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IN THE TENNESSEE REGULATORY AUTHORITY
AT NASHVILLE, TENNESSEE

IN RE: PETITION FOR A GENERAL RATE INCREASE, IMPLEMENTATION OF A DISTRIBUTION SYSTEM INFRASTRUCTURE CHARGE AND THE ESTABLISHMENT OF TRACKING MECHANISMS FOR PURCHASED POWER, PENSIONS AND CHEMICAL EXPENSES	))))))	**DOCKET NO. 12-00049**

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DIRECT TESTIMONY
OF
TERRY BUCKNER

****

August 27, 2012

IN THE TENNESSEE REGULATORY AUTHORITY
AT NASHVILLE, TENNESSEE

IN RE: PETITION FOR A GENERAL RATE INCREASE, IMPLEMENTATION OF A DISTRIBUTION SYSTEM INFRASTRUCTURE CHARGE AND THE ESTABLISHMENT OF TRACKING MECHANISMS FOR PURCHASED POWER, PENSIONS AND CHEMICAL EXPENSES	))))))	**DOCKET NO. 12-00049**

AFFIDAVIT

I, Terry Buckner, Regulatory Analyst, for the Consumer Advocate Division of the Attorney General's Office, hereby certify that the attached Direct Testimony represents my opinion in the above-referenced case and the opinion of the Consumer Advocate Division.

Terry Buckner
TERRY BUCKNER

EMILY KNIGHT
STATE OF TENNESSEE NOTARY PUBLIC
DAVIDSON COUNTY, TENN.
My Commission Expires JULY 6, 2015

Sworn to and subscribed before me
this 27th day of August, 2012.

Emily Knight
NOTARY PUBLIC

My commission expires: July 6, 2015

Q. Please state your name, business name and address for the record.

A. My name is Robert T. ("Terry") Buckner. I am operating as a sole proprietorship, Robert T. Buckner CPA, 2783 Saundersville Ferry Road, Mount Juliet, Tennessee 37122.

Q. On whose behalf are you testifying in this docket?

A. I am submitting testimony and work papers on behalf of the Consumer Advocate and Protection Division ("Consumer Advocate") in the Office of the Attorney General for the state of Tennessee ("Office").

Q. How long have you been employed in conjunction with the public utility industry?

A. I have been employed in conjunction with the public utility industry for over thirty years. Before my retirement from the Office, I was employed by the Comptroller's Office for the state of Tennessee for nearly two years as the Assistant Director responsible for public utility audits after approximately eight years of prior employment with the Office. Formerly, I was employed with the Tennessee Public Service Commission ("Commission") in the Utility Rates Division as a financial analyst for approximately six years. My responsibilities included testifying before the Commission as to the appropriate cost of service for public utilities operating in Tennessee. Prior to my employment with the Commission, I was employed by TDS Telecom for eight years and the First Utility District of Knox County for three years.

Q. What is your educational background and what degrees do you hold?

A. I have a Bachelors degree in Business Administration from the University of Tennessee, Knoxville with a major in Accounting.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to provide my exhibit of work papers ("work papers of Terry Buckner") for forecasted Operation and Maintenance expenses and Taxes Other Than Income for Tennessee American Water Company ("TAWC") for the attrition year ending November 30, 2013. Also, my testimony will address TAWC's proposed Distribution System Infrastructure Charge ("DSIC").

SUMMARY OF RESULTS

Q. Please summarize why the Consumer Advocate is projecting $2.1 million less in Operation and Maintenance ("O&M") expenses than TAWC.

A. The $2.1 million difference in O&M expenses between the Consumer Advocate and TAWC is due to the Consumer Advocate's projecting: (1) $0.361 million in lower O&M Labor; (2) $0.211 million less in Fuel and Power Expense; (3) $0.043 million less in Chemical Expense (4) $0.991 million less in management fees now referred to as "Support Services" by TAWC; and (5) $0.579 million less in Pension Expense.

The salaries and wages differential of $0.361 million is due to the Consumer Advocate's rejection of TAWC's forecasted employee levels of 107 employees for the attrition year. The Consumer Advocate rejects this projection because TAWC in case after case overstates the number of employees when compared to what the Company actually retains on the payroll. As a result in the last docket, TAWC's customers were actually charged for an employee level that TAWC never achieved for the entire forecast period.[1] Customers' water rates should not be set on employee levels that are never sustained.

In addition, the Consumer Advocate rejects TAWC's plan to charge customers for bonuses paid to salaried employees for increasing the regulated earnings of the company. This activity benefits TAWC's shareholders by moving money to their pockets from the pockets of TAWC's customers. Since customers are provided no benefit from this activity, they should not have to pay any costs associated with it.

