] *Response to Notice to Appear*, May 18, 2012.
[17] *Consumer Advocate's Petition to Intervene*, June 28, 2012.
[18] *Order Appointing Hearing Officer*, June 21, 2012.
[19] *Order Requiring Laurel Hills Condominiums Property Owners Association to Appear and Show Cause Why A Cease and Desist Order and Civil Penalties & Sanctions Should Not Be Imposed Against It For Violations of State Law*, July 17, 2012.

Show-Cause proceeding in abeyance on August 7, 2012, which was followed by an Agreed Order by the Hearing Officer.[20]

C. Docket 12-00030: Amended Petition of Laurel Hills

On August 3, 2012, Laurel Hills filed the *First Amended Petition* requesting a CCN and a monthly charge of $134.26 per customer.[21] The Customer Intervenors filed a supplemental petition to intervene on August 21, 2012.[22] The Hearing Officer approved the Consumer Advocate's June 28, 2012 Petition to Intervene and the Customer Intervenors' August 21, 2012 Petition to Intervene and established a procedural schedule for the docket.[23] In the following months, the parties filed discovery requests and responses, revisions to the procedural schedule, and direct testimony (by Laurel Hills, Consumer Advocate, and the Customer Intervenors only). On November, 30, 2012, the Customer Intervenors led the deposition of Everett Bolin, the General Manager of Crab Orchard Utility District ("COUD"), the water supplier for the Laurel Hills water system. Laurel Hills submitted rebuttal testimony on January 14, 2013.[24] The hearing on the merits was conducted before the Authority on February 13, 2013.

D. Cumberland County Chancery Court

On February 1, 2013, Laurel Hills filed a *Motion to Dismiss* in Chancery Court of Cumberland County Case No. 2012-CH-513 and requested a hearing on the motion on Tuesday, February 19, 2013, the third business day after the Authority's hearing on Wednesday, February 13, 2013.[25] On Friday, February 15, 2013, the parties in the Chancery Court case had a

[20] *Joint Motion to Hold Proceedings in Abeyance*, August 7, 2012.
[21] *First Amended Petition*, August 3, 2012.
[22] *Supplemental Petition to Intervene of the Customer Intervenors*, August 21, 2012.
[23] *Order Granting, In Part Petitions to Intervene and Establishing a Procedural Schedule*, September 19, 2012.
[24] *Rebuttal Testimony of Mr. McClung*, January 14, 2013.
[25] Monday, February 18, 2013 was President's Day.

conference call with Chancellor Thurman, the presiding judge,[26] to decide whether the motion hearing would indeed be on February 19, 2013. During the conference call, Chancellor Thurman moved the motion hearing from February 19, 2013, to a date to be determined and reminded Laurel Hills that the injunction to keep water service remained on and anything that would be done to disturb may be considered contempt. At the Chancery Court on February 19, 2013, Laurel Hills conceded that its *Motion to Dismiss* had become moot.

It is important to note that the Friday after the Wednesday hearing at the Authority, Laurel Hills was attempting to dismiss the case and thereby lift the injunction that compels them to provide water.

E. Status

At present, the water is on and Laurel Hills' customers are receiving service. The status of the Authority's Docket 12-00077, Show-Cause, is in abeyance. The injunction from the Chancery Court Case No. 2012-CH-513 remains and awaits the Authority's decision in this Docket No. 12-00030. A hearing is scheduled in the Chancery Court on April 22, 2013.

In this post-hearing brief, the Consumer Advocate analyzes Laurel Hills' application for a CCN and its current request for a rate increase of $147.71 per month or $98.75 plus a $47.49 surcharge. Based on its analysis, the Consumer Advocate recommends the Authority deny the CCN and charge an interim rate of $29.54 until the water system can be divested to a suitable operator.

II. THE AUTHORITY SHOULD DENY PETITIONER'S CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY ("CCN").

Laurel Hills cannot satisfy the requirements necessary to operate a public utility under the direction of its current board and, therefore, the Authority should deny the CCN. Tennessee law

[26] At the time, the parties were the Authority, the Consumer Advocate, and Laurel Hills. On February 19, 2013, the Customer Intervenors' *Petition to Intervene* was granted.

requires companies to obtain a CCN from the Authority to operate a public utility in Tennessee.[27] As shown in Section A, Tennessee law further requires that applicants requesting a CCN should at a minimum "possess sufficient managerial, financial, and technical abilities to provide the applied for services."[28] As discussed in Section B, not only does the President of Laurel Hills admit that the company does not have the managerial, financial, or technical abilities to operate the water system, but also the evidence overwhelmingly supports this conclusion. Under the current board and company conditions, the Consumer Advocate must recommend the Authority deny the CCN to Laurel Hills.

As discussed in Section C, instead of issuing the CCN to Laurel Hills, the Consumer Advocate recommends the Authority order Laurel Hills to divest the water system to a purchaser whose CCN is approved or is otherwise suitable but exempt from obtaining a CCN (*e.g.* a utility district or a co-op). Before divestment occurs, the Consumer Advocate recommends the Authority provide instructions as to the treatment of Laurel Hills' debt and the valuation of the water system. The Authority has presided over a divestment of a public utility in 2006 for Red Boiling Springs gas company.[29]

If the Authority is not persuaded to order Laurel Hills to divest, the Consumer Advocate may consider not objecting to a conditional CCN to Laurel Hills if certain changes were made to help ensure the company meets the standards necessary to operate a public utility. Any such conditions should be explored at a hearing in this Docket No. 12-00030, the existing Show Cause proceeding in Docket No. 12-00077 that is at abeyance, or a new docket entirely. The Consumer Advocate has concerns that Laurel Hills may indicate that it would make any necessary changes, but not in fact implement meaningful changes to meet the standards required to operate a public

[27] Tenn. Code Ann. § 65-4-201(a).
[28] *See* Tenn. Code Ann. § 65-4-201(c)(2).
[29] *See Order Closing Docket*, Docket No. 06-00281, Nov. 30, 2007.

utility. Since Laurel Hills has many deficiencies in its current application for a CCN, the Consumer Advocate recommends that a hearing occur as to what conditions would be appropriate to ensure that Laurel Hills will meet the standards required for the public utility, the timeline to meet the conditions, and the monitoring that conditions are timely met.

A. Tennessee law gives the Authority plenary power to ensure utilities comply with the law, including the minimum standard that water utilities with a CCN must "possess sufficient managerial, financial and technical abilities" to provide water.

Laurel Hills is a public utility, as defined in Tenn. Code Ann. § 65-4-101, seeking a monopoly to provide water service to the people of Renegade Mountain. As a public utility, Laurel Hills is required to obtain a CCN from the Authority under Tenn. Code Ann. § 65-4-201 to operate the water system. Under Tenn. Code Ann. § 65-4-113, Transfer of Authority to Provide Utility Services specifies:

> (b) Upon petition for approval of the transfer of authority to provide utility services, the authority **shall take into consideration all relevant factors, including, but not limited to, the suitability, the financial responsibility, and capability of the proposed transferee to perform efficiently the utility services to be transferred and the benefit to the consuming public to be gained from the transfer**. The authority shall approve the transfer after consideration of all relevant factors and upon finding that such transfer furthers the public interest.[30]

Based on this statute, CCN applicants must meet the following minimum requirements: (1) suitability; (2) financial responsibility; (3) capability to perform utility services efficiently; and (4) the applicant's performance of utility services benefits the consumers. The statutory requirements for utilities applying for a CCN in a competitive environment serve as guidance to determining "suitability." The Authority shall grant CCNs to competitors attempting to enter the market "if after examining the evidence presented, the authority finds: (1) The applicant has demonstrated that it will adhere to all applicable authority policies, rules and orders; and (2) The

[30] Tenn. Code Ann. § 65-4-113 (emphasis added).

applicant possesses sufficient managerial, financial and technical abilities to provide the applied for services."[31]

Therefore, in order to obtain a CCN as the monopoly water provider of Renegade Mountain, Laurel Hills needs to, at minimum, show it:

(1) is "suitable" as indicated by demonstrating it
  (a) will adhere to all applicable authority policies, rules and orders; and
  (b) possesses sufficient managerial, financial, and technical abilities to provide water;
(2) exhibits financial responsibility;
(3) is capable of providing water services efficiently;
(4) can and will operate the water system in a manner that benefits its customers.

As discussed in Section B, Laurel Hills does not meet any of these minimum statutory standards.

Under Tennessee law, the Authority has the authority to make the changes necessary to ensure that the people of Renegade Mountain receive continuous, safe, reliable potable water. Tennessee statutes and case law support the Authority's plenary authority over public utilities, including the "power over their property, property rights, facilities, and franchises, so far as may be necessary for the purpose of carrying out the provisions of this chapter."[32] Although it has never done so, the Authority has the authority to request the Comptroller's office to "appraise and value the property of any public utility, as defined in § 65-4-101, whenever in the judgment of the authority such appraisal and valuation shall be necessary for the purpose of carrying out any of the provisions of this chapter."[33]

As further discussed in Section C, because Laurel Hills does not meet any of the statutory minimum standards to operate this water system, the Consumer Advocate recommends the

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[31] Tenn. Code Ann. § 65-4-201(c).
[32] Tenn. Code Ann. § 65-4-104; *BellSouth Adver. & Pub'g Corp v. Tenn. Reg. Auth.*, 79 S.W.3d 506, 512 (Tenn. 2002) ("The General Assembly, therefore, has "signaled its clear intent to vest in the [TRA] practically plenary authority over the utilities within its jurisdiction." (quoting *Tennessee Cable Television Ass'n v. Tennessee Public Service Comm'n*, 844 S.W.2d 151 (Tenn. Ct. App., 1992))).
[33] Tenn. Code Ann. § 65-4-117.

Authority order Laurel Hills to divest the water system at a value consistent with a valuation conducted by the Comptroller's office.

B. <u>The Authority should deny the CCN because Laurel Hills does not meet Tennessee's minimum standard to operate a public utility.</u>

The Consumer Advocate recommends the Authority deny the CCN to Laurel Hills because there is no evidence in the record that shows it does (or even can) meet the minimum statutory standards:

(1) is "suitable" as indicated by demonstrating it
  (a) will adhere to all applicable authority policies, rules, and orders; and
  (b) possesses sufficient managerial, financial, and technical abilities to provide water;
(2) exhibits financial responsibility;
(3) is capable of providing water services efficiently;
(4) can and will operate the water system in a manner that benefits its customers.

Requirement 1: All evidence in the record indicates that Laurel Hills is certainly not suitable to operate the water system, including but not limited to the admission of its own president that it does not know the applicable laws[34] and it does not possess the sufficient managerial, financial, and technical abilities to provide water.[35]

The Authority has had to go to extreme measures to ensure that Laurel Hills adheres to the statutes as well as the Authority's policies, rules and orders. As discussed further in Requirement 4, the Authority had to obtain an injunction from the chancery court just to get Laurel Hills to turn water back on for 87 customers. Indeed, sometimes even extreme measures could not compel Laurel Hills to comply. For example, no one showed up for its show cause hearing in Docket No. 12-00077.[36] If the past is any indication of the future, if the CCN is approved, then the Authority will have to closely watch Laurel Hills to make sure it adheres to all applicable statutes as well as Authority policies, rules, and orders. To qualify for a CCN,

[34] *Transcript of Proceedings*, Docket No. 12-00030, p. 190, Feb. 13, 2013.
[35] *Id.* at 82-84.
[36] *Id.* at 190-91.

certainly utilities should demonstrate they know and will adhere to applicable statutes, policies, rules, and orders.

The Consumer Advocate's brief provides evidence that Laurel Hills does not have the managerial, financial, or technical ability to provide water. It would be impracticable if not impossible to list all the characteristics necessary to manage a water system. The Consumer Advocate lists a few of the characteristics that Laurel Hills did not meet: knowledge of the laws so it can operate under them;[37] requirements to receive, log, and address customer complaints in a timely manner;[38] awareness of how to obtain services to perform maintenance and construction at a reasonable cost (including but not limited to competitive bidding with local, non-affiliated entities);[39] avoidance of subsidizing unregulated operations with the water system operations;[40] ability to provide safe drinking water without compulsion by a court-order;[41] ability to provide water efficiently;[42] ability to customer relations;[43] ability maintain a good relationship with critical vendors;[44] ability to pay its bills in a timely manner;[45] avoidance of liabilities with no

[37] To see Laurel Hills' inadequacy for this managerial characteristic, see, for example, *supra* notes 34-36 and accompanying text.
[38] To see Laurel Hills' inadequacy for this managerial characteristic, see, for example, *Transcript of Proceedings*, Docket No. 12-00030, p. 78-79, Feb. 13, 2013.
[39] To see Laurel Hills' inadequacy for this managerial characteristic, see, for example, *Transcript of Proceedings*, Docket No. 12-00030, p. 107-09, 112, Feb. 13, 2013.
[40] To see Laurel Hills' inadequacy for this managerial characteristic, see, for example, Part III, Revenues (showing how none of Laurel Hills' eight timeshare units pay for water service) and Expenses, Line 17 (showing Laurel Hills' agreement to a budget for electricity that would subsidize its timeshare operations).
[41] To see Laurel Hills' inadequacy for this managerial characteristic, see, for example, discussion in Requirement 4.
[42] To see Laurel Hills' inadequacy for this managerial characteristic, see, for example, discussion in Requirement 3.
[43] To see Laurel Hills' inadequacy for this managerial characteristic, see, for example, discussion in Requirement 4.
[44] To see Laurel Hills' inadequacy for this managerial characteristic, see, for example, the testimony of Mr. Bolin, General Manager of COUD, that he has seen no good faith effort from Laurel Hills to pay the water bill in eight months. *Transcript of Proceedings*, Docket No. 12-00030, p. 355, Feb. 13, 2013.
[45] To see Laurel Hills' inadequacy for this managerial characteristic, see, for example, discussion about Surcharges in Part III.

corresponding asset values from affiliate entities;[46] avoidance of using the water system as security for affiliate debt;[47] and so on and so forth.

Quite simply, Laurel Hills has no financial ability to operate a utility. Laurel Hills cannot borrow money, does not control its costs, does not maintain sufficient financial records, and does not even know how to use the Uniform System of Accounts ("USOA") as required by law, and expects ratepayers to pay for USOA training at the CPA firm Laurel Hills uses to keep books.[48] More discussion that supports the Consumer Advocate's conclusion of Laurel Hills' complete lack of financial ability is discussed further in Requirements 2 and 3 as well as in Part III (rates discussion).

For all intents and purposes, Laurel Hills has no technical ability and has demonstrated that it does not even have the ability to hire contractors with the technical expertise who are not from affiliated companies. Laurel Hills has insufficient technical abilities because it neither provides all necessary services with its internal employees, nor has the capabilities to competitively bid services to find the best contractor for the job at a cost-efficient price. Mr. Bolin, the General Manager of COUD, testified that he is not only aware of qualified contractors in the area, but he ensures COUD competitively bids to determine which contractor is the best for the project.[49] But Mr. McClung testified that he could not find contractors in the area, that he could only find a staffing agency that had cafeteria personnel and the like.[50] Instead, Laurel Hills

[46] To see Laurel Hills' inadequacy for this managerial characteristic, see, for example, discussion under Requirement 2.
[47] To see Laurel Hills' inadequacy for this managerial characteristic, see, for example, discussion under Requirement 2.
[48] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 10-11, Jan. 14, 2013. Indeed, Mr. McClung wants ratepayers to pay for the CPA firm he uses for his bookkeeping to learn the Uniform Systems of Accounts.
[49] *Transcript of Proceedings*, Docket No. 12-00030, p. 348, Feb. 13, 2013.
[50] *Transcript of Proceedings*, Docket No. 12-00030, p. 112-13, Feb. 13, 2013.

relies heavily on affiliates like Renegade Resources and Gold Mine Golf to provide services,[51] without verifying whether their charges are reasonable and prudent despite the high risk of overstated prices in affiliated transactions.[52] In determining how to bring the water tank back online to the system, it chose to obtain one bid from a Pittsburgh company to completely redo the tank for $183,000.[53] Mr. Bolin, General Manager of COUD, indicated that it rehabilitates one water tank each year at a cost of approximately $54,000.[54]

Requirement 2: Laurel Hills has demonstrated without a doubt that it has no financial responsibility, and it has not demonstrated that it is even capable of establishing financial responsibility if given the opportunity. Indeed, much evidence is provided throughout this brief, particularly when discussing rates in Part III, where it is clear that not only does Laurel Hills not know how utility accounting works, but it lacks the basic understanding of the differences between expenses and capitalized costs. Even though the Consumer Advocate could make many more comments here, it limits its discussion to Laurel Hills' ability to borrow funds and its purported existing debt to show that Laurel Hills has no financial responsibility.

