IN THE TENNESSEE REGULATORY AUTHORITY
AT NASHVILLE, TENNESSEE

IN RE: JOINT PETITION OF TENNESSEE AMERICAN WATER COMPANY, THE CITY OF WHITWELL, TENNESSEE AND TOWN OF POWELL CROSSROADS, TENNESSEE, FOR APPROVAL OF A PURCHASE AGREEMENT AND WATER FRANCHISE AGREEMENT AND FOR THE ISSUANCE OF A CERTIFICATE OF CONVENIENCE AND NECESSITY	)	**DOCKET NO. 12-00157**

POST-HEARING BRIEF OF THE CONSUMER ADVOCATE

RESPECTFULLY SUBMITTED,

Robert E. Cooper, Jr. (BPR #010934)
Attorney General and Reporter
State of Tennessee

Charlena Aumiller

Charlena S. Aumiller (BPR #031465)
Assistant Attorney General
Office of the Attorney General
Consumer Advocate and Protection Division
P.O. Box 20207
Nashville, Tennessee 37202-0207
(615) 741-2812

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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. 12-00157.[1]

I. INTRODUCTION

This Docket concerns the proposed acquisition of the water system currently owned and operated by the City of Whitwell ("Whitwell system" or "system") by Tennessee American Water Company ("TAWC"), a public utility serving Chattanooga, Lone Oak, and Suck Creek. The Whitwell system was first built in the 1950s and serves both the City of Whitwell and Powells Crossroads.[2] In 2004, the Whitwell system expanded through eminent domain when water system assets then owned by West Valley were condemned and transferred to the City of

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[1] *RE: 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 and for the Issuance of a Certificate of Convenience and Necessity*, Docket No. 12-00157 (Dec. 27, 2012).

[2] *Tennessee American Water Company's Responses to Data Requests by Consumer Advocate Division (Confidential)*, Docket No. 12-00157, DR #1, TAWC_RESP_CAPD_1DR_000242 (Mar. 13, 2013).

Whitwell.[3] At the time of the condemnation, a valuation valued the West Valley assets at a negative amount of at least $435,200.[4]

The Whitwell system has many problems. Since 2004, the system has been plagued with leaks, which reached a water loss level of over 50% in 2011.[5] The financial statements of the system have been audited along with the other City of Whitwell assets; none of the last three annual audits were unqualified, or "clean", opinions.[6] The audits for 2010 and 2011 were adverse and the audit opinion for 2012 was qualified. In each of the annual audits, the auditors reported numerous material weaknesses in Whitwell's financial control environment. For all intents and purposes, the Whitwell system's financial statements are unreliable. Indeed, even Mayor Easterly testified that despite the audited financial statements stating the system had income in 2010, she believed that the water system had an operating loss and the failure of internal controls had caused financial issues for the water system.[7]

TAWC's *Petition* contains several requests, some of which are not in dispute. First, TAWC seeks the TRA approval of the acquisition of the Whitwell system. In conjunction with this acquisition, TAWC is properly requesting a Certificate of Public Convenience and Necessity ("CCN") to serve the City of Whitwell and approval of a franchise agreement to serve Powells Crossroads. The acquisition, CCN, and franchise agreement are not in dispute. The Consumer Advocate has never objected to TAWC's ownership of the Whitwell system, nor has it challenged TAWC's application for a CCN and franchise agreement to serve the system's customers.

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[3] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, pg. 79 (May 6, 2013).
[4] *Id.* Ex. 14, pg. 12 (May 6, 2013).
[55] *Direct Testimony of Cindy Easterly Adopting Testimony of Steve Hudson*, Docket No. 12-00157, Ex. 1, pg. 2 (Apr. 22, 2013); *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, Ex. 13, pg. 12 (May 6, 2013).
[6] *See infra* notes 73-75 and accompanying text.
[7] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, pgs. 76-77 (May 6, 2013).

Several of the requests in the *Petition* are issues of first impression in Tennessee. In its *Petition*, TAWC makes the TRA approval of the accounting and ratemaking treatment of the assets to be acquired a requirement for the purchase to occur.[8] Specifically, TAWC seeks the Authority to approve rate base treatment of the acquisition at the time of the application for CCN as opposed to waiting until a rate proceeding or the completion of its comprehensive study of the system. TAWC also requests the TRA to approve the depreciation and contributions amortization calculations at the time of its CCN application rather than during a rate proceeding. In addition, TAWC seeks a deferred accounting for the due diligence costs.

The Petitioners' requests that are issues of first impression are in dispute. The accounting and ratemaking treatment request is contested because the Consumer Advocate contends the appropriate time for addressing accounting and rate-making treatment is best performed during a future rate proceeding when the value of the assets are known and measurable, all factors concerning rates are considered, and the ratepayers will have the due process that comes with rate-setting. The Consumer Advocate disputes the deferred accounting request for due diligence costs because these costs are inappropriate costs for a deferred accounting at all.

II. RATE BASE CANNOT BE DETERMINED IN THIS PROCEEDING BECAUSE TAWC HAS BEEN UNABLE TO PROVIDE ADEQUATE NOTICE TO RATEPAYERS, THE VALUE OF ASSETS IS NOT KNOWN AND MEASURABLE, AND EVIDENCE SUGGESTS THAT NET ORIGINAL COST RESULTS IN AN ACQUISITION ADJUSTMENT.

In its *Petition*, TAWC seeks the Authority to "[a]pprove accounting and rate base treatments that reflect the full purchase price, plus the acquisition and transaction costs . . . or other guidance that shows that future rate base determinations will be consistent with the value

[8] *RE: 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 and for the Issuance of a Certificate of Convenience and Necessity*, Docket No. 12-00157, pgs. 6-7, ¶ 22, pg. 9, ¶ (3) (Dec. 27, 2012).

of the full purchase price plus acquisition and transactions costs."[9] Put another way, TAWC is asking the Authority to approve the rate base or make a decision that will be consistent with its rate base decisions in a future rate proceeding before the acquisition is even completed. TAWC is not seeking a rate change in this case because Whitwell's existing rates are more than adequate for operations and, therefore, any rate change would likely result in a decrease.

TAWC's request for rate base determination before the acquisition is complete is highly problematic. Even though TAWC is not seeking a rate change in this Docket, this does not change the fact that TAWC seeks Authority approval regarding rate base that will necessarily impact rates in the future. Unlike in a rate proceeding, however, no notice has been given to any ratepayers in this proceeding – not to existing TAWC or Whitwell customers. Even if notice had been given, any hearing about rate base would be inadequate since the condition of the system and related value of the system will not be known and measurable until the system has been inspected, which will not occur after the acquisition of the water system.

TAWC asserts that original cost is the only appropriate value, relying on financial statements with adverse audit opinions and under a control environment with numerous reported material weaknesses. This proposed valuation method ignores the condition of the system, including that it has had 43-53% unaccounted for water over the past two years and is expected to require well over $5 million in capital expenditures to reduce the water loss problem. The approval of rate base before the acquisition would incorrectly shift the risk of overpayment to the ratepayers. Moreover, the timing of such rate base approval can undermine the dynamics of arm's length negotiation.

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[9] *RE: 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 and for the Issuance of a Certificate of Convenience and Necessity*, Docket No. 12-00157, pg. 9, ¶ (3) (Dec. 27, 2012).

The Consumer Advocate recommends the Authority deny TAWC's request for rate base determination or any other guidance that the purchase price will be reflected in rate base in the future. Approving rate base in any form prior to the acquisition is inappropriate and unfair to ratepayers, especially without notice as to what the impact on rates will actually be. Waiting to determine rate base until a future rate proceeding is consistent with other states handling of similar acquisitions.

A. Cases in Tennessee, the practice in other states, and the basic principles of negotiation indicate that rate base should be determined in a future rate proceeding rather than prior to or at the time of acquisition.

The Tennessee Supreme Court ruled on the issue of determining rate base without the opportunity for a hearing in *Tennessee Eastern Electric Co. v. Hannah*, 12 S.W.2d 372, 375 (Tenn. 1928). In *Tennessee Eastern Electric Co.*, the utility applied for a CCN during construction, and the commission required the utility to commit itself to rate base at the time of the CCN. The utility challenged the commission's requirements. The Supreme Court held that the commission did not have the power under statute to set conditions on the CCN that required a utility to "commit itself irretrievably" to rate base in advance and without a hearing.[10] The Court's reasoning was as follows:

> It will be borne in mind that these rules require, as a condition precedent to the consideration by the commission of an application for a certificate of necessity and convenience, that the applicant agree *in advance*, (c) to the fixing of a basis for future determination of values and rates involving valuable rights; . . . . By this requirement of an advance or preliminary agreement by the applicant against its interest, and waiving or conceding its valuable rights, the applicant was deprived of all opportunity for a hearing before the commission, or otherwise, or elsewhere, of its day in that or any other court.[11]

[10] *Tennessee Eastern Electric Co. v. Hannah*, 12 S.W.2d 372, 375 (Tenn. 1928) (emphasis added).
[11] *Id.* at 374.

It is equally unfair and against due process standards to deprive ratepayers of the opportunity to have a hearing before committing the ratepayers irretrievably and before the value of assets to be considered for rate base are known and measurable or determined to be used and useful.

When TAWC petitioned the Authority to purchase Suck Creek from Marion County, Docket No. 03-00388, TAWC requested approval of the purchase agreement.[12] TAWC made no requests for approval of the rate base at that time.[13] Four years after its original petition, it provided the accounting entry in response to a TRA data request.[14] During the 2007 data response, TAWC indicated that, even though it had recorded the accounting transaction it "has not proposed any particular regulatory treatment of this amount at this time, as the former Suck Creek system is treated separately from the Company's remaining operations for ratemaking purposes."[15] Indeed, TAWC responded that it would wait until it requested a rate change before it proposed regulatory treatment related to the accounting transaction:

> The Company anticipates that over time, as the Suck Creek system expands, the Company will petition the Authority to change the Suck Creek rates, and/or to combine the Suck Creek system with the company's remaining operations under a single tariff for ratemaking purposes. At that time, the Company will include a proposal for regulatory treatment . . . .[16]

Just like in Suck Creek, the regulatory treatment of one component of rates (*i.e.*, rate base) should be determined when all factors that affect rates are considered.

Many other states do not approve rate base at the time of the CCN application, and instead wait until a future rate proceeding. For example, the commissions in Virginia,[17] West

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[12] *Joint Petition of Tennessee-American Water company and Marion County, Tennessee for Approval of Purchase Agreement*, Docket No. 03-00388, pg. 1-2.
[13] *See id.*
[14] *Data Response of Tennessee American Water Company*, Docket No. 03-00388, pgs. 3-4 (May 24, 2007).
[15] *Id.* at A2, pgs. 1-2 (emphasis added).
[16] *Id.* at A2, pgs. 1-2 (emphasis added).
[17] *See, e.g.*, Va. Code Ann. § 56-265.2; Va. Code Ann. § 56-232, et seq.; *Application of Appalachian Power Co., AEP Generating Co., and American Electric Power Co., Inc.*, Case No. PUE-2011-00023, pg. 6 ¶ 6 (Va. P.U.E., July 20, 2011).

Virginia,[18] Missouri,[19] and Pennsylvania[20] all wait until a rate proceeding before approving rate base. States that wait to determine rate base may consider the reasonableness of the purchase price as to whether the overall transaction is in the public interest or rather if it is a public detriment.[21] New York, on the other hand, does not wait until a rate proceeding. Rather, New York requires sufficient evidence to be provided with the CCN application that permits the commission to calculate rates (and not just rate base) during the CCN hearing.[22]

If rate base is determined prior to the acquisition, the basic principles of negotiation can be undermined. As one commission articulated, approving the rate base determination for a purchase is an "inherent contradiction" because the purchase price is a result of market forces, while rate base is a regulatory determination.[23] During typical arm's length negotiations, a seller has the incentive to negotiate the highest purchase price, while a buyer has the incentive to negotiate the lowest purchase price. Factors that can affect the negotiations are market demands

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[18] *Joint Petition for Consent and Approval of the Water Utility Assets of the Town of Clendenin to West Virginia-American and for Approval of the Purchase Agreement*, Order, Case No. 06-1032-W-PC, pg. 5 (W.V. P.S.C., Sept. 1, 2006) (It is therefore ordered that, pursuant to W. Va. Code § 24-2-12(b) and *without approving the underlying terms and conditions*, the Commission grants it prior consent and approval for WV-AWC, Clendenin and its water board to enter into the sale agreement. . . . The Commission's approval is subject to the Clendenin voters' upcoming decision on whether to approve of the sale of the water utility assets.) (emphasis added), *available at* http://www.psc.state.wv.us/scripts/WebDocket/ViewDocument.cfm?CaseActivityID=190990&NotType='WebDocket'.