The $0.211 million reduction in Fuel and Power is primarily driven by the growing level of unaccounted for water loss. This is the same reason for the $0.138 million difference in Chemical Expense. The Consumer Advocate's calculations limiting unaccounted for water percentage to fifteen percent is consistent with the two previous TRA Orders for TAWC.[2]

The difference in TAWC's and the Consumer Advocate's Support Service forecast is about $0.991 million. TAWC's growth in Support Services exceeds normal economic or cost-savings justification, and has far outstripped inflation. Furthermore, TAWC failed to exclude costs memorialized in TRA Order #10-00189.[3]

The $0.579 million reduction in Pension Expense is caused by TAWC's failure to recognize that the TRA's ratemaking allows only the minimum required contribution as recommended in the latest actuarial report.[4]

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[1] TRA Docket #10-00189, Order dated August 21, 2012.

[2] TRA Order dated January 13, 2009, TRA Docket No. 08-00039, Page 17; TRA Docket No. 10-00189, Page 67.

[3] TRA Order #10-00189 dated April 27, 2012, Pages 82 and 83.

[4] TRA Order #10-00189 dated April 27, 2012, Page 86.

Q. Please summarize why the Consumer Advocate's forecast of taxes other than income taxes is $0.499 million lower than TAWC's other tax calculations.

A. This difference is primarily due to the Consumer Advocate's computation of lower property taxes. In computing its property tax forecast, the Consumer Advocate used a more recent property assessment value than TAWC.

<u>OPERATION AND MAINTENANCE EXPENSES</u>

Q. Please describe the components of O&M Expenses.

A. There are 17 O&M Expense categories subject to forecast in this docket. The first category is forecasted O&M Labor. This category was projected based on a payroll price-out.

In two categories, Fuel & Power and Chemicals, there is a direct correlation between TAWC's forecasted revenues and the volume of water filtration expenses.

For the categories of Support Services and Pension Expense, the Consumer Advocate used TRA precedent for TAWC to forecast these amounts.

For the other eleven categories, the Consumer Advocate adopted the amounts per account for the test period ended December 31, 2011 and increased each amount by the annual GDP Chained Price Deflator growth rate of 2.12%.[5] The compounded growth rate from December 2011 through No-

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[5] Terry Buckner work paper, E-GDP, Index of work papers, page 26.

vember 2013 is approximately 4.12%. There is zero customer growth forecasted in this docket. This methodology is the standard procedure that the Consumer Advocate uses to forecast non-salary and wage O&M Expenses in rate proceedings before the TRA.

Due to the large number of differences between the Consumer Advocate and TAWC in the amounts within O&M expense categories, as well as the amounts within expense accounts within each category, the Consumer Advocate will address only the significant net differences in its O&M expense forecast and the O&M expense forecast of TAWC. The details of the forecast, however, are presented in the Consumer Advocate's work papers, which are referenced in the following discussion of each O&M category. Additionally, the Consumer Advocate recognized non-recurring expenses as adjusted by TAWC.

Q. What are the significant differences between TAWC and the Consumer Advocate in O&M Expenses for the forecasted attrition year?

A. Consumer Advocate work paper E-REC-1[6] provides a reconciliation of the differences in the calculation of O&M Expenses.

The significant differences in O&M Expense for the forecasted attrition year are: (1) $361,353 in lower labor costs; (2) $210,857 in lower Fuel and Power costs; (3) $43,198 in lower Chemicals expense; (4) $991,160 in lower Support Services; (5) $579,014 in lower Pension costs. Accordingly, the Consumer Advocate's total O&M Expense forecast is $2,097,969 less

[6] Terry Buckner work paper, E-REC-1, Index of work papers, page 1.

than TAWC's forecast.

Q. Please describe your forecast methodology for O&M Labor.

A. Total O&M Labor was calculated using actual employee levels, actual wage rates per employee, actual overtime hours as of December 31, 2011, and prospective pay increases at January 1, 2012 and March 1, 2013 for salaried employees.

At December 31, 2011, TAWC had 75 filled hourly positions and 24 filled salary positions for a total of 99 employees. TAWC averaged 100 employees for the test year ended December 2011. The hourly employees receive an annual pay raise at November 1 of each year per their contract. The O&M Labor amount was derived from the calculated total salary and wage dollars minus salary and wage dollars charged to capitalization, i.e., work on capital projects. The capitalized salaries and wages were calculated using TAWC's actual average capitalization rate for the twelve months ended December 31, 2011. Forecasting O&M salaries and wages through this price-out methodology is the standard procedure that the Consumer Advocate uses to forecast salaries and wages in rate proceedings before the TRA.

Q. Please explain the differences in the calculation of O&M Labor.

A. Consumer Advocate work paper E-PAY-6[7] provides a reconciliation of the differences in the calculation of O&M Labor. In summary, O&M Labor as

[7] Terry Buckner work paper, E-PAY-6, Index of work papers, page 8.

forecasted by TAWC for the attrition year is overstated by $361,353.