By its own admission, Laurel Hills cannot borrow funds.[55] The inability to borrow funds is a serious problem, but even more serious is the reason why the system cannot borrow funds. Mr. McClung alleges the reason he must get debt from affiliates is because the utility cannot borrow funds. Actually, it is likely that the reverse is true: the utility cannot borrow funds because of the affiliate debt. According to the Balance Sheet as of August 31, 2012, Laurel Hills has a negative equity balance of $(373,954.71).[56] This negative equity is a direct result of a

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[51] *Transcript of Proceedings*, Docket No. 12-00030, p. 107-12, Feb. 13, 2013.
[52] *See Transcript of Proceedings*, Docket No. 12-00030, p. 296, 304-05, Feb. 13, 2013.
[53] *Transcript of Proceedings*, Docket No. 12-00030, p. 196, Feb. 13, 2013.
[54] *Deposition of Everett Bolin*, Docket No. 12-00030, p. 17, Nov. 30, 2012 (filed on Dec. 17, 2012).
[55] *See, e.g., Transcript of Proceedings*, Docket No. 12-00030, p. 65, lines 17-19, Feb. 13, 2013.
[56] *Response of Laurel Hills Condominiums Property Owners Association to Staff Data Request*, Attachment for Data Response No. 3, Sept. 7, 2012.

$400,000 note payable allegedly due to Moy Toy and a note payable recorded at $53,038 allegedly due to Renegade Mountain Timeshares. Per the filings with the Secretary of the State, Mr. McClung, President of Laurel Hills, is Managing Member of Moy Toy and Renegade Mountain Timeshares. Thus, for both of the notes payable recorded on Laurel Hills' balance sheet, Mr. McClung was conveniently on both sides of the transaction.

Essentially, Laurel Hills is imposing the water system with alleged debt to affiliated parties but the water system is receiving little, and sometimes none, of the debt proceeds.

The $400,000 note was purportedly entered into as the purchase price of the system, but Mr. McClung, who was on both sides of the transaction with Moy Toy, provided no independent records to support its "value."[57] Indeed, if the system were worth $400,000, the debit in the transaction would have been to an asset account. Instead, Laurel Hills had to debit its equity account, creating negative equity. Thus, for all practical purposes it is a distribution (*i.e.*, a benefit to the persons who control Laurel Hills).

Even if Laurel Hills could convince the Authority that this is legitimate note payable for the water system, Laurel Hills does not even have the financial responsibility to recognize that the $400,000 note is invalid. First, Laurel Hills' charter filed with the Secretary of State disallows distributions.[58] Second, under Tenn. Code Ann. § 48-58-302, conflict of interest transactions[59] must be fair and are subject to close scrutiny;[60] or conflict of interest transactions must be approved by one of the following methods: (1) a majority of the board members, and those members must be disinterested and independent;[61] (2) the Attorney General;[62] or (3) a

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[57] *Transcript of Proceedings*, Docket No. 12-00030, Jan. 29, 2013, pp. 4-5 (disallowing the $400,000 note because no independent documentation had been provided to support it as compelled in *Order on November 7, 2012 Status Conference*, Docket No. 12-00030, pp. 2-6, Jan. 25, 2013).
[58] *Transcript of Proceedings*, Docket No. 12-00030, Ex. 1, tab 19, p. 27, Feb. 13, 2013.
[59] Tenn. Code Ann. § 48-58-302 (providing a definition).
[60] *Summers v. Cherokee Children and Family Service, Inc.*, 112 S.W.3d 486, 504 (Tenn. Ct. App. 2002).
[61] Tenn. Code Ann. § 48-58-302(d).

court of record having equity jurisdiction in an action in which the Attorney General is joined as a party.[63] Laurel Hills could not satisfy the burden of proof required under Tennessee law to prove this conflict of interest transaction was fair at the time entered or otherwise approved, and therefore it is void. Third, even if Laurel Hills were a for-profit company, this note would be invalid under Tenn. Code Ann. § 48-16-401(c)(2) because it is constructively a distribution, and distributions that create negative equity are prohibited under state law. Fourth, under Tenn. Code Ann. § 65-4-109, all utility debt that is payable over more than one year requires approval from the Authority, regardless of if the entity is a for-profit or nonprofit company and no requisite approval was obtained.

To illustrate how unreliable these affiliated transactions are, one only needs to look at the numerous inconsistent statements that Laurel Hills has provided the Authority regarding them. Laurel Hills asserted first that it had an outstanding note payable for $50,000 to $53,000 to Renegade Mountain Timeshares in the Balance Sheet that it provided to the Authority in its data response on September 7, 2012,[64] again when it provided a copy of the alleged note in Exhibit 2 of Mr. McClung's rebuttal testimony filed on January 14, 2012,[65] and even portrayed it as a $50,000 note at the hearing.[66] Just minutes after calling it a $50,000 note at the hearing, when asked to explain how the $50,000 proceeds were used, Mr. McClung changed the amount and character of the note on the stand and testified for the first time that only $38,000 had been borrowed by Laurel Hills and that the alleged note was more of a "line of credit, so to speak."[67]

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[62] Tenn. Code Ann. § 48-58-302(b)(3)(A).
[63] Tenn. Code Ann. § 48-58-302(b)(3)(B).
[64] *Response of Laurel Hills Condominiums Property Owners Association to Staff Data Request*, Attachment for Data Response No. 3, Sept. 7, 2012.
[65] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, Ex. 2, Jan. 14, 2013.
[66] *Transcript of Proceedings*, Docket No. 12-00030, p. 136, Feb. 13, 2013.
[67] *Id.* at 138-39 (indicating $11,500 was used for TDEC penalties, $15,000 was used to pay for the pumps, and $12,000 was used for attorneys' fees that were later made questionable as to whether the attorneys fees related to utility or personal, non-utility needs (*see id.* at 175)).

No language in the note suggests that it is a line of credit.[68] No documentation (*i.e.* bank documents showing cash deposits, etc.) has been provided to support the borrowings on the line of credit. The only evidence that Laurel Hills received any proceeds from the note is the note itself, which on its face is $50,000 and was only found after Mr. McClung's "additional searches,"[69] and Mr. McClung's inconsistent statements that Laurel Hills note payable ranged from $53,000 down to $38,000 when asked to explain the proceeds.

If one interprets all of Laurel Hills' allegations of a $50,000 note payable as a mistake, when Mr. McClung was asked whether Laurel Hills could draw the remaining $12,000 on the alleged line of credit, Mr. McClung testified "No. . . . Because those people [Laurel Hills] have been bad credit. We [Renegade Mountain Timeshares] won't be able to get any more money."[70] Thus, Mr. McClung, who was on both sides of the alleged transaction between Laurel Hills (as President) and Renegade Mountain Timeshares (as Managing Member), took an affirmative action to ensure the debt was $38,000, but continued to report to the Authority that Laurel Hills received and owed over $50,000. Indeed, Mr. McClung even warned that "[t]hese are valid debts of the water system[;] if Laurel Hills is not able to pay the balance of the note off through water operations, Renegade Mountain Timeshares, LLC and/or Moy Toy may foreclose on the note costing Laurel Hills significant legal and other expenses."[71]

Additionally, even though Laurel Hills alleges it did not acquire the water system until May 1, 2011,[72] the $50,000 note, dated April 8, 2011, is secured by all of Laurel Hills' timeshare weeks, equipment motors, and the "framework for the pump stations that are purchased and

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[68] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, Ex. 2, Jan. 14, 2013.
[69] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 9, Jan. 14, 2013.
[70] *Transcript of Proceedings*, Docket No. 12-00030, p. 139, lines 12-18 Feb. 13, 2013.
[71] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 9, lines 7-9, Jan. 14, 2013.
[72] *Petition*, Docket No. 12-00030, ¶¶ 2-3, Apr. 10, 2012.

utilized by [Laurel Hills] in connection with its *existing* water system at Renegade Mountain, and all additions, replacements, and spare parts related thereto that are subsequently acquired (the "Collateral")."[73]

The numerous assertions that Laurel Hills has a $50,000 note payable when it had at most $38,000 in debt is certainly definitive evidence that Laurel Hills does not have the financial responsibility deserving of a CCN, nor can it be relied upon to provide accurate accounting records from which this tribunal could even determine permanent rates. Consequently, throughout its recommendation of rates in Part III, the Consumer Advocate makes numerous recommendations to verify Laurel Hills' accounting of expenses and capital, especially when the cost resulted from an affiliated party transaction.

Requirement 3: The fact that Laurel Hills has requested rates of $147.71 or $98.75 plus a $47.49 surcharge,[74] which is nearly $120 per month more than the average bill of $28.50 for COUD's customers in the same area,[75] demonstrates that Laurel Hills cannot efficiently provide water service to its customers. Indeed, the $120 difference in rates is even more shocking when considering that it is likely that many of COUD's 7,800 customers are living in a 400-mile radius[76] are full-time residents, while a majority of Laurel Hills' customers are part-time residents or vacant homes.[77] As discussed throughout Part III, the lack of competitive bidding and the use of affiliated parties for debt and operations likely contribute significantly to Laurel Hills having higher costs than COUD.[78]

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[73] *Transcript of Proceedings*, Docket No. 12-00030, Ex. 1, tab 16, p. 1, Feb. 13, 2013. (emphasis added).
[74] *Transcript of Proceedings*, Docket No. 12-00030, p. 68, Feb. 13, 2013.
[75] *Id.* at 356-57 (showing that COUD's average bill to homes is $14.23 for each 2,000 gallons and each home uses approximately 4,000 gallons, or a total of approximately $28.50 per month).
[76] *Id.* at 343.
[77] *See Response of Gary Haiser*, Docket No. 12-00030, Ex. 4, Oct. 1, 2012 (showing only 38 full-time residents).
[78] Contrast this with COUD, which competitively bids for services when it uses contractors. *Transcript of Proceedings*, Docket No. 12-00030, pp. 346, 355, Feb. 13, 2013.

Regardless of the reason why Laurel Hills claims it needs such high rates, Laurel Hills has failed to prove that it can efficiently provide water service to its customers and, therefore, it does not meet this statutory standard.

Requirement 4: Rather than benefiting its customers, the evidence overwhelmingly suggests that Laurel Hills is a detriment to the water system's customers. In this case, the customers have intervened as a party. Many were present at the hearing, several of whom drove from out of state.[79] It is important to note that Laurel Hills is providing water service today only because an injunction compels it to keep it on and charge only $43.20 per month until the Authority orders a different rate.[80] Indeed, Laurel Hills shut off the water to 87 customers on February 1, 2012.[81] The Authority had to file for a temporary restraining order, which the Cumberland County Chancery Court ordered on February 3, 2012.[82] Despite the serving of an employee, Laurel Hills still did not turn on water service until February 6, 2012.[83] When trying to turn on the water system, sand was found to have been put in the valve to sabotage its operating ability.[84] Laurel Hills claimed it shut off water because of non-payment of an unauthorized rate of $86.40.[85] This "notice" was posted to the guard shack just five days after 80% of the water system's customers filed a lawsuit against Mr. McClung and Laurel Hills in the Cumberland County Chancery Court regarding a matter unrelated to the water system.[86] Thus, there are reasonable concerns that Laurel Hills used its control over the water system against the

[79] *See, e.g., Transcript of Proceedings*, Docket No. 12-00030, pp. 8-32 (showing public commenters Mr. Laneback came from Georgia and Mr. Harkleroad, came from Kansas just for the hearing).
[80] *Transcript of Proceedings*, Docket No. 12-00030, Ex. 1, tab 14, p. 3-5, Feb. 13, 2013.
[81] *Id.* at 314.
[82] *Id.* Ex. 1, tab 14, p. 1-2.
[83] *Id.* at 315.
[84] *Id.* at 315-16, Ex. 11.
[85] *Id.* Ex. 1, tab 5, p. 3.
[86] *Transcript of Proceedings*, Docket No. 12-00030, pp. 199-200, Feb. 13, 2013.

system's customers. Such behavior by a utility is certainly not, under any standard, appropriate customer treatment, and it certainly does not lead to a benefit to the customer.

Since February 2012, Laurel Hills has not shown any improvement in its behavior that would suggest it could benefit the water system's customers. Now, instead of the unauthorized $86.40 rate Laurel Hills attempted to charge, Laurel Hills wants to charge its customers almost $150 a month for water but has shown no signs of attempting to control costs.[87]

Moreover, Laurel Hills has provided no mechanism for its customers to report issues or file complaints and has no ability to borrow money to invest in the system certainly indicates Laurel Hills would indeed be a detriment to the water system's customers.

In summary, Tennessee law holds utilities to a high standard before granting the authority to operate, as well it should. Water utilities are monopolies, and customers oftentimes have no practical alternative for a water source. If a water utility abuses its control by unlawfully withholding water or otherwise not properly treating its customers by threatening extremely high rates, the Tennessee statutes indicate the Authority should deny the CCN. Accordingly, the Consumer Advocate recommends the Authority deny the CCN to Laurel Hills for its failure to meet the minimum statutory standards for obtaining the privilege of operating a monopoly utility.

C. The Consumer Advocate recommends the Authority deny Laurel Hills' application for a CCN and instead facilitate changes to enable the system to provide safe, clean, and reliable water to the people of Renegade Mountain.

Because Laurel Hills has failed to show that it meets the minimum statutory standards necessary to operate a utility, the Consumer Advocate recommends the Authority deny the CCN and take steps to apply to an appropriate tribunal to order Laurel Hills to divest the water system.

[87] See discussion in Part III.

Although orders to divest are rare, the Authority did facilitate a divestment of Red Boiling Springs in 2006.[88] Prior to divestment, the Consumer Advocate recommends the Authority request the Comptroller to perform a valuation on the system, under its regulatory powers in Tenn. Code Ann. § 65-4-117(2).

The Consumer Advocate recommends the Authority consider providing instructions to the Comptroller in its valuation, including but not limited to (1) valuing as appropriate the land still owned by Moy Toy that is under any water system pipes or property under eminent domain conditions within the Authority's statutory limits; and (2) discounting as appropriate the value by the land to permit any subsequent purchaser to obtain it through eminent domain. This will ensure that a subsequent purchaser will not pay full price for property that will also have to undergo eminent domain proceedings.[89] Moreover, the Consumer Advocate recommends the Authority instruct the Comptroller to discount the system by any and all revenue that the Laurel Hills system did not collect from its unregulated operations, including but not limited to the eight units of the Laurel Hills timeshare operations, as discussed under Revenues in Part III.

Additionally, the Consumer Advocate recommends the Authority order that the debt Laurel Hills entered into is Laurel Hills' debt and not the water system's debt, and therefore, the debt is not assumed by any subsequent purchaser. The rationale for such an order is that (1) the debt was not authorized by the Authority as required by Tenn. Code Ann. § 65-4-109, and (2) the debt should be disallowed because it is not a reasonable and prudent transaction for the system, and (3) using a water system as collateral for a company's debt is against public policy since any

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[88] *See Order Closing Docket*, Docket No. 06-00281, Nov. 30, 2007.

[89] It should be noted that eminent domain is available to utility districts under eminent domain under Tenn. Code Ann. § 7-82-305, and public utilities with the authority and necessity to distribute water under Tenn. Code Ann. § 65-4-101 may obtain the land under eminent domain under Tenn. Code Ann. §§ 65-27-101 *et seq.*

foreclosure upon such debt would necessarily transfer authority to provide utility services without Authority approval, which contradicts Tenn. Code Ann. § 65-4-113.

As part of its order, the Consumer Advocate recommends the Authority to order that Laurel Hills has violated, *inter alia*, Tenn. Code Ann. § 65-4-113 from May 1, 2011 to date. As a result of these violations, the Consumer Advocate recommends the Authority assess daily civil penalties against Laurel Hills for each violation for an amount consistent with the pervasiveness of its numerous violations under Tenn. Code Ann. § 65-4-504. The order should clarify that these penalties may be paid in cash or by liquidation of the assets that Laurel Hills owns. The Consumer Advocate recommends the Authority could consider a stay of these penalties on the condition that Laurel Hills complies with certain injunctive conditions in the future, including but not limited to all laws that apply to public utilities until it divests the system, paying its bills on time, agreeing to a voluntary audit of its records by the state entity, and fully cooperating with the Comptroller during the valuation of the water system.

The Consumer Advocate recommends that the Authority order that if Laurel Hills is non-compliant with any of the conditions to stay the penalties, such as violating laws or conditions applicable to lawfully operated utilities (including but not limited to receiving rates and not paying the expenses listed under Expenses in Part III so the system can continue service, *e.g.*, water bill, electricity), then the Consumer Advocate recommends the Authority order that (1) any stayed penalties are immediately imposed upon determination of non-compliance with the conditions of the stay; (2) Laurel Hills go into receivership so that the system will continue providing water service; (3) the receiver be paid by any proceeds from the divestment before Laurel Hills receives any proceeds; and (4) if the receiver costs more than the proceeds of the

divestment, the Authority may want to consider using the penalties assessed to Laurel Hills to the cost of facilitating the divestment.

III. THE CONSUMER ADVOCATE RECOMMENDS THE AUTHORITY AUTHORIZE INTERIM RATES FOR WATER BEING SUPPLIED.

Even if Authority denies Laurel Hills the CCN, interim rates still need to be set for the water being supplied until the divestment occurs. The amount of the rates will vary depending on who will be the ultimate operators of the water system, meaning, if Laurel Hills divests the water system, one of three outcomes may occur. First, if the new investor is a utility district, then the Authority no longer has jurisdiction over the water system and the utility district could charge the rates it deems necessary to run the water system consistent with state law. Second, it is possible that the consumers could turn the water system into a cooperative arrangement, which, like utility districts, would not be under the Authority's jurisdiction. Third, if the new investor is a private entity, however, then the new investor will need to file a petition for a CCN that will require approval from the Authority. It is very likely that many costs will vary from their present amount under new management. With this in mind, the Consumer Advocate provides its recommendation of rates by grouping costs by function, such as operating or administrative costs, as well as indicating which costs may fluctuate under new ownership. This approach also allows the Authority to set a rate for Laurel Hills in the event the Authority approves the CCN.