[19] *In the Matter of the Joint Applications of Great Plains Energy Inc., Kansas City Power & Light Co., and Aquila, Inc., for Approval of the Merger of Aquila, Inc., with a Subsidiary of Great Plains Energy Inc. and for Other Related Relief*, Order, Case No. EM-2007-0374, 266 P.U.R. 4th 1, 549 (Mo. P.S.C., July 1, 2008) ("Nothing in this order shall be considered a finding by the Commission of the value for ratemaking purposes of the transaction herein involved.")

[20] 52 Pa. Code § 69.721(b) (2013) ("Inclusion of acquisition assets in rate base. *After* the approval of an acquisition, as evidenced by the receipt of a certificate of public convenience, an acquiring utility may request the inclusion of the value of the used and useful assets of the acquired system in its rate base. *A request will be considered during the acquiring utility's next filed rate case proceeding.*") (emphasis added).

[21] *State ex rel. AG Processing, Inc. v. Public Service Commission of the State of Missouri and Aquila, Inc.*, 120 S.W.3d 732, 736 (Mo. Oct. 28, 2003) ("While PSC may be unable to speculate about future merger-related rate increases, it can determine whether the acquisition premium was reasonable, and it should have considered it as part of the cost analysis when evaluating whether the proposed merger would be detrimental to the public.").

[22] *See, e.g.*, 16 CRR-NY 31.1, Transfer of Certificates, Permits and/or Property.

[23] *In the Matter of the Determination of a Rate Base Value for Miracle Valley Water Company, Cochise Water Co., Horseshoe Ranch Water Co., Crystal Water Co., Mustang Water Co., Coronado Estates Water Co. and Sierra Sunset Water Co., Owned by Johnny A. McLain, and Performance of a Reconstructed Cost New Study to Aid in the Determination of the Rate Base Value*, 2006 WL 322227, * 6 (Ariz. C.C., Jan. 23, 2006).

and supply, but also the needs and objectives of both the buyer and the seller. If, prior to acquisition, a buyer knows that it will recover the entire purchase price and earn a rate of return on that investment from a third party (*i.e.,* ratepayers), then such protection from the risk of overpaying for assets removes the important incentive for the buyer to negotiate the lowest price. Indeed, this unintended consequence could explain why Mr. Bickerton's rebuttal testimony only discusses Whitwell's incentive to negotiate rather than TAWC's incentive to negotiate the lowest price: "Whitwell has a clear interest in bargaining for and receiving fair value for its water system assets, and there is no reason to conclude that Whitwell did not protect its interest here."[24] Mr. Bickerton also insisted that "it is appropriate to value Whitwell's assets based on what TAWC is willing to pay and on what Whitwell is willing to accept."[25] But, interestingly, TAWC is not willing to pay for the assets out of its own pocket; TAWC is willing to pay for the assets only if it gets approval from the Authority that the entire purchase price will be included in rate base.

Approval of rate base prior to the acquisition places the third-party ratepayers, who are not part of the negotiations process, in the shoes of the buyer since it is the third-party ratepayers who will ultimately pay the purchase price plus a return to TAWC. Indeed, regulatory certainty for utilities in acquisition transactions necessarily shifts the risk of overpaying for the acquisition to the ratepayers. Put another way, an acquisition in which the related rate base is already approved is the essence of "a deal between two parties but the money is the ratepayers.'"[26] Or more simply, it is easy to make a deal when using somebody else's money. In acquisition transactions where the utility seeks to avoid the risk of a bad deal, the shareholders have interests

[24] *Pre-filed Rebuttal Testimony of Daniel P. Bickerton*, Docket No. 12-00157, pg. 2, lines 52-54 (Apr. 19, 2003).
[25] *Id.* at lines 50-51.
[26] *Transcript of Proceedings, Nov. 8, 2012*, pg. 59 (quoting Chairman Allison regarding the Chattanooga Gas/Conoco Phillips Settlement).

that are necessarily adverse to the ratepayers because neither the shareholders nor the ratepayers want to bear the risk of loss of overpaying for assets.

The best way to ensure buyers are motivated to negotiate the lowest price is by permitting normal market effects to occur and maintain the integrity of the negotiation process. That is, the buyer negotiating the purchase price should assume the risk of overpaying for assets.

B. Rate base and other determinations that affect rates should be approved altogether to avoid single-issue ratemaking and in a rate proceeding, where ratepayers have due process including notice and the opportunity for a meaningful hearing.

A rate proceeding typically sets rates based on the following formula:

Rate Base x Rate of Return
+ Operations and Maintenance ("O&M") Expense
+ Depreciation and Amortization Expense
+ Taxes
Revenue Requirement[27]

In its *Petition*, TAWC wants to keep the existing Whitwell rates but requests the Authority to approve rate base, depreciation, and CIAC amortization.[28] The rate of return is set for the utility as a whole rather than by individual system, and TAWC's rate of return was recently set in a settlement of the rate case in October 2012.[29] TAWC is not seeking determination of the system-specific costs of service of O&M expenses or the taxes, which would be the only other two components of determining the revenue requirement. Nonetheless, TAWC has forecasted its O&M expenses and taxes, and its forecasted utility operating income is expected to allow it to

[27] *See, e.g.*, *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, Ex. 5 (May 6, 2013) (showing the calculations determining rates in the most recent TAWC rate case).
[28] *RE: 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 and for the Issuance of a Certificate of Convenience and Necessity*, Docket No. 12-00157 (Dec. 27, 2012).
[29] *See Transcript of Proceedings*, Vol. I, Docket No. 12-00157, Ex. 5 (May 6, 2013)

over earn beyond its authorized rate of return by at least $[redacted].[30] It should be noted that these over earnings are based on a forecast that appears to use overestimated expenses, so this forecast may actually understate the over earnings.[31] Thus, if TAWC had asked for the Authority to determine all the components of rates, it is likely the existing Whitwell rates would have actually been reduced as opposed to staying the same or increasing.

Consistent with the requirements of administrative law, Tennessee law confers power to the Authority to fix rates of public utilities after hearing upon notice.[32] The Authority's rules indicate that petitions for revision of rates require a summary of the changes to be included in clear, simple, and understandable language in a newspaper in the affected service area.[33] Whether the notice is required in this case turns on whether the Petitioners' request requires the Authority to fix just and reasonable individual rates, charges, or schedules.

The parties disagree as to whether TAWC's requests would bind this Authority in future rate proceedings. The Consumer Advocate's witness Mr. Novak stated in his pre-filed testimony that TAWC's request for the Authority to approve the rate base would bind the TRA in future rate proceedings: "Therefore, even though TAWC is not asking for a rate increase at this time, the accounting and regulatory treatment that it has requested will ultimately impact rates."[34] Mr. Bickerton replied for TAWC that he disagreed with Mr. Novak: "Even if the Authority grants the regulatory treatment that TAWC is seeking with respect to the purchase price, the Authority has the ability, in appropriate circumstances, to reconsider its regulatory determinations in a future

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[30] *Transcript of Proceedings*, Vol. II (Confidential), Docket No. 12-00157, Ex. 20 (May 7, 2013) (adding cell E112 and F112 indicates TAWC will over earn by over $[redacted]).

[31] *See id.* pgs. 174-79; Ex. 16 & 17. The forecast in Exhibit 20 was created using Company numbers that are likely overstating expenses, as indicated in *Transcript of Proceedings*, Vol. II (Confidential), Docket No. 12-00157, pgs. 174-79, Ex. 16, 17, & 20 (May 7, 2013).

[32] Tenn. Code Ann. § 65-5-101 (emphasis added); *Consumer Advocate and Protection Division's Proposed Issues List*, Docket No. 12-00157, pg. 2, ¶1(a) & note 4 (Mar. 18, 2013) (quoting *Martin v. Sizemore*, 78 S.W.3d 249, 267 (Tenn. Ct. App. 2001)

[33] TRA Rule 1220-4-1-.05.

[34] *Direct Testimony of William H. Novak*, Docket No. 12-00157, pf. 4, A9 (Apr. 12, 2013).

rate proceeding."[35] At the hearing, when asked to elaborate as to what "appropriate circumstances" would permit the Authority to change its decision in a later rate proceeding, he could not provide any specifics and instead said that the Authority could make the changes upon its own initiative.[36] Mr. Bickerton continued to state "of course, Tennessee -- Tennessee American would obviously submit some sort of response to that [change in determination]."[37] Contrary to Mr. Bickerton's belief, this Authority cannot make arbitrary and capricious changes to its previous decisions. Thus, it would require more than the Authority merely changing its mind before it could make changes in future rate proceedings to the determinations made in this proceeding.

Fixing just and reasonable rates does not necessarily mean that rates would have to change. Although it is unlikely, it is possible for a utility to have changes to its expenses and revenues and, during a hearing for rate determination, the various expenses and revenues work out to a revenue requirement that equals the rates before the utility had the hearing.[38] Even though TAWC is seeking to maintain the rates that will allow it to over earn without adjustment, it is seeking the Authority's approval of many requests that will impact rate determinations in future rate proceedings.

The question of whether the Authority's approval to maintain the existing rates is asking it to confer its power to "fix just and reasonable rates" is less certain since there is no test period of financial data by which the Petitioners could even calculate rates. Whitwell's existing rates are based on a revenue requirement determined on a cash flow basis, rather than the actual

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[35] *Pre-filed Rebuttal Testimony of Daniel P. Bickerton*, Docket No. 12-00157, pg. 2 (Apr. 19, 2003).
[36] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, pg. 113-14 (May 6, 2013).
[37] *Id.* at 114.
[38] This Authority found that Chattanooga gas had a revenue deficiency of only $60,068 in its 2009 rate case. *Order*, Docket No. 09-00183, pg. 45 (Nov. 8, 2010). The utility had filed its rate case reporting a $2.6 million revenue deficiency. *Id.* at 4. The revenue deficiency in the order was 0.2% of the utility's forecasted base revenue. *See id.* at 15 (showing its base revenues as $29,028,086).

expenses and rate base rate-of return methodology utilized by the Authority.[39] Since TAWC will have different expenses, the continued use of Whitwell rates may not be just and reasonable under TAWC's ownership. In situations where the utility does not have sufficient information, the Authority has approved emergency or interim rates.[40] Emergency rates were set with the condition that the utility file a rate case within a certain period of time that was consistent with the time period necessary to gather test period financial data. To allow the utility to maintain rates for an indeterminate period of time, however, makes the authorization to maintain rates more similar to the Authority fixing rates, rather than permitting an emergency rate since sufficient data is not available.

The Petitioners' requests for Authority determinations that impact future rate proceedings, however, are certainly asking the TRA to fix only certain aspects of the Whitwell rates. As a policy matter, it should be noted that the Authority determining isolated factors that affect rates without considering all the factors that affect rates can be considered "single-issue ratemaking" and it is generally prohibited unless expressly authorized by statute. Indeed, TAWC agrees that there are many factors that go into determining rates and, therefore, "to rely upon a single factor can be misleading."[41] Despite the awareness it can be misleading to consider single issues, however, TAWC is choosing only a few of those factors to get selective Authority approval for during this proceeding. The following proposals for regulatory treatment are requests for Authority approval in the *Petition* that necessarily impact the determination of rates:

i. Approve accounting and rate base treatments that reflect the full purchase price, plus the acquisition and transaction costs . . . or other guidance that shows that

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[39] *Tennessee-American Water Company's Responses to the TRA's January 22, 2013, Data Requests*, DR #10 (Jan. 28, 2013).

