BUTLER | SNOW

May 24, 2013

VIA ELECTRONICALLY

Hon. James Allison, Chairman
c/o Sharla Dillon
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, TN 37243-0505

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, TRA Docket No. 12-00157

Dear Chairman Allison:

Enclosed for filing please find the *Post-Hearing Brief of Tennessee-American Water Company* in the above-captioned matter.

As required, an original of this filing, along with four (4) hard copies, will follow. Should you have any questions concerning this filing, or require additional information, please do not hesitate to let me know.

Very truly yours,

BUTLER, SNOW, O'MARA, STEVENS & CANNADA, PLLC

Melvin J. Malone

clw
Attachment
cc: Parties of Record

The Pinnacle at Symphony Place
150 3rd Avenue South, Suite 1600
Nashville, TN 37201

MELVIN J. MALONE
615.651.6705
melvin.malone@butlersnow.com

T 615.651.6700
F 615.651.6701
www.butlersnow.com

BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

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**

POST-HEARING BRIEF OF TENNESSEE-AMERICAN WATER COMPANY

Pursuant to the Procedural Schedule established by the Tennessee Regulatory Authority ("TRA" or "Authority") in this matter, Tennessee-American Water Company ("TAWC") respectfully submits its Post-Hearing Brief.

For the reasons set forth in the Joint Petition, the evidentiary record and this Post-Hearing Brief, TAWC respectfully requests the approval of the Joint Petition, including the approval of the acquisition of the City of Whitwell's ("Whitwell") water system, coupled with the accounting, ratemaking and regulatory treatment sought, the approval of the franchise with the Town of Powells Crossroads ("Crossroads"), and the granting of a Certificate of Convenience and Necessity to serve the areas currently served by Whitwell.[1]

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[1] The *Joint Petition* also requests approval to encumber the properties comprising the Whitwell System with the lien of TAWC's Mortgage Indenture.

I.

JOINT PETITIONERS' REQUESTS

A. The City of Whitwell and the Town of Powells Crossroads

Whitwell is a Tennessee municipality that currently owns and operates source of water supply systems, water treatment and storage systems and water distribution systems within the City of Whitwell, Tennessee, the Town of Powells Crossroads, Tennessee, unincorporated portions of Marion County, Tennessee and unincorporated portions of Sequatchie County, Tennessee.[2] As set forth in both the Purchase Agreement[3] and the Joint Petition, Whitwell has determined that it is in the best interest of the City of Whitwell and those served by the System for TAWC to acquire the System.[4] Therefore, Whitwell desires to sell all of the assets that constitute or are used in furtherance of the System to TAWC.[5]

As set forth in both the Franchise Agreement[6] and the Joint Petition, Crossroads has determined that it is in the best interests of the Town of Powells Crossroads for Crossroads to continue to be served by the System subsequent to the acquisition of the System by TAWC.[7] Therefore, Crossroads desires to grant an exclusive water utility franchise to TAWC.[8]

B. The Agreed Upon Purchase Price

Under the terms of the Purchase Agreement, the purchase price is defined as the total rate base value of the Acquired Assets as of the Closing Date, calculated using the original cost

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[2] A copy of the locations of the City of Whitwell's water system (the "System") is generally shown on the map attached to the *Joint Petition* as **Exhibit C**.

[3] A copy of the Asset Purchase Agreement (the "Purchase Agreement") between TAWC and Whitwell is attached as **Exhibit A** to the *Joint Petition*.

[4] *See e.g., Pre-Filed Testimony of City of Whitwell Mayor Cindy Easterly*, TRA Docket No. 12-00157 (April 22, 2013) (adopting the Pre-Filed Testimony of City of Whitwell Mayor Steve Hudson); and *Hearing Transcript Vol. I*, pp. 74 – 75 (May 6, 2013) (hereinafter "*Tr. Vol. I*").

[5] *See Pre-Filed Testimony of Mayor Easterly.*

[6] A copy of the Water Franchise Agreement (the "Franchise Agreement") between TAWC and Crossroads is attached to the *Joint Petition* as **Exhibit B**.

[7] *See Pre-Filed Testimony of Town of Powells Crossroads Mayor Ralph Chapin*, TRA Docket No. 12-00157 (Dec. 27, 2012).

[8] *Id.*

method of accounting, of the System and the Acquired Assets, as determined by TAWC, subject to the approval of the Authority, and upon which the Authority authorizes TAWC to earn a specific rate of return, but excluding the value of any cash, working capital, accumulated deferred income taxes, and accumulated deferred investment tax credits. The purchase price is further addressed in the *Pre-Filed Direct Testimony of Daniel P. Bickerton.*[9]

C. The Franchises

As part of the consideration for the purchase of the System, and as set forth in the Purchase Agreement, Whitwell has agreed to grant an exclusive franchise to TAWC to operate a water system within the City of Whitwell and to grant TAWC the right to access all public rights-of-way, streets, alleys, sidewalks and utility easements that are necessary in order to install, maintain, test, repair, replace, extend and modify the System. Likewise, TAWC and Crossroads have entered into the Franchise Agreement dated November 20, 2012. Under the terms of the Franchise Agreement, Crossroads has granted to TAWC the exclusive right, among other things, to construct, install, operate, repair, replace, remove, and maintain the System in and through the corporate limits of Crossroads.

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[9] *See Pre-filed Direct Testimony of Daniel P. Bickerton*, TRA Docket No. 12-00157, p. 3 (Dec. 27, 2012). *See also Pre-Filed Rebuttal Testimony of Daniel P. Bickerton*, TRA Docket No. 12-00157, p. 2, LL 17 - 23 (April 19, 2013).