Under Tennessee law, the Authority has the power to fix just and reasonable rates.[90] When any public utility seeks to increase an existing rate, the utility has the burden of proof its requested increase in rates are just and reasonable.[91]

[90] Tenn. Code Ann. § 65-5-101(a).
[91] Tenn. Code Ann. § 65-5-103(a).

Just and reasonable rates should provide a utility with the opportunity to earn a rate of return on used and useful property commensurate with the returns on alternative investments with similar risks.[92] As a general rule, public utility commissions such as the Authority examine investments by a utility to determine whether such investments were "prudent."[93]

In prior cases, the TRA has stated that it considers petitions for a rate increase filed pursuant to Tenn. Code Ann. § 65-5-103(a) (2004), under the guidance 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."[94]

The Authority has further stated that it "is obligated to balance the interests of the utilities subject to its jurisdiction with the interests of Tennessee consumers; it is obligated to fix just and reasonable rates."[95]

Rates are prospective rather than retroactive.[96] "Retroactive ratemaking is prohibited based on the general principle that those consumers who use the utility's service should pay for

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

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

[94] *In re: Petition of Tennessee American Water Company for a General Rate Increase, Final Order*, Docket No. 10-00189, p. 24 (Apr. 27, 2012).

[95] *Id.* (citing Tenn. Code Ann. § 65-5-101 (Supp. 2011)); *see also Tennessee Cable Television Ass'n v. Tennessee Public Service Comm'n*, 844 S.W.2d 151, 159 (Tenn. Ct. App. 1992) (stating rates should take into consideration the interests of both the consumer and the utility).

[96] *See, e.g., American Ass'n of Retired Persons v. Tennessee Public Service Commission*, 896 S.W.2d 127, 134 (1994); *South Central Bell v. Tennessee Public Service Comm'n*, 675 S.W.2d 718, 719 (Tenn. Ct. App. 1984); *Porter v. South Carolina Public Service Comm'n*, 493 S.E.2d 92 (S.C. 1997); *Popowski v. Pa. Pub. Util. Comm'n*, 642 A.2d 648 (1994); *S.C. Elec. & Gas Co.v. Pub. Serv. Comm'n*, 272 S.E.2d 793 (S.C. 1980).

its production rather than requiring future rate payers to pay for past use."[97] In Tennessee, the appellate court has declared that "the Legislature never intended to extend retroactive ratemaking power" beyond what is expressly stated in what is now Tenn. Code Ann. § 65-5-103(b).[98]

In determining what period and related data to analyze to determine the revenue required for the utility, the Authority has declared that "[i]t 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.[99] Indeed, "[t]he 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."[100]

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

> But if the amounts charged to operating expenses and credited to the account for depreciation reserve are excessive, to that extent subscribers for the [utility] service are required to provide, in effect, capital contributions, not to make good losses incurred by the utility in the service rendered and thus to keep its investment unimpaired, but to secure additional plant and equipment upon which the utility expects a return.[101]

When considering the appropriate rate of return, the Authority has stated that "[t]here is no single, precise measure of the fair rate of return a utility is allowed an opportunity to earn."[102] The Authority "must exercise its judgment in making an appropriate determination."[103]

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[97] *Porter v. South Carolina Public Service Comm'n*, 493 S.E.2d 92 (S.C. 1997); *Popowski v. Pa. Pub. Util. Comm'n*, 642 A.2d 648 (1994).
[98] *South Central Bell v. Tennessee Public Service Comm'n*, 675 S.W.2d 718, 719 (Tenn. Ct. App. 1984).
[99] *In re: Petition of Tennessee American Water Company for a General Rate Increase, Final Order*, Docket No. 10-00189, p. 25 (Apr. 27, 2012).
[100] *Id.*
[101] *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 607 n. 10 (1944).
[102] *In re: Petition of Tennessee American Water Company for a General Rate Increase, Final Order*, Docket No. 10-00189, p. 25 (Apr. 27, 2012).
[103] *Id.*

Finally, Tennessee law prohibits any utility from making unjust discriminatory charges or unreasonable preferences in its charges.[104]

In this section, the Consumer Advocate provides its recommendation of rates and supporting documentation and calculations. The Consumer Advocate provides its recommendation for the calculation of revenues, expenses, rate base, the rate of return, and the resulting rates in Section A. Sections B and C provide the Consumer Advocate's recommendations to the Authority on how to handle debt and future construction.

A. The Consumer Advocate uses foundational ratemaking principles to calculate the rates it recommends the Authority to adopt.

Neither the Authority nor the intervening parties are confined by law or regulatory practice to accepting the test period data proposed by the regulated utility seeking a rate increase. Tennessee courts have never required the Authority to use a specific test period methodology for setting rates; indeed the courts have stated repeatedly that the Authority has the discretion to choose its own test period.[105]

The only limit placed on a ratemaking body is the statutory requirement that rates be just and reasonable. Rates therefore need not be determined using definite rules or precise formulas.[106] Thus, the TRA is not bound by any specific means by which rates are set so long as the end result produces just and reasonable rates.

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[104] Tenn. Code Ann. § 65-4-122.

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

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

In setting rates, the TRA has unfettered discretion to select the test period.[107] A "test year" is a measure of a utility's financial operations and investment over a specific twelve-month period. It provides the baseline or "raw material" for developing an "attrition year" measure of the utility's financial operations and investment (that is, the utility's Rate Base, Operations and Maintenance Expense, Depreciation Expense, and Taxes). An "attrition year," also known as a forecast period, is the "finished product" and is the chief determinant in whether a utility is operating with a revenue deficiency or surplus. If the utility is operating at a revenue deficiency or surplus from authorized rates, then rates must be adjusted.

In this Docket, despite numerous requests, Laurel Hills failed to provide sufficient records prior to the hearing to perform a full analysis for determining its rate of return, revenues, rate base, expenses, or taxes.[108] The lack of information forced the Consumer Advocate's experts to analyze incomplete or highly uncertain data.[109] As a result, Dr. Chris Klein could not provide a rate of return.[110] The Consumer Advocate expert witness Mr. William H. Novak made his best attempt to calculate rates on the incomplete data that Laurel Hills did provide.[111] As discussed further in this part, information that was not made available during discovery was provided during the hearing. With this new data, the Consumer Advocate is able to provide a more certain rate of return. Additionally, some of the data affects components of Mr. Novak's proposed rates. Moreover, the record makes it apparent that many costs used to calculate rates would be affected, and likely could be lowered, if the water system operated under new ownership or management.

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[107] See *Order,* Docket 06-000187 (November 27, 2008), pp. 5-6 for a clear example of the Authority's conclusions as to its discretion in selecting a test year period. *See also Powell Telephone v. T.P.S.C.*, 660 S.W.2d 44, 46 (Tenn.1983) (citing *CF Industries v. T.P.S.C.*, 599 S.W.2d 536, 542 (Tenn.1980)).
[108] *Transcript of Status Conference*, Feb. 13, 2013, p. 305-06.
[109] *Id.*
[110] *Testimony of Chris Klein*, Docket No. 12-00030, p. 11, Oct. 1, 2012.
[111] *See Testimony of William H. Novak*, Docket No. 12-00030, Dec. 13, 2012.

It is essential to determining just and reasonable rates that the data used is updated with the most current and accurate information available, including but not limited to the consideration of changes in operations or management that may affect the forecast of current data. Therefore, Part III provides the Consumer Advocate's updated calculation of revenue, expenses, rate base, and rate of return to reflect the most current information available in the record.

1. Interim Rates

The Consumer Advocate recommends the Authority implement an interim rate that reflects the known and measurable cost of service that includes only reasonable and prudent costs. As discussed throughout the following sections, a permanent rate cannot be calculated based on the information provided thus far. For example, at this time, the record does not contain known and measurable costs for the reasonable and prudent expenditures of several rate base items. Moreover, if the Authority orders Laurel Hills to divest the water system, a new owner will likely have vastly different expenses and costs of capital and the rate would therefore change to match the new owner's cost of service.

The interim rate of $29.54 was calculated based on the cost of service that can be determined based on the information currently available in the record. This rate includes $3,812 in monthly expenses, as discussed further under "Expenses." The rate also incorporates $20,817 in rate base, as discussed further under "Rate Base." The rate of return for the interim rate is 3.32%, based on the weighted average of all known and measurable debt that was invested in the utility.

Laurel Hills has been operating at a revenue surplus. This annualized cost of service of the interim rate is $46,431. As shown in the "Revenues" section, Laurel Hills has had nearly

$130,000 in revenue for the 21-month period of May 1, 2011 through January 31, 2013. Of the $129,779, $119,793 was estimated as actual receipts and approximately $9,986 is owed to the water system from Laurel Hills' timeshare operations. The estimated cost of service for the same 21-month period would have been approximately $81,254.25 (or $46,431/12 x 21 months). The surplus of revenue that Laurel Hills has received is $48,524.75.

Even after 107 data responses and a nine-hour hearing,[112] the question remains: Where is the money going?

Since Laurel Hills cannot provide documentation to indicate where this surplus has been spent, and since it is a nonprofit that cannot receive distributions according to Article XII of its own charter,[113] the Consumer Advocate recommends the Authority consider deeming the revenue surplus as having been re-invested in the utility as accelerated depreciation and amortization that would reduce rate base. To permit Mr. McClung and Mr. Guettler to retain the revenue surplus simply because they have not kept adequate records would be wholly unfair to ratepayers. Since all the rates previously imposed (including the court-ordered $43.20 rate) can be classified as a sort of "blackbox" rate (*i.e.*, each rate had no support of the underlying cost of service), the Authority could treat the revenue surplus as accelerated depreciation and amortization without violating the prohibition against retroactive ratemaking.

2. <u>Revenue</u>

Most simply, a utility's forecasted revenue is calculated by multiplying the current rate times the number of customers it serves. In this case, however, the calculation of revenue is anything but simple because both the rates and the number of customers have been a moving

[112] On February 13, 2013, the hearing started at 1:50 p.m. and concluded at 11:00 p.m. *Transcript of Proceedings*, Docket No. 12-00030, p. 5, 380, Feb. 13, 2013.
[113] *Transcript of Proceedings*, Docket No. 12-00030, Ex. 1, tab 20, p. 27, Feb. 13, 2013.

target. In this section, the Consumer Advocate first discusses the number of customers, and then it discusses the past, present, and recommended future rates.

Number of Customers: The water system provides water through connections to single family homes, an 84-unit condominium ("Cumberland Point Condominiums Association" or "CPCA"), and other units that operate as timeshares.[114] The connected units may house full-time or part-time residents, while other units are vacant.[115]

The number of consumers has ranged from 120 to 135 consumers.[116] In a data response, Laurel Hills stated, "the water system has lost 15 customers for various reasons . . . ."[117] At the hearing, Mr. McClung discussed only four customers' disconnections for a total of five units.[118] Mr. McClung testified at the hearing that water was disconnected to the unit owned by Mr. McMeans because it was under foreclosure.[119] Mr. McClung then testified that the water was disconnected to the two units owned by the Nunezes, because they indicated that they were not returning to the property.[120] The other two customers' units with disconnected service discussed are Moy Toy[121] and Standing Rock, LLC ("Standing Rock").[122] Mr. McClung has ownership in both of these entities,[123] and he is Managing Member of at least one of the entities.[124] When

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[114] *Response of Gary Haiser*, Docket No. 12-00030, Ex. 4, Oct. 1, 2012.
[115] *See id.*
[116] *See Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 15, lines 4-8, Jan. 14, 2013.
[117] *Response of Laurel Hills Condominiums Property Owners Association to the First Discovery Request of the Consumer Advocate and Protection Division*, p. 16, Discovery Response No. 26, Sept. 25, 2012.
[118] *Transcript of Proceedings*, Docket No. 12-00030, pp. 229, 235, 240, Feb. 13, 2013.
[119] *Id.* at 229.
[120] *Id.*
[121] *Id.* at 235.
[122] *Id.* at 240.
[123] Mr. McClung is the only Director of Moy Toy, LLC. *Id.* at Ex. 1, tab 18 (showing Moy Toy, LLC's annual report filed with the Tennessee Secretary of State on Jan. 15, 2013). Mr. McClung also confirmed that Mr. Guettler, another board member of Laurel Hills, is also involved in the ownership of Standing Rock, LLC. *Id.* at 239. Mr. McClung claims to have a "minority-owned company that has a minority-owned position in Standing Rock." *Id.* at 240.
[124] Mr. McClung has been inconsistent as to his involvement in other companies he is involved with. For example, on January 14, 2013, Mr. McClung filed rebuttal testimony claiming "I misidentified myself as the managing member of Moy Toy, and I am not. I own a non-controlling, minority interest in Moy Toy and am not its managing

asked why Laurel Hills disconnected Standing Rock, Mr. McClung responded that it was because Standing Rock did not pay its water bill out of protest of the rate since it claims it has not used any water.[125]

Based on the reasons provided at the hearing for losing four of the alleged fifteen customers lost, the Consumer Advocate is not convinced that the water system has only 120 customers on a permanent basis. First, Laurel Hills has not provided any data to support that it has disconnected service to fifteen customers permanently. At the hearing, Laurel Hills presented an accounts receivable aging report as of August 24, 2012,[126] but it should not be considered a reliable source of Laurel Hills' accounts receivable balance for a couple of reasons. First, the aging does not reflect a month-end balance. Meaning, this aging does not reflect the closing of the books for the month of August. For example, there could have been off-setting payments that were not yet applied at the time the aging was printed. Second, and probably related to the first reason, the aging as of August 24, 2012 shows a balance of $91,235.60,[127] while the accounts receivable balance on the balance sheet just a week later on August 31, 2012 reflects a $67,652.26 balance[128]—a difference of $23,585.34.

Even if the aging could be considered a reliable source to determine customers who were disconnected permanently, Mr. McClung's contention that there are only 120 customers is

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member." *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 15, lines 4-8, Jan. 14, 2013; *Transcript of Proceedings*, Docket No. 12-00030, Ex. 2, tab C, p. 25, Feb. 13, 2013. The very next day, Mr. McClung signed Moy Toy, LLC's annual report filed with the Tennessee Secretary of State, identifying itself as a director-managed LLC and listing only Mr. McClung as its Director. *Transcript of Proceedings*, Docket No. 12-00030, Ex. 2, tab C, p. 25, Feb. 13, 2013. Since Mr. McClung has been inconsistent about his involvement and control over other entities, the Consumer Advocate recommends that the Authority accept Mr. McClung's testimony that he is an owner of Standing Rock only and not as evidence that he does not control the company in some form.

[125] *Transcript of Proceedings*, Docket No. 12-00030, pp. 238-39, Feb. 13, 2013.

[126] *Transcript of Proceedings*, Docket No. 12-00030, Ex. 3, Feb. 13, 2013.

[127] *Transcript of Proceedings*, Docket No. 12-00030, Ex. 3, Feb. 13, 2013.

[128] Accounts receivable balance is from Balance Sheet as of August 31, 2012 provided to the Authority to support its petition. *Response of Laurel Hills Condominiums Property Owners Association to Staff Data Request*, Attachment for Data Response No. 3, Sept. 7, 2012.

simply not supported. Indeed, the water system's accounts receivable as of August 24, 2012 still shows 135 users, even after taking out the four customers discussed at the hearing.[129] The most information about the customers available in the record was provided by the Customer Intervenors in their data response to the Authority's Staff Data Request.[130] This exhibit provides a summary of the details such as customer name and residency status (*i.e.*, vacant, full-time resident, part-time resident, etc.) surrounding each connection to the water system as of September 20, 2012.[131] By comparing the overview provided by the Customer Intervenors ("Overview") with the accounts receivable aging as of August 24, 2012, the Consumer Advocate found twelve customers that have past due balances greater than thirty days on the accounts receivable aging, and according to the Overview, show as "vacant" or "part-time" with an uncertain or unknown residency status (*e.g.*, disconnection notice sent, possible vacancy).[132] It is uncertain how many of the customers have stopped paying their bills because, like Standing Rock, they protest the increased rate because they have used little or no water since their units are vacant or only used part-time. It is very likely that these customers will want water service as soon as they start using the unit again.

The Consumer Advocate identified another discrepancy in comparing the Overview with the accounts receivable aging. Three customer connections are listed on the Overview that are not listed on the accounts receivable aging: Benson, Laurel Hills Timeshares, and one of the Moy Toy connections.[133] Unless Benson is not connected and is unlikely to connect in the future (*i.e.*, this unit has a well, etc.), Laurel Hills should be receiving funds for this connection. As for

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[129] *Transcript of Proceedings*, Docket No. 12-00030, Ex. 3, Feb. 13, 2013; *Response of Laurel Hills Condominiums Property Owners Association to Staff Data Request*, Data Response No. 5, Sept. 7, 2012.
[130] *Response of Gary Haiser*, Docket No. 12-00030, Ex. 4, Oct. 1, 2012.
[131] *Id.*
[132] These customers are Bowles, Burman, Butz, Crawford, Ellis, Forrester, Henman, Hogarth, Lindsay, Materdomini, Patterson, and Warden.
[133] *Response of Gary Haiser*, Docket No. 12-00030, Ex. 4, Oct. 1, 2012. Laurel Hills Timeshares is the timeshare operations of Laurel Hills, the petitioner.