The significant differences between TAWC and the Consumer Advocate in the calculation of O&M Labor are attributable to the following:

(1) According to TAWC's testimony, the forecast of O&M Labor includes 107 employees for the attrition year; TAWC adopted the overtime hours and the capitalization rate of 17.57% for the test period ended April 2012; TAWC's O&M Labor is $5,549,827.

(2) Consumer Advocate work papers E-PAY-1 and E-PAY-3[8] provide a price out of all employees for the attrition period. The Consumer Advocate adopted an employee level of 99. The Consumer Advocate used the actual capitalization rate for the twelve months ended December 31, 2011 of 14.97% and the Consumer Advocate excluded 50% of TAWC's Annual Incentive Plan ("AIP") and all of the Long Term Incentive Plan ("LTIP").

Q. Why did the Consumer Advocate use current employee levels in its forecast rather than TAWC's projection of future employee levels?

A. The Consumer Advocate used an employee count of 99 as of December 31, 2011, because TAWC has historically inflated its employment levels. The TRA has found that TAWC does not achieve or maintain their forecasted employment levels.[9] TAWC's continued requests to set rates using an inflated employee level rather than a realized employee level should be denied.

In TRA Docket #03-00118, TAWC included in its forecast 119 em-

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[8] Terry Buckner work papers, Index of work papers, Pages 2-3.

[9] TRA Docket #10-00189, Order dated August 21, 2012.

ployees.[10] Subsequent to the TRA Order, in July 2003, TAWC cut the number of employees to 108. The actual average employee level for the attrition year in TRA Docket #03-00118 was 113[11] rather than the 119 TAWC had forecasted. As a result, the actual O&M Labor expense for TRA Docket #03-00118 was $4,631,351[12] rather than TAWC's forecast of $5,066,066[13], a difference of $434,715.

In TRA Docket #04-00288, TAWC forecasted 106[14] employees for the attrition year ended December 2005. However, the average employee level for that period was only 99.[15] TAWC forecasted O&M Labor expense of $4,383,883[16] for that attrition year. Once more, TAWC's forecast was significantly overstated. The actual expense for that period was $3,765,383[17], a difference of $618,500.

Again, in TRA Docket #06-00290, TAWC contended that it would need 111 employee positions.[18] Yet, TAWC averaged only 108 employees. At one point, TAWC stated in the proceeding it would have 110 employees by the following Monday in April of 2007.[19] Yet, based on TAWC's response, that employment level either did not occur or was quite brief. Consumer Advo-

[10] TRA Docket #04-00288, Direct Testimony, M. Miller, Page 14, Lines 17-18.
[11] Terry Buckner work paper, E-PAY-5, Index of work papers, Pages 6-7.
[12] TRA Docket #04-00288, TAWC Exhibit No.2, Schedule 3, Page 1 of 1, Line 1. +
[13] TRA Docket #03-00118, S. Valentine Exhibit No. 2, Schedule 3, Page 1 of 1, Line 1.
[14] TRA Docket #04-00288, Direct Testimony, M. Miller, Page 14, Lines 16-17.
[15] Terry Buckner work paper, E-PAY-5, Index of work papers, Pages 6-7.
[16] TRA Docket #04-00288, Exhibit No. 2, Schedule 3, Line 1.
[17] TRA Docket #06-00290, TAWC Rebuttal Exhibit MAM-15, Page 2 of 2.
[18] TRA Docket #06-00290, Rebuttal Testimony, J. Watson, Page 6.
[19] TRA Docket #06-00290, Transcript dated 4/18/07, afternoon session, Page 272, J. Watson.

cate work paper E-PAY-5[20] compares the actual employee levels of TAWC with the forecasted employee levels by TAWC. (A Consumer Advocate chart[21] from this data demonstrates that TAWC has repeatedly maintained employee levels below their forecasted employee levels used to justify their filings before the TRA.)

In TRA Docket #08-00039, TAWC proposed an employee level of 114. Yet, TAWC averaged only 107 filled positions for the attrition year.

In TRA Docket #10-00189, TAWC included 110 employees for the attrition year ended December 31, 2011. Yet, TAWC averaged 100 employees over the attrition year.

While it is common for businesses to lay off employees in an effort to achieve their targeted rate of return, it is not appropriate for the TRA to set rates using a forecasted employee level for "feather bedding" purposes to guarantee TAWC achieves their targeted rate of return. Employee vacancies occur for a variety of reasons. Therefore, it would be prudent for the TRA to set rates on filled employment positions and not vacant positions.

Historically, it appears that TAWC has difficulty in finding the appropriate employee configuration for providing water service to its customers.

Therefore, the Consumer Advocate recommends to the TRA that only known and measurable salaries and wages necessary for the provision of water service be included in the attrition year.

The TRA should reject the O&M Labor Expense forecast of TAWC and set rates based on actual employee levels, not on speculative employment

[20] Terry Buckner work paper, E-PAY-5, Index of work papers, Pages 6-7.

positions that never materialize. TAWC "can be subject to economic downturns and must hold the line on expenses and employee growth during lean times."[22]

Finally, TAWC's employment history also demonstrates that the current employee level is sufficient for operation of the company.