As noted by TAWC Witness Dan Bickerton in his Pre-Filed Direct Testimony (p. 3, LL 87-89), TAWC anticipates no utility plant acquisition adjustments, as the purchase price is expected to equate to the rate base as determined using the format outlined in Exhibit 1 to Mr. Bickerton's Pre-Filed Direct Testimony. This Exhibit 1 represents Mr. Bickerton's attempt to explain how TAWC plans to calculate rate base (purchase price) as of the closing. For illustrative purposes only, Exhibit 1 utilizes a closing date of December 31, 2012. The schedule set forth in Exhibit 1 is more fully explained and updated in TAWC's response to TRA Staff DR #10, CAPD DR #5, Hearing Exhibit No. 4 and Bickerton's testimony (*Tr. Vol. I* at 144, LL 16-24 and p. 145, LL 1-6; *Tr. Vol. II* at 211 - 213). While Exhibit 1 and the afore-referenced further explained and updated numbers do not either exactly match each other in all instances or exactly match the financial models provided confidentially under seal, they remain forecasts (*Hearing Transcripts. Vol. II* at 178, LL 9-10 (May 7, 2013) (Bickerton) (hereinafter "*Tr. Vol. II*"), subject to change. Notwithstanding the relatively minor errors, which Mr. Bickerton freely corrected without hesitation during the hearing, the underlying methodology for ultimately determining rate base, and thus the purchase price, at closing remains the same.

D. The Accounting, Ratemaking and Regulatory Treatment Requested by TAWC

As shown in the evidentiary record, Whitwell has a limited source of supply, has previously exceeded its plant designed capacity, has imposed a selective moratorium on new taps, and has a history of water quality advisories.[10] Furthermore, Whitwell must invest in significant infrastructure replacement to eliminate unreasonably high water loss.[11] Given the existing state of affairs with respect to the System, coupled with TAWC's unwavering commitment to provide safe, reliable drinking water to the System's customers,[12] TAWC is seeking full rate base recognition of its investment in the System, as well as the following proposed adjustments:

a. TAWC proposes to utilize the financial statements, records and reports provided by Whitwell and its accountant to support the original cost value of utility plant in service ("UPIS") as of the Closing Date.[13]

b. Due to the financial reporting changes promulgated under GASB 34, in 2003, Whitwell wrote-off all contributions in aid of construction ("CIAC") on its balance sheet and booked subsequent CIAC as revenue. TAWC proposes to re-establish the CIAC balance previously written-off by Whitwell, as well as those recorded as revenue, to be consistent with TAWC accounting practices.

c. TAWC further proposes to calculate accumulated amortization on the CIAC balance written-off in 2003 by applying the percentage of accumulated depreciation in 2003 to 2003 UPIS 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.

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[10] *See Pre-Filed Testimony of Bickerton* at 3; *Pre-Filed Testimony of Deron Allen*, TRA Docket No. 12-00157, p. 2 (Dec. 27, 2012); and *Pre-Filed Testimony of Mayor Easterly* at Exhibit 1, p. 2. *See also Tr. Vol. I* at 8, LL 19-25 and p. 9, LL 1-3 (Testimony of Deron Allen).

[11] *See Pre-Filed Testimony of Bickerton* at 3 and 5; *Pre-Filed Testimony of Allen* at 2; *Pre-Filed Testimony of Mayor Easterly* at Exhibit 1, p. 2; and *Tr. Vol. I* at 10, LL 12-14 (Testimony of Deron Allen). *See also Hearing Exhibits Nos. 1 (2010 City of Whitwell Audit Report), 2 (2011 City of Whitwell Audit Report), 3 (2012 City of Whitwell Audit Report) and 7*, TRA Docket No. 12-00157. *Hearing Exhibit No.* 7 is **CONFIDENTIAL** and was marked **CONFIDENTIAL** and filed **UNDER SEAL**.

[12] *See Pre-Filed Direct Testimony of Bickerton* at 5.

[13] *See Pre-Filed Direct Testimony of Bickerton* at 3; and *Pre-Filed Rebuttal Testimony of Bickerton* at 2.

d. TAWC proposes to adopt the current TRA-approved TAWC depreciation rates and CIAC amortization rates for Whitwell upon Closing.

e. TAWC proposes no UPAA with this transaction, as the purchase price is equivalent to the System rate base at Closing, assuming the afore-referenced adjustments.

f. In conducting the necessary due diligence and prudency evaluation with respect to the System, which preliminary reviews benefit both shareholders and current ratepayers, and in properly documenting the transactions, TAWC has necessarily incurred reasonable acquisition expenses, which, under the circumstances presented, are appropriate for recovery. With respect to such costs, TAWC is proposing that these expenses be deferred until closing and upon closing be accounted for as a regulatory asset. In the next rate case, the Authority will decide whether such expenses should be amortized over the remaining life of the Whitwell assets and thus recovered.[14]

Pursuant to the Purchase Agreement, TAWC will continue to provide service to the System customers at the current rates they are paying now.[15]

As the Authority well knows based upon its own experiences, the ever-growing pressures of needed capital investments mount more and more, causing smaller utilities to confront substantial, and oftentimes insurmountable, difficulties. In order for better positioned utilities, such as TAWC, to provide the necessary relief, to offer the opportunity for improved services, and to promote the public interest in such circumstances, fair and balanced regulatory treatment is essential. Finally, the above-outlined accounting and ratemaking treatment requests are reasonable and consistent with the TRA's ratemaking practices.[16]

E. The Joint Petition is in the Public Interest

Under the terms of the Purchase Agreement, a condition precedent to the closing of the sale of Whitwell's water system is TAWC obtaining a Certificate of Convenience and Necessity,

[14] *See Pre-Filed Rebuttal Testimony of Bickerton* at 2.
[15] *Tr. Vol. II* at 217, LL 17-19 (Testimony of Bickerton) (May 7, 2013).
[16] *See, e.g., Tr. Vol. I* at 114, LL 20 – 25 (Testimony of Bickerton).

along with acceptable accounting, ratemaking and regulatory approvals, from the Authority. On December 27, 2012, TAWC, Whitwell and Crossroads submitted an Expedited Joint Petition for review and consideration by the Authority. The Consumer Advocate and Protection Division of the Office of the Attorney General ("Consumer Advocate" or "CAPD") intervened on January 28, 2013, and submitted its Proposed Issues List on March 18, 2013.[17] The hearing on the merits was held at the Authority on May 6th and 7th, 2013.