[40] *In re: Petition of Laurel Hills Condominiums Property Owners Association for a Certificate of Public Convenience and Necessity*, Order, Docket NO. 12-00030 (Apr. 18, 2013) (approving interim rates); *In re: Petition of Navitas TN NG, LLC for Emergency Relief for Natural Gas Rates*, Order, Docket No. 11-00060 (Dec. 1, 2011) (authorizing a settlement for emergency rates).

[41] *Pre-filed Rebuttal Testimony of Daniel P. Bickerton*, Docket No. 12-00157, pg. 3, lines 81-82 (Apr. 19, 2003).

future rate base determinations will be consistent with the value of the full purchase price plus acquisition and transactions costs.[42]

- *Impact*: Approving rate base necessarily affects rate base determinations in future rate proceedings. As discussed in Part III, allowing a deferred accounting to be recorded as a regulatory asset indicates to the financial community that such regulatory asset is probable for recovery.

ii. Consistent with the Joint Petition, authorize TAWC to apply the rules, regulations, rates and charges generally applicable to TAWC's Chattanooga operations, as the same may be changed from time to time, to service to be provided by TAWC in the areas currently served by the System.[43]

- *Impact*: TAWC has not been specific as to what rules it intends to apply, but it is possible that these rules could include the treatment of customer fees that have already been paid (i.e. tap fees of $1,250)[44] as non-refundable fees rather than deposits. If so, it is possible that existing Whitwell ratepayers may want to know of this change since they could be under the belief that any fees they paid were actually refundable deposits. There is evidence indicating that Whitwell treated at least some of these fees as refundable deposits.[45]

iii. TAWC further proposes to calculate accumulated amortization on the contributions in aid of construction ("CIAC") balance written-off in 2003 by applying the percentage of accumulated depreciation in 2003 to 2003 UPIS [utility plant in service] and taking that percentage times the CIAC balance written-off. Annual amortization of CIAC from 2003 through Closing would equal the annual depreciation rate taken each year by Whitwell.[46]

- *Impact*: While it is not unreasonable for a commission to require CIAC to be included as an offset to the purchase price in determining whether the transaction is in the public interest, the determination of amortization would affect future rates and should be avoided until all factors of the rates are considered. On a related matter, if the Authority does make any determination of the CIAC amortization in this proceeding, the Consumer Advocate recommends that the Authority consider making the

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[42] *RE: 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 and for the Issuance of a Certificate of Convenience and Necessity*, Docket No. 12-00157, pg. 9, ¶ (3) (Dec. 27, 2012).
[43] *Id.* at 9-10, ¶ (5).
[44] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, Ex. 3, pg. 97 (May 6, 2013)
[45] *Id.* Ex. 3, pg. 32 (May 6, 2013) ("According to the Internal Control and Compliance Manual for Tennessee Municipalities, a customer's refundable meter deposit should e applied to the final billing and any remaining balance should be refunded.").
[46] *RE: 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 and for the Issuance of a Certificate of Convenience and Necessity*, Docket No. 12-00157, ¶ 22 (Dec. 27, 2012).

amortization period of CIAC agree with the useful life of the plant it was used to purchase. Under TAWC's current request, the CIAC is amortized over 20 years, while the plant has a useful life of 42 years.[47] While it may be uncertain when the CIAC was received and the in-service date of the plant it was used to purchase,[48] it is certain that CIAC should not be amortized at twice the amount of the related plant depreciation it was used to purchase.

iv. TAWC proposes to adopt the current TRA-approved TAWC depreciation rates and CIAC amortization rates for Whitwell upon Closing.[49]

- *Impact*: As discussed in iii, the determination of amortization or depreciation rates necessarily affects rates in the future and should therefore be determined in a rate proceeding where ratepayers have notice.

v. TAWC proposes no [plant acquisition adjustment] with this transaction . . . .[50]

- TAWC seeks the Authority to determine that no acquisition adjustment is necessary. As discussed further in Part II.C-D, there are numerous red flags indicating that the assets are impaired and, therefore, net original cost would not be the appropriate value. Thus, it is uncertain whether a negative plant acquisition adjustment is necessary. Any determination of the acquisition adjustment at this time, including stating that there is none, would necessarily affect the rates in the future.

At the hearing in this proceeding, it became apparent that Whitwell was only informed that their rates would not change and was not informed of the impact on rates that the accounting and ratemaking requests discussed above will have regardless if the rates changed in this proceeding. Mayor Easterly, the witness made available to represent Whitwell, was able to provide limited information as to what was discussed at some public meetings but was not

[47] The useful life of plant and CIAC are mathematical calculations based on information provided by TAWC in the TRA data responses. *See Transcript of Proceedings*, Vol. II, Docket No. 12-00157, pg. 157, & Ex. 4 (May 6, 2013). Nevertheless, the useful life and amortization period were also confirmed as accurate during the confidential portion of the proceeding. Because these numbers could be calculated mathematically using non-confidential data, the Consumer Advocate considers this information public.

[48] *Transcript of Proceedings*, Vol. II (Confidential), Docket No. 12-00157, pg. 175 (May 7, 2013).

[49] *RE: 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 and for the Issuance of a Certificate of Convenience and Necessity*, Docket No. 12-00157, ¶ 22 (Dec. 27, 2012).

[50] *Id.* ¶ 22.

present at these meetings.[51] Also, when asked about the rate-setting process and whether she was aware of how the process would impact Whitwell, she said she was aware that the Authority would have to approve rate increases,[52] but she was not familiar with how the process works.[53] Mr. Bickerton, TAWC's witness who was present at these meetings, confirmed that some general information was handed out at the public meetings, but the only mention of rates is that they would remain the same at closing.[54] The handout does mention that the purchase price is equal to rate base at the date of closing, however, the only explanation defining "rate base" is that it, as TAWC contends, is net original cost.[55] Mr. Bickerton testified at the hearing that cities often are not concerned with their fixed assets and base rates off of cash flow.[56] There is no evidence in the record to indicate that Whitwell's commissioners or its citizens have an understanding of what "rate base" is, much less understand how it could impact rates. It is very likely that the use of a technical term of "rate base" and how it would impact rates. Mr. Bickerton testified that TAWC was available to answer any questions,[57] but this may not have been a meaningful opportunity for Whitwell leaders or customers to ask questions if they do not understand how the transaction impacts them. Indeed, even though TAWC was available to answer questions, Whitwell confirmed there was no discussion of the purchase price.[58]

Even if one could argue that Whitwell negotiated TAWC's requests at this proceeding as part of the acquisition, there is no evidence to suggest discussions and disclosures made during the negotiations were adequate notice for ratepayers in setting rates. After the hearing, it is clear that the requests before this tribunal now were not negotiated as part of the transaction nor

[51] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, pg. 80-81 (May 6, 2013).
[52] *Id.* at 81.
[53] *Id.* at 82.
[54] *Id.* Ex. 11.
[55] *Id.*
[56] *Id.* at 132.
[57] *Id.* at 94-95.
[58] *Id.* at 84, Ex. 10.

discussed to the level necessary to provide adequate notice to ratepayers. Thus, there is no evidence to suggest ratepayers have received adequate notice or have had the opportunity for a meaningful hearing about rates.

Therefore, the Consumer Advocate recommends the Authority deny Petitioners' requests to make any determinations that affect rates, in part or in whole, or that may affect rate determinations in the future. Moreover, the Consumer Advocate recommends that the Authority order that maintaining the existing Whitwell rates is merely a temporary rate and request the utility to file a rate case after a year or other reasonable time period to allow sufficient information to be gathered and used to fix just and reasonable rates. Since TAWC is maintaining separate books and records for the Whitwell system, it should make identifying system-related costs of service fairly attainable and thereby reduce the risk of subsidization among the various TAWC systems.

C. Rate base cannot be determined at this time because the used and useful assets are not known and measurable and evidence strongly suggests asset impairment that should reduce true value below the net original cost.

In this case, TAWC utilized only the original cost net of accumulated depreciation and CIAC ("net original cost"). Evidence strongly suggests, however, that net original cost is greater than the true value of the Whitwell system. Even if TAWC elects to exclude this evidence in determining the purchase price for the system, the Authority should not ignore such evidence when determining the reasonable, necessary, and prudent expenditures for rate base and recovery in rates.

1. The purchase price and related asset valuation should reflect the parties' considerations of many factors, including net original cost, risks, obligations, impairment, and the used and usefulness of the assets to be acquired.

A valuation of assets requires more than just considering original cost. In the professional appraisal report for West Valley, the professional appraiser described the valuation as starting with the annual report, but then "[t]he final figure should be adjusted based on the system's audited worth at the time of any transfer of ownership as modified by factors such as unusually good or bad condition of pipes, meters and other facilities. The opinion of value is based, also, on known conditions of the system and on engineering judgment."[59]

Factors other than original cost to consider include but are not limited to the condition of the asset and the risks and obligations that will transfer from the seller to the buyer. For example, a rational buyer will not pay for assets that it cannot use or assets that are not useful to it. Also, assets that have related risks or obligations that will transfer from the seller to the buyer would reduce the asset value for any rational buyer. Likewise, a seller may be willing to reduce the purchase price below the seller's cost in exchange for relieving itself of risks and obligations it would otherwise have as the asset owner. Debt, accrued liabilities, and correcting regulatory violations are examples of some risks and obligations that a seller and buyer would want to consider as a reduction to the value of any related assets. In some instances, net original cost may be appropriate even after considering all factors, but all factors should be considered nonetheless.

Mr. Bickerton stated in his rebuttal testimony that other states accept original cost as the basis for valuing assets, naming Virginia, West Virginia, Missouri, Pennsylvania, and New York.[60] As mentioned previously, net original cost may be the appropriate value, even after

[59] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, Ex. 14, pg. 11 (May 6, 2013).
[60] *Pre-filed Rebuttal Testimony of Daniel P. Bickerton*, Docket No. 12-00157, pg. 3 (Apr. 19, 2003).

considering all relevant factors. If net original cost is the appropriate value, it logically follows that it would be accepted as the basis of valuing assets. Mr. Bickerton's assertion could be construed to indicate that these states always accept original cost as the basis of rate base, and that is not true. Many states require assets to be used and useful prior to inclusion in rate base and/or only allow rate recovery of reasonable, necessary, and prudent costs.[61] Paying for assets that a utility has knowledge could be impaired and may not be used or useful after acquisition are certainly not "necessary" costs, and many would argue not reasonable or prudent costs. Some states have a statutory maximum value of net original cost but are silent as to using net original cost as the minimum value when valuing assets for rate base.[62] A few states may have alternative methods for determining the purchase price for municipal states, such as requiring a vote by the ratepayers.[63] While all states are different, it appears that typically most states' processes permit the reduction of the purchase price from net original cost when assets are impaired at the time acquired or for assets that will not otherwise be used or useful to ratepayers after the acquisition. To deny a reduction to rate base, state commissions would be encouraging waste through the purchase of assets that will provide no benefit to ratepayers.

a. Examples of transactions that differed from net original cost

Many transactions do not utilize net original cost as the purchase price. In the Suck Creek transaction, for example, TAWC did not use net original cost as the purchase price.

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[61] *See, e.g.*, 52 Pa. Code § 69.721(b) (2013) (4) ("*Plant retired/not booked/not used and useful.* The acquiring utility should identify all plant retirements and plant no longer used and useful and complete the appropriate accounting entries."); Va. Code Ann. § 56-35 ("DETERMINATION OF USED AND USEFUL FACILITIES IN FIXING RATE BASE. --In determining the rate base upon which a utility is entitled to a reasonable rate of return, the Commission must decide which facilities are used and useful in providing service to the public.").

[62] *See, e.g.*, 16 CRR-NY 31.2 ("[T]he commission will not approve a transfer or lease where it appears that the transferee or the lessee is paying for a franchise, consent or right to engage in utility business in excess of legitimate original cost less proper amortization.").

[63] West Virginia requires the acquisition of municipal systems pass by a majority vote of the ratepayers affected. *See Joint Petition for Consent and Approval of the Water Utility Assets of the Town of Clendenin to West Virginia-American and for Approval of the Purchase Agreement*, Order, Case No. 06-1032-W-PC, pg. 5 (W. Va. P.S.C., Sept. 1, 2006).