Laurel Hills Timeshares and Moy Toy, just as CPCA must pay a rate for each of its 84 units, so should Moy Toy and Laurel Hills have to pay rates for each of its connections. By Laurel Hills Timeshares not paying a rate for each of its units, the water system is subsidizing Laurel Hills' unregulated operations. Just as Mr. McClung argued that association fees for the timeshares should not be used for the operation of the water system,[134] neither should the water system revenue be used to subsidize the timeshares. Moreover, treating CPCA differently than Moy Toy and Laurel Hills is unauthorized rate discrimination in violation of state law.[135] Thus, Moy Toy should have been charged for two connections in the accounts receivable aging, and Laurel Hills should have been charged for the eight units used for its timeshare operations.[136]

The Consumer Advocate recommends the Authority use 131 customers[137] for calculating interim rates if Laurel Hills is ordered to divest.

If, however, the Authority approves the CCN to Laurel Hills or considers issuing a CCN to any subsequent applicant, the Consumer Advocate recommends that the Authority consider requiring discovery via audit to obtain a more thorough list of the current connections and the status of residency in the related units before setting permanent rates. Additionally, the Consumer Advocate recommends the Authority consider including tariff provisions deterring

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[134] *Rebuttal Testimony of Michael McClung*, Docket No. 12-00030, p. 24, Jan. 14, 2013.

[135] Tenn. Code Ann. § 65-4-122; *see also supra* text accompanying note 104.

[136] Moy Toy has two connections and Laurel Hills has eight units for its timeshare operations. *See Response of Gary Haiser*, Docket No. 12-00030, Ex. 4, Oct. 1, 2012. Laurel Hills requested that one of the units be used part time for management of the water system. *Rebuttal Testimony of Michael McClung*, Docket No. 12-00030, p. 24, Jan. 14, 2013. If the Authority orders Laurel Hills to divest, this cost will not be necessary. If the Authority approves the CCN, and allows one unit to be dedicated to management of the water system by a part-time employee, then the Consumer Advocate recommends the Authority reduce the total number of customers by one.

[137] The Consumer Advocate calculated 131 customers by adding (1) the 54 customer units and the 86 units from CPCA from the accounts receivable aging, *supra* note 129 and accompanying text; and (2) at least one additional Moy Toy connection and at least eight additional Laurel Hills connections, *supra* note 133 and accompanying text, to arrive at 148 units or connections. The Consumer Advocate then subtracted (1) the five connections discussed at the hearing by McClung, *supra* notes 118-125 and accompanying text; (2) the additional Moy Toy connection, *supra* note 133 and accompanying text; and (3) the twelve customer connections that appear to have likely disconnected service at least temporarily, *supra* note 132 and accompanying text, to arrive at 131 customer connections.

disconnection and reconnection initiated by the customer for convenience purposes consistent with other utilities' tariffs.[138]

Rates: The rates have ranged from a monthly rate of $25.00[139] in May 2011 to $86.40[140] in June 2011, not including Laurel Hills' present request for $147.71 or $98.75 plus a $47.49 surcharge.[141] The current rate charged to customers has been in place since February 28, 2012, when the Cumberland County Chancellor ordered a monthly rate of $43.20[142] be charged for each connection and $3,628.80 for the 84 units at CPCA.

As supported by the analysis provided in the following sections, the Consumer Advocate recommends interim rates of $29.43 per month if the CCN is denied or $31.68 per month if the CCN is approved. If the CCN is approved, more permanent rates will need to be calculated after the additional capitalized costs can be measured for inclusion in rate base.

Revenue in Test Period: The inconsistent and incomplete records submitted by Laurel Hills never provided the precise amount of revenue it has received. The Consumer Advocate calculates that Laurel Hills received approximately $130,000 in water revenue at the time of the hearing:

	Service Period	Total
A)	Jan. 1, 2011 to Dec. 31, 2011 - Actual	$ 47,623.60
B)	Jan. 1, 2012 to Aug. 31, 2012 - Actual	$ 53,859.40
C)	Sept. 1, 2012 to Dec. 31, 2012 - Forecasts ($43.20 x 131 customers x 4 month)	$ 22,636.80
D)	Jan. 1-31, 2013 - Forecasts ($43.20 x 131 customers x 1 month)	$ 5,659.20
E)	**Total Revenue Received (May 1, 2011 – January 31, 2013):**	**$129,779.00**

[138] Laurel Hills requested a $500 reconnection charge in its amended petition. *First Amended Petition*, p. 9, ¶ 25, Aug. 3, 2012. The Consumer Advocate's recommendation does not provide a specific amount nor does it suggest Laurel Hills' amount of a reconnection charge is reasonable.
[139] *Transcript of Proceedings*, Docket No. 12-00030, p. 268, Feb. 13, 2013.
[140] *Id.* at 62.
[141] *Id.* at 68. In its original petition, Laurel Hills requested $86.40. *Petition*, Docket No. 12-00030, p. 6, Apr. 10, 2012.
[142] *See First Amended Petition*, Ex. 6, p. 2, Aug. 3, 2012 (providing a copy of the temporary restraining order in Case No. 2012-CH-513 dated Feb. 28, 2013).

Lines A and B are the actual revenue reported on Laurel Hills' Profit & Loss statements for January 1, 2011 to December 31, 2011 and January 1, 2012 to August 31, 2012, respectively.[143] Since these statements are produced on a cash basis, the revenue is equal to the cash received.[144] Lines C and D are estimates calculated by multiplying the current rate of $43.20 by 131 customers for each month.

The above calculation of revenues includes the eight connections for Laurel Hills' timeshare operations. Since Laurel Hills has not been paying for water service for eight units, the revenue above is overstated by the amount owed to the water system for Laurel Hills' timeshare operations:[145]

Service Period	Rate	Months	Units	Total
May 2011	$ 25.00	5	8	$ 1,000.00
June 2011 to Feb. 2012	$ 86.40	8	8	$ 5,529.60
March 2012 to Dec. 2012	$ 43.20	10	8	$ 3,456.00
				$ 9,985.60

3. Expenses

There are several types of expenses a utility incurs, including but not limited to operations and maintenance expenses ("O&M expenses") and depreciation and amortization.

Expenses can vary greatly based on who owns the water system and how the water system is managed and operated. When possible, the Consumer Advocate identifies how each

[143] The revenue lines indicated as "Actual" are from the Profit & Loss by Class for January through December 2011 and January through August 2012, as provided to the Authority. *Response of Laurel Hills Condominiums Property Owners Association to Staff Data Request*, Attachment for Data Response No. 3, Sept. 7, 2012. Presumably, these financial statements were prepared by the CPA firm that performs its accounting services. *Rebuttal Testimony of Michael McClung*, Docket No. 12-00030, p. 10, Jan. 14, 2013.

[144] *See id.* (indicating "Cash Basis" in the upper right-hand corner of both reports).

[145] There is evidence that Laurel Hills charged customers for five months of service, January through May 2011, at $25.00 per month in its first bill to customers in May 2011. *Transcript of Proceedings*, Docket No. 12-00030, p. 311, Feb. 13, 2013.

cost could vary when it is possible that any interim rate may change if the water system is under new management or ownership.

By their very nature, expenses do not include capitalized costs. Investors recover capitalized costs through depreciation and amortization of rate base.

Laurel Hills provides two schedules of expenses.[146] The first schedule of expenses provided by Laurel Hills includes anticipated as well as retroactive costs.[147] The second schedule includes anticipated expenses and a surcharge to recover costs incurred in the past.[148] To simplify the expense analysis, the Consumer Advocate first discusses the proposed surcharge, and then discusses the remaining expenses requested but not covered by the proposed surcharge.

a. Costs in Surcharge

At the hearing, the question arose as to how a nonprofit can raise funds to pay debts if it is not included in their current revenue stream.[149] The question is not how can this nonprofit water system raise funds to pay off the debts of COUD and TDEC fines and penalties (discussed in Lines A and D below). The question is how did this nonprofit water system assume these liabilities in the first place?

As discussed in the analysis that follows, the Consumer Advocate recommends the Authority deny the surcharge Laurel Hills proposes: [150]

Item	Expense Type	Amount
A	Back Due Amount to Crab Orchard	$ 23,659.18
B	McQueen Payment	$ 36,500.00
C	Legal Fees	$ 65,317.60

[146] *Rebuttal Testimony of Michael McClung*, Docket No. 12-00030, p. 14, Jan. 14, 2013.
[147] *Id.*
[148] *Id.* at 14, 24.
[149] *Transcript of Proceedings*, Docket No. 12-00030, p. 287-88, Feb. 13, 2013
[150] *Id.* at 24 (using 120 customers to calculate the surcharge per customer per month).

D	TDEC Civil Penalty	$ 11,282.50
	Total	$136,759.28
	Monthly Total Over 2 Years	$5,698.30
	Monthly Total Per Customer	$ 47.49
	COUD ONLY	$ 8.21

Line A - Back Due Amount to Crab Orchard: According to the above chart, Laurel Hills argues that present and future rate payers should pay the past due balance for water provided to rate payers in the past. The past due balance of $23,659.18 was the balance owed to COUD as of November 30, 2012 for water services provided to rate payers prior to November 30, 2012.[151] This debt comprises of two types: (1) pre-acquisition amount of $18,000;[152] and (2) post-acquisition amount of approximately $6,000.

Pre-acquisition Debt - $18,000: The Consumer Advocate recommends the Authority deny recovery of the pre-acquisition debt as Laurel Hills did not assume its liability.

Tennessee follows the traditional rule regarding corporate successorship and related assumed liabilities:

> when one company transfers some or all of its assets to another company the successor is not liable for the debts of the predecessor except when: '(1) The purchaser expressly or impliedly agrees to assume such debts; (2) the transaction amounts to a consolidation or merger of the seller and purchaser; (3) the purchasing corporation is merely a continuation of the selling corporation; or (4) the transaction is entered into fraudulently in order to escape liability for such debts . . . . A fifth exception, sometimes incorporated . . . , is the absence of adequate consideration for the sale or transfer.'[153]

[151] *Transcript of Proceedings*, Docket No. 12-00030, Ex. 9, p. 19, Feb. 13, 2013.
[152] *Transcript of Proceedings*, Docket No. 12-00030, p. 232, line 21, Feb. 13, 2013.
[153] *Hopewell Baptist Church v. Southeast Window Mftg., Co., LLC*, 2001 WL 708850, *4 (Tenn. Ct. App., June 25, 2001) (citations omitted).

Assuming without conceding that Laurel Hills is a separate legal entity for all intents and purposes, the second and third means of assuming liabilities under the traditional rule do not apply. As for the fourth means, it is possible that Moy Toy transferred the water system to its affiliate Laurel Hills to avoid the debts; and if this is true, then that does not change the Consumer Advocate's recommendation to disallow the cost because it merely means that the people committing the fraud through transfer would still be liable—not the ratepayers. The fifth means of inadequate consideration may also be possible, if one compares the asset of a completely depreciated system with the debts Laurel Hills alleges it owes. Even then, the fifth means would have the same analysis as the fourth. Also, the fifth means would only apply if one accepts that Laurel Hills actually indeed assumed the liabilities.

Here, one needs to look no further than the acquisition agreements between Moy Toy and Laurel Hills to determine that Laurel Hills assumed none of the liabilities it seeks to recover in the surcharge. First, the "Bill of Sale," dated May 1, 2011, states the "title so conveyed is free and clear of all liabilities, liens, charges, security interest and any other encumbrances; and further, that [Moy Toy] does warrant and will defend the same against all claims of all persons whomsoever."[154] Second, the "Warranty Deed," dated May 31, 2011, references the May 1, 2011 transaction and states that the water system and related property listed in Exhibit A to the Warranty Deed[155]

> are free from all encumbrances and that [Moy Toy] will forever warrant and defend the said premises and the title thereto against the lawful claims of all persons whosever; provided, however, this conveyance is made subject to the matters set forth on Exhibit "B" attached and 2011 taxes, which [Laurel Hills] assumes and agrees to pay.[156]

[154] *First Amended Petition*, Docket No. 12-00030, Ex. 1, p. 7 (Aug. 3, 2012).
[155] *First Amended Petition*, Docket No. 12-00030, Ex. 1, pp. 1, 4-5 (Aug. 3, 2012).
[156] *First Amended Petition*, Docket No. 12-00030, Ex. 1, p. 1 (Aug. 3, 2012).

Of the sixteen assumed encumbrances in Exhibit B to the Warranty Deed, none mentions the assumption of liabilities for the past due balance owed to COUD.[157] Thus, by the terms of the acquisition, Moy Toy is liable for the COUD past due balance and the TDEC fines and penalties.

Even if the Authority is not persuaded that Laurel Hills did not assume the pre-acquisition debt, the reasons to disallow the post-acquisition debt also apply to the pre-acquisition debt.

Post-acquisition debt - $6,000: First, if the Authority were to allow the utility to recover rates from present and future rate payers for costs incurred by past rate payers, the Authority would violate the prohibition against retroactive ratemaking. As previously stated, "[r]etroactive ratemaking is prohibited based on the general principle that those consumers who use the utility's service should pay for its production rather than requiring future rate payers to pay for past use."[158] The Tennessee Court of Appeals declared that "the Legislature never intended to extend retroactive ratemaking power" beyond what is expressly stated in what is now Tenn. Code Ann. § 65-5-103(b).[159]

Second, the repayment of COUD's past due balance in future rates is not warranted because Laurel Hills and presumably the prior owners had the funds to pay the water bill. According to the COUD's account history of the water system, there was a carry-forward balance of $6,704.05 in 1999.[160] Based on a review of the net payments and bills, the account would settle at this same carry-forward balance from January 1999 to January 2007.[161] This

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[157] For a list of the encumbrances, see *First Amended Petition*, Docket No. 12-00030, Ex. 1, p. 6 (Aug. 3, 2012). According to *In re: Petition of Laurel Hills Condominiums Property Owners Association for a Certificate of Public Convenience and Necessity*, Docket No. 12-00030, Ex. 2, ¶ 1, Apr. 10, 2011, the Attorney General's Office commenced litigation against Moy Toy's predecessor J.L. Wucher Company, LLC on July 10, 2009.

[158] *Porter v. South Carolina Public Service Comm'n*, 493 S.E.2d 92 (S.C. 1997); *Popowski v. Pa. Pub. Util. Comm'n*, 642 A.2d 648 (1994).

[159] *South Central Bell v. Tennessee Public Service Comm'n*, 675 S.W.2d 718, 719 (Tenn. Ct. App. 1984).

[160] *Transcript of Proceedings*, Docket No. 12-00030, Ex. 9, p. 1, Feb. 13, 2013.

[161] *Id.* at 1-10.

means that the owners at the time were able to pay the balance for the water provided in the present period, thereby paying expenses incurred for the ratepayers paying rates. According to the customers, they paid no more than $25.00 a month prior to Laurel Hills acquiring the system. Thus, whoever the owners were from 1999 to January 2007, it appears they were able to pay their water bills with a $25.00 monthly rate from customers.[162]

It is uncertain who owned the system from 2007 to 2010, when Moy Toy purchased it in September and later transferred it to Laurel Hills in May 2011. Whoever owned it, however, received rates. Those rates should have been used to pay the water bill. During that period, the bills were not higher than what they were in the years prior when the bills were paid. Indeed, the monthly water bills from 2007 to 2012 were often a fraction of the monthly bills charged prior to 2007.[163]

The future consumers of Laurel Hills should not be saddled with past due bills that they had no control to avoid. While the review of these few records of the applicable rate and the COUD account history is far from a complete analysis, there is nothing in the record that suggests that the prior owners did not have sufficient funds from rates paid by then-ratepayers to pay the water bill. Indeed, since the President of Laurel Hills is the Director of Moy Toy, the entity who transferred the water system to Laurel Hills, Mr. McClung cannot claim that he was unaware of the past due water bill. As a result of this knowledge, Mr. McClung should have acted as any prudent transferee of an entity and secured repayment of a prior owner's debt as a condition of the transfer. Nevertheless, since Laurel Hills has been receiving $43.20 for each connection since February 28, 2012, almost double the $25.00 rate that consumers paid

[162] *Pre-filed Direct Testimony of John S. Moore*, Docket No. 12-00030, pp. 3-4 (indicating that John Moore paid a $1500 connection fee in 2005, built his house and started to pay a $25 monthly fee in 2006).
[163] *See Transcript of Proceedings*, Docket No. 12-00030, Ex. 9, Feb. 13, 2013 (showing that no monthly water bill was lower than $2,000 from January 2000 to July 2001, but many monthly bills were lower than $2,000 in 2007 and beyond).

previously, Laurel Hills had the funds from rates to pay the then-current water bill due as well as catch up on at least the $6,704.05 carry-forward balance that seems to be the steady past due amount from 1999 until January 2007.