As set forth in much greater detail in the Joint Petition, the Purchase Agreement and the Franchise Agreement are necessary and proper for the public convenience and properly conserves the public interest.[18] Additionally, the issuance of a Certificate of Convenience and Necessity to TAWC will serve the public interest as well.[19]

As set forth within the evidentiary record, Whitwell believes it is in the best interests of the City of Whitwell and the residents served by the System for TAWC to acquire the System from Whitwell, with the result that TAWC will be the exclusive provider of water within the corporate limits of Whitwell.[20] Likewise, and as set forth within the evidentiary record, Crossroads has determined that it is in the best interests of the Town of Powells Crossroads to grant an exclusive water utility franchise to TAWC, with the result that TAWC will be the exclusive provider of water within the corporate limits of Crossroads.[21] As demonstrated in the evidentiary record, and as discussed below, this transaction will benefit the current and future

[17] Prior to the May 6-7th hearing on the merits, the Consumer Advocate informed the Authority and TAWC that the Consumer Advocate was voluntarily removing Item No. 3 from its Proposed Issues List.
[18] *See Pre-Filed Direct Testimony of Bickerton* at 5; *Pre-Filed Direct Testimony of Allen* at 3; *Pre-Filed Direct Testimony of Mayor Easterly,* Exhibit 1, p. 3; *Pre-Filed Direct Testimony of Mayor Chapin at* 3.
[19] *See supra* n. 18.
[20] *Pre-Filed Direct Testimony of Mayor Easterly,* Exhibit 1, pp. 2-3
[21] *Pre-Filed Testimony of Mayor Chapin* at 2-3.

customers of the System through, among other things, the professional management, long-term planning, and sustained investment by TAWC.[22]

II.

OVERVIEW OF APPLICABLE AUTHORITY

A. The TRA Possesses the Authority to Approve the Whitwell Acquisition, the Purchase Price, and the Accounting and Ratemaking Treatments Sought by the Petitioners.

As it has maintained since the filing of the Joint Petition, TAWC submits that the TRA has the authority to grant the relief requested in the Joint Petition. As discussed at the outset of this Post-Hearing Brief, the petitioners request the following relief: (1) approval of the acquisition—including guidance regarding the purchase price as rate base at closing; (2) approval of the franchise agreements between TAWC and Whitwell and Crossroads; (3) approval of a Certificate of Convenience and Necessity to allow TAWC to operate the System; and (4) approval of certain accounting and ratemaking treatments relative to the recording of the acquisition and deferral of specific due diligence and closing costs. As demonstrated in more detail below, the TRA has both the expressed and implied authority to grant the requested relief.

1. The TRA has both the expressed and implied power to approve the acquisition purchase price and the accounting treatment sought by the Petitioners.

TAWC submits that the power to approve its acquisition of the System — including the purchase price and associated accounting and ratemaking treatments — rests well within the Authority's purview. The Tennessee General Assembly long ago charged the TRA and its predecessor agency with "general supervisory and regulatory power, jurisdiction and control

[22] *Pre-Filed Direct Testimony of Bickerton* at 3 and 5; *Pre-Filed Direct Testimony of Allen* at 2; *Pre-Filed Direct Testimony of Mayor Easterly* at Exhibit 1, p. 2; and *Pre-Filed Testimony of Mayor Chapin* at 2. *See also Tr. Vol. I* at 10, LL 16-18 (Testimony of Deron Allen).

over all public utilities."[23] In fact, the Legislature has explicitly directed that statutory provisions relating to the authority of the TRA shall be given "a liberal construction" and has mandated that "any doubts as to the existence or extent of a power conferred on the [TRA] shall be resolved in favor of the existence of the power, to the end that the TRA may effectively govern and control the public utilities placed under its jurisdiction..."[24] By this statute, the General Assembly, therefore, has "signaled its clear intent to vest in the TRA practically plenary authority over the utilities within its jurisdiction."[25] This plenary authority serves as firm grounds for the TRA to review and approve the acquisition, the purchase price, and the accounting and ratemaking treatments sought by the petitioners. Should the Consumer Advocate question the TRA's authority in relation to any aspect of the Joint Petition, the Authority need look no further than the General Assembly's clear and unambiguous pronouncements.

2. The TRA has the implied, inherent power to approve the acquisition, the purchase price and the requested accounting and ratemaking treatments.

In addition to the foregoing, TAWC submits that the TRA's authority over the selling and transferring of assets or utilities under circumstances similar to those presented in the *Joint Petition* can be inferred from the unique status of public utilities.[26] Public utilities have an obligation to furnish reasonably adequate service and facilities while charging just and reasonable rates.[27] As noted, for example, by the Montana Supreme Court in another acquisition case, this obligation to serve grants public utilities a special status in law as entities affected with a public interest.[28] In expanding on this rationale, the Court reasoned that:

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[23] *See* Tenn. Code Ann. § 65-4-104.
[24] *See* Tenn. Code Ann. § 65-4-106.
[25] *See Tennessee Cable Television Ass'n v. Tennessee Public Service Comm'n*, 844 S.W.2d 151, 159 (Tenn. App. 1992).
[26] *See also* Tenn. Code Ann. §§ 65-4-112 and 65-4-113.
[27] *See e.g.* 2007 Mont. PUC LEXIS 54 *16 (July 31, 2007) (Docket No. D2006.6.82); *citing Great Northern Utils. Co. v. Public Serv. Comm'n*, 293 P. 294, 298 (Mon. 1930).
[28] *Id.*

> When one devotes his property to a use in which the public has an interest, he in effect grants to the public an interest in that use, and must submit to be controlled by the public for the common good to the extent of the interest he has thus created." The U.S. Supreme Court has also found that" "[p]roperty becomes clothed with a public interest when used in a manner to make it of public consequence and affect the community at large.[29]

Thus, it logically follows that, in addition to the express statutory authority, the TRA possesses the implied authority to approve an acquisition of a water system by a public utility in furtherance of the public interest and its charge by the General Assembly.

3. Tennessee statutory law expressly grants authority to the TRA to approve the petitioners' request for approval of the franchise agreements and a certificate of convenience and necessity.