Q. What adjustment to the Incentive compensation did you make?

A. The Consumer Advocate also has disallowed fifty percent, or $99,122 of O&M Labor for "incentive payroll." The incentive payroll known as AIP is based on two performance measures: (1) Financial; and (2) Operational.[23] Also, the Consumer Advocate has disallowed the incentive compensation known as LTIP, which amounts to $16,672. Both disallowances are in accordance with TRA Order #10-00189 dated April 27, 2012.[24]

Q. What other labor adjustment did you make?

Finally, the Consumer Advocate eliminated 20% of the Government Affairs Specialist position, which amounts to $15,798 in accordance with the previous TRA Order for TAWC.[25]

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[21] Terry Buckner work paper, Index of work papers, Page 9.

[22] TRA Order #08-00039 dated January 13, 2009, Page 13.

[23] TAWC response to TRA Data Request #37 and 2010 Plan per Direct Testimony of Ralph C. Smith, Consumer Advocate Division, W. Va. Case No. 10-0920-W-42T, dated November 12, 2010, Page 35, Exhibit RCS-2.

[24] TRA Order #10-00189 dated April 27, 2012, Page 61.

[25] TRA Order #10-00189 dated April 27, 2012, Page 61.

Q. What is the primary issue with Fuel and Power Expense?

A. The primary difference between TAWC and the Consumer Advocate concerns the amount of Fuel and Power Expense for the loss of unaccounted for and non-revenue water. The unaccounted for and non-revenue water loss has continued to grow.[26] Consistent with the TRA's Order in Docket No. 08-00039[27], the Consumer Advocate has capped the amount of unaccounted for and non-revenue water loss to fifteen percent in its calculation of Fuel and Power Expense.

Additionally, TAWC is proposing a tariff rider for recovery or crediting incremental changes in Fuel and Power Expense through a tariff rider.[28] Given TAWC's practice of filing bi-annual rate cases, the Consumer Advocate contends that such a rider or tracker is not necessary.

Therefore, the Consumer Advocate recommends that $2,577,355[29] be adopted by the TRA and that the loss of unaccounted for and non-revenue water be capped at 15% as previously established by the TRA.

Q. What is the primary issue with Chemicals Expense?

A. Again, the primary difference between TAWC and the Consumer Advocate concerns the amount of Chemicals Expense for the loss of unaccounted for and non-revenue water. The unaccounted for and non-revenue water loss has continued to grow.[30] Consistent with the TRA's Order in

[26] Terry Buckner work paper E-FP, Index of work papers, Page 11.
[27] TRA Order dated January 13, 2009, Page 15.
[28] TAWC Direct Testimony, VerDouw, Page 54.
[29] Terry Buckner work paper E-FP, Index of work papers, Page 11
[30] Terry Buckner work paper E-CHEM, Index of work papers, Page 12.

Docket No. 08-00039[31], the Consumer Advocate has capped the amount of unaccounted for and non-revenue water loss to fifteen percent in its calculation of Chemicals Expense.

Once more, TAWC is proposing a tariff rider for recovery or crediting incremental changes in Chemical Expense through a tariff rider.[32] Again, given TAWC's practice of filing bi-annual rate cases, the Consumer Advocate contends that such a rider or tracker is not necessary.

Therefore, the Consumer Advocate recommends that $986,930[33] be adopted by the TRA to take into account known and measurable price increases and that the loss of unaccounted for and non-revenue water be capped at 15% as established by the TRA.

Q. What are Support Services?

A. Support Services, known as Management Fees in the past, are the result of a service agreement between American Water Works Service Company ("AWWSC") and TAWC in effect as of January 1, 1989. AWWSC

> is a service company that is designed to aid, assist, and advise other subsidiaries, such as TAWC, in their business operations by providing accounting, administration, communications, corporate secretarial, engineering, financial, human resources, information technology, operations, rates and revenue, risk management, and water quality services.[34]

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[31] TRA Order dated January 13, 2009, Page 15.
[32] TAWC Direct Testimony, VerDouw, Page 54.
[33] Terry Buckner work paper E-CHEM, Index of work papers, Page 12.
[34] Schumaker & Company, Affiliate Audit Report, August 2010, Page 13.

Support Services may be directly charged or allocated from AWWSC to TAWC. An allocation does not mean that work was actually performed for TAWC, but only that a dollar amount of overhead costs was assigned to TAWC.