The Consumer Advocate recommends the Authority deny recovery of past due amounts to COUD in future rates paid to Laurel Hills so as to not violate the prohibition against retroactive ratemaking for an entirely avoidable expense.

Line B - McQueen Payment: Laurel Hills requests the Authority include a surcharge to repay past due amounts to Mr. McQueen for his services performed as engineer and operator. As of October 2012, Laurel Hills had a past due balance with Mr. McQueen of $36,500.[164] Mr. McClung testified at the hearing that he "guessed" 35% of this invoice, or $12,775, represented engineering services, including the design of the pumps that were later installed.[165] As discussed in Line 21 in the "Rate Base" section, the engineering services for designing the pumps are costs that should be capitalized as rate base rather than recovered as an expense; however, the Consumer Advocate recommends the Authority obtain reasonable verification that approximately $12,775 would be the costs for an engineer to design the pumps installed. As with the proposed surcharge for the past due balance owed to COUD, for the Authority to authorize a surcharge for present ratepayers to pay for the expenses incurred by past ratepayers would violate the prohibition against retroactive ratemaking. Therefore, just as the Consumer Advocate recommends the Authority deny the surcharge for the COUD past-due balance because it could have been (and should have been) paid out of then-received rates, the Consumer Advocate also recommends the Authority deny the surcharge for Mr. McQueen's past due balance.

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[164] *Transcript of Proceedings*, Docket No. 12-00030, Ex. 1, tab 10, Feb. 13, 2013 (providing the invoice that Mr. McQueen has not been paid for any services in 2011 or 2012).
[165] *Id* at 168-69.

Line C – Legal Fees: This cost is discussed further in Line 23 in the "Rate Base" section.

Line D – TDEC Civil Penalty: Although the costs to remediate environmental infractions are recoverable through rates, the recovery of fines and penalties resulting from environmental infractions from ratepayers is not only prohibited as retroactive ratemaking, but it is also against public policy and not an excepted encumbrance in the Warranty Deed protecting Laurel Hills.

First, fines and penalties are intended to deter undesirable behavior. If a utility is permitted to recover fines and penalties resulting from environmental infractions from ratepayers, then the ratepayers bear the punishment of the utility's bad acts even though the utility has the sole control of conditions to avoid fines and penalties.

Second, any fines and penalties permitted for recovery should be amortized because they are non-recurring extraordinary expenses,[166] and therefore increase rate base. Rate base, like assets in a non-utility company, is typically reserved for utility plant in service and other amortized costs that benefit rate payers over time. An increase to rate base for fines and penalties, however, would overstate the value of the utility by an amount that provides zero value to the present and future ratepayers.

Third, the liability that resulted in these fines and penalties is not listed on the encumbrances Laurel Hills assumed as part of the Bill of Sale or the Warranty Deed discussed in Line A. [167] The liability was certainly known since the Attorney General first filed its petition against Moy Toy's predecessor, J.L. Wucher Company, LLC ("Wucher"), for violations of the

[166] Other non-recurring extraordinary expenses that the Authority often amortizes are reasonable and prudent and known and measurable legal fees, sometimes referred to as "rate case" expenses.

[167] *See supra* notes 154-157. For a list of the encumbrances, see *First Amended Petition*, Docket No. 12-00030, Ex. 1, p. 6 (Aug. 3, 2012).

Tennessee Safe Drinking Water Act, Tenn. Code Ann. § 68-221-701 *et seq.*, on July 10, 2010.[168] Thus, Moy Toy is responsible for reimbursing Laurel Hills for all fines and penalties since they resulted from an encumbrance that was not listed as an exception to the Warranty Deed.

Although Laurel Hills has refused to provide any documentation surrounding Moy Toy's purchase of the water system and related valuation,[169] Mr. McClung knew or should have known about the pending litigation for TDEC violations since he was on both sides of the transaction in the transfer on May 1, 2011[170] from Moy Toy LLC (as he is the only named director on the Secretary of State reports)[171] to Laurel Hills (as President listed on the Secretary of State reports).[172] Laurel Hills' current plant operator, Gerald Williams, [173] certainly knew about the issues because he was plant operator in 2010 just before sending a letter to TDEC on or around March 29, 2010, where he states that he would no longer be responsible for being operator in charge because of the "lack of communications, all of the ownership issues, and the lack of cooperation between the Water System and the [TDEC]."[174]

The transfer of the pending litigation and related fines and penalties in not only one, but two, transactions is the equivalent of asking someone else to pay for your mistakes. The ratepayers bore enough punishment by having water from a water system that violated state laws for safe drinking water from 2009 to 2011. It is not fair to shift the cost of the fines and penalties of such infractions to the ratepayers, when the ratepayers had no control to remedy the violations

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[168] *In re: Petition of Laurel Hills Condominiums Property Owners Association for a Certificate of Public Convenience and Necessity*, Docket No. 12-00030, Ex. 2, ¶ 1, Apr. 10, 2011.
[169] *See, e.g., Response of Laurel Hills Condominiums Property Owners Association to First Discovery Request of the Customer Intervenors to Laurel Hills Condominiums Property Owners Association*, Data Response Nos. 7-8, pp. 3-4, Sept. 27, 2012. Indeed, if the transaction between Moy Toy and Wucher was an arm's length transaction, then Moy Toy should have received a discount on the fair market value of the undeveloped land and the water system in exchange of assuming the potential liability of the pending litigation. If it was not an arm's length transaction, then certainly, future ratepayers should not have to pay for faulty negotiations in a related party transaction.
[170] *Petition*, Docket No. 12-00030, ¶¶ 2-3, Apr. 10, 2012.
[171] *Transcript of Proceedings*, Docket No. 12-00030, Ex. 18, Feb. 13, 2013.
[172] *Transcript of Proceedings*, Docket No. 12-00030, Ex. 19, Feb. 13, 2013.
[173] *Transcript of Proceedings*, Docket No. 12-00030, p. 105, Feb. 13, 2013.
[174] *Petition*, Docket No. 12-00030, Ex. 4 to Ex. 2, Apr. 10, 2012.

but at least two entities prior to Laurel Hills did have the ability and obligation to deal with the issues.

Summary on Costs in Proposed Surcharge: Other than the legal fees and the engineering portion of Mr. McQueen's invoice, which are discussed in the following "Rate Base" section, the Authority should deny the recovery of the costs Laurel Hills lists in its proposed surcharge. The past due balance to COUD, the portion of Mr. McQueen's invoice that pertains to operating and other non-engineering services, and the TDEC fines and penalties should be denied because recovery of these costs incurred in the past by present and future ratepayers would violate the prohibition against retroactive ratemaking.

The evidence suggests the rates received during these periods could have, and should have, been used to pay these costs. As for the pre-existing debts of the COUD balance and the TDEC fines and penalties, these costs existed in some form when Moy Toy, LLC acquired the water system in a larger transaction from J.L. Wucher, LLC. Presumably, the purchase price of the larger transaction was at a discount of the fair market value to reflect the liabilities Moy Toy, LLC assumed. Rather than paying the liabilities it assumed with the cash saved from the discount, Moy Toy, LLC kept the assets with value and transferred the assumed liabilities to Laurel Hills. These costs were incurred in the past, and should have been paid in the past. It would be unfair to saddle the ratepayers with the burden of repaying these past debts that should arguably never have been transferred to Laurel Hills.

b. Monthly Expenses:

When a cost provides its entire benefit in less than twelve months, these costs are typically considered expenses. Reasonable and prudent expenses incurred by the utility in the interest of ratepayers are recoverable in rates. Many utilities recover costs that go to operate and maintain the system ("O&M"), as well as costs for general and administrative functions

("G&A"). The management of a system can greatly influence the amount of both O&M expenses as well as G&A expenses.

In this section, the Consumer Advocate discusses the expenses in the following chart:

EXPENSE TYPE	CAPD - CCN Denied	CAPD - CCN Approved	COMPANY	DIFFERENCE (CAPD w/o CCN- COMPANY)
O & M Expenses				
Engineering & Labor (includes McQueen Invoice)	$333	$333	$2,500	($2,167)
Construction Contracts	0	0	1,400	($1,400)
Water Testing	600	600	600	$0
Depreciation	88	88	500	($412)
Property Tax	200	200	200	$0
Telephone	61	61	61	$0
Permits & Penalties	25	25	1,200	($1,175)
Interest Expense	0	0	1,900	($1,900)
Legal Expense (Amortization expense)	0	187	2,500	($2,500)
Accounting & Management Services	242	242	1,550	($1,308)
Office Expenses	14	14	200	($186)
Insurance Expense	433	433	433	$0
Postage Expense	8	8	8	$0
Equipment Rental Expense	6	6	150	($144)
Maintenance & Repair Expense	0	0	2,000	($2,000)
Wholesale Water Expense	1,528	1,528	1,750	($222)
Electricity Expense	274	274	467	($193)
Total Monthly Expenses	$3,812	$3,999	$17,419	($7,853)
Expenses Annualized	$45,740	$47,986	$209,028	($94,240)

Line 1 – Engineering & Labor: Laurel Hills budgeted $2,500 a month, or $30,000 annually, for engineering and labor. Laurel Hills stated that the $2,500 included the past-due

amount of $26,000 owed to Mr. McQueen.[175] The Consumer Advocate addressed the past-due amount owed to Mr. McQueen previously in the "Surcharges" section. Removing the $26,000 invoice leaves the Company with a request of $4,000 annually, or $333 monthly, for labor.[176] The Consumer Advocate recommends the rates include $333 monthly for labor for interim rates.

Line 2 – Construction Contracts: Laurel Hills budgeted $1,400 per month for its affiliate leasing company to, according to the $17,425.52 invoice, locate and mark twenty water gate valves, locate and mark nineteen service valves, install and replace eight service valves, as well as the labor, materials, and lodging for a Georgia company to perform these services.[177] This invoice from Gold Mine Golf, Inc. ("Gold Mine Golf"), dated November 12, 2012, was signed by David Guettler, a relative of two of the three members on the board of Laurel Hills.[178] As a threshold matter, locating and marking thirty-nine valves is not a specialty task and should have been done by a standard operator, which in this case Laurel Hills purports is Mr. McQueen. Since labor was discussed under Line 1, the costs related to labor in operations should not be duplicated here, especially by an out-of-area company when local labor is available. Second, if valves were in fact installed, then those costs should be capitalized and depreciated over time as a rate base item. The Consumer Advocate discusses the capitalization of these costs further in Line 22 the "Rate Base" section.

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[175] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 5, Jan. 14, 2013.
[176] *Testimony of William H. Novak*, Docket No. 12-00030, p. 7, Dec. 13, 2012.
[177] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 6, Ex. 1, Jan. 14, 2013.
[178] David Guettler is the brother of Phillip Guettler and uncle to Darren Guettler, *Transcript of Proceedings*, Docket No. 12-00030, p. 108, Feb. 13, 2013. Both Phillip Guettler and his son Darren Guettler are two of the three board members for Laurel Hills, according to the annual report filed with the Tennessee Secretary of State on January 15, 2013. *Transcript of Proceedings*, Docket No. 12-00030, Ex. 19, Feb. 13, 2013.

Line 3 – Water Testing: Laurel Hills budgeted $600 per month for water testing.[179] The Consumer Advocate does not dispute this amount for interim rates. It should be noted for divestment purposes this expense may be different for any subsequent purchaser.

Line 4 – Depreciation: Laurel Hills budgeted $500 per month for depreciation.[180] In his testimony, Mr. Novak recommended $88 per month.[181] The specific differences between the depreciation calculated by Laurel Hills and the Consumer Advocate are unclear because Laurel Hills did not show how it calculated its monthly depreciation expense. Nevertheless, the calculation of depreciation and amortization depends on the rate base. For purposes of determining interim rates, the Consumer Advocate considered the depreciation of only the known and measurable capital, which is the pumps. The amortization is discussed under Legal Fees (Line 7).

In determining depreciation expense for the interim rates, the Consumer Advocate recommends the Authority include $88 per month for the pumps. Mr. Novak calculated this expense by using a value of $15,757 and divided it by a 15-year useful life, both of which were utilized to calculate the depreciation expense for Laurel Hills' 2011 tax return.[182] If the valuation of rate base changes, as the Consumer Advocate recommends the Authority consider for the pumps, the pump designs, and the valves in its "Rate Base" discussion, then this expense line will likely need recalculation.

Line 5 – Property Tax: Laurel Hills budgeted $200 per month for property taxes.[183] For interim rates, the Consumer Advocate does not object to $200 per month for property taxes. It

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[179] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 6, Jan. 14, 2013.
[180] *Id.* at 7.
[181] *Testimony of William H. Novak*, Docket No. 12-00030, p. 8-9, Dec. 13, 2012.
[182] *Id.*
[183] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 7, Jan. 14, 2013.

should be noted for divestment purposes that this expense may be different for any subsequent purchaser, depending on whether that purchaser obtains a CCN or is a utility district.

Line 6 – Telephone: For telephone expenses, Laurel Hills agreed with the Consumer Advocate that $61 per month is a reasonable and prudent expense.[184] Consumers currently have no phone number to communicate questions, concerns, or complaints by telephone.[185] When there was a number provided to customers, it was answered by an answering machine, but there was no requirement for the utility to return or address calls, nor was a log of the voicemails and messages maintained and how resolved or addressed.[186] If consumers are going to pay for a telephone in rates, the Consumer Advocate recommends that the Authority order Laurel Hills to provide the related phone number to consumers as a method for them to communicate questions and concerns to the utility, as well as require the utility to implement policies and procedures of logging calls and important information (*e.g.*, who called, what was the message about, when they called, and who received the message the utility, how it was addressed, and the date) and requiring calls be addressed in a timely manner (*i.e.*, within three days for non-emergencies). If Laurel Hills does not want to create and follow policies and procedures for permitting customers to contact the utility by phone, however, the Consumer Advocate recommends the Authority disallow telephone expenses in rates.

Line 7 – Permits & Penalties: Laurel Hills budgeted $1,200 per month for permits and penalties expenses, or $14,400 annually.[187] Of the $14,400 annual expense requested, the Consumer Advocate recommends only the $300 annual fee charged by TDEC be included in

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[184] *Id.* at 8.
[185] *Transcript of Proceedings*, Docket No. 12-00030, pp. 78-79, Feb. 13, 2013.
[186] *Transcript of Proceedings*, Docket No. 12-00030, p. 79, Feb. 13, 2013.
[187] *Id.* at 8.

rates.[188] The Consumer Advocate addressed the $11,282.50 in TDEC penalties that is also included in this expense amount previously under the "Surcharges" section. Laurel Hills has neither explained nor provided support for what the remaining $2,817.50 represents and, therefore, the Consumer Advocate recommends excluding it from rates. Thus, the Consumer Advocate recommends the Authority include in rates the known and measurable costs associated with permits of $300 per year, or $25 per month.

Line 8 – Interest Expense: Laurel Hills budgeted $1,900 per month for interest expense on its debt.[189] Interest expense is a "below the line" expense; meaning, interest expense is not directly recovered in rates like operation and administrative expenses, but rather the utility recovers its interest expense as a component of its rate of return. A utility only earns a rate of return on capital (including debt) that is actually invested in the utility. It is unfair for ratepayers to pay interest expense on investor's debt that is not invested in the utility. For these reasons, the Consumer Advocate recommends the Authority exclude any interest expense in rates other than what is authorized in the rate of return.[190]

Line 9 – Legal Expense: Laurel Hills budgeted $2,500 per month for legal expenses.[191] For purposes of a monthly budget, the Consumer Advocate recommends zero recovery for expenses. According to Mr. Novak's review of the invoices available at the time of his testimony, all those legal expenses pertained to Laurel Hills defending itself in the lawsuit against the Authority and the Consumer Advocate and in another lawsuit against its customers (*i.e.*, no benefit to ratepayers).[192]

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[188] *Testimony of William H. Novak*, Docket No. 12-00030, p. 10, Dec. 13, 2012; *see also Response of Laurel Hills Condominiums Property Owners Association to Staff Data Request*, Data Response No. 1, page 12 of 192, Attachment 1, Sept. 7, 2012.
[189] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, pp. 4, 8, Jan. 14, 2013.
[190] *Testimony of William H. Novak*, Docket No. 12-00030, p. 10, Dec. 13, 2012.
[191] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 10, Jan. 14, 2013.
[192] *Testimony of William H. Novak*, Docket No. 12-00030, p. 11, Dec. 13, 2012.

As for amortizing the legal expenses, the Consumer Advocate asserts that, if the CCN is denied, it would be imprudent to amortize any legal fees in this case as discussed further in the discussion for Line 23 in the "Rate Base" section.

If the Authority is not persuaded to deny recovery of the legal fees or the CCN is approved, the Consumer Advocate recommends the Authority consider amortizing only $33,690 for recovery from ratepayers, as the remaining costs after a review of all bills confirming they are only in regards to the CCN application are not reasonable and prudent expenditures for a utility, as discussed in Line 23 in the "Rate Base" section. Although it would be unfair to include in rates the legal fees in excess of $33,690, the Consumer Advocate provides no opinion as to whether these fees were reasonable and prudent for Laurel Hills' management for non-utility purposes. Meaning, the Consumer Advocate is not suggesting that only $33,690 be actually paid to Laurel Hills' attorneys; rather, the Consumer Advocate recommends that ratepayers bear the cost of only $33,690 in legal fees if the CCN is approved.