The petitioners' request for a Certificate of Convenience and Necessity and approval of the franchise agreements between TAWC and Whitwell and Crossroads are expressly governed by Tennessee statutory law. In fact, Tenn. Code Ann. § 65-4-201, prohibits any public utility from operating any system without first obtaining approval from the Authority.[30] Likewise, Tenn. Code Ann. § 65-4-107 provides that no privilege or franchise granted to a public utility shall be valid until approved by the Authority.[31] As noted in the statute, the Authority may approve the franchise upon finding it to be necessary, proper and properly concerning the public interest. Accordingly, as evidenced by these laws, the TRA has the express authority to grant the Petitioners' requests to approve TAWC's certificate of convenience and the franchise agreements between TAWC and the City of Whitwell and the Town of Powells Crossroads.

B. The TRA should approve TAWC's request to approve the purchase price based on the original-cost method of accounting.

In addition to possessing the authority to approve the purchase price of the acquisition as the rate base at closing, TAWC also submits that the TRA should accept the petitioner's use of

[29] *Id. citing Munn v. Illinois, 94 U.S. 113 (1876). See also Memphis Natural Gas v. McCanless*, 194 S.W.2d 476 (Tenn. 1946).
[30] *See* Tenn. Code Ann. §65-4-201.
[31] *See* Tenn. Code Ann. §65-4-107.

the original-cost accounting basis to value the Whitwell assets. In the 1987 case of *United Cities Gas Co. v. Tennessee Public Service Commission*, the Tennessee Court of Appeals acknowledged that recording assets at original cost is the practice in Tennessee for accounting for assets in an acquisition.[32] The case resulted from United Cities Gas Company acquiring the gas assets of the City of Franklin. After acquiring the assets, the company unsuccessfully sought to recover the full purchase price in the company's subsequent general rate filing with the Tennessee Public Service Commission, the predecessor agency to the TRA.[33] After the Commission allowed only about half of the requested rate increase and twice denied the Company's request for a full increase, the Company appealed the decision to chancery court, claiming that the Commission had incorrectly calculated the original-cost value of the Franklin System. The chancery court ruled in favor of the Commission, and the Company appealed the decision.[34] The primary issue before the Court of Appeals was whether the doctrine of res judicata applied to the Commission's prior rulings.[35] In addition to ruling in favor of the Commission with regards to the application of the res judicata doctrine, the Court analyzed the detailed process used to arrive at the book value of the Franklin System's assets.[36] By doing so, the Court again recognized that the original-cost method was the proper method to apply to determine the value of the Franklin System. In the Joint Petition, the petitioners have requested the same accounting treatment—use of the original-cost method— to value the Whitwell assets as approved by the Commission and recognized by the Court of Appeals in *United Cities*. It

[32] *See United Cities Gas Co. v. Tennessee Public Service Commission*, 1987 Tenn. App. LEXIS 3046 * 2 (1987), *overruled on unrelated grounds by United Cities Gas Co. v. Tennessee Public Service Commission*, 789 S.W.2d 256 (Tenn. 1990).
[33] *Id.*
[34] *Id.* at *4.
[35] *Id.* at *5.
[36] *Id.* at *19-20.

therefore follows that the TRA should follow Tennessee regulatory precedent and grant the petitioners' good-faith request to use the original-cost method.

Jurisprudence from other states also supports the use of the original-cost method. As is often the case on almost any material regulatory issue, however, some states may differ in their respective views on this subject matter. In a host of cases, this issue has arisen in the form of requests for acquisition adjustments by public utilities.

For example, in a 2007 decision concerning the acquisition of an electric utility by one of its competitors, the Montana Public Service Commission found that using the original-cost basis — the value of the plant in rate base less depreciation — was "a long held regulatory principle of the Commission."[37] Moreover, the Commission determined that the original cost of utility property is determined when the asset is first dedicated to public service. Thus, according to the Montana Commission, the action of selling a utility, absent any compelling reason, was not sufficient to allow an adjustment to the original-cost basis in rate base to reflect acquisition costs.[38]

The Missouri Public Service Commission has also opined on this issue as well. In a 2004 order, the Missouri Commission stated that it had, for many years, used a net original cost standard to place a value on utility plant after a merger.[39] The Commission further found that the original-cost standard was proven to be fair to utilities as well as to ratepayers and that there was no reason to vary from that standard. Finally, and as noted by TAWC Witness Bickerton during the hearing, this is the same reasoning and regulatory treatment that the Authority has long-used to set TAWC's rates.

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[37] 2007 Mont. PUC LEXIS *93 (July 31, 2007) (Docket No. D2006.6.82).
[38] *See* 2007 Mont. PUC LEXIS 54 *93 (July 31, 2007) (Docket No. D2006.6.82).
[39] *See In the Matter of the Joint Application of UtiliCorp United Inc. and St. Joseph Light & Power Company for Authority to Merge St. Joseph Light & Power Company with and into UtiliCorp United Inc.*, Mo. PUC, Case No. EM-2000-292, Second Report and Order, p. 7 (Feb. 26, 2004).

III.

ARGUMENTS

At the outset of this section of TAWC's Post-Hearing Brief, it is appropriate to acknowledge and recognize what is not at issue here. The Consumer Advocate is not opposing either the proposed acquisition or the related franchise agreements.[40] Moreover, the Consumer Advocate is not challenging TAWC's technical, managerial or financial abilities with respect to the Joint Petition.[41] Therefore, TAWC's Post-Hearing Brief will primarily focus upon the contested issues as identified by the Consumer Advocate.[42]

A. It is appropriate and prudent for TAWC to seek the Authority's guidance.

In the Joint Petition, petitioners transparently disclosed that the required TRA approvals are a condition precedent to the closing of the sale of Whitwell's System.[43] As the Authority well knows, such a pre-condition is not unusual. Thus, at the outset of this matter, and since, the petitioners have conspicuously disclosed the need for guidance from the Authority with respect to the pending transaction, including the requested accounting, ratemaking and regulatory treatments.

With respect to the purchase price, at the hearing Mr. Bickerton explained the reason for the mutually agreed upon approach taken by both Whitwell and TAWC. Since the parties did not know when the closing would occur, Whitwell and TAWC mutually decided that the best approach would be to develop a sound, reasonable and acceptable methodology, consistent with

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[40] *Tr. Vol.* I at 11-12.
[41] *Id.*
[42] To ease the administrative burden upon the Authority, TAWC incorporates by reference, as if set forth fully herein, its previously submitted support and arguments in this case. Therefore, TAWC will not attempt here to re-assert each and every argument that it has previously raised in this matter.
[43] *Joint Petition* at 2.