Q. What is the history of the Management Fees issue for TAWC?

A. Management Fees have been an issue in Tennessee for the last five years.

In TRA Docket #04-00288, as a result of reorganization, TAWC included a 22% increase of $555,664 in Management Fees which brought the total forecasted 2005 Management Fees to $3,062,940. TAWC represented that this increase would "enable the Company to operate more efficiently and cost effectively while at the same time improving and enhancing the service that the Company provides."[35] Reorganization in this instance meant the elimination of jobs in Chattanooga and the creation of jobs in other AWWSC locations. However, TAWC has booked $3,716,559 in 2005 and $4,376,059 in 2006 for Management Fees.[36]

Subsequently, in TRA Docket #06-00290, TAWC forecasted $4,064,421 for the attrition year ended February 2008, a 33% increase over the 2005 forecast amount. In support for this level of increase, TAWC claimed that full time employees ("FTEs") had been shifted to the Regional Service Company.[37] Further, TAWC claimed that it was not appropriate to use the 2005 forecasted amount because it was a settlement amount.[38] In support of their forecasted Management Fees, TAWC filed a an exhibit using a starting point of March 31, 2004 per TRA Docket #03-00118 to compare an inflated fully loaded company labor to their forecasted management fees

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[35] TRA Docket #04-00288, Direct Testimony of M. Miller, Pages 14-15, Lines 15-16 and Lines 2-4.
[36] Schumaker & Company, Affiliate Audit Report, August 2010, Exhibit II-10, Page 25.
[37] TRA Docket #06-00290, Rebuttal Testimony, M. Miller, Page 53, lines 29-30.
[38] TRA Docket #06-00290, Rebuttal Testimony, M. Miller, Page 54, lines 7-10.

and forecasted labor.[39] TAWC had management fees of $4,734,432 for 2007[40] which results in a 56% increase over the forecasted December 2005 amount. Despite the claims of TAWC, rates were set in TRA Docket #04-00288 for the forecast period ending December 31, 2005 and a Management Fee amount of approximately $3 million. This Management Fee amount was not the result of settlement, but was simply TAWC's amount included in its filing.

In TRA Docket #08-00039, the Consumer Advocate based its forecast of an appropriate Management Fees amount using the 2005 amount as a starting point. The Consumer Advocate contended that TAWC's level of Management Fees was simply **not** just and reasonable for the ratepayers. While TAWC's other expenses continue to rise, there was no offset anywhere in TAWC's forecast to account for the rise in Management Fees. Therefore, contrary to TAWC's position, their forecasted Management Fees did not provide a more cost efficient operation. Even TAWC concedes this.[41] Additionally, TAWC's management audit known as the Independent Cost Assessment Report ("ICAR") concluded that the growth from 2005 to 2006 was "Above the average cost change"[42] of the peer group. A 33% increase without any offset is also unreasonable and out of step with TAWC's current growth indicators such as inflation and customer growth.

As a result, in Docket #08-00039, the TRA found that the performed management audit "did not adequately address the issue of prudency of the management fees, and that the audit was not an independent audit as ordered in TRA Docket No. 06-00290."[43] Also, "a majority of the panel voted

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[39] TRA Docket #06-00290, Rebuttal Exhibit MAM-15, Page 1 of 2.
[40] Schumaker & Company, Affiliate Audit Report, August 2010, Exhibit II-10, Page 25.
[41] TRA Docket #06-00290, Rebuttal Testimony, M. Miller, Page 54, Lines 10-13.
[42] TRA Docket #08-00039, TAWC Direct Testimony, J. Van Den Berg, Page 12.
[43] TRA Docket #08-00039, Order dated January 13, 2009, page 20.

to set the Management Fee attrition year expense amount at $3,529,933."[44] Finally, the TRA,

> ordered the Company to develop a Request for Proposal ("RFP") for a comprehensive management audit by an independent certified public accountant....Further, the audit shall evaluate and attest to the charges allocated to TAWC, including the efficiency of processes and/or functions performed on behalf of TAWC, as well as the accuracy and reasonableness of the allocation factors utilized.[45]

On September 10, 2010, an Affiliate Audit Report was filed by Schumaker & Company in TRA Docket #09-00086.

By TAWC's own admission, the forecasted 2011 Management Fees for TAWC will be 46.55%[46] higher than their 2005 Management Fees amount. A 2005 amount which was $.7 million more than the original TAWC forecasted amount in TRA Docket #04-00288.

Finally, the TRA adopted a Management Fees amount of $4,741,068 in Docket #10-00189.[47]

Q. What is the appropriate amount of Support Services to be included for setting rates in this docket?

A. The Consumer Advocate recommends a Support Service attrition year amount of $4.825 million[48] in this docket. This amount is consistent with the TRA's adopted methodology in Docket #10-00189.

[44] TRA Docket #08-00039, Order dated January 13, 2009, page 21.

[45] TRA Docket #08-00039, Order dated January 13, 2009, Page 22.

[46] TAWC Direct Testimony, Mr. Mike Miller, Exhibit MAM-10, Page 1 of 1.

[47] TRA Docket #10-00189, Order dated April 12, 2012, Page 83.

[48] Terry Buckner work paper E-SUPPORT SERV, Index of work papers, Page 14.