Instead, TAWC made the purchase price equal to the outstanding debt at the time of closing.[64] In the purchase agreement, it stated that if Marion County paid off the debt before closing, then no consideration would need to be paid by TAWC, regardless of the net original cost of the system.[65] This is an example of when the seller was motivated to transfer the debt and the obligation to repair the system to a buyer regardless of cost. In this transaction, however, the debt exceeded the net original cost.[66]

Similarly, when the City of Whitwell acquired West Valley, it acquired the assets at no cost but assumed the system's debt.[67] A professional valuation had been done on the West Valley system, and the appraisal reported that the assets had negative value of at least $435,200.[68] Meaning, any subsequent owner would incur more costs than benefits in acquiring the system. Put another way, the appraiser found it would cost any subsequent owner at least $435,200 to operate the system with the necessary repairs and maintenance to reduce the excessive water loss and make the system functional. Although the appraisal showed West Valley had negative value for the average willing buyer, Whitwell did incur the cost of debt to acquire the West Valley assets. One important factor significantly affected Whitwell's determination to acquire West Valley that was not reflected in the appraisal: Whitwell needed the customer base that West Valley provided in order to survive as a water system.[69]

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[64] *Re: Joint Petition of Tennessee-American water Company and Marion County, Tennessee, for Approval of Purchase Agreement*, Docket No. 03-00388, Petition, ¶ 2 (June 12, 2003).
[65] *Id.* Ex. A, pg. 4.
[66] *Data Response of Tennessee American Water Company*, Docket No. 03-00388, DR #A2 & pgs. 3-4 (May 24, 2007).
[67] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, pg. 79 (May 6, 2013).
[68] *Id.* Ex. 14, pg. 12 (May 6, 2013).
[69] *City of Whitwell v. West Valley Water System*, 2003 Tenn. App. Lexis 783, *7-8 (Tenn. Ct. App., Sept. 4, 2003) (indicating Whitwell would "suffer immediate and irreparable economic harm" if TAWC purchased the West Valley water system without assuming the contract to purchase water from the City of Whitwell).

b. Comparison of examples to this transaction

If the Suck Creek approach to valuation was utilized here, then the purchase price would be the cost of the debt at the time of closing. In this transaction, the purchase price would be a maximum of $687,185.09 plus any accrued interest and net of payments made since June 30, 2012,[70] less than half of the $1.6 million net original cost.

As for the Whitwell/West Valley transaction, the same factors that were considered in the West Valley system appraisal exist here (*e.g.*, excessive water loss, significant repairs needed), with the exception of the buyer's motivations. The cost of necessary repairs and replacement to operate the system exceeding the net original cost of the West Valley system is similar to the present transaction: TAWC has forecasted over $5 million in capital expenditures to repair and replace aspects of a system that have a net original cost of $1.6 million. Thus, in this transaction, Whitwell is a motivated seller like West Valley was, but TAWC does not have the same dire necessity for a customer base that Whitwell had.

Such a difference in dynamic would suggest that TAWC should get at least as good of or a better deal on the system to be purchased than Whitwell got when it acquired West Valley (*i.e.*, acquisition at cost of debt). Instead of incorporating the necessary and expected costs to repair and replace system assets like the appraiser did for West Valley, however, TAWC suggests the value of the system is the net original cost and excludes any considerations that would reduce such value. This does not make business sense and supports the premise that an unintended consequence of approving rate base prior to the acquisition undermines the normal market effects on the negotiation process for buyers to actively work to negotiate the lowest price in an arm's length transaction.[71]

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[70] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, Ex. 3, pg. 25 (May 6, 2013).
[71] See discussion *supra* note 23-26 and accompanying text.

2. Evidence strongly suggests the net original cost reported in the financial statements exceeds the value of the used and useful assets to be acquired.

In this case, evidence strongly suggests the net original cost reported in the financial statements exceeds the true value of the system. First, significant evidence exists that the financial statements are unreliable and should therefore have been weighted accordingly when determining the purchase price. Evidence also strongly indicates it is possible that not all the assets in the financial statements are used and useful, but rather much of the system requires replacement. A rational buyer would incorporate such indications of impairment in negotiating a purchase price lower than the net original cost of the asset because the buyer would not have a reasonable expectation that it could use the assets acquired without the costs of significant repairs or even replacement.

a. Financial Statements: Adverse Audit Opinions and Material Weaknesses

TAWC relied upon the audited financial statements and related schedules (*i.e.*, depreciation schedules) in calculating the original cost and depreciation of the assets when determining the purchase price.[72] For at least the past three years, however, the auditors have found significant issues with the financial statements and have been unable to issue an unqualified, "clean" audit opinion. Indeed, in both 2010 and 2011, the auditors issued an adverse audit opinion:

> Certain financial documentation was unavailable or incomplete due to overall lack of controls in the financial processes of the City. We were thus unable to properly test certain financial areas for City of Whitwell, Tennessee. Therefore, the amounts that would be reported in the financial statements are not reasonably determinable. Additionally, an investigative audit conducted by the State of Tennessee Division of Municipal Audit revealed an apparent misappropriation of funds which is further discussed in Note 16.

[72] *Direct Testimony of Daniel P. Bickerton*, Docket No. 12-00157, pg. 3 (Dec. 27, 2013) (emphasis added). The 2011 audit opinion is worded the same except for the date is shown as June 30, 2011 as opposed to June 30, 2010. *Id.* Ex. 2, pg. 4.

> In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to previously do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of the City of Whitwell, Tennessee, as of June 30, 2010, or the changes in its financial position or, where applicable, its cash flows for the year then ended.[73]

The auditors are indicating to users of these financial statements that they "do not present fairly" the generally accepted accounting standards. Thus, these financial statements are unreliable: they may be accurate, but they also may not be. The auditors could not be certain even after an audit.

In 2012, the auditors issued a qualified audit report instead of an adverse opinion.[74] The auditors do not indicate anywhere in their audit that they audited transactions outside of the audit period of the fiscal year ended June 30, 2012. Thus, the transactions that occurred prior to 2012 and were recorded in the unreliable financial statements presumably carried forward to the 2012 audit.

In conjunction with the auditors indicating problems with the financial statements, the auditors also found numerous deficiencies and weaknesses in Whitwell's control environment that could have affected the amounts recorded as original cost. The auditors defined their classification of results as follows:

> A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees in the normal course of performing their assigned functions to prevent or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. . . .

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[73] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, Ex. 1, pg. 4 (May 6, 2013).
[74] *Id.* Ex. 3, pg. 4.

> A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.[75]

Mr. Bickerton testified that he considered these deficiencies, but he did not see anything that would have affected the recording of capital assets.[76] The Consumer Advocate found that several deficiencies that could affect the recording of fixed assets. Some of the deficiencies and examples of how they could have impacted the capital expenditures are as follows:[77]

a) 2002 (02-01) Bid Process: "Audit tests indicated that all required purchases were not subjected to the bidding process, nor were required purchases presented to the Board of Commissioners for their approval. . . . This problem still existed at June 30, 2012."[78]
   - The failure to bid and approve purchases would cause concern over the reasonableness and prudency of expenditures.

b) 2008 (08-02) Inadequate Segregation of Duties: "In our review of the overall accounting controls of the City of Whitwell's accounting system, we found several areas where proper segregation of duties might be obtained. . . . As of June 30, 2012, this problem still exists."[79]
   - Inadequate segregation of duties allows employees to perpetrate and conceal fraud without detection. An example of how this could happen is Employee A initiates the purchase of a part or service by approving the purchase order, Employee A is also responsible for receiving the part or service, and Employee A is also responsible for authorizing the payment to the vendor. A control that can mitigate Employee A's ability to perpetrate and conceal fraud is requiring certain supporting documentation before disbursements will be made. Control deficiencies 09-03, 09-04, 09-15, 11-05, and 11-06 indicate that there are not many other controls in place to mitigate the risks caused by inadequate segregation of duties.

c) 2009 (09-03) Inadequate Support for Disbursements: "The municipality's files did not include adequate supporting documentation for each disbursement. Testing revealed invoices being paid from a statement. . . . As of June 30, 2012, this problem still exists."[80]
   - The risk of inadequate support is that disbursements could be made for non-municipal purposes.[81]

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[75] *Id.* Ex. 3, pg. 26 (May 6, 2013).
[76] *Id.* at 127.
[77] The Consumer Advocate is merely providing examples to illustrate how these deficiencies *may* affect the water company.
[78] *Id.* Ex. 3, pg. 30.
[79] *Id.* Ex. 3, pg. 32.
[80] *Id.* Ex. 3, pg. 33.
[81] *See id.*

d) 2009 (09-04) Purchase Orders: "During our test of disbursements, we found where purchase orders were not filled out completely or no purchase order was used. We also noted instances of purchase orders being dated after the invoice. . . . As of June 30, 2012, this problem still exists."[82]

- Referring back to 08-02 and 09-03, purchase orders are typically used to initiate the purchase. If disbursements are made without a purchase order or if the purchase order is dated after the invoice (*i.e.*, after being billed), then non-municipal or otherwise unauthorized purchases could be made.

e) 2011 (11-05) Journal Entries: "Testing revealed a lack of controls over the journal entry process. Supporting documentation was not made available during testing. Additionally, there was no indication of approval prior to posting. . . . As of June 30, 2012, this problem still exists."[83]

- The lack of adequate support or appropriate approval allows transactions to be recorded that may be inaccurate or unauthorized, including but not limited to a result in overstating assets. This deficiency could also contribute to the adjustments necessary to the trial balance, as discussed in the 07-02 deficiency.

TAWC failed to provide any evidence indicating that these control deficiencies have not affected the water system's financial statements.[84] Indeed, Mr. Bickerton said that, in his experience of purchasing municipal systems generally, "[t]he bottom line is they really don't care about the value of fixed assets. They're more concerned about cash flow."[85] Based on Mr. Bickerton's testimony, one can conclude municipalities are ambivalent toward the value of assets, thus making it even more likely that the municipality would take fewer, if any, control measures to ensure the accuracy of the transactions recorded affecting the value of fixed asset.

TAWC agreed that unreliable financial statements and fraud in an entity only increases the risk of the transaction,[86] but it still did not negotiate a lower price for the higher risk. Mr. Bickerton agreed that controls over financial reporting go to the heart of recording and

[82] *Id.* Ex. 3, pg. 34.
[83] *Id.* Ex. 3, pg. 41.
[84] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, pg. 129-30 (May 6, 2013).
[85] *Id.* at 132.
[86] *Id.* at 120-21.

presenting capital expenditures.[87] He testified he gained comfort with the numbers by looking at the plant and the tank and various assets.[88] The physical verification that the overall asset exists mitigates only one risk related to the assets recorded on the financial statements – that is, whether the asset exists at all. It would be difficult or even impossible through physical observation to perform a financial verification or otherwise accurately and appropriately assess the value of an asset merely by touring a plant or otherwise verifying its existence.

Many risks related to the valuation of assets remain, such as the condition of the system and whether the transactions capitalized were actually related to the asset. When asked about the condition of the water system, Mr. Allen could not provide concrete answers because their abilities to inspect the system are limited until TAWC owns it.[89] As for the weak control environment, the controls over financial reporting directly impact whether the transactions capitalized were actually related to the asset, and there is no evidence that controls over financial reporting exist that would prevent or detect errors or material misstatements in the capital expenditures recorded. Rather, all evidence strongly indicates that there are no reliable controls over financial reporting.