Tennessee's regulatory principles, to determine the purchase price.[44] Among other things, this approach would eliminate the need for Whitwell officials and TAWC to revisit the purchase price time and again and risk jeopardizing the transaction due to perceived delays and uncertainties.[45] As for the request for approval of the proposed acquisition prior to closing, Mr. Bickerton testified that given the amount of the purchase price, it is reasonable for TAWC to seek guidance from the Authority now, as opposed to waiting until the next rate case.[46] Again, there is no hidden motive here. In fact, it is fairly common for regulated entities to seek prior approval from the Authority in a number of contexts.[47]

Finally, Mr. Bickerton testified that the Authority's dearth of precedent with respect to acquisitions justifies TAWC's request for guidance.[48] In fact, in response to a question from the Directors, Consumer Advocate Witness Hal Novak confirmed Mr. Bickerton's testimony on this point.[49]

Hence, there is nothing sinister about this transparent approach. Under the circumstances presented, it is both appropriate and prudent to seek the guidance of the Authority.[50] Among other things, if TAWC learns from such guidance that the Authority's policies may result in a significant risk of not recovering the proposed investment, then TAWC can act in a manner that is in the best interest of all involved.[51]

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[44] *See Tr. Vol. II* at 210, L 25, and p. 211, LL 1 – 5 (Testimony of Bickerton); and *id* at 213, LL 14 – 25, and p. 214, LL 1 – 2 (Testimony of Bickerton).
[45] *Tr. Vol. I.* at 95, LL 20 – 25 and p. 96, LL 1 – 10 (Testimony of Bickerton).
[46] *Tr. Vol. I* at 114, LL 1 – 9.
[47] *See, c.f.,* Tenn. Code Ann. §§ 65-4-109 (mandatory pre-approval), 65-4-112 and 65-4-113 (mandatory pre-approval). There are other non-statutory contexts in which regulated entities seek prior approval from the Authority.
[48] *Id.* at 115, LL 1 – 7.
[49] *Tr. Vol. II* at 249, L 7 -8 ("It will be short because there's not very many of them.") (Testimony of Novak).
[50] *See BellSouth Telecommunications v. Bissell*, 1996 Tenn. App. LEXIS * 29 (August 28, 1996). reasoning that courts should give deference to the decisions of an administrative agency that has acted within its area of specialized knowledge and should not substitute its judgment for that of the agency on highly technical matters.
[51] *Id.* at 208, LL 19 – 23 (Testimony of Bickerton).

B. The acquisition will benefit both TAWC's current customers and Whitwell's customers.

As set forth earlier herein, the Joint Petition, including the Pre-Filed Testimony, clearly demonstrates that the acquisition will benefit both TAWC's current customers and Whitwell's customers. Despite any direct or implied suggestions to the contrary, the proposed transaction will serve the public interests. At the hearing, Deron Allen, President of TAWC, testified that circumstances have converged to present a really unique opportunity for the customers of the City of Whitwell's Water System, the customers of TAWC, the City of Whitwell, the Town of Powells Crossroads, and TAWC.[52] Among other things, it's an opportunity for investment, growth, safety, reliability, conservation and efficiencies.

Since a fair number of benefits to both the customers of TAWC and the customers of Whitwell are included within the evidentiary record, there is no need to reassert them all here. Nonetheless, a few representative examples are warranted. With respect to the Whitwell customers, the acquisition will result in certain modernizations of the System,[53] which will pave the way for much needed efficiencies,[54] improve the System's reliability and safety[55] and make way for growth opportunities so crucial to smaller communities,[56] all of which will serve the public interest. Further, Whitwell's customers will also benefit both from infrastructure

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[52] *Tr. Vol. I* at 8, LL 10-15.

[53] *See, e.g., Tr. Vol. I* at 9-10 (Testimony of Deron Allen).

[54] *Id. See also, e.g., Pre-Filed Direct Testimony of Mayor Easterly* at 2, LL 45 – 46 ("It has been a challenge for our small community to maintain the System, invest in infrastructure replacement[.]").

[55] *See, e.g., Pre-Filed Direct Testimony of Mayor Chapin* at 2, LL 40 – 45 and 55-56 ("[T]he quality of the water provided by the System needs improvement as well."). *See also Joint Petition* at 6 (citing Whitwell's history of water quality advisories). *See also Hearing Exhibits Nos. 8 (Phase I Environmental Site Assessment Whitwell Water Treatment Plant, Exhibit D) and 9 (EPA's Enforcement & Compliance History of the City of Whitwell's Water System)*, TRA Docket No. 12-00157. With respect to safety and reliability issues and some of Whitwell's historical challenges, TAWC President Deron Allen testified that "[p]eople began to lose confidence in their system[.]" *Tr. Vol. I* at 63, L 25 and p. 64, L1.

[56] *See, e.g., Pre-Filed Testimony of Mayor Easterly* at 2, LL 38 – 39 ("Some potential customers have been denied water service because of the System's limitations."); *Pre-Filed Direct Testimony of Bickerton* at 60 (citing the limiting of new taps due to System limitations); and *Joint Petition* at 6 ("Among other things, . . . Whitwell has a limited source of supply . . . has imposed a selective moratorium on new taps.").

improvements, and TAWC's experience, substantive knowledge base and management.[57] In the evidentiary record, Whitwell's Mayor independently summed up the benefits to the citizens of Whitwell this way:

> "Preparing Whitwell for the future is the basic premise behind this transaction.[58] . . . Without addressing Whitwell's need for an alternative source of water and making other necessary improvements to the System, there was essentially little growth potential in the area."[59]

Finally, when asked at the hearing about a more quantifiable example of potential benefits from the acquisition, Mr. Bickerton used chemical expenses. Having actually projected TAWC's chemical expense, Mr. Bickerton testified that significant savings in the purchasing of chemicals will benefit Whitwell's customers.[60] Further, Mr. Bickerton testified that TAWC's overall purchasing power will benefit Whitwell customers in other areas as well, including, but not limited to, materials, capital, pipe and hydrants.[61]