Q. What amount of Support Services is TAWC seeking in this docket?

A. TAWC is seeking $5.817 million,[49] which is a 14.5% increase over the test period ending December 2011.

Q. Is the amount of Support Services sought by TAWC in this docket just and reasonable for setting rates?

A. No.

Q. Please provide an overview of why the Support Services amount as proposed by TAWC is not just and reasonable for setting rates.

A. The TAWC Support Services amount is not just and reasonable because it includes costs unnecessary for the provision of water service, such as the following: (1) External Affairs costs of $109,883 that was eliminated in TRA Docket #10-00189[50]; (2) $127,333 of Business Development costs that was eliminated in TRA Docket #10-00189[51]; (3) $161,305, which is 50% of AIP compensation that was eliminated in TRA Docket #10-00189[52].

Q. Did you make any adjustment to Support Services for the Business Transformation ("BT") program?

A. No. TAWC did provide a response with Confidential Information, but

[49] TAWC Direct Testimony, Bridwell, Page 10, Line 3.
[50] TRA Order dated April 27, 2012, Page 82.
[51] TRA Docket #10-00189 dated April 27, 2012, Page 82.
[52] TRA Docket #10-00189 dated April 27, 2012, Page 82.

insists that the provided [redacted]."[53]

Q. What are the primary issues with Pension Expense?

A. Apparently, TAWC does not accept the TRA's ratemaking treatment of pension expense which includes only the minimum required contribution as recommended in the latest actuarial report.[54] This is troubling because the actuarial report by an independent source is the latest known and measurable amount for calculating Pension Expense.

Next, TAWC has included $500,335 to "true up" the Service Company's Pension Expense accounting with its subsidiary, i.e., the Service Company accounts for Pension Expense under FAS 87 and TAWC's minimum pension contribution under ERISA accounting.

Third, TAWC proposes to establish a method for deferring pension costs in excess or deficiency of this amount for future rate recovery or refund.[55] Notably, the Public Utilities Commission of California Docket #12-06-016 dated June 7, 2012 found that the ERISA pension funding amount reasonable for California American Water Company and FAS 87 pension amounts for the Service Company reasonable too.[56] Consequently, there is

[53] TAWC response to CAPD DR #106 (informal).
[54] TAWC Direct Testimony, Schwarzell, Page 13, Lines 14-16.
[55] TAWC Direct Testimony, VerDouw, Page 67, Lines 6-7.
[56] PUC of California Docket #12-06-016 dated June 7, 2012, Page 57.

no need to adopt a singular accounting method for Pension Expense for TAWC.

In addition, the Public Service Commission of West Virginia adopted a defined pension expense "based on the actuarial report....The current volatility of the equity markets also weighs against including pension expenses that are significantly beyond a test year or making significant changes to the Commission treatment at this time."[57] Again, given TAWC's practice of filing bi-annual rate cases, the Consumer Advocate contends that such a rider or tracker is not necessary.

Therefore, the Consumer Advocate's forecasted Pension Expense of $941,837 is just and reasonable.

Q. Please summarize the forecast differences in O&M expense.

A. Simply put, the differences in O&M forecasts are primarily due to TAWC's ignoring TRA precedent from the most recent TAWC cases. Clearly, the costs of excessive water losses and the consistency in employee position vacancies should not be put on the backs of the ratepayers. Notably, TAWC's forecast does not include any savings from their Business Transformation Project, which was presented to American Water's Board of Directors in May 2010.[58] American Water wants to improve their regulated O&M efficiency ratio (O&M/Regulated Revenues) to below 40%. Thus far, the historical improvement in the ratio has come through rate increases.[59]

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[57] MFR #7, PSC of West Virginia Order 10-920-W-42T dated April 18, 2011, Pages 41-42.
[58] PUC of California Docket #12-06-016 dated June 7, 2012, Page 61.
[59] MFR #5, 2011 10-K report, pages 46-47.

A Consumer Advocate comparative chart[60] demonstrates that the cumulative historical growth in O&M expenses by TAWC far exceeds the cumulative historical growth of the other three large TRA regulated public utilities: Atmos Energy, Chattanooga Gas ("AGL"), and Piedmont Natural Gas. The natural gas companies have an alternative energy source in electricity for consumers to consider. Consequently, they have to control and manage their O&M costs. TAWC has only the TRA to provide the needed regulatory restraint to their O&M costs, in particular Support Services.

Therefore, since TAWC's O&M amount ignores just and reasonable TRA precedents, the TRA should reject their O&M expense forecast.

Q. Do you have any other comments about TAWC's Operating Expenses in this docket?

A. Yes. The Consumer Advocate is accepting the Company's estimate of rate case expense in the calculation of Regulatory Expense. However, the Consumer Advocate reserves the right to review rate case expense based on the Tennessee Court of Appeals ruling in the 2008 rate case. In the event, however, the Company should not receive 100% of the rate case expense unless it receives 100% of its requested rate increase.