The Petitioners have provided only the audited financial statements and related schedules of depreciation and contributions to support its determination of the purchase price. Yet, there is a large volume of evidence suggesting the financial statements that Petitioners' rely on could be unreliable. Nonetheless, TAWC accepted and presents to this tribunal the financial statements and related schedules as the basis for the net original cost and asserts this evidence is sufficient to demonstrate that it has met its burden of proof that the Authority should approve the purchase price and determine rate base. Clearly, this limited evidence does not permit an adequate review

[87] *Id.* at 129.
[88] *Id.* at 128.
[89] *Id.* at 20-21.

of the assets by this tribunal and, as such, the Consumer Advocate recommends the Authority find that the Petitioners have failed to meet their burden of proof for establishing rate base.

b. Condition of the System: 43% to 53% Unaccounted for Water and Over $5 million Expected in Capital Expenditures

As previously mentioned, appraisals often consider factors in addition to the original cost reported on financial statements, including but not limited to the condition of the system and the transfer of risks and obligations to the buyer. In this transaction, TAWC did not incorporate into the purchase price the condition of the system or the risks and obligations it will assume. Mr. Allen stated that TAWC will not know the condition of the system and extent of repairs necessary until after the comprehensive study is completed, which TAWC will not perform until after acquisition.[90] Even though there has been no comprehensive study performed, it is undeniable and clearly established that the condition of the Whitwell system is in great need of significant repairs, including replacement. Indeed, this is one of the reasons the City desires to sell the system.

First, the system has had excessive water losses, strong evidence that at least aspects of the system are not operating in an acceptable manner. The unaccounted for water in 2011 was 53.221%.[91] It lowered nearly 10% in 2012 to 43.761%.[92] This level of unaccounted for water is considered "excessive" by the state and, under the law, if Whitwell remains the owner, it would be under the supervision of the Comptroller's Office to work on a plan to reduce the unaccounted for water.[93] Even though TAWC would not be under the Comptroller's Office, it does have an

[90] *Id.* at 20-25.
[91] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, Ex. 3, pg. 22 (May 6, 2013).
[92] *Id.* Ex. 2, pg. 21.
[93] Tenn. Code Ann. § 68-221-1010(d); Tenn. Code Ann. § 68-221-1009(8); Tennessee Comptroller of the Treasury, Utility Management Review Board, New Water Loss Information, http://www.comptroller.tn.gov/umrb/ (last visited May 22, 2013).

initial plan to identify how it can reduce the unaccounted for water. Although the plan is in its preliminary stages, TAWC expects, based on its experience, the system will obligate whoever owns the system to spend over $5 million in capital expenditures in the first five years of ownership.[94]

Even if the purchase price is net original cost, the current reports of excessive unaccounted for water and the estimates of significant capital expenditures (which may significantly increase after the comprehensive planning study is done) all indicate that the reasonable, necessary and prudent standard for determining recovery in rates would be violated by the use of a net original cost that is not adjusted for the risks and obligations that necessarily follow the system. Whoever owns the system, it is undeniable that significant costs will need to be spent, which are estimated now at *over 3 times the net original cost purchase price*. A buyer who must accept the risk of loss for overpaying for assets and who is expected to spend over $5 million in repairs and replacement of the system would logically request a reduction in the purchase price.

3. Instead of approving rate base at this time, the Consumer Advocate recommends the determination of rate base occur at a time when the value of used and useful assets acquired and any impairment are known and measurable.

Even if the Authority is not persuaded to wait to determine rate base until a future rate proceeding for the reasons mentioned previously (*e.g.*, notice to ratepayers, integrity of the negotiation process, etc.), the Consumer Advocate recommends the Authority wait to determine rate base until a time when the used and useful assets and any related impairment are known and measurable. The condition and usefulness of the assets to be acquired are too uncertain at this

[94] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, pg. 23, 83 (May 6, 2013).

time to meet the reasonable, necessary, and prudent standard to determine what should be recovered in rates from ratepayers.

When asked whether rate base would be reduced if impairments are found during the comprehensive study, Mr. Bickerton responded: "I think the responsibility is with the company in their final due diligence to confirm the integrity of the assets it is acquiring before the evaluation even starts."[95] But, as mentioned previously, Mr. Allen stated that TAWC will not know the condition of the system and extent of repairs necessary until after the comprehensive study is completed, which TAWC will not perform until after acquisition.[96] Indeed, the forecast of over $5 million in capital expenditures may change significantly after the comprehensive planning study.[97] Despite Mr. Bickerton's acknowledgement that confirming the integrity of the assets is TAWC's responsibility before evaluation, TAWC is still seeking rate base determination before fulfilling its responsibility to confirm the integrity of the assets and condition of the system.

When discussing TAWC's recent purchase of a utility district in West Virginia, Mr. Bickerton indicated, "We obviously required the approval of the commission."[98] When asked if TAWC would ever authorize an acquisition where the shareholders would accept the risk of loss, Mr. Bickerton testified that he would need to "see the specifics of the deal."[99] He continued, "I know in this case we're quite comfortable with the value of the assets on the books of the city."[100] Nevertheless, TAWC has elected in this case to make the acquisition contingent upon

[95] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, pg. 154 (May 6, 2013).
[96] *Id.* at 20-25.
[97] *Id.* at 23-25.
[98] *Id.* at 133.
[99] *Id.* at 134.
[100] *Id.*

the Authority's approval of rate base so that the shareholders do not bear the risk of loss for overpaying for the assets.

The Consumer Advocate recommends the Authority deny approving rate base until a time when the used and useful assets and any related impairments are known and measurable.

4. If rate base is approved at this time, the rate base should reflect an adjustment from the purchase price to reflect the risks and obligations that ratepayers will assume.

If the Authority is not persuaded to wait to determine rate base for any reason, then the Consumer Advocate recommends that the rate base approved reflect the risks and obligations that ratepayers will assume that are currently excluded from the purchase price. TAWC argues that net original cost is the appropriate value because there is no active market in Tennessee.[101] This argument is deflated, however, when considering that net original cost was inappropriate for TAWC if the city wants to repurchase the Whitwell system.[102] Instead, TAWC requires an appraisal that includes replacement cost (new) less depreciation ("RCNLD"), which tends to be higher than net original cost. As mentioned previously, the purchase price commonly reflects adjustments to the net original cost for risks and obligations. Indeed, the professional appraiser was able to perform a valuation even though there is not a market, and he did make adjustments to the net original cost for the risks and obligations that would transfer with the assets.[103] In this transaction, the forecasted obligations are the costs the owner can expect to spend to repair the system and reduce the unaccounted for water, just as the appraiser had done when valuing the West Valley system assets.

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[101] *Pre-filed Rebuttal Testimony of Daniel P. Bickerton*, Docket No. 12-00157, pg. 2 (Apr. 19, 2003).
[102] *RE: 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 and for the Issuance of a Certificate of Convenience and Necessity*, Docket No. 12-00157, Purchase Agreement, pg. 11, and Franchise Agreement, pg. 3 (Dec. 27, 2012).
[103] *See Transcript of Proceedings*, Vol. I, Docket No. 12-00157, Ex. 14 (May 6, 2013).

If the same methods are applied here as were used in the West Valley appraisal, the result would be that the system would have a negative value with the evidence available at this time. At this time, that capital expenditures expected for repairs to the Whitwell system exceed $5 million. So, in addition to the purchase price, these forecasted costs are a necessary cost of the acquisition.[104] If there were benefits that had been quantified, then those benefits would offset any costs. In this case, however, TAWC has not provided any quantification of the benefits to either the Whitwell or the existing TAWC customers, so none should be used to offset the costs.[105] The appraiser in the West Valley appraisal actually took the estimated costs necessary to reduce the unaccounted for water as an offset to the net original cost to arrive at a negative value to reflect that the costs of owning the system were greater than the benefits of the net original cost.[106] If that is done here, then the negative value would be the $1.6 million net original cost less the forecasted expenditures of $5.4 million,[107] or a negative value of $3.8 million. Thus, the cost of ownership exceeds the value of the purchase.[108]

Mr. Novak calculated an acquisition adjustment to apply to the purchase price to arrive at rate base in the event the Authority decides to determine rate base at this time. Mr. Novak's acquisition adjustment is [redacted] and was calculated using the then available forecasted

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[104] This is similar to the approach taken by the appraiser in the West Valley system assets. *See id.* Ex. 14, pg. 12 of 12.

[105] *See Transcript of Proceedings*, Vol. I, Docket No. 12-00157, pgs. 103-04 (May 6, 2013).

[106] *See id.* The appraiser also offset the book value by the system's debt, but here, TAWC is not assuming the debt so such offset would be inappropriate.

[107] This total forecasted expenditures were retrieved from a confidential document. *See Transcript of Proceedings*, Vol. II (Confidential), Docket No. 12-00157, Ex. 18 (May 7, 2013). Although this number is in a confidential document, it is not confidential since a rounded version of the total amount of expenditures was indicated in public information when TAWC responded to the TRA Data Request. *Tennessee-American Water Company's Responses to the TRA's January 22, 2013, Data Requests*, DR #5 (Jan. 28, 2013) (indicating $5 million in forecasted expenditures). The total amount of capital expenditures of $5.4 million from the confidential document was used instead of the public data response because Mr. Bickerton confirmed on the stand that this is an accurate total of the current forecast. *See Transcript of Proceedings*, Vol. II (Confidential), Docket No. 12-00157, pg. 183 (May 7, 2013). This approach of allowing the total capital expenditures to be public was confirmed with TAWC in informal communication before the hearing.

[108] Mr. Bickerton agreed that negative value means that the cost outweigh the benefits received in a transaction. *See Transcript of Proceedings*, Vol. I, Docket No. 12-00157, pg. 146 (May 6, 2013).

capital expenditures of $5.1 million.[109] This acquisition adjustment assumes a rate base of $1,772 per person or $4,880,088 for all 2,754 customers.[110] The $1,772 rate base per person was calculated using TAWC's existing rate base per customer, including the systems of Chattanooga, Suck Creek, Lone Oak, and all other systems under TAWC's existing tariff. Given that the TAWC rate base per person covers many of the systems in the area, this is a fair benchmark of rate base per person that reflects reasonable, necessary, and prudent costs.

Moreover, comparing only the rate base for the Whitwell system and the current TAWC systems provides a more accurate comparison than comparing overall rates. In addition to rate base, overall rates include actual reasonable, necessary, and prudent expenses to run the system, which are likely to vary from system to system.[111] Although Mr. Bickerton responded to Mr. Novak's testimony by stating that the Whitwell rates will be accretive (as opposed to dilutive) to TAWC if only using the purchase price, the shareholders are expected to keep any over earnings or "accretive" earnings.[112] Thus, any accretive effect will not benefit existing TAWC customers if TAWC's petition is granted as is and, therefore, should not offset any future dilutive effect to TAWC ratepayers. Mr. Bickerton also argues that Whitwell's rates are higher and therefore can support a higher rate base. This is true for the years that TAWC will be able to earn its authorized rate of return with those rates. When rates are insufficient to support capital expenditures that are over triple the existing rate base, which is expected to occur after two years

[109] *Direct Testimony of William H. Novak*, Docket No. 12-00157, Ex. 1 (Apr. 12, 2013).
[110] *Id.*
[111] The formula for calculating rates in Tennessee is generally Rates = (Rate Base x Rate of Return) + Operating Expenses + Depreciation and Amortization + Taxes. *See, e.g., Transcript of Proceedings*, Vol. I, Docket No. 12-00157, Ex. 5 (May 6, 2013) (showing the calculations determining rates in the most recent TAWC rate case).
[112] *Pre-filed Rebuttal Testimony of Daniel P. Bickerton*, Docket No. 12-00157, pgs. 3-4 (Apr. 19, 2003).

before a majority of the repairs are completed,[113] then Mr. Bickerton's argument that Whitwell rates support its higher rate base fails.

TAWC intends to treat the Whitwell system as it does the Suck Creek system currently,[114] which is, TAWC requests an overall rate increase and then applies the same increase to each system, regardless of how much is actually spent for each system. The capital costs are allocated to each system based on the investment,[115] but this is only based on the initial purchase price and does not include the capital expenditures expected to incur after the acquisition. How this works for Suck Creek is that TAWC's percentage increase is applied based on classes of customers (*e.g.*, residential, commercial, industrial, etc.), and not by system (*e.g.*, Lone Oak, Suck Creek, Chattanooga), regardless of the underlying capital expenditures that were invested in rate base.[116] For example, assume that TAWC receives a 12% rate increase. Everyone's rates would increase by 12% even if capital expenditures for the Whitwell system increase by 200% (which is likely considering the expected investment in the next five years is over three times the net original cost). Thus, under TAWC's approach to rate base and rate increases, the necessary capital expenditures forecasted for Whitwell will be subsidized by TAWC's existing customers.