The benefits from the acquisition flowing to TAWC's customers were first addressed in the Joint Petition. In his Pre-Filed Testimony, TAWC Witness Dan Bickerton states as follows:

> "TAWC continuously explores opportunities to reduce costs, increase revenues, or otherwise enhance its business to keep ratepayer costs low and minimize rate increases. One way to do that is to grow TAW's customer base, particularly by providing service in areas within close geographic proximity to current TAWC operations. In many of these situations, there is a greater opportunity to benefit both TAW's existing customers and potential new customers from economies of scale. We believe that customer growth through quality acquisitions provides

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[57] *Tr. Vol. I* at 10 ("[TAWC] believes it will need to make infrastructure upgrades and improvement to the overall system in Whitwell. . . . [W]e plan to operate the system, do a comprehensive planning study, and to use our experience and engineering and system maintenance and to really improve the overall system.") (Testimony of Deron Allen). *See also Tr. Vol. I* at 83, LL 2 – 8 ("[I]t doesn't matter who has the system[.] . . . The $5 million is going to be spent one way or the other, whether it's under the leadership of the citizens of Whitwell that doesn't have the experience or whether it's under the experience and leadership of [TAWC].") (Testimony of Mayor Easterly); and *Pre-Filed Direct Testimony of Mayor Easterly* at 2, LL 47 – 50 ("It is apparent that a professionally run organization, like TAWC, is in a better position to make the necessary capital investments and properly manage the assets[.]").

[58] *Pre-Filed Direct Testimony of Mayor Easterly* at 2, LL 50.

[59] *Pre-Filed Direct Testimony of Mayor Easterly* at 2, LL 53 – 55.

[60] *Tr. Vol. I* at 104, LL 2 – 10.

[61] *Id.* at LL 11 – 17.

immediate revenue benefits, a larger customer base on which to spread fixed costs and serves to mitigate future rate increase impacts."[62]

Mr. Bickerton also addressed the question of how the proposed acquisition might benefit the customers of TAWC at the hearing. Among other things, Mr. Bickerton noted increased revenue, emergency enhancements, procurement savings and shared services (i.e. allocation of costs).[63]

In sum, the evidentiary record contains an outline of some of the many benefits that will accrue to the customers of TAWC and the customers of Whitwell should the acquisition move forward as contemplated.

C. The arms-length nature of the transaction and the valuation of the System are supported by the record.

During its cross-examination of TAWC's witnesses, the Consumer Advocate appeared to attempt to discredit the transaction on a number of fronts. While TAWC will rely on the clarity and breadth of the evidentiary record in most of these instances, it remains necessary to address a few of those attempts in this Post-Hearing Brief.

1. The deficiencies in Whitwell's audited financial statements are not dispositive.

During the hearing, the Consumer Advocate spent a fair amount of time cross-examining TAWC Witness Dan Bickerton regarding Whitwell's 2010, 2011 and 2012 audited financial statements. It is true that the foregoing statements contain various deficiencies. After easily acknowledging the shortcomings in Whitwell's audits, Mr. Bickerton testified that TAWC was

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[62] *Pre-Filed Testimony of Bickerton* at 2, LL 49 – 56. *See also Tr. Vol. I* at 95, LL 8 – 13 ("Obviously, we're looking for ways to keep our rates as low as possible, Tennessee American. And we think one way to do that is try to find additional customers through quality acquisitions so we have an increased revenue stream and increased customer base to spread our costs over.") (Testimony of Bickerton); and *Tr. Vol. I* at 98, LL 12 – 16 ("We do believe this transaction will benefit the customers of [TAWC] and Whitwell in the long term through our professional management and long-term planning and sustained investment by the company.") (Testimony of Bickerton).

[63] *Tr. Vol. II* at 210 – 221.

well aware of the deficiencies during the evaluation and negotiation processes.[64] Moreover, Mr. Bickerton testified that TAWC evaluated the audited financial statements, including the deficiencies, and in doing so did not uncover any significant issues regarding Whitwell's ability to record capital assets.[65]

Finally, Mr. Bickerton declined several overtures to characterize the System as a high risk investment.[66] Rather, he noted that unlike the context of evaluations of other types of assets, here TAWC had the advantage of being able to actually inspect the assets — i.e. plants, tanks, intake structures, booster stations, pumps — during the negotiations and valuation process.[67] When asked directly whether he had actually examined the assets of Whitwell, Mr. Bickerton responded "I've been to all the sites - - all the facilities myself."[68] After conducting these inspections, along with other analyzes, including title searches,[69] Mr. Bickerton concluded as follows:

> "So we felt comfortable with the assets that were recorded on their financial statements as being a sound basis for the determination of the base of the purchase price."[70]

In sum, employing his vast experience with acquisitions, Mr. Bickerton testified that:

> "[M]ost small systems don't have detailed continuing property records. It's not uncommon to see this level of recordkeeping. I mean, the bottom line is they really don't care about the value of fixed assets. They're more concerned about cash flow."[71]

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[64] *Tr. Vol. I* at 119, L 4 and p. 123, L 2.
[65] *Id.* at 127, LL 9 – 11.
[66] *Id.* at 121, LL 21 – 25 and p. 122, LL 1 – 10. *See also Tr. Vol. I* at 134, LL 21 – 23.
[67] *Id.* at 128, LL 1 – 6 and *Tr. Vol. I* at 122, LL 2 - 5.
[68] *Tr. Vol. I* at 122, LL 15 – 16.
[69] *Id.* at 128, L 5.
[70] *Tr. Vol. I* at 122, LL 6 – 9.
[71] *Id.* at 132, LL 18 – 24.