Additionally, if the Authority amortizes legal expense at any amount, the Consumer Advocate recommends it use an amortization period of 15 years for purposes of determining interim rates for a couple of reasons. First, the amortization period for the legal fees should match the period of time that it relates. This case is about a CCN that, if approved, has no termination or expiration date. Nevertheless, the Consumer Advocate recommends the amortization period match the remaining useful life of the utility plant in service, consistent with other CCN Applications.[193] In this case, the useful life of the known and measurable rate base items is 15 years.

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[193] *See Joint Petition of Tennessee-American Water Company, The City of Whitwell, Tennessee, and the Town of Powells Crossroads, Tennessee, for Approval of a Purchase Agreement and a Water Franchise Agreement for the Issuance of a Certificate of Convenience and Necessity*, Docket No. 12-00157, p. 7, ¶ 22(f) , Dec. 27, 2012 (proposing that TAWC recover a regulatory asset that includes legal fees using an amortization period of the

The amortization period consistent with CCN applications as opposed to the shorter period of rate cases is appropriate here because this is a CCN application. Although the determination of rates was considered throughout this case, there is still insufficient information to determine a semi-permanent rate because the company lacked the documentation to support requests, failed to competitively bid services, and failed to utilize basic accounting principles to distinguish expenses from capital. The evidence provided in this case is far below the evidentiary standard required for setting rates; rather, this case at best provides guidance to the company on how to apply for rate increases in the future. Since this is not procedurally or substantively a rate case, the typical amortization period for a rate case should not be considered.

Second, using a 15-year amortization period would help avoid rate shock. The customer base for this system is small. Amortizing legal fees over a period of three to five years could result in even more customers disconnecting service or abandoning their timeshare until alternative services are available or the economy recovers and they can sell. It is in no one's interest for more customers to leave. Consequently, it is in the best interest of both the company and the customers to amortize any allowable legal costs over 15 years. Moreover, if Laurel Hills divests the water system, and no receivership fees need to be paid from the proceeds, then Laurel Hills should theoretically receive its allowable regulatory expense at the time of divestment, rather than over 15 years.

Line 10 – Accounting & Management Services: Laurel Hills budgeted $1,550 per month for accounting and management services.[194] Mr. Novak reviewed the actual accounting

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remaining life of the System asset); *see also Data Response*, Docket No. 12-00157, Data Response No. 3, Jan. 28, 2013 (indicating the amortization period of 18.6 years).

[194] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 10-12, Jan. 14, 2013.

fees for May 2011 through August 2012 and calculated a total expense of $3,865, [195] or an average of $242 per month. As noted by Mr. Novak, "it is not entirely clear how much of these accounting fees are related to the Water System and how much are related to the Company's other operations."[196] It is reasonable to allocate some of these costs to the non-utility operations of Laurel Hills, including but not limited to a portion of the $365 preparation of the company's federal corporate income tax return and all of the $200 for preparing the homeowner dues invoices.[197] Taking into account that not all of these accounting services relate to the water system, the Consumer Advocate recommends the Authority include $242 per month in interim rates. It should be noted for divestment purposes that this expense may be different for any subsequent purchaser.

Line 11 – Office Expense: Laurel Hills budgeted $200 per month for office expenses.[198] Laurel Hills provided no documentation to support its budget.[199] Mr. Novak reviewed the actual office expenses for May 2011 through August 2012 through August and found a total of $221,[200] or $14 per month. As a result, the Consumer Advocate recommends the Authority include in interim rates only the known and measurable office expense of $14 per month. It should be noted for divestment purposes that this expense may be different for any subsequent purchaser.

Line 12 – Insurance Expense: Laurel Hills budgeted $433 per month for insurance expense, which was based on Mr. Novak's 50% allocation of the company's actual insurance expense.[201] The Consumer Advocate therefore recommends the Authority include in interim rates $433 per month for insurance expense. If the Authority approves the CCN, then it should

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[195] *Testimony of William H. Novak*, Docket No. 12-00030, p. 11-12, Dec. 13, 2012.
[196] *Id.* at 12.
[197] *See id.*
[198] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 12, Jan. 14, 2013.
[199] *Testimony of William H. Novak*, Docket No. 12-00030, p. 12, Dec. 13, 2012.
[200] *Id.*
[201] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 12, Jan. 14, 2013.

require Laurel Hills to submit the insurance policy coverage prior to inclusion to verify the costs for the insurance policy are reasonable and prudent.[202] Also, it should be noted for divestment purposes that this expense may be different for any subsequent purchaser.

Line 13 – Postage Expense: Laurel Hills and the Consumer Advocate agree on the monthly budget of $8 for postage expense.[203]

Line 14 – Equipment Rental Expense: Laurel Hills budgeted $150 per month for equipment rental expense.[204] The Company provided no support for this budget.[205] Mr. Novak reviewed the actual equipment rental expenses for May 2011 and August 2012 and calculated a total expense of $98,[206] or an average of $6 per month. The Consumer Advocate therefore recommends the Authority include in interim rates only the known and measurable equipment rental expense of $6 per month. It should be noted for divestment purposes that this expense may be different for any subsequent purchaser.

Line 15 – Maintenance & Repair Expense: Laurel Hills budgeted $2,000 per month for what Mr. McClung calls maintenance and repair expense, but it is actually Laurel Hills' budget for rehabilitating the water tank.[207] As Mr. Novak pointed out, costs to rehabilitate the water tank should be capitalized and recovered through depreciation expense.[208]

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[202] *See Transcript of Proceedings*, Docket No. 12-00030, p. 213, Feb. 13, 2013 (indicating that the insurance declaration sheet was not provided in any data response but it was only first available at the hearing, but it was not entered into the record nor did anyone other than Laurel Hills get to view it).
[203] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 12, Jan. 14, 2013.
[204] *Id.* at 12.
[205] *Testimony of William H. Novak*, Docket No. 12-00030, p. 14, Dec. 13, 2012.
[206] *Id.*
[207] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 12-13, Jan. 14, 2013.
[208] *Testimony of William H. Novak*, Docket No. 12-00030, p. 14-15, Dec. 13, 2012.

Mr. McClung expressed concern that Mr. Novak included $0 for what Laurel Hills calls "maintenance and expense."[209] Since Laurel Hills provided no other support for the maintenance and expense budget other than one company's estimated costs to rehabilitate the tank, then it is likely that any repairs and maintenance that have occurred since Laurel Hills took over the water system were expensed through the budgeted items of labor or equipment rental, both of which the Consumer Advocate has provided a recommended budgeted amount based on historical, actual costs incurred by the water system. Therefore, the Consumer Advocate is not suggesting that Laurel Hills receive no recovery of repairs and maintenance expense, but rather the Consumer Advocate suggests that these costs are merely in a different category in Laurel Hills' budget.

The Consumer Advocate recommends the Authority provide no recovery for the water tank rehabilitation in expenses. Rather, the Consumer Advocate recommends these costs be incurred by the new owner once Laurel Hills divests itself. If, however, the Authority approves the CCN for Laurel Hills, the Consumer Advocate recommends that the Authority order Laurel Hills to competitively bid these services and require these costs to be capitalized for ratemaking purposes in accordance with traditional accounting principles.

Line 16 – Wholesale Water Expense: Laurel Hills budgeted $1,750 per month for wholesale water expense.[210] Since Mr. Novak provided his testimony, COUD has made available its account history with the water system.[211] This account history provides more accurate and reliable information as to the actual monthly water expense. The Consumer Advocate added the monthly water bills and related sales tax from May 24, 2011, the first month that Laurel Hills

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[209] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 12-13, Jan. 14, 2013.
[210] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 5, Jan. 14, 2013.
[211] *Transcript of Proceedings*, Docket No. 12-00030, Ex. 9, Feb. 13, 2013.

was responsible for payment, through November 28, 2012, the last month available on the account history, to arrive at a total of $29,025.20 in water expense for nineteen months, or $1,527.64 per month.[212] The Consumer Advocate recommends the Authority include recovery of $1,527.64 per month for water expense in the interim rates. The Consumer Advocate provided its recommendation for treatment of the past-due balance owed COUD in the "Surcharges" section.

Line 17 – Electricity Expense: Laurel Hills agreed with Mr. Novak's recommendation for $467 per month for electricity expense,[213] but it should not have because it knew or should have known that this monthly amount includes subsidization for its unregulated operations (*i.e.*, timeshares, etc.). Mr. Novak calculated the monthly average based on electricity bills for the twelve months ended August 31, 2012.[214] According to Laurel Hills' data response to the Customer Intervenors, however, the electricity bills included all of Laurel Hills' operations (*i.e.*, timeshares, etc.) in 2011.[215] Only the summary provided for the 2012 bills was limited to the Mullinex Drive meter, which is the meter that serves the water system's pumps.[216] The Consumer Advocate recommends the Authority include in interim rates only $274 per month for electricity, so as to prevent the ratepayers from subsidizing the unregulated operations of Laurel Hills.

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[212] *See id.* at 17-19.
[213] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 13, Jan. 14, 2013.
[214] *Testimony of William H. Novak*, Docket No. 12-00030, p. 16, Dec. 13, 2012 (referencing the bills provided in attachment 1 to Data Response 1 in Laurel Hills' September 7, 2012 response to the Staff Data Request).
[215] *See, e.g., Response of Laurel Hills Condominiums Property Owners Association to First Discovery Request of the Customer Intervenors to Laurel Hills Condominiums Property Owners Association*, Data Response Nos. 12, p. 5, Sept. 27, 2012.
[216] *Id.*

4. Rate Base

Rate base is the capital invested by investors. Before including costs in rate base, the cost must have been (1) known and measurable[217] and (2) a reasonable and prudent cost.[218] Investors get the return *of* investment through depreciation expense, which is calculated by taking the capitalized cost divided by the useful life. Investors get a return *on* the investment through the rate of return.

Typically, investors would only earn a rate of return on the average capital in the forecast or attrition year; this case is atypical, however. In this case, if the Authority orders Laurel Hills to divest, there will not be an entire year in the forecast period. For the purpose of calculating interim rates until divestment, the Consumer Advocate calculated the return on the investment by multiplying the rate of return by the known and measurable capital invested at the time of the hearing. As part of the divestment process, the Consumer Advocate recommends the Authority instruct the valuators to value the reasonable and prudent costs to install valves and create the pump designs as well as the cost of the pumps if Gold Mine Golf installed them, so the known and measurable costs that were reasonable and prudent can be included in rate base.[219] If the Authority approves the CCN, however, the Consumer Advocate recommends the Authority open

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[217] For example, a utility may purchase capital, making it a known cost, but if the related value of that capital item is uncertain, then it will not be included in rate base because it is not measurable.

[218] For example, if a utility purchased a capital item from an affiliated party that has a lower fair market value than what was actually paid for it, only the fair market value should be included in rate base because anything exceeding fair market value would not be considered a reasonable or prudent expense.

[219] The Consumer Advocate is aware that there are many ways to value assets. As for the valves, the Consumer Advocate recommends the Authority instruct the valuators to assign a value and useful life by (1) verifying the type of valves installed; (2) obtaining costs of the valves and number of hours of related labor from Gold Mine Golf, Inc.; (3) obtaining the costs of the valves from the manufacturer or distributors and comparing the costs with Gold Mine Golf, Inc.'s costs; (4) multiplying the final estimate of hours of labor to install the valves by the fair market value hourly rate for valve installation in the area (possibly available from COUD or TDEC); and (5) identifying the typical useful life for the type of valves installed. For example, Mr. Everett Bolin, President of COUD, testified in his testimony that they install Ford brass setter valves with a riser and use all copper fixtures. *Transcript of Proceedings*, Docket No. 12-00030, p. 348, Feb. 13, 2013. This type of valve costs COUD an average of $824 to install, including labor. *Id.* As for the pump designs, the Consumer Advocate recommends the Authority instruct the valuators to (1) ask how long Mr. McQueen indicates it took him to draft the designs; (2) verify this estimated time is reasonable by asking TDEC, COUD, and other knowledgeable parties to review the designs and estimate how many hours it would take to draft the designs; and (3) multiply the final estimate of hours to design the pumps by the fair market value hourly rate of engineers in the area (also possibly available from TDEC or COUD).

up the proof on the narrow issue of ascertaining the value of the valves installed and the pump designs so they can be included in rate base, and then applying the rate of return on the average rate base for the attrition year.[220]

In this section, the Consumer Advocate discusses the rate base components in the following chart:

	Rate Base:	CAPD - NO CCN	CAPD - CCN	COMPANY
20	Plant in Service: Pumps	$15,757	$15,757	$15,757
21	Plant in Service: Designs		Insufficient Information	
22	Plant in Service: Valves		Insufficient Information	
23	Legal Fees	$0	$33,690	
24	Accumulated Depreciation	-525	-525	-525
25	Working Capital (1/8 of O&M Expenses)	5,585	5,585	$26,128.50
26	**Total Rate Base**	**$20,817**	**$54,507**	$41,885.50
27	Rate of Return	3.32%	3.32%	6.67%
28	**Return on Invested Capital**	**$691**	**$1,810**	**$2,793**
29	**Total Cost of Service**	**$46,431**	**$49,796**	**$211,821**
	Number of Customers	131	131	120
	Interim Rate	**$29.54**	**$31.68**	**$147.10**

Line 20 - Pumps: Originally, the parties agreed on the capitalized cost of $15,747, the in-service date is June 21, 2011, and the asset has a 15-year life, which was information utilized in preparing the company's tax return.[221] After Mr. McClung's testimony at the hearing, it

[220] If the Authority is valuing the assets itself, the Consumer Advocate recommends it consider using valuation methods discussed in footnote 219.

[221] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 13, Jan. 14, 2013; *Testimony of William H. Novak*, Docket No. 12-00030, p. 8, 16, Dec. 13, 2012. This information is from the Depreciation Listing form used to calculate depreciation for the 2011 tax return. *Response of Laurel Hills Condominiums Property Owners Association to Staff Data Request*, Attachment for Data Response No. 1, Item 1, p. 62, Sept. 7, 2012.

appears that Gold Mine Golf may have been the contractor who installed the pumps.[222] If Gold Mine Golf installed the pumps, the Consumer Advocate has concerns about whether the $15,747 costs are entirely reasonable and prudent given that David Guettler of Gold Mine Golf is the brother and uncle of two of the three board members for Laurel Hills and the project was not competitively bid.[223] The Consumer Advocate included the $15,747 value in rate base for purposes of calculating interim rates; however, the Consumer Advocate recommends that the valuation of the pumps be scrutinized to verify the costs were actually reasonable and prudent (*i.e.*, at fair market value according to comparables in the Cumberland County area) for the purposes of valuing the company for divestment purposes or to determine permanent rates if the CCN is approved.

Line 21 – Pump Designs: As discussed previously regarding the "McQueen" payment in the "Surcharges" section, the costs related to the design of the pumps should have been capitalized. The record, however, does not have sufficient information to provide a known and measurable value of the reasonable and prudent costs to draft the designs for these pumps. The only information provided regarding the value of the designs is Mr. McClung's "guess" that the value is approximately 35% of Mr. McQueen's outstanding invoice for $36,500 for services from June 1, 2011 through October 31, 2012.[224] The record contains no evidence of how many hours Mr. McQueen alleges it took to draft the designs, verification that the number of hours was reasonable (*i.e.*, the hours Mr. McQueen took are within the range of reasonableness of an experienced engineer drafting designs for pumps of similar complexity), or the fair market value of an hourly rate for an engineer with similar experience as Mr. McQueen. Without this

[222] *Transcript of Proceedings*, Docket No. 12-00030, p. 108, Feb. 13, 2013.
[223] *Id.*; *see also supra* note 178.
[224] *Transcript of Proceedings*, Docket No. 12-00030, 168-69, Feb. 13, 2013 (referencing the invoice that Mr. McQueen has not been paid for any services in 2011 or 2012 available in Exhibit 1, tab 10 of the transcript).

information, the value of the reasonable and prudent costs to draft the pump designs cannot be measured for purposes of determining the interim rates.

As discussed previously, if the Authority approves the CCN, however, the Consumer Advocate recommends the Authority verify the value of the pump designs for inclusion in the rate base for either the purposes of divestment or, if the Authority approves the CCN, the purposes of determining permanent rates.[225]

Line 22 - Valves: As discussed in Line 2 of the "Expenses" section, the costs to install valves should be capitalized and included in rate base rather than recovered through expenses.

The record, however, does not have sufficient information to provide a known and measurable value of the reasonable and prudent costs to install the valves in Cumberland County. The invoice from the Georgia-based company Gold Mine Golf ("Gold Mine Golf") did not provide the level of detail necessary: (1) the type of valve installed, (2) the cost of the valves, (3) the number of hours to install them, (3) the hourly rate for installation labor, (4) the in-service date of the valves, and (5) the useful life.