Tennessee does not have a statute encouraging or otherwise permitting one system's customers subsidizing another. Indeed, if the potential buyer was going to own a single system post acquisition, then the only source of capital would be through rates or from shareholders – there would be no other ratepayers from which to fund capital expenditures.

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[113] *Transcript of Proceedings*, Vol. II (Confidential), Docket No. 12-00157, Ex. 20 (May 7, 2013) (showing the third year will have a revenue deficiency).

[114] *RE: 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 and for the Issuance of a Certificate of Convenience and Necessity*, Docket No. 12-00157, Direct Testimony of Deron Allen, pg. 2, line 19 (Dec. 27, 2012).

[115] *Id.* at 2, lines 23-24.

[116] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, Ex. 5, Schedule 12 (May 6, 2013) (showing that all residential customer rates would change by 12.72% as a result of the 2012 settlement).

Whitwell does have excessive water loss, but it has shown it is capable of making the repairs necessary to reduce water loss. Even if Whitwell could not make the necessary repairs, however, the Authority should not make special considerations for TAWC to acquire the assets. Tennessee law states that it is the Comptroller's Office who would be charged with facilitating the transfer of ownership of a system with rates insufficient to reduce the excessive water loss.[117] Tenn. Code Ann. § 68-221-1010 is the closest law that Tennessee has to a troubled system statute, and it has conferred any related authority over municipal systems to the Comptroller's Office, not the Authority.

The necessary negative acquisition adjustment of $[redacted] million is necessary to avoid the existing TAWC customers from subsidizing the improvements to the Whitwell system. Mr. Novak states that a preferred alternative to recording a negative acquisition adjustment now would be to wait until the capital expenditures necessary for the Whitwell system are known and measurable.

D. The Consumer Advocate recommends the Authority provide guidance regarding the connection to the Dunlap system.

Although TAWC is not seeking approval of the capital expenditures for the costs to connect the Whitwell system to the Dunlap system at this time, the Consumer Advocate recommends the Authority provide guidance about this capital expenditure. Ratepayers should only be required to pay for those costs that are reasonable, necessary, and prudently incurred. And, generally, capital expenditures occurred in the normal course of business meet the reasonable, necessary, and prudent standard. It has come to the Consumer Advocate's attention during this proceeding that the Dunlap connection is an extraordinary expenditure outside the normal course of business that may not be a reasonable, necessary, and prudent cost. Moreover,

[117] Tenn. Code Ann. § 68-221-1010.

TAWC has not communicated to Whitwell how much this connection will cost.[118] There is no reason for this to be confidential information, because if the ratepayers are expected to pay for it, the information should be available for public scrutiny. To help avoid any surprises later, after the capital expenditures have already been spent, the Consumer Advocate raises this issue now.

TAWC has indicated it requires this connection so that Whitwell has an emergency connection;[119] however, this explanation raises more questions than answers. TAWC has asserted the Dunlap connection will provide a maximum of 500,000 gallons per day when it has only forecasted system delivery of 516,000 gallons per day in the near term, which is expected to drop to 504,900 gallons per day by 2017.[120] Whitwell currently has the storage capability of at least 870,000 gallons,[121] and Whitwell is in compliance with all state laws as to water availability.[122] Moreover, evidence supports the logical assumption that reduction in water loss will increase the water available.[123] [redacted][124]

Despite this evidence, TAWC is planning on constructing the Dunlap connection even before it has completed the system repairs necessary to reduce the water loss.

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[118] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, pg. 102, lines 3-7 (May 6, 2013).
[119] *Tennessee American Water Company's Second Responses to Data Requests by Consumer Advocate and Protection Division of the Office of the Attorney General*, Docket No. 12-00157, DR #25 (Apr. 4, 2013).
[120] *Id.* DR #24.
[121] Mr. Allen indicated in his pre-filed testimony that Whitwell has 930,000 gallons of storage available, *RE: 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 and for the Issuance of a Certificate of Convenience and Necessity*, Docket No. 12-00157, Direct Testimony of Deron Allen, pg. 2 (Dec. 27, 2012), and in his testimony at the hearing that Whitwell has just under a million gallons of storage available. *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, pg. 9 (May 6, 2013).
[122] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, Ex. 12, pg. 1 & Ex. 13, pg. 1 (May 6, 2013). Mr. Allen mentioned in his pre-filed testimony that Whitwell has 930,000 gallons of storage available and in his testimony at the hearing that Whitwell has just under a million gallons of storage available.
[123] The unaccounted for water was 53% in 2011 and was reduced 10% to 43% in 2012. *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, Ex. 2, pg. 21, Ex. 3, pg. 22 (May 6, 2013). TDEC reported the water usage as 898,000 gallons per day in 2011 and 805,000 gallons per day in 2012, a 10% drop in water usage. *Id.* Ex. 12, pg. 1, & Ex. 13, pg. 1.
[124] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, Ex. 7, pg. 3 (May 6, 2013).

The costs of the Dunlap connection may outweigh the benefits to ratepayers. No evidence is in the record to indicate that the plant and intake were out of commission repeatedly (emergency or otherwise) to warrant the need for a back up supply. Indeed, an experienced operator like TAWC would want to be proactive about repairs through scheduling and thereby minimize the risk of having to react to emergencies. If so, such preventative repairs and maintenance could be scheduled during off-peak usage times and wet periods when the tanks are full, thereby significantly reducing the need for a $[redacted] million back up supply. TAWC has failed to provide evidence that indicates an emergency connection that costs over $[redacted] million for 2,754 customers is reasonable, necessary, and prudent.[125]

The Consumer Advocate recommends the Authority provide guidance regarding the timing of the capital expenditures of the connection to Dunlap. This is not an ordinary capital expenditure to repair or otherwise maintain the existing system. Rather, it is an extension of the existing system. Given that there is already a hefty amount expected to be spent to reduce the unaccounted for water, which are unavoidable costs, the Consumer Advocate is concerned the Whitwell customers' rates will skyrocket for an emergency connection that may or may not be necessary. The Consumer Advocate recommends the Authority consider requesting evidence supporting the need for such an extraordinary capital expenditure prior to its commencement. Also, since it appears the level of unaccounted for water impacts the water supply, the Consumer Advocate recommends the timing of such assessment occur after the comprehensive planning study and the resulting efforts to reduce unaccounted for water are well underway so the impact of such efforts can assist in the assessment of whether a connection to Dunlap is reasonable, necessary, and prudent.

[125] *Transcript of Proceedings*, Vol. II (Confidential), Docket No. 12-00157, pg. 184 & Ex. 19 (May 7, 2013)

III. A DEFERRED ACCOUNTING FOR DUE DILIGENCE COSTS IS NOT REASONABLE, NECESSARY, OR PRUDENT FOR PROVIDING SERVICE TO RATEPAYERS AND SHOULD THEREFORE BE DENIED.

In its petition, TAWC requests a deferred accounting for its due diligence costs.[126] Applying the established criteria from Tennessee and other states, as well as considering the facts that TAWC voluntarily embarked upon this acquisition and is expected to earn much more than its authorized rate of return in its first two years of operating the Whitwell system, the Consumer Advocate recommends the Authority deny TAWC a deferred accounting for due diligence costs. If the Authority does permit TAWC a deferred accounting, then the Consumer Advocate recommends the deferred accounting include both costs and revenues to help ensure fairness for the ratepayers.

A. Because deferred accounting can permit sanctioned retroactive ratemaking or single-issue ratemaking, its approval should be limited to specific and narrow circumstances, such as an uncontrollable, unforeseeable, extraordinary triggering event resulting in substantial, unavoidable costs, none of which exist with TAWC's acquisition.

Deferred accounting mechanisms permit utilities to track costs or revenues for future recovery in a rate case. Contrary to one utility's argument that "[t]he whole purpose of deferred accounting is to permit a utility to defer certain past or present costs for recovery against future ratepayers,"[127] deferred accounting can occur for costs and revenues alike.[128] Typically, the balance of a deferred accounting is recorded as a regulatory asset or a liability, depending on

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[126] *RE: 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 and for the Issuance of a Certificate of Convenience and Necessity*, Docket No. 12-00157, pg. 7, ¶ 22.f, pg. 9, ¶ (3) (Dec. 27, 2012).

[127] *Re Piedmont Nat. Gas. Co., Inc.*, Docket No. G-9, Sub 340 (N.C. Utils. Comm'n, Oct. 1, 1993) (quoting Piedmont).

[128] *Re Open an Investigation Related to Deferred Accounting*, 2005 WL 2660063, at 1 (Or. P.U.C., Oct. 5, 2005) ("The use of deferred accounts allows a utility to capture and track costs and revenues without passing them to customers until a later time . . . .).

whether it is a net cost or net revenue that is deferred. Indeed, Mr. Bickerton indicated that TAWC wants to record any approved deferred accounting as a regulatory asset.[129]

Because deferred accounting can violate the prohibition against retroactive ratemaking and/or permit single-issue ratemaking, many states limit its application and approve it sparingly. Tennessee has relatively few dockets that include deferred accounting, but the utilities' requests are increasing in recent years. Only a couple of these dockets explain the reasons why the Authority permitted the deferred accounting. Tennessee has not established formal criteria to determine whether deferred accounting is appropriate. Many other states, however, have established criteria for determining whether to even permit deferred accounting treatment.

1. Tennessee law indicating the criteria for approving a deferred accounting is sparse.

Only a handful of utilities have applied for a deferred accounting for costs other than legal fees incurred during a case for a general rate increase, and no TRA approvals were found to defer accounting of revenue. The sparse history of deferred accounting petitions is as follows:

a) *In re: Application of United Cities Gas Company, A Division of Atmos Energy, Inc., Nashville Gas Company, A division of Piedmont Natural Gas Company, Inc. and Chattanooga Gas Company for Approval of Deferred Accounting*, Docket No. 01-00802, Order Approving Deferral of Uncollectible Accounts (Jan. 29, 2002): The Order notes that the applicants had requested a deferred accounting of the bad debt expense associated with the purchased gas. The petitioners stated reasons for its request as the increase in bad debt expenses was "unprecedented,"[130] the costs were "substantial," the costs could not be recovered in the allowed rates, the "excessive expenses" were "obviously outside the norm," and "were not caused by the actions and/or inactions of the Applicants."[131] The Authority approved the deferred accounting, stating that the increased expenses were "despite [the Applicants'] efforts" and that "it is appropriate under these extraordinary circumstances to allow the Applicants to defer [the costs]."[132]

[129] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, pgs. 96-97 (May 6, 2013).
[130] *In re: Application of United Cities Gas Company, A Division of Atmos Energy, Inc., Nashville Gas Company, A division of Piedmont Natural Gas Company, Inc. and Chattanooga Gas Company for Approval of Deferred Accounting*, Docket No. 01-00802, Order Approving Deferral of Uncollectible Accounts, pg. 2 (Jan. 29, 2002) (emphasis added).
[131] *Id.* at 3 (emphasis added).
[132] *Id.* at 5 (emphasis added).

b) *In re: Petition of Lynwood Utility Corporation for Approval of a Cost Recovery mechanism for Deferred Odor Elimination Costs*, Docket No. 08-00060, Order Approving Settlement Agreement (Apr. 29, 2009): The Authority approved deferred accounting when it approved the settlement agreement, but it provided no additional comments beyond those in the settlement agreement indicating criteria used to approve this deferred accounting.[133]

c) *In re: Petition of Kingsport Power Company D/B/A AEP Appalachian Power for Approval to Defer Certain Costs Associated with Winter Storms Occurring in December 2009*, Docket No. 10-00144, Order Granting Request for Deferred Accounting (Oct. 5, 2010): In this docket, the Authority considered Kingsport Power Company's request for a deferred accounting of $1,629,352 of operating and maintenance expense incurred resulting from winter storms on December 8, 2009 and December 15, 2009.[134] In its approval of deferred accounting, the Authority stated that "the deferral of this expense does not guarantee future recovery – either in whole or part – if such is sought by the Company."[135]

d) *In re: Petition of Navitas TN NG, LLC for Approval to Book as a Regulatory Asset Its Costs Associated with its Distribution Integrity Management Program*, Docket No. 12-00020, Order Granting Request for Deferred Accounting (May 22, 2012): In this docket, Navitas requested approval to defer costs and to record a regulatory asset for the expenditures associated with hiring a contractor to assist in implementing the federally-mandated Distribution Integrity Management Program ("DIMP").[136] The Authority approved the request and "found that the proposed treatment of the unusual and infrequent expenses is an accepted regulatory accounting treatment...."[137] The Authority "specifically stated that the deferral of these costs does not equate to a determination that the company will be allowed to recover such costs when they are considered by the Authority." Nevertheless, the Authority allowed Navitas to book as a regulatory asset the costs associated with implementing DIMP requirements.[138]

e) *In re: Petition of Kingsport Power Company D/B/A AEP Appalachian Power to Implement a Storm Damage Rider Tariff for Recovery of Storm Costs*, Docket No. 12-00051, Order Approving Proposed Tariff (Nov. 28, 2012): In this docket, Kingsport Power requested recovery of deferred accounting the Authority

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[133] Although this was a request for a surcharge and not a deferred accounting, it is often referenced in orders as a deferred accounting case. Consequently, the Consumer Advocate lists it here.