So, while the deficiencies in Whitwell's audited financial statements are not to be taken lightly,[72] and must be appropriately reviewed, analyzed and weighed, the deficiencies are not in and of themselves solely determinative of the value of the System.[73]

2. The proposed interconnection with the City of Dunlap's Water System is supported by the record.

The Consumer Advocate challenges whether the proposed interconnection with the City of Dunlap's Water System is warranted. As TAWC is fully persuaded that this issue is sufficiently addressed in the evidentiary record, it will only make a few observations here.[74]

Based largely on the testimony of TAWC Witnesses Bickerton and Allen, the record contains a plethora of support and justification for the proposed Dunlap interconnection for emergency and other reasons. Still, it is important to note that TAWC is not informing the Authority second-hand of whether the interconnection is essential. Rather, Mayor Easterly testified that the Dunlap interconnection was expected by the City of Whitwell.[75] In fact, when asked at the hearing whether she was aware that the estimated $5 Million capital expenditures included the cost of the proposed Dunlap interconnection, Mayor Easterly responded "Yes."[76] Mayor Easterly was also asked if Whitwell continues to own the System whether it will

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[72] During her cross-examination, Mayor Easterly was asked about that portion of her Pre-Filed Direct Testimony in which she referenced "System financial losses." *Pre-Filed Direct Testimony of Mayor Easterly* at 2, L 43. Even though she confirmed that there were losses over several years and acknowledged that "the financial challenges have been remedied for now," at the hearing Mayor Easterly struggled to immediately recall the exact time frame of the losses. *Id.* at 2, L 43- 44; and Tr. Vol. I at 89, LL 1 - 5. TAWC Witness Bickerton, however, did in fact recall that the "consecutive operating losses" occurred prior to the 2010 audit year. *Tr. Vol. I* at 94, LL 1 – 11.

[73] *Tr. Vol. I* at 134, LL 21 – 23 ("I know in this case we're quite comfortable with the value of the assets on the books of the city.") (Testimony of Bickerton).

[74] It should be highlighted here that Mr. Bickerton noted two different potential interconnection points with Dunlap. The first one, which is much less expensive than the second, would be to interconnect at a point in the West Valley area. *Tr. Vol. I* at 105, L 19 – 25 and p. 106, LL 1 – 4. The second approach would constitute a much larger connection with broader impact and service capabilities. *Id.* at 106, LL 5 – 9.

[75] *See Pre-Filed Direct Testimony of Mayor Easterly* at 2, LL 28 – 30 ("Intake modifications are necessary to accommodate these low flows, as well as an interconnection with neighboring water systems.").

[76] *Tr. Vol. I.* at 80, L 20.

interconnect with Dunlap. To this question, Mayor Easterly answered "It's got to be done, yeah."[77] Also, *Hearing Exhibit No. 7* — submitted **UNDER SEAL** as **CONFIDENTIAL** — confirms the necessity, for the reasons set forth within the exhibit, of an interconnection with the Dunlap Water System.[78]

Not being previously familiar with Whitwell's long-held recognition of the need for interconnection, Mr. Bickerton testified that while TAWC's analysis clearly revealed that the interconnection with Dunlap was essential, he was worried that Whitwell would balk and that this item might thereafter "be a deal killer."[79] As confirmed by the testimony of Mayor Easterly directly above, Mr. Bickerton's worries were unfounded.

As concerning the proposed interconnection with Dunlap, Mr. Bickerton was cross-examined about Whitwell's water storage requirement. Apparently, the Consumer Advocate was attempting to demonstrate that the extra capacity (i.e. 500,000 gallons) that would be made available to the (Whitwell) System via the Dunlap interconnection is unnecessary in light of Whitwell's water storage requirement.[80] Although it is true, as Mr. Bickerton acknowledged at the hearing, that Whitwell's average demand is about 800,000 plus gallons per day pursuant to *Hearing Exhibits Nos. 12 and 13*,[81] it is likewise undisputed that a commensurate level of storage, as required, will at best only provide the area served by Whitwell with no more than a single day's supply of water.[82] One day. Mr. Bickerton responded two-fold. First, he noted that it must be taken into account that in the everyday real world storage tanks are rarely 100% full

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[77] *Id.* at 83, L 12.
[78] *Hearing Exhibit No. 7*, TRA Docket No. 12-00157, pp. 6, 10 and 15. This exhibit is **CONFIDENTIAL** and was marked **CONFIDENTIAL** and filed **UNDER SEAL.**
[79] *Tr. Vol. I* at 102, LL 19 – 25 and p. 103, LL 1 – 9.
[80] *Id.* at 109, LL 22 – 25 ("Question [from The CAPD to Mr. Bickerton]: So the 500,000 gallons for the Dunlap connection that Tennessee American is extremely concerned about, that would be 500,000 plus the 870,000 as water available; correct?").
[81] *Hearing Exhibits No. 12 (Chattanooga Environmental Filed Office, Sanitary Survey, May 4, 2012) and 13 (Chattanooga Environmental Filed Office, Sanitary Survey, April 29, 2011)*, TRA Docket No. 12-00157.
[82] *Id.* at 110, L 16 (Testimony of Bickerton).

all the time.[83] Second, and most importantly, Mr. Bickerton testified that one purpose of a neighboring connection is to protect the community in the event of an emergency, such as, but not limited to, a failure at either the plant or the intake, which is likely not to be adequately resolved by a single day's supply.[84]

Lastly, as concerning the perceived discrepancy between Whitwell's average demand of about 800,000 gallons per day and TAWC's forecast of approximately 500,000 gallons per day, Mr. Bickerton plainly explained that TAWC cautiously employed, among other conservative inputs, a much lower assumption of water loss in its forecast than reported in Whitwell's 2012 audit, as it plans to mitigate Whitwell's substantial water losses.[85]

As clearly shown above, the proposed interconnection with Dunlap to protect the communities served by the System in the event of a crisis is supported by the evidentiary record.

3. The 10-year old valuation of the West Valley Water System is not relevant.

As reflected in the evidentiary record, the West Valley Water System ("West Valley") is a part of the (Whitwell) System. Notwithstanding that it laid no substantive foundation with respect to whether it was performed by a certified appraiser, whether comparable data was available, whether the income approach was utilized, or whether the underlying request and/or purpose for the "appraisal" impacted the methodology employed,[86] the Consumer Advocate relied on a 2003 valuation of West Valley at the hearing.