The record is inconsistent as to how many valves were installed. Mr. McClung testified at the hearing that ten or twelve shutoff valves were installed,[226] but in his rebuttal testimony explaining the budget for construction costs, he references the Gold Mine Golf invoice (indicating installation of "approximately" eight valves).[227] Moreover, because Gold Mine Golf is a related party to Laurel Hills board members[228] and no competitive bidding occurred,[229] any

[225] *Supra* notes 219-220 and accompanying text.
[226] *Transcript of Proceedings*, Docket No. 12-00030, p. 108, Feb. 13, 2013.
[227] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 6, Ex. 1, Jan. 14, 2013.
[228] *See supra* note 178.
[229] *Transcript of Proceedings*, Docket No. 12-00030, p. 355, Feb. 13, 2013.

value that Gold Mine Golf would provide for the cost of installation should be scrutinized as possibly overvalued and potentially not reasonable or prudent expenditures.

The record does include evidence of how much valves cost COUD, but the comparability of these valves is too uncertain to identify a known and measurable cost for rate base at this time. Mr. Bolin, General Manager of COUD for ten years,[230] testified that the cost to install valves varies depending upon the type of valve being installed, but the Ford brass setter with a riser and all copper fixtures costs COUD an average of $824, including labor.[231] When COUD did have to contract valve services within the past couple of years, contractors were local and able to perform services for approximately $720.[232] Thus, COUD's cost for installing eight valves ranged from $5,760 to $6,592 over the span of a couple of years. The Gold Mine Golf invoice does not indicate what type or quality of valves it installed, so it is possible that COUD's valves are a different quality and, therefore, a different cost. Consequently, there is insufficient information available in the record to measure the value of the valves installed for inclusion in rate base for determining the interim rates.

As discussed previously, if the Authority approves the CCN, however, the Consumer Advocate recommends the Authority verify the value, in-service date, and the useful life of the valves for inclusion in rate base for the either purposes of divestment or, if the Authority approves the CCN, the purposes of determining permanent rates.[233]

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[230] *Id.* at 342.
[231] *Id.* at 348.
[232] *Id.*
[233] *Supra* notes 219-220 and accompanying text.

Line 23 – Legal Fees: Laurel Hills submitted costs and estimates of $51,045.39 for this proceeding and an additional $53,135.00 for the cost of two proceedings before the Chancery Court of Cumberland County ("Chancery Court").[234]

This Authority has cited the U.S. Supreme Court's holding that "a public utility cannot include negligent or wasteful losses among its operating charges in a rate proceeding and only property and necessary expenses should be recovered."[235] Moreover, "the TRA takes the position that the ability of a utility to recover its expenses is not 'absolute nor immutable' . . . ."[236] Although this is a CCN petition and not a rate case, in its analysis of the reasonable and prudent costs for legal fees recoverable from ratepayers, the Consumer Advocate followed the guidance set forth by the Tennessee Court of Appeals regarding regulatory expenses in rate cases:

> The record and Final Order do not explain what specific expenses the TRA deemed unnecessary, improvident, or improper or that the Authority closely examined the costs associated with the rate case to determine the portion to be recovered from rate payer and the portion to be born by the shareholders. Such an examination should have taken place and its results included in the record and Final Order.[237]

The Consumer Advocate recommends the Authority disallow all legal fees from recovery if it denies the CCN for the reasons that the regulatory expense is not "used or useful" to the water system's current or future ratepayers since Laurel Hills could not meet the CCN standards. The ratepayers cannot control who applies for a CCN. Indeed, if the customers could choose, all

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[234] *Response of Laurel Hills Condominiums Property Owners Association to Staff Data Request*, Ex. A & B, Feb. 8, 2013.

[235] *Tennessee American Water Company v. Tennessee Regulatory Authority*, 2011 WL 334678, *26 (Tenn. Ct. App., Jan. 28, 2011) (citing *W. Ohio gas Co. v. Pub. Utilities Comm'n of Ohio*, 294 U.s. 63, 68 (1935).

[236] *Id.*

[237] *Tennessee American Water Company v. Tennessee Regulatory Authority*, 2011 WL 334678, *27 (Tenn. Ct. App., Jan. 28, 2011) ("The record and Final Order do not explain what specific expenses the TRA deemed unnecessary, improvident, or improper or that the Authority closely examined the costs associated with the rate case to determine the portion to be recovered from rate payer and the portion to be borne by the shareholders. Such an examination should have taken place and its results included in the record and Final Order.").

evidence suggests that they would not have picked Laurel Hills as its water system operator.[238] Nonetheless, Laurel Hills, under court order and after withdrawing it once, finally submitted a petition to apply for a CCN to get authority to operate the water system. As indicated in Part II, Laurel Hills does not meet any of the minimum statutory standards required to operate a utility. Consequently, Laurel Hills should be denied a CCN.

The denial of a CCN is analogous to a utility cancelling construction mid-project. Like a customer will never reap a benefit from abandoned construction projects, customers here will never reap a benefit from regulatory expenses resulting from a denied CCN. Thus, regardless of whether the costs were reasonable and prudent for legal fees, the denial of the CCN will not be "used and useful" if denied. The regulatory expenses for such denied CCN should therefore be disallowed in the rate base as it would be unfair to burden future ratepayers with costs that provided them no benefit. The disallowance of recovery of reasonable and prudent costs that are not "used and useful" is consistent with holdings of the U.S. Supreme Court.[239]

Indeed, if the Authority approves legal fees for a CCN that is denied, it may force customers to pay for two CCNs: one that is denied, and one that is later approved. Ratepayers should not be burdened with regulatory expenses that will not be useful to them.

If the Authority approves the CCN, however, then the Consumer Advocate recommends the Authority limit the recovery of the legal fees to only those reasonable and prudent costs related to this Docket, or as the Consumer Advocate shows below, $33,690. The Consumer Advocate recommends reducing Laurel Hills' request by the following costs that are not considered reasonable or prudent, and therefore, unfair to burden customers to pay in rates. For

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[238] *See, e.g., supra* notes 80-87 and accompanying text.

[239] *See, e.g., Duquesne Light Co. v. Barasch*, 488 U.S. 299, 302-305, 313 (1989) (holding that Pennsylvania's selective application of the "used and useful requirement" to disallow recovery of construction costs for a canceled plant was constitutional and not considered a taking even though there was evidence that proved the utility's costs of the construction and the later cancellation were reasonable and prudent).

the same reasons the Consumer Advocate recommends disallowing the fees associated with the Chancery Court proceeding that were submitted as "TRA Proceeding Fees",[240] as discussed under Line A below, the Consumer Advocate also recommends the Authority disallow the entire $53,135 submitted as fees for "Other Matters." [241]

The Consumer Advocate recommends the Authority disallow the below costs as not reasonable and prudent or unnecessary and wasteful:

	TRA Proceeding Fees Total	$ 51,045.39
Reductions for unnecessary and wasteful or not reasonable and prudent fees:		
A	Chancery Court	$ 3,722.89
B	Show Cause Proceeding	$ 540.00
C	Discovery Avoidance/Motions to Compel	$ 547.50
D	Drafting and Revising McClung's Direct and Rebuttal Testimony	$ 8,295.00
E	Reducing the Overstated Anticipated Expenses	$ 4,250.00
	Total not reasonable and prudent or unnecessary and wasteful fees	$ 17,355.39
	Net potentially reasonable and prudent fees	**$ 33,690.00**

Line A – Chancery Court: The Chancery Court proceedings only started because Laurel Hills unlawfully shut off water to 87 customers, requiring the Authority to obtain an injunction keeping Laurel Hills from shutting off the water and charging only $43.20 (rather than the unauthorized $86.40 in unlawfully charged) until this Authority can issue an order for this Docket No. 12-00030.[242] The legal fees for Laurel Hills to defend itself against the Authority for an injunction compelling the continuation of water services should undoubtedly be excluded. To include these costs would not only be against public policy requiring utilities to provide service that is "reasonably continuous and without unreasonable interruptions or delay,"[243] but also it

[240] *Response of Laurel Hills Condominiums Property Owners Association to Staff Data Request*, Ex. A, Feb. 8, 2013.
[241] *Id.* Ex. B.
[242] *See, e.g., supra* notes 80-87 and accompanying text.
[243] *Duquesne Light Co. v. Barasch*, 488 U.S. 307, 313 (1989).

would be unfair for ratepayers to pay for such legal fees since it is against their interest to have the water unreasonably and unlawfully shut off. Therefore, the Consumer Advocate recommends exclusion of the following fees:

- $225.00 for drafting letter to Mrs. Davis for Chancery Court proceeding, research for terminating water service, conferring with Mr. York over Crab Orchard Billing Dispute, confer with TRA "regarding intervenors" and objections to intervenors.[244]
- $45.00 to confer with TRA regarding payments to Crab Orchard Utility District.[245]
- $265.00 for research of Appellant Court Procedure in connection with the preparation and filing of an Agreed Order waiving an interlocutory appeal filed with the Chancery Court.[246]
- $855.00 in charges for the drafting of discovery responses for the Chancery Court proceeding.[247]
- Charges of $1,155.00 for review, preparation and participation in the deposition of Mr. McClung that took place in connection with the Chancery Court proceedings in Cumberland County, not at the TRA.[248]
- Travel and expenses of $173.39 and $114.50 for a court reporter for deposition costs of Mr. McClung for proceedings in the Chancery Court in Cumberland County.[249]
- $45.00 to confer with Crab Orchard over dispute and confer with TRA for deposition of Mr. McClung (for Chancery Court proceeding).[250]

Additionally, many entries for the attorney fees claimed by Laurel Hills are not segregated for work on a specific case, but the narrative provided with the claimed legal expenses indicates charges for Chancery Court proceedings and the billing dispute with Crab Orchard Utility District submitted by the utility for recovery. Based on what evidence and justification Laurel Hills has provided, the Consumer Advocate has made the following

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[244] *Response of Laurel Hills Condominiums Property Owners Association to Staff Data Request*, Ex. A, Feb. 8, 2013 (Bill #48139, August 21, 2012).
[245] *Id.* Ex. A (Bill # 48139. Aug. 20, 2012).
[246] *Id.* Ex. A (Bill 48426. Oct. 25 and Oct. 30, 2012).
[247] *Id.* Ex. A (Bill #48559, Oct. 20, 2012).
[248] *Id.* Ex.A (Bill #48644, Dec. 11-12, 2012).
[249] *Id.* Ex. A (Bill #48644, Dec. 5, 2012;"0009" Expenses Billed, Jan. 22, 2013).
[250] *Response of Laurel Hills Condominiums Property Owners Association to Staff Data Request*, Ex. A, Feb. 8, 2013 (Bill # 48644, Dec. 5, 2012).

conservative adjustments to non-segregated entries for legal fee charges, based on similar charges for similar services, for excluding such costs.

- $30.00 for conferring with Roger York regarding outstanding bill to Crab Orchard.[251]
- $95.00 in charges for drafting and editing proposed agreed order in Cumberland County Chancery Court, confer with counsel the same.[252]
- $75.00 in charges for drafting and editing correspondence to Mr. York.[253]
- $75.00 in charges to finalize correspondence to Mr. York and review joint motion and order to stay TRA show cause proceeding.[254]
- $75.00 in charges to review correspondence from Mr. York and draft and edit letter back to Mr. York.[255]
- $150.00 in charges to prepare a letter to Mr. York regarding termination of water service from Crab Orchard.[256]
- $45.00 in charges to confer with TRA counsel regarding status of Chancery Court case and confer with counsel (Mr. Scholes).[257]
- $120.00 in charges for internal conference discussing client's decision not to pay water and electric bill.[258]
- $120.00 in charges for drafting and editing discovery response in Cumberland County court case.[259]
- $60.00 to review Answer filed by TRA in Chancery Court case.[260]

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[251] *Id.* Ex. A (Bill #47953; adjustment based on comparison with Bill #48644, charge for conferring with Mr. York on Dec. 5, 2012).
[252] *Id.* Ex. A (Bill #48139, Aug. 2, 2012. Reasonable approximation based on the narrative provided.).
[253] *Id.* Ex. A (Bill # 48139, Aug. 6, 2012. Reasonable approximation based on the narrative provided utilizing Mr. Gastel's rate of $150 an hour, assuming the correspondence took 30 minutes to draft and edit.).
[254] *Id.* Ex. A (Bill #48139, August 7, 2012. Reasonable approximation based on the narrative provided utilizing Mr. Gastel's rate of $150 an hour, to finalize and send correspondence to Mr. York previously drafted and edited on August 6 and review time for joint order and motion to stay TRA show cause proceeding.).
[255] *Id.* Ex. A (Bill 48139, August 17, 2012. Reasonable approximation based on the narrative provided utilizing Mr. Gastel's rate of $150 an hour, to review correspondence and prepare reply.).
[256] *Response of Laurel Hills Condominiums Property Owners Association to Staff Data Request*, Ex. A, Feb. 8, 2013 (Bill #48306, Sept. 7, 2012. Reasonable approximation based on the narrative provided utilizing Mr. Scholes's rate of $300 an hour, to review correspondence and prepare reply to Mr. York.).
[257] *Id.* Ex. A (Bill #48306, Sept. 19, 2012. Reasonable adjustment based on comparison with similar communication with TRA, Bill #48139, August 20, 2012.).
[258] *Id.* Ex. A (Bill #48559, Nov. 16, 2012. Represents one-third of the charges for internal conference that included discussion of the Hearing Officer's decision to compel and responses to intervenors.).
[259] *Id.* Ex. A (Bill # 48559, Nov. 19, 2012. Represents approximation based on the narrative provided.).
[260] *Id.* Ex. A (Bill #48559, Nov. 20, 2012. Reasonable approximation based on narrative provided.).

In its deliberations, the Authority must bear in mind that the Customer Intervenors retained an attorney to initiate action in the Cumberland County Chancery Court to prevent the termination of their water service. Thus, consumers are already bearing considerable legal expenses just to keep their water on in addition to their legal representation in this proceeding to pay a fair rate. The Renegade Mountain customers already have to foot their own legal bills. Requiring them to also shoulder the legal fees of Laurel Hills would undermine of the Authority's policy of balancing the interests of utilities and consumers. It is simply not just and reasonable to allow Laurel Hills to recover legal expense from customers for actions related to the Chancery Court proceedings.

Line B – Show Cause Proceeding: Any legal expense connected with the Authority's Show Cause proceeding should be excluded from recovery because, like the fees for the Chancery Court proceedings, it would be against public policy requiring utilities to submit to the Authority's jurisdiction and be unfair for ratepayers to pay for such legal fees since it is against their interest that Laurel Hills use legal maneuvering to unlawfully evade the Authority's oversight.

The Show Cause proceeding was initiated by the Authority because Laurel Hills, under court order, filed its petition and acknowledged the Authority's jurisdiction and then subsequently withdrew its CCN petition in this Docket No. 12-00030, claiming it would cease providing water service to the public and thus would no longer be a public utility subject to Authority regulation.[261]

Accordingly, on July 17, 2012, the Authority issued a show-cause order requiring Laurel Hills to appear for various violations of state law after Laurel Hills refused to appear before the

[261] *Notice of Voluntary Dismissal and Withdrawal*, May 7, 2012.

Authority on May 21, 2012.[262] The Authority opened Docket 12-00077 for the show-cause proceeding. The docket has been held in abeyance and Laurel Hills has since submitted itself to the jurisdiction of the Authority.

The show cause proceeding and actions preceding it contributed no benefit to Laurel Hills as a public utility, the quality of its service, or to its customers. Rather, such actions only contributed to regulatory costs and increased legal fees that served no legitimate purpose. Laurel Hills has to some extent recognized this. No legal bills were submitted for the Authority Proceeding fees prior to July 16, 2012, the day before the Authority issued the show cause order. Nonetheless, Laurel Hills did include a few fees incurred after July 16, 2012 that the Consumer Advocate recommends the Authority disallow:

- $210.00 in charges for conferring with the TRA regarding the CCN process and show cause proceeding and review Tennessee rules for appellate procedure.[263]
- $330.00 in charges for the preparation and filing of a Notice of Reinstatement and a call with Greg Logue on Chancellor's statements in the Community Club case.[264]

In addition to the public policy reasons and the notions of fairness for ratepayers, the Consumer Advocate notes that conferring with the Authority, researching of appellate procedure,[265] and filing a Notice of Reinstatement would not have been necessary had Laurel Hills not acted imprudently and abandoned its initial petition in this matter. Thus, these expenses are also considered unnecessary and wasteful, in addition to not reasonable and prudent or used and useful.

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[262] *Order Requiring Laurel Hills Condominiums Property Owners Association to Appear and Show Cause Why A Cease and Desist Order and Civil Penalties & Sanctions Should Not Be Imposed Against It For Violations of State Law*, July 17, 2012.

[263] *Response of Laurel Hills Condominiums Property Owners Association to Staff Data Request*, Ex. A, Feb. 8, 2013 (Bill #47953, July 16, 2012)..

[264] *Id.* Ex. A (Bill # 47953, July 19, 2012).

[265] As the TRA has issued no Final Order and Laurel Hills was submitting itself to the Authority's jurisdiction, fees for reviewing appellant procedure can only be connected with the Chancery Court proceedings or were unreasonably premature.

Line C – Discovery Avoidance/Motions to Compel: In this Docket, the Hearing Officer was required to rule upon a motion to compel filed by Laurel Hills and a motion to compel filed by the Customer Intervenors. On both counts, the Hearing Officer ruled against Laurel Hills.[266] The Hearing Officer's decision on the Customer Intervenors' Motion to Compel is illustrative of the lack of support Laurel Hills was willing to provide for its proposed rates and the unwillingness to provide information. Thus, the Consumer Advocate submits the following should be excluded.