[134] *In re: Petition of Kingsport Power Company D/B/A AEP Appalachian Power for Approval to Defer Certain Costs Associated with Winter Storms Occurring in December 2009*, Docket No. 10-00144, Order Granting Request for Deferred Accounting, pg. 1 (Oct. 5, 2010).

[135] *Id.* at 2.

[136] *See In re: Petition of Navitas TN NG, LLC for Approval to Book as a Regulatory Asset Its Costs Associated with its Distribution Integrity Management Program*, Docket No. 12-00020, Order Granting Request for Deferred Accounting, pg. 1-2 (May 22, 2012).

[137] *Id.* at 2 (emphasis added).

[138] *Id.* at 3.

approved in Docket No. 10-00144 that was discussed previously. The Authority noted that, as a result of the approval of the deferred accounting, the utility recorded a regulatory asset for the amount of $1,629,352 in September 2010.[139] In its petition for recovery, Kingsport Power indicated that these storms resulted in the "largest amount of snowfall experienced in the Kingsport service territory since the blizzard of January, 1996, and Kingsport was severely impacted because of the high moisture content of the snow."[140] The Authority approved the requested recovery "because the costs were the result of extraordinary forces of nature beyond the Company's control. Such non-recurring costs, such as these storm costs, are not included in the Company's base rates and there is no other mechanism in place for recovery."[141] The Authority also voted that Kingsport Power maintain and submit detailed recoveries from customers.

f) *Petition of Berry's Chapel Utility, Inc. for Approval of Deferred Accounting*, Docket No. 13-00052, petition for Approval of Deferred Accounting (Apr. 1, 2013): The most recent request for deferred accounting is by Berry Chapel seeking to recovery legal fees purportedly not included in the legal fees previously provided for in the Docket No. 11-00180 rate proceeding concerning a general rate increase and the flood damage costs. The Authority approved this deferred accounting.[142]

Although the Authority has not provided specific criteria for authorizing deferred accounting, there are some common factors that the Authority considered in past dockets. With the exception of Docket No. 13-00052 (no written order published at the time of the brief) and Docket No. 08-00060 (settlement), all the deferred accounting dockets were for (1) costs related to infrequent, unusual, or extraordinary events, (2) outside of the company's control, and (3) there was no other mechanism for the utility to recover the costs. The only docket the Authority specifically discussed the magnitude of the cost to the utility was in Docket No. 01-00802, when the Order indicated the petitioners stated these costs were "substantial."

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[139] *In re: Petition of Kingsport Power Company D/B/A AEP Appalachian Power to Implement a Storm Damage Rider Tariff for Recovery of Storm Costs*, Docket No. 12-00051, Order Approving Proposed Tariff, pg. 2 (Nov. 28, 2012).
[140] *Id.* at 2.
[141] *Id.* at 4 (emphasis added).
[142] *Transcript of Proceedings*, May 6, 2013 Conference, at 10-11.

2. Other states have established criteria that petitioners must meet before approving requests for deferred accounting.

Nearly all states consider whether costs are appropriate for a deferred accounting at the time of considering the petition requesting a deferred accounting and do not wait until the time of recovery to determine whether the deferred accounting is appropriate.[143] This determination is consistent with the accounting concept that regulatory assets recorded under Financial Accounting Standard 71 (now Accounting Standards Codification ("ASC") 980-10) are "probable" for recovery and the utility has "reasonable assurance" of the existence of an asset based on the regulator's actions.[144] States use their established criteria in considering whether to approve or deny the petition for a deferred accounting.

Each state has different criteria for determining whether a deferred accounting is appropriate. In every state, however, the commissions are concerned that a deferred accounting will violate the prohibition against retroactive ratemaking or single-issue ratemaking. Thus, the criteria for a deferred accounting should require more reasons than ultimately allowing the utility to recover for unexpected or otherwise unrecovered expenses or losses incurred. To permit the utility to recover expenses or losses generally violates the prohibition against retroactive ratemaking and allows single-issue ratemaking. Likewise, a commission would not expect to refund to consumers unexpected savings or profits that exceed the authorized rate of return. To

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[143] *See, e.g., Duke Energy Indiana, Inc. v. Office of Utility Consumer Counselor*, 983 N.E.2d 160, 171 (Ind. Ct. App., Dec. 28, 2012) (denying a deferred accounting request for costs associated with an ice storm for the reason that the ice storm was not "extraordinary"); *Re West Valley Crystal Water Co., Inc.*, 2012 WL 1978187, *3-5 (N.Y.P.S.C., Apr. 25, 2012) (denying a deferred accounting request for repairs and maintenance expenses); *In re: Petition for Increase in Rates by Gulf Power Co.*, 296 P.U.R.4th 171, Order, pg. 1 (Fla. P.S.C., Apr. 3, 2012) (declining to approve deferred accounting until need was determined); *Re United Water Delaware Inc.*, 284 P.U.R.4th 496, 2010 WL 4915803, at 501-02 (Del. P.S.C., Sept. 21, 2010) (denying a petition by a water utility for approval of accounting treatment to track and defer for recovery in its next rate case a projected decline in revenue associated with a reduction in water usage by an industrial customer); *Re Piedmont Nat. Gas Co., Inc.*, 1993 WL 501432, Docket No. G-9, Sub 340, Order (N.C.U.C., Oct. 1, 1993) (order denying deferred accounting request for post-retirement benefit costs).

[144] For one commission's analysis, see *Re United Water Delaware Inc.*, 284 P.U.R.4th 496, 2010 WL 4915803, at 500-02 (Del. P.S.C., Sept. 21, 2010).

ensure that the deferred accounting treatment is not retroactive ratemaking or single-issue ratemaking, like the Authority, many states look at the (a) nature of the triggering event and (b) costs.

The factors that states consider when looking at the nature of the triggering event are similar to the Authority's considerations. These include whether the cost was foreseeable; was it an extraordinary, unusual, or infrequent event; and was it within the company's control.[145] These factors typically preclude a deferred accounting for any costs that could have been recovered during a rate case since those costs would have been foreseeable and not extraordinary, unusual, or infrequent.[146] Put another way, if a utility mistakenly excludes a cost or underestimates a cost, the utility's shareholders bear the cost, not the ratepayers.[147]

The factors that states consider when looking at the costs are the magnitude of the costs; whether the utility's earnings will sufficiently absorb the costs; and whether the costs are necessary expenditures.[148] Even if the costs are substantial, states have denied deferred accounting to avoid retroactive ratemaking and single-issue ratemaking.[149] The Consumer Advocate could not find a single state that does not regularly consider the magnitude of the costs and, even if such costs are substantial, whether the utility's earnings could absorb the costs without a deferred accounting. As for the necessity of expenses, this factor generally works in tandem with whether the nature of the triggering event and resulting costs are within the utility's control. Meaning, costs necessary to provide utility service to ratepayers are considered an

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[145] *See supra* note 143.

[146] *See, e.g., Re Iowa-American Water Company*, 1996 WL 103692, *1 (Feb. 13, 1996) ("Unless a past loss results from an extraordinary or unforeseeable event, the prohibition against retroactive ratemaking prevents companies from recovering for past losses.").

[147] *See, e.g., Re United Water Delaware Inc.*, 284 P.U.R.4th 496, 501, 2010 WL 4915803 (Del. P.S.C., Sept. 21, 2010) ("Ratemaking is normally forward-looking . . . . As such, the ratemaking procedure does not look to adjust for past losses or gains to either the utility or consumers.").

[148] *See supra* note 143.

[149] *See, e.g., Re West Valley Crystal Water Co., Inc.*, 2012 WL 1978187, *3-5 (N.Y.P.S.C., Apr. 25, 2012); *Re United Water Delaware Inc.*, 284 P.U.R.4th 496, 2010 WL 4915803, at 501-02 (Del. P.S.C., Sept. 21, 2010).

acceptable cost to consider for a deferred accounting.[150] If, however, the triggering event resulting in costs occurred by the utility's choice and/or the costs are not necessary to provide utility service, then a deferred accounting would be inappropriate.

B. Other states have denied the recovery of due diligence costs as a cost that should be borne by the shareholders.

Other states have considered and denied the recovery of due diligence costs or other similar costs performed to complete the transaction (sometimes referred to as "transaction costs").

The Missouri Commission denies transaction costs. In one case, it was argued:

> Transaction costs are generally not recovered through rates but rather charged to shareholders because transaction costs consist of costs incurred by both the acquiring company as well as the acquired company to complete the transaction, and not to facilitate the provision of utility service – such costs are properly considered to be a part of the purchase price of the acquisition.
>
> Absent the specific rate and accounting treatment being requested by the Applicants, pursuant to Generally Accepted Accounting Principles, transaction costs would be added to the value of the consideration . . . to arrive at the total purchase price of the transaction.
>
> Transaction costs do not meet the normal criteria for traditional expenses used to establish rates. These costs are not used or useful nor necessary for the provision of safe and adequate service. These costs are investor costs incurred in the buying and selling of their stock. . . . Great Plains and its Board decided to incur these costs. . . .[151]

The commission denied recovery of the transaction costs, concluding that allowing recovery would have "the same effect of artificially inflating rate base in the same way as allowing recovery of an acquisition premium."[152] It further concluded "it is not a detriment to the public interest to deny recovery of the transaction costs . . . ."[153]

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[150] *See, e.g., Re United Water Delaware Inc.*, 284 P.U.R.4th 496, 501, 2010 WL 4915803 (Del. P.S.C., Sept. 21, 2010).
[151] *In the Matter of the Joint Application of Great Plains Energy Incorporated, Kansas City Power & Light Company, and Aquila, Inc., for Approval of the Merger of Aquila, Inc., with a Subsidiary of Great Plains Energy Incorporated and for Other Related Relief*, 266 P.U.R.4th 1, 240-41 (Mo. P.S.C., 2008).
[152] *Id.* at 472-73.
[153] *Id.* at 473.

Another Missouri case was less specific as to the reasons for denying the transaction costs, but it was specific as to why it denied Missouri-American's request to share in savings from an acquisition.[154] As for the transaction costs related to the acquisition between American Water Works and National Enterprises, the commission concluded that the costs were "non-recurring and inappropriate for inclusion in rates . . . ."[155] When discussing whether Missouri-American should be permitted to recover a portion of any "savings", the commission opined:

> The Company argues that adopting a policy of allowing utilities to retain some of the savings they achieve will encourage them to pursue mergers and acquisitions. The Commission rejects this argument for two reasons. First, the utility industry, including water utilities, seems to be pursuing mergers and acquisitions quite willingly without this Commission approving shared savings plans.[156]

Other states have also denied due diligence or transaction costs. Arizona denied recovery for an environmental review related to selling the Company's operations and due diligence review of its system relating to potential acquisition of three water companies.[157] The staff argued that the "environmental review was not related to providing water service and the due diligence review was not the result of its normal cost of doing business."[158] Staff asserted that "shareholders rather than ratepayers reaped the benefits of these expenditures. If the company had not been seeking to sell operations or acquire other companies, it would not have commissioned either study."[159] The Arizona commission concurred with the staff and denied the

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[154] *In the Matter of St. Louis county Water Company for Authority to File Tariffs Reflecting Increased Rates for Water Service*, 10 Mo. P.S.C. 3d 255 (May 3, 2001).
[155] *Id.* ¶1.C.(1).
[156] *Id.*
[157] *In the Matter of the application of Bella Vista Water Co., Inc. an Arizona Corporation to Determine the Fair Value of Its Properties for Rate Making Purposes, to Fix a Just and Reasonable Rate of Return Thereon, and to Approve Rate Schedules and Tariffs Designed to Develop Such Return*, 2002 WL 32862770, at 9 (Ariz.CC, Nov. 1, 2002).
[158] *Id.*
[159] *Id.*

recovery of due diligence costs.[160] The commission found "the Company did not incur these expenses for the benefit of ratepayers, and they are not on-going expenses."[161] Similarly, in a merger, the Wisconsin Commission declared "[t]ransaction costs are not recoverable in rates in any context . . . ."[162] Likewise, Illinois has excluded transaction costs agreeing with the staff's argument that transactional costs are non-recurring, non-operation costs "incurred in order to effectuate a change in Company ownership, rather than as a result of utility operations."[163]

Thus, many states deny recovery of due diligence costs or other transaction costs. This treatment is much different than TAWC's request for a deferred accounting for $65,000 in due diligence costs in this purely voluntary transaction, not to mention the over earnings of $[redacted] in the forecasted utility operating income from the first two years of ownership.[164]

C. The criteria established by Tennessee and other states support the denial of TAWC's request for a deferred accounting of due diligence costs.

The Consumer Advocate recommends the Authority deny TAWC's request for a deferred accounting of due diligence costs for several reasons. First, TAWC's request does not meet the criteria the Authority has used in previous requests for deferred accounting. TAWC's request for a deferred accounting does not warrant exception from the Authority's precedents because it is not substantial and TAWC is able to recover the costs from its Whitwell earnings. Second, due diligence costs are generally improper for recovery through rates because such costs are not necessary to provide utility service. Therefore, should be borne by the shareholders rather than

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[160] *Id.* at 10.
[161] *Id.*
[162] *Re WPS Resources Corporation and Peoples Energy Corp.*, 255 P.U.R.4th 460, 467 (Wis. P.S.C., Feb. 16, 2007).
[163] *Illinois Power company Proposed Revisions to Delivery Services Tariff Sheets and Other Sheets*, 2002 Ill. PUC Lexis 366, at 63, 67 (Ill. CC, Mar. 28, 2002).
[164] *Transcript of Proceedings*, Vol. II (Confidential), Docket No. 12-00157, Ex. 20: Utility Operating Income – Forecast (May 7, 2013) (adding cell E112 and F112). This forecast was created using Company numbers and is for illustrative purposes only. The Consumer Advocate does not concede the forecasted expenses were accurately calculated as evidence presented during the hearing suggests that some of the expenses are overstated. If the expenses are overstated, the overearnings would be expected to increase.

the ratepayers. Third, all due diligence in this case has been to mitigate risk for the shareholder, and oftentimes, shift risk to the ratepayer.

As previously discussed, with the exception of Docket No. 13-00052 (no written order published at the time of this brief) and Docket No. 08-00060 (settlement), the Authority has indicated in its approval of all deferred accounting dockets that the costs deferred were (1) related to infrequent, unusual, or extraordinary events; (2) outside of the company's control; and (3) unable to be recovered through another mechanism. Although TAWC has not made many acquisitions, making these transaction costs technically infrequent at this time, it has indicated that it would like to make more.[165] Even if TAWC meets the first criterion of an infrequent cost, it certainly does not meet the other two criteria. As for the second criterion, TAWC has voluntarily pursued this acquisition. Therefore, not only are the costs within the control of TAWC, but the triggering event resulting in costs is also within TAWC's control. As for the third criteria, TAWC has a mechanism for recovering the costs other than through a deferred accounting. Its own forecasted revenue and expenses for Whitwell calculate to TAWC earning at least $[redacted] over its authorized rate of return.[166]

Moreover, if the Authority incorporates the factor of evaluating the magnitude of the costs like in other states, then this factor strongly weighs in favor of denying the deferred accounting. The due diligence costs are insubstantial to TAWC. Even Mr. Bickerton alluded that the due diligence costs in this case may not be material.[167] The fact that TAWC can recover these costs through the excess earnings of Whitwell in the first two years is even more of a reason that approving a deferred accounting is wholly unfair for ratepayers who will not reap the benefits of any excess earnings if TAWC's petition is approved as is.

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[165] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, at 18-29 (May 6, 2013).
[166] *See supra* note 164.
[167] *Transcript of Proceedings*, Vol. II (Confidential), Docket No. 12-00157, at 199-200 (May 7, 2013).

As other states have concluded, due diligence or other transaction costs are not appropriate for recovery through rates, much less considered for a deferred accounting exception to retroactive ratemaking and single-issue ratemaking. First, due diligence costs are incurred by a company to determine whether to make the acquisition. Due diligence costs are not incurred for the prospective buyer to actually provide service. Thus, due diligence costs are non-operational. It is unfair to force ratepayers to pay for costs that are not necessary to delivering water service. Second, as previously discussed, due diligence costs have been equated to an acquisition premium. Acquisition premiums are disfavored because they force ratepayers to pay higher rates simply because ownership of utility plant has changed, without any actual change in the usefulness of the plant.[168] Shareholders should bear the cost of due diligence costs, not ratepayers.

TAWC's due diligence was not only non-operational, but it has also caused TAWC to take steps that only increase risks for the ratepayers. For example, TAWC's [redacted].[169] As discussed in Part II, if approved, this request necessarily shifts the risk of loss from the shareholder to the ratepayer. Thus, in many instances, TAWC's due diligence strategy is a detriment to ratepayers. Making the ratepayers pay for efforts that are adverse to their interests would be unfair.

For these reasons, the Consumer Advocate recommends the Authority deny the request for a deferred accounting for due diligence. If the Authority does approve the deferred accounting, the Consumer Advocate respectfully requests the Authority order TAWC to track all

[168] *In the Matter of the Joint Application of Great Plains Energy Incorporated, Kansas City Power & Light Company, and Aquila, Inc., for Approval of the Merger of Aquila, Inc., with a Subsidiary of Great Plains Energy Incorporated and for Other Related Relief*, 266 P.U.R.4th 1, 469 (Mo. P.S.C., 2008).
[169] *Transcript of Proceedings*, Vol. II (Confidential), Docket No. 12-00157, Ex. 21 (May 7, 2013).

costs *and* revenues associated with the Whitwell acquisition until the next rate case, thereby permitting the ratepayers to share in the benefits, and not just the costs, of the acquisition. If the Authority orders a deferred accounting of all costs and revenues, the Consumer Advocate recommends the tracking of actual expenses be based on the most recent rate case as an objective benchmark. If the current forecasted expenses are used without adjustment, then net revenues could be understated.[170] Also, the Consumer Advocate recommends that Authority order that the approval of the deferred accounting should not result in a regulatory asset, as intended by TAWC,[171] because regulatory assets and liabilities should only be recorded if it is probable that the funds will be recovered.

IV. THE AUTHORITY SHOULD NOT ALLOW ITSELF TO BE INFLUENCED BY A UTILITY'S STRATEGIC NEGOTIATION WITH A SELLER.

TAWC has stated many times that it is eager to expand its operations.[172] Yet, TAWC has made the acquisition contingent upon the Authority's approval of the accounting and ratemaking treatment and the deferred accounting of due diligence costs. As shown in Parts II and Parts III, these requests are necessarily adverse to the ratepayers' interest because it shifts the risk from the shareholder to the ratepayers. Indeed, evidence shows that [redacted].[173] TAWC has every right to seek to mitigate its risks and ask the Authority for any type of relief. The Authority, however, should not permit such risk

[170] For example, the calculation of Other Expenses was questionable as to whether it was based on the amounts authorized in the Settlement approved in October 2012. *Transcript of Proceedings*, Vol. II (Confidential), Docket No. 12-00157, at 176-179 (May 7, 2013).
[171] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, pgs. 96-97 (May 7, 2013).
[172] *See, e.g., Transcript of Proceedings*, Vol. I, Docket No. 12-00157, pg. 19 (May 7, 2013).
[173] *Transcript of Proceedings*, Vol. II (Confidential), Docket No. 12-00157, Ex. 21 (May 7, 2013).

mitigation to be at the expense of ratepayers, especially when the ratepayers do not have adequate notice.

TAWC has every right to negotiate the terms of contracts with third parties the way it wants, but the Authority sets the terms for ratemaking. Instead of the Authority's rules and regulations providing guidance to TAWC in how it should proceed for ratemaking purposes, it appears from its petition that TAWC is seeking to use its strategic negotiations as a reason to encourage this Authority to depart from traditional ratemaking principles. TAWC's strategies in negotiations with third parties, however, should not influence the Authority in making its decisions. It is TAWC's goal to grow. TAWC's goal to expand should not be at the expense of its ratepayers, but rather should at least cause no harm to its existing ratepayers, or ideally even provide a net benefit to its existing ratepayers. If TAWC wants to expand its operations, it should be in compliance with traditional ratemaking principles and fairness standards. The Authority should determine the terms, not the utility.

The merits of this case and the existing laws in this state all point toward denying TAWC's accounting and ratemaking and deferred accounting requests. There is no statute setting forth a preference of whether water systems are operated by municipalities, utility districts, or public utilities. Although this municipal system has apparent problems, as indicated by its excessive water loss, the Tennessee statutes confer authority to the Comptroller's Office to oversee those issues.[174] In this instance, Whitwell has shown that it has the ability to reduce the excessive water, but even if it could not, that would be an issue for the Comptroller's Office.[175] Whitwell's commissioners approved the sale in a 3-2 vote,[176] indicating that at least some of the community is comfortable with operating the system if TAWC decides to abandon the purchase

[174] Tenn. Code Ann. § 68-221-1010.
[175] *Id.*
[176] *Transcript of Proceedings*, Vol. I, Docket No. 12-00157, Ex. 10, pgs. 5, 7 (May 6, 2013).

if the Authority does not approve its requests in full. Thus, even if Whitwell remained the owner, there is no suggestion that it would be a detriment to the public.

V. CONCLUSION

For the reasons stated above, the Consumer Advocate recommends the Authority approve the CCN, the franchise agreement, and the acquisition itself. The Consumer Advocate does not dispute that TAWC has the managerial, financial, and technical wherewithal to own and operate the Whitwell system.

The Consumer Advocate recommends the Authority deny all of TAWC's request for accounting and ratemaking treatment and deny TAWC's request for a deferred accounting for the due diligence costs. The Consumer Advocate recommends the denial of the accounting and ratemaking treatment in this Docket because it can undermine the negotiation process; ratepayers have not been provided adequate notice that the Authority will make decisions that will impact rates in the future; and the true value of the used and useful assets and related impairment are not known and measurable at this time. If the Authority does approve rate base at this time, the Consumer Advocate recommends the Authority include a negative acquisition adjustment of negative $[redacted] million so that existing TAWC customers do not subsidize the Whitwell system improvements. The Consumer Advocate recommends the denial of the deferred accounting of due diligence costs because these costs are inconsistent with the deferred accounting criterion applied by Tennessee in the past as well as other states.

CERTIFICATE OF SERVICE

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

Junaid Odubeko
Melvin J. Malone
Butler, Snow, O'Mara, Stevens & Cannada, PLLC
1200 One Nashville Place
150 Fourth Avenue, North
Nashville, TN 37219-2433
(615) 503-9105
mmalone@millermartin.com

Kevin Rogers
Operations Manager
Tennessee-American Water Company
1101 Broad Street
Chattanooga, TN 37402
(423) 755-7622
Kevin.n.rogers@amwater.com

This the 24th day of May, 2013.

Charlena Aumiller

Charlena S. Aumiller