A cursory review of the "appraisal" (*Hearing Exhibit 14*) seems to suggest that the 2003 valuation was requested in connection with an eminent domain/condemnation proceeding and that the decade-old valuation was performed by a registered engineer, as opposed to a certified

[83] *Id.* at 110, LL 1 – 2 (Testimony of Bickerton).
[84] *Id.* at LL 9 – 13 (Testimony of Bickerton).
[85] *Id.* at 234 - 237.
[86] *Tr. Vol. II.* at 230, LL 3 – 18 (Testimony of Bickerton).

appraiser or a certified public accountant. Further, while the documents relied upon by the engineer in deriving his "opinion of value" may have been available a decade ago to the Marion County Circuit Court, they are certainly not a part of the evidentiary record in this proceeding.[87] Absent such supporting documents, surely the valuation cannot withstand the normally applied regulatory scrutiny. Finally, under the "opinion of value" section of the valuation, the engineer concludes that West Valley's estimated net book value must be adjusted downward. In deriving this adjustment, the engineer conceded the following:

> "This amount must be adjusted for the unusually poor condition of the system's water lines and the *probable* poor condition of a large number of customer meters. *Without a detailed study*, there is *no way to accurately estimate* the footage of water lines needing repair or replacement and, consequently, the cost of that repair or replacement. There is also *no accurate way to predict* the number of customers' meters needing replacement." (emphasis added).[88]

While this rough and rudimentary "valuation," coupled with the supporting documentation, may have been useful for its intended purpose in an eminent domain/condemnation proceeding 10 years ago, it would be, at best, inappropriate here for its intended purposes by the Consumer Advocate. To conclude otherwise, under the circumstances presented here, would run afoul of basic tenets of fairness.[89]

Notwithstanding the foregoing, it was acknowledged that the "appraisal" noted that initially West Valley's water lines were Class 160 PVC, which was acceptable at the time the system was constructed. According to the appraisal, Class 160 PVC has been banned as unacceptable due to excessive breakage under use. Further, it was acknowledged that, based upon the "methodology" employed by the engineer, the 10-year old appraisal noted that West

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[87] *See Hearing Exhibit No. 14*, p. 2 of 12, TRA Docket No. 12-00157.
[88] *Hearing Exhibit No. 14*, p. 11 of 12.
[89] *See e.g. Tennessee Consumer Advocate v. Tennessee Regulatory Authority*, 1997 Tenn. App. LEXIS 148 *10; concluding that the Public Service Commission committed a violation of basic principles of fairness in failing to afford the Consumer Advocate reasonable access to the materials to be considered and reasonable opportunity to cross-examine or otherwise impeach the origin of such materials.

Valley's estimated book value of $187,300 should be adjusted downward for various reasons associated with the condition of the system, bringing its estimated net worth to a negative $435,200.

With the foregoing in mind, Mr. Bickerton was asked whether TAWC considered this appraisal in determining the acquisition price. He responded "no" and explained that TAWC valued the System based on its rate base value, as that is how the Authority determines TAWC's rates.[90] As he alluded to often in his testimony, as noted elsewhere herein, if TAWC had not been comfortable with the condition of the assets that constitute the System, it would not have agreed to the current structure of the transaction, including, but not limited to, the post-acquisition application of Whitwell's current rates.

Next, Mr. Bickerton was asked whether West Valley's challenges set forth within the appraisal "sound very familiar to what's going on right now[.]"[91] In response, Mr. Bickerton highlighted the outdated nature of the appraisal, and he also clarified that "[t]here have been improvements to that system since the time of this appraisal."[92] When challenged by the Consumer Advocate on whether there had actually been upgrades to West Valley, Mr. Bickerton gave a specific example by noting that several miles of pipeline along the Cartwright Loop have been replaced due to the issue with Class 160 PVC.[93] Obviously, any such upgrades further impact the already outdated appraisal.

Finally, the Consumer Advocate seemed to suggest that due solely to the high water loss, TAWC should not pay 100% of the historical original cost.[94] Such a suggestion is surprising, as Mr. Bickerton testified that there are many potential inputs and factors with respect to

[90] *Tr. Vol. I* at 137, LL 1 – 6. *See also id.* at 137, LL 19 – 25 and p. 138, L 1.
[91] *Tr. Vol. I* at 139, LL 14 – 15.
[92] *Tr. Vol. I* at 139, LL 18 – 22.
[93] *Tr. Vol. I* at 140, LL 21 – 24.
[94] *Tr. Vol. I* at 147, LL 18 – 22.

determining the cause of water loss.[95] For example, billing errors could be a determinative factor in water loss.[96] In fact, and as noted at the hearing, it is not unusual for smaller systems to experience "40 to 60" percent water loss.[97] Nonetheless, these smaller systems continue to operate for years and years and provide a valuable and essential service to their respective communities. So, while some may characterize such systems as "dilapidated," others experienced in the industry recognize that in many cases they represent part of the core and fabric of the communities that they serve.[98] Hoping to highlight the point, Mr. Bickerton even noted that TAWC's system has water loss.[99]

In sum, if not irrelevant, the focus upon West Valley is certainly not meaningful within the context of the Joint Petition.[100]

IV.

CONCLUSION

For the foregoing reasons, and consistent with the evidentiary record, TAWC respectfully requests the approval of the Joint Petition, including the approval of the acquisition of the water system owned by The City of Whitwell ("Whitwell"), coupled with the accounting and

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[95] *Tr. Vol. I* at 151, LL 21 – 25 and p. 152, LL 1 – 5.
[96] *Id.* at 152, L 1 (Testimony of Bickerton).
[97] *Id.* at 53, LL 18 – 25.
[98] It is axiomatic that every water system is, by its very non-permanent nature, declining at some level each and every day.
[99] *Id.* at 149, L. 25. Mr. Bickerton also noted the distinction between *replacing* assets in West Valley and *repairing* assets in West Valley. *Id.* at 154, LL19 – 20. Any assumption that the assets of West Valley will be replaced in mass, and thus overlooking that some infrastructure will only require maintenance and repairs and that other potential causes of water loss may be uncovered, is simply not supported in the record. *See also Tr. Vol. I* at 23, LL 1 – 3 ("You just don't want to go in and start replacing stuff based on just what somebody tells you or anything.") (Testimony of Allen).
[100] Liberally partaking of the expression "having your cake and eating it too," earlier in the