- $120.00 in charges for the preparation and filing of a motion to compel, which the Hearing Officer denied.[267]
- $427.50 in charges, representing half of the amount billed, for the hearing, preparation, and research of the term "control" and "custody" under the civil rules of procedure. [268]

On the matter of the Customer Intervenors' Motion to Compel, specifically the issue of support for the alleged $400,000 promissory note to Moy Toy,[269] the Hearing Officer agreed with the intervenors and determined that if support could not be provided, the $400,000.00 promissory note would not be included in rate base. No such information was ever provided.

Line D – Drafting and Revising McClung's Direct and Rebuttal Testimony: The legal expenses proposed by Laurel Hills for recovery in this Docket include thousands of dollars invested in the drafting and revision of Michael McClung's direct and rebuttal testimony. Considering the extent of the lawyers' involvement in the drafting and preparation of the testimony and the credibility, weight and assistance such testimony contributed to the Authority in this matter, such costs should be excluded. Furthermore, the testimony contributed absolutely

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[266] *Order on November 7, 2012 Status Conference*, January 25, 2013.
[267] *Id.* Ex. A (Bill #48559); *Order on November 7, 2012 Status Conference*, pp. 6-8.
[268] *Id.* Ex. A (Bill #48559, original charges of $630.00 and $225.00 on November 11, 2012, which the CAPD has reduced by 50%).
[269] See *supra* notes 55-73 and accompanying text for affiliated debt, including the alleged note with Moy Toy.

nothing that could be said benefits the utility, the service provided to customers or the customers themselves.

Entries based solely for the drafting and revision of pre-filed direct and rebuttal testimony total $2,925.00.[270] However, as with many of the billing entries for legal expenses submitted, the bulk of those bills that deal with the drafting and revision of pre-filed testimony also include other activities by Laurel Hill's attorneys. Entries for the drafting and revising of Mr. McClung's pre-filed direct testimony also include preparing responses to TRA Data Requests. These total 25.9 hours of Mr. Scholes's time with $7,500.00 in billed charges. The TRA Data Request of August 28, 2012, which Laurel Hills responded to on September 7, consisted of a total of ten questions and requested basic financial and management data as it would any applicant for a CCN.

The charges of $2,505.00 from January 9, 11, 13-14, 2013, for the drafting and editing of Mr. McClung's rebuttal testimony by Mr. Gastel are informative in terms of hours spent preparing pre-filed testimony. These entries are solely for the preparation of testimony and no other purpose and provide a benchmark for comparison. Based on his hourly rate of $150.00, the preparation, drafting and editing of Mr. McClung's rebuttal testimony took 16.7 hours of time. By making a reasonable and conservative assumption that Mr. Scholes also utilized 16.7 hours of time to draft and edit Mr. McClung's pre-filed direct testimony at Mr. Scholes's hourly rate of $300.00, the cost of the pre-filed direct testimony was $5,010.00. This calculation is more than reasonable as it still leaves 9.2 hours at $300.00 an hour for Mr. Scholes to prepare responses to ten TRA data requests.

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[270] *Response of Laurel Hills Condominiums Property Owners Association to Staff Data Request*, Ex. A, Feb. 8, 2013 (Bill #48426 October 5, 2012;Bill #48306, September 9, 2012; "Fees Unbilled", January 9, 11, 13-14, 2013).

The charges also include $660.00 at 2.2 hours of time for Mr. Scholes to attend the scheduling conference on August 23, 2012 and e-mails and conferences with Mr. Gastel for the preparation of Mr. McClung's direct testimony.[271] The scheduling conference convened at 10:30 a.m. and adjourned at 10:55 a.m.[272] Presuming one hour is sufficient for the 25-minute conference and related travel time, $360.00 was billed by Mr. Scholes concerning Mr. McClung's pre-filed direct testimony. Thus, the total for the preparation, drafting and revising of McClung's pre-filed direct and rebuttal testimony in this matter amounted to $8,295.00.[273]

The Consumer Advocate submits such costs should be excluded from recovery in rates. Attorneys should not be the primary drafter and editor of an expert's testimony. Pre-filed testimony is the primary vehicle for experts and knowledgeable witnesses to provide opinions and recommendations to the Authority. It should not be an avenue for lawyers to become so invested in playing the role of accountant or utility management. The Authority should consider the weight and credibility of Mr. McClung's pre-filed testimony and proposed monthly rate of $136.26 in assisting the Authority in the final outcome of this case.

Line E – Reducing the Overstated Anticipated Expenses: Laurel Hills submitted an estimate of $12,000.00 "anticipated" legal expense for the hearing and conclusion of this proceeding. The estimate was in no way supported by Laurel Hills, the party with the burden of proof in this case. In the absence of justification, the Authority should consider excluding the $12,000 estimate from consideration in this docket.

If the Authority is not persuaded to disallow the anticipated costs, the Consumer Advocate recommends the Authority allow a maximum of $7,750 for these anticipated costs as

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[271] *Id.* Ex. A (Bill #48139, Aug. 23, 2012).
[272] *Transcript of Status Conference*, Aug. 23, 2012, p. 2, 17.
[273] To recap, this is a total of $2,925 of actual and segregated fees, *supra* note 270, as well as the estimates of $5,010 and $360 in fees for Mr. Scholes drafting testimony based on the estimated hours spent drafting rebuttal and the estimated hours of the other activities combined in the hourly totals for those line items.

anything more would be not reasonable or prudent and unnecessary and wasteful. The Consumer Advocate's adjusted estimate of $7,750 is based on the following facts and reasonable assumptions:

- The ten hour length of the hearing (at $150.00 an hour) and participation by Mr. Gastel for $1,500.00.
- The five hours Mr. Scholes spent at the hearing (at $300.00 an hour) for $1,500.00.
- Ten hours of preparation by Mr. Gastel for the hearing (at $150.00 an hour) for $1,500.00.
- Fifteen hours for the preparation of a post-hearing brief by Mr. Gastel (at $150.00 an hour) for $2,200.00.
- Two hours of review of the brief by Mr. Scholes (at $300.00 an hour) for $600.00.
- One hour for attendance for each attorney for the Authority Conference that will have deliberations for this Docket No. 12-00030 at $450.00.

The Consumer Advocate acknowledges this is only an estimate, but one that is based in part on the length of the hearing and constitutes a more reasonable estimate of what are reasonable and prudent costs to complete this matter.

Line 24 – Accumulated Depreciation: Laurel Hills agreed with the Consumer Advocate that $525 is the appropriate value of accumulated depreciation.[274] The Consumer Advocate recommends that this amount be updated once the valuation of rate base, and related depreciation expense, is ascertained (*i.e.*, pumps, pump design, valves).

Line 25 – Working Capital: Laurel Hills and the Consumer Advocate agree that working capital is calculated using the "1/8" method, that is multiplying 12.5% by annualized O&M expenses (*i.e.*, annualized expenses less depreciation).[275] Using this method, the Consumer Advocate recommends the Authority include $5,875 in the interim rates. It should be

[274] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 13, Jan. 14, 2013; *Testimony of William H. Novak*, Docket No. 12-00030, pp. 8, 16, Dec. 13, 2012.
[275] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 13, Jan. 14, 2013; *Testimony of William H. Novak*, Docket No. 12-00030, p. 16-17, Dec. 13, 2012.

noted for divestment purposes that the calculation of working capital, including the underlying expenses and the method of calculation, may be different for any subsequent purchaser.

Funding Construction: If the Authority approves the CCN, as previously mentioned, the Consumer Advocate recommends the Authority set conditions on the CCN and hold another hearing to consider the appropriate conditions. One of the conditions would likely need to address how to fund construction. As Mr. Novak testified, it is possible that the construction could be funded by the customers through a mechanism called "contributions in aid of construction" ("CIAC").[276] If this mechanism is used, the Consumer Advocate recommends the Authority order any CIAC rates and orders the proceeds to be maintained in an escrow account outside of the control of Mr. McClung and the other board members of Laurel Hills until they are used. Laurel Hills has not proven that it can manage its own money properly; the Consumer Advocate advises against giving them other people's (*i.e.*, customer's) money to handle as well. Additionally, Laurel Hills would not earn a rate of return on CIAC funds because it is not Laurel Hills' funds being used.

5. Rate of Return

As discussed previously, a utility earns a return on the capital invested in it.[277] This rate of return is so the utility can recover from ratepayers its cost of capital.[278] The Authority has previously ordered:

> 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

[276] *Transcript of Status Conference*, Feb. 13, 2013, pp. 306-07.
[277] *See supra* note 92 and related text.
[278] *Testimony of Chris Klein*, Docket No. 12-00030, pp. 6-7, Oct. 1, 2012.

weighted average of the component rates to account for the proportion of each component.[279]

Dr. Klein did not have sufficient information to recommend a certain rate of return prior to the hearing because of the lack of documentation supporting the capital investments and related debt coupled with the high uncertainty of information that was provided.[280] Nevertheless, the Consumer Advocate's accounting expert, Mr. Novak, applied a "hypothetical rate of return" of 6.68% in his calculation of rates.[281] Laurel Hills provided no rate of return, but Mr. McClung indicated that "Laurel Hills will not dispute the 6.668% rate of return."[282]

At the hearing, Mr. McClung clarified several issues that now make it possible for the Consumer Advocate to propose a more certain rate of return that is consistent with the Authority's methodology used previously. The chart below is a summary of the discussion that follows it:

Source	Capital	Portion of Total Capital	Interest rate	Weighted Average
Daryl McQueen	$36,500	49%	0%	0%
Line of Credit used	$38,000	51%	6.50%	3.32%
	$74,500	100%		3.32%

a. Capital Structure: The Consumer Advocate recommends a capital structure comprised of the company's debt that has been invested in the utility, which in this case is the $38,000 borrowed against the line of credit from its affiliate Renegade Mountain

[279] *Final Order, In re: Petition of Tennessee American Water Company for a General Rate Increase*, Docket No. 10-00189, p. 120, Apr. 27, 2012.
[280] *Testimony of Chris Klein*, Docket No. 12-00030, p. 11, Oct. 1, 2012.
[281] *Testimony of William H. Novak*, Docket No. 12-00030, p. 17, Dec. 13, 2012.
[282] *Rebuttal Testimony of Michael McClung, President of Laurel Hills*, Docket No. 12-00030, p. 13, line 17, Jan. 14, 2013.

Timeshares,[283] as well as $36,500 owed to Mr. McQueen discussed previously in the "Surcharges" section. It is worth noting that neither the COUD invoices nor the invoice to Mr. McQueen had been paid at the time of the hearing.[284] Thus, both of these past due balances would have increased to approximately $27,000 and $44,500, respectively, by the time of the hearing on February 13, 2013.[285] Even though the outstanding balances have certainly increased, the Consumer Advocate included only the debt owed by Laurel Hills[286] and sought repayment of in future rates.

The Consumer Advocate recognizes that it is highly unusual to consider past-due bills as a source of capital to be included in the capital structure. A utility having outstanding bills that are over two years old is a highly unusual situation, however. By not paying these invoices, Laurel Hills has had a source of essentially interest-free debt[287] because it has been able to use

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[283] *Transcript of Proceedings*, Docket No. 12-00030, p. 137-39, Ex. 1, tabs 16 & 20, Feb. 13, 2013 (showing the note in tab 16 and the Secretary of State documents showing Mr. McClung and Phillip Guettler as Managing Members of Renegade Mountain Timeshares). Mr. McClung testified that the $50,000 "note" shown in Exhibit 1, Tab 16, was actually a line of credit. *Id.* at 61, 139. He also testified that Laurel Hills had only used $38,000 of that line of credit, and the remainder of the line of credit was rescinded by Renegade Mountain Timeshare because Laurel Hills was a "bad credit risk." *Id.* at 179-80. Interestingly, Mr. McClung, who is managing member of Renegade Mountain Timeshares, *Id.* at Ex. 1, tab 20, claims it was his "fiduciary responsibility" to rescind the remainder of the line of credit. *Id.* The terms of the line of credit indicate that funds borrowed would have an interest rate of 6.5%. *Id.* Ex. 1, tab 16, p. 1.

[284] As also explained in the "Surcharges" section, $18,000 of the COUD was not assumed by Laurel Hills, and thus remains Moy Toy's debt. The remaining $6,000 of the COUD debt has been a source of interest-free capital for Laurel Hills in the past, but COUD provided formal notice after the Authority's hearing that Laurel Hills has no further credit. Therefore, the Consumer Advocate cannot in good faith include $6,000 (or what would have actually have been $9,000 of post-acquisition debt at the time of the hearing) as a source of capital for the time period that Laurel Hills would receive interim rates.

[285] As discussed in the "Surcharges" section, the $24,000 COUD bill was through November 30, 2012, and the $36,500 bill for Mr. McQueen was dated October 2012. *Transcript of Proceedings*, Docket No. 12-00030, Ex. 9 & Ex. 1, tab 10, Feb. 13, 2013 (providing COUD's account history and Mr. McQueen's invoice). Mr. Bolin testified on behalf of COUD that the outstanding water bill at the time of the hearing was around $28,000. *Id.* at 344. Mr. McQueen's past due balance would have increased as well. Mr. McClung testified that Mr. McQueen was to be paid $500 per week, *Transcript of Proceedings*, Docket No. 12-00030, p. 167, lines 12-19, Feb. 13, 2013, as was verified by Mr. McQueen's invoice in Exhibit 1, Tab 10. *id.* As of the date of the hearing, the October 2012 invoice of $36,500 for 73 weeks would have been $44,500 for the 89 weeks of retainer since June 1, 2011.

[286] In addition to the reasons discussed in *supra* note 285, the Consumer Advocate did not consider adding the pre-acquisition debt owed to COUD because, as discussed in the "Surcharges" section, it is not a debt owed by Laurel Hills.

[287] Mr. McQueen charges neither a late fee nor interest on his invoices. It should be noted that, based on an analysis of COUD's account history, it charges a 10% penalty for late payments. *Transcript of Proceedings*, Docket No. 12-

the revenue from rates for other purposes—purposes that remain unclear even after the hearing, but could likely have been used to repay the debt or invoices to affiliated parties, including but not limited to the line of credit for Renegade Mountain Timeshares or the October 2012 invoice for Gold Mine Golf.

The Consumer Advocate also recognizes it is highly unusual to have a capital structure without equity. According to Laurel Hills' balance sheets as of December 31, 2011 and as of August 31, 2012, the company had negative equity of $(351,712.89) and $(373,954.71), respectively.[288] Thus, for interim rate purposes, the balance sheet of the company indicates that it does not have equity invested in the utility. Moreover, as Dr. Klein articulated in his pre-filed testimony, the rationale for providing a return on equity to an investor in a utility does not apply to Laurel Hills since it is a nonprofit and it does not raise capital by selling stock, and consequently, its rate of return does not have to attract investors to buy its stock.[289]

b. Cost rates: For interim rate purposes, the Consumer Advocate recommends the Authority use 6.5% for the capital sourced from the affiliate's line of credit and 0% on the past due balances owed to vendors.

c. Weighted-Average Cost of Capital: Based on the above discussion, the Consumer Advocate recommends the Authority use a weighted-average cost of capital of 3.32%.

d. Alternative approach: If the Authority is not persuaded to include the past due balances owed to COUD and Mr. McQueen in its capital structure, the Consumer Advocate respectfully urges the Authority to, at minimum, consider an alternative approach for rate of

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00030, Ex. 9, Feb. 13, 2013. This late penalty is only applied to the monthly bills, and not the entire past due balances. Meaning, the late fee is similar to a late fee charged by a credit card if a payment is missed, but it is not the same as the interest a credit card charges on the outstanding balance. Thus, this penalty fee is not interest and the outstanding balance is therefore interest free.

[288] *Transcript of Proceedings*, Docket No. 12-00030, Ex. 3, Feb. 13, 2013; *Response of Laurel Hills Condominiums Property Owners Association to Staff Data Request*, Attachment to Data Response No. 5, Sept. 7, 2012.

[289] *Testimony of Chris Klein*, Docket No. 12-00030, p. 8-9, Oct. 1, 2012.

return for interim rate purposes so that ratepayers do not pay 6.5% on rate base as a cost of Laurel Hills' debt with affiliates while unaffiliated vendors providing services necessary for operations go unpaid.

IV. CONCLUSION

For the foregoing reasons, the Consumer Advocate recommends the Authority deny the CCN in this Docket 12-00030 and take steps to apply to an appropriate tribunal to order Laurel Hills to divest the water system. Until the system is divested, the Consumer Advocate recommends an interim rate of $29.54 per month. If the Authority approves the CCN, the Consumer Advocate recommends an interim rate of $31.68 until more information is made available to determine more permanent rates. Additionally, if the CCN is approved, the Consumer Advocate recommends the Authority set a hearing to establish conditions on the CCN to ensure continuous water service.

RESPECTFULLY SUBMITTED,

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Dated: March 15, 2013

CERTIFICATE OF SERVICE

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

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This the 15th day of March, 2013.

Charlena Aumiller