[60] Terry Buckner work paper, Index of work papers, Page 28

TAXES OTHER THAN INCOME TAXES

Q. What are the significant differences from TAWC in Taxes Other Than Income for the forecasted attrition year?

A. The significant differences in Taxes Other Than Income for the attrition year are primarily due to the forecast of Property Taxes. TAWC has calculated property taxes based on Plant in Service at the end of the attrition period.[61] However, much of the attrition period property taxes will be calculated using the year ending December 2012. Consequently, the property tax forecasted by TAWC is $452,203 too high. TAWC's accrual of property taxes for 2011 was over estimated by $167,117.

Q. Please explain the Consumer Advocate's calculation of Property Taxes.

A. Consumer Advocate work paper T-OTAX1A provides the calculation of property taxes. The Consumer Advocate adopted the 2012 gross assessment for the attrition year ended November 2013, even though Consumer Advocate work paper T-OTAX1 shows that TAWC's gross assessment has declined over the last year (2011 to 2012). The current economic climate has contributed to the decline in property values. While the appraisal of public utility property can use two different approaches, the balance sheet approach and the income approach, it is largely a matter of judgment by the appraiser. Yet, the appraiser should not ignore current economic conditions. Consequently, municipalities must raise property tax rates to offset

[61] TAWC Exhibit Schedule EXP-18A.1

the decline in appraisal values of public utility property. The City of Chattanooga is one such municipality with this circumstance.

As a result, the Consumer Advocate took the 2012 assessment value and grew it 2.49%, which is the growth in net plant from 2011 to 2012 times the 2011 effective tax rate. The 2012 property tax bills will not be issued until later this year.

Therefore, the TRA should adopt the Consumer Advocate property tax amount of \$2,757,695, which is \$452,203 lower than TAWC's forecasted amount.

DISTRIBUTION SYSTEM INFRASTRUCTURE CHARGE

Q. Please address the proposed Distribution System Infrastructure Charge ("DSIC").

A. Regulated public utilities have historically set rates based on the concept of opportunity and not a guarantee. A utility business is allowed to earn (but not guaranteed) a "reasonable" profit.[62] TAWC's proposed DSIC moves the setting of rates from an opportunity to a guarantee. This is contrary to the very definition of a public utility.

Q. Do you have concerns with the proposed Distribution System Infrastructure Charge ("DSIC") and other tracking mechanism proposed by the Company?

A. Yes. Tracking mechanisms shift business risk to consumers and weaken the incentives of public utilities to control costs. In the free market, competition creates the pressure on businesses to make efficient decisions and control costs. Regulation is the substitute for a lack of market competition. "Regulatory Lag", the term for the time period between rate cases, is in essence the regulatory incentive for public utilities to control costs and make prudent business decisions. Tracking mechanisms that guarantee cost recovery for specific expenses, or in the case of the DSIC which guarantees a return, distorts the regulatory compact in favor of the monopolistic utilities.

This is disconcerting given these economic times that the households, businesses, and manufacturing community in the Chattanooga area should be required to take on a greater share of a public utility's business risk and guarantee a monopoly a specific return.

Q. Please address the proposed DSIC.

A. Traditional rate-making is based on looking at all components of operations: revenues, expenses, investment and a fair return in a snapshot. Known and measurable changes are taken into account and rates are set for not just the present, but the future to allow a public utility to have the opportunity to make a reasonable return on the investment made in the public utility. TAWC's proposed DSIC moves the setting of rates from an opportunity to a guarantee. Again, Pennsylvania-American Water Company has a DSIC, which is collected from the ratepayer to guarantee a 10.20% return on equity.[63] However, regulated public utilities have historically set rates based

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[62] *Accounting for Public Utilities*, Hahne & Aliff §1.01 Page 1-2.

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

on the concept of opportunity and not a guarantee. Establishing trackers for operating expenses and infrastructure improvements outside of base rates violates accepted rate-making principles such as the prohibition on single-issue rate-making and the matching principle.

Approving the DSIC and the other proposed tracking mechanisms would represent a paradigm shift in Tennessee. Generally, state public service commissions have approved such mechanisms after their respective state legislators have granted statutory authority to do so. States such as Connecticut, Delaware, Illinois, Indiana, Maine, Missouri, Ohio, and Pennsylvania have instituted DSIC or similar infrastructure surcharges after specific and detailed laws were enacted by state legislators.[64] In 2009, the Tennessee General Assembly considered legislation that would have instituted various tracking proposals for regulated natural gas utilities before deciding on a bipartisan vote to study such proposals rather than enact them.[65]

Q. Are there differences in how DSIC proposals have been implemented?

A. Yes, there are differences in how DSIC have been implemented, operated and audited by regulators and interested parties. For example, in those states that have enacted the DSIC, the cap on spending has varied between 3% to 7.5% of revenues.[66] TAWC's proposal is a cap of 10% of revenues, an extremely high cap based on other states.

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[64] C.G.S.A. § 16-262w, 26 Del.C.§ 314, Ill. Stat. § 9-220.2, IC § 8-1-31, *et seq.* , 35-A MRSA § 6107-A, V.A.M.S. § 293.1000-393.1006, O.R.C. § 4909.1762, 66 PA C.S. § 1350, *et seq.*

[65] HB 1349/SB 1375 of the 106th General Assembly.

[66] Most caps range from 3% in Ohio to 7.5% in states such as Pennsylvania and Connecticut. Mis-

Q. Have any states rejected a DSIC mechanism?

Yes. The Iowa Utilities Board recently rejected a DSIC proposal, known as the Qualified Infrastructure Replacement mechanism or "QIP" proposed by Iowa American Water Company. The Iowa Board found the QIP proposal simply did not meet the standards for approval based on whether costs are outside the control of management, prone to variation, and of a significant cost of providing service.[67]

West Virginia also rejected a DSIC proposal from West Virginia American Water Company.[68] Arizona rejected a DSIC mechanism for Arizona American Water Company.[69] Commissions in New York and California which respectively have allowed a form of a DSIC in a settlement with Long Island American Water Company and an experimental DSIC for one area of California American Water Company's service area no longer authorize the mechanisms.

Q. Has the TRA rejected a similar mechanism?

A. Yes. In a rate case for Chattanooga Gas Company in 2004 the TRA rejected a pipeline replacement tracker for replacing bare-steel and cast iron pipes. The TRA considered such a surcharge would not make for "sound

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souri has authorized a cap of 10%.

[67] Final Order and Order Approving Settlement of the Iowa Utilities Board, In Re: Iowa American Water Company, Docket RPU-2011-0001, February 23, 2012, p. 6-14.

[68] Order of the West Virginia Public Service Commission, Case No. 10-0920-W-42T, April 18, 2011, p. 4-8.

[69] Order of the Arizona Corporation Commission, Docket W-01303 A-09-0343, p. 90-92, January 6, 2011.

regulatory policy" and could strain the TRA's limited staffing resources.[70] The TRA concluded recovery of such costs should be through the rate case process and not a separate surcharge.

Q. Has the implementation of DSIC in other states reduced the frequency of rate cases?

A It does not appear so. The pace of biannual or frequent rate cases for many American Water ("AW") regulated affiliates appears to continue in those states that have approved a DSIC mechanism. Based on my experience in prior TAWC rate cases, the trend in increased costs of AW service company support services, and the proposed Business Transformation costs which are expected to grow, one cannot foresee a DSIC forestalling future rate cases.

Q. Has the CAPD ever opposed an infrastructure project for TAWC?

A. Based on my involvement in the past several TAWC rate cases, the CAPD has never opposed any infrastructure projects such as new pipes, replacing old pipes or similar infrastructure needed to provide water service. Based on my experience, I believe the CAPD has never opposed any such project for any public utility. To my knowledge, the financial impact of such projects has always been included in the calculation of base rates proposed by the CAPD and/or authorized by the TRA.

[70] TRA Order, Chattanooga Gas Company Petition to Raise Rates, Docket 04-00034, October 20, 2004, p. 16.

Q. Have other public utilities in Tennessee invested in infrastructure projects and remained profitable without resorting to frequent rate cases and tracking mechanisms?

A. Yes. For example, Piedmont Natural Gas Company did not file a rate case between 2004 and 2011.[71] During that period, Piedmont made investments in Tennessee of $272 million[72] while making at or close to its authorized rate of return annually per TRA surveillance reports.

Q. Rather than proposing tracking mechanisms, is there another policy option to encourage investment in infrastructure?

TAWC is a monopoly water provider in their Chattanooga service area. There is no alternative provider for the TAWC ratepayers. Much of the net income of TAWC is paid out as dividends to the parent company, instead of being reinvested in the infrastructure of TAWC. In effect, water rates are raised to produce more net income to be flowed to the parent company's shareholders in dividend payments.

Therefore, in order to solve this inequity the Consumer Advocate recommends the TRA institute a safeguard of TAWC's equity by limiting TAWC's dividend payments to AW in cases where TAWC receives little to no capital investment. This is similar to the concept of "ring fencing" and serves as a way for state public service commissions to prevent a level of dividend payments that would reduce utility equity or retained earnings below a specified level. This regulatory tool has been utilized for a variety of

[71] TRA Docket 03-00313; TRA Docket 11-00144.
[72] TRA Docket 11-00144, Direct Testimony of Thomas Skains, p. 7.

public utilities, including Kentucky American Water Company.[73]

Q. Does this conclude your testimony?

A. Yes.

[73]Order of the Maryland Public Service Commission, In Re Balt. Gas & Elec. Co. Order No. 82986, October 30, 2009; Order of the Kentucky Public Service Commission, In re: Kentucky American Water, Case No. 2009-00359, May 14, 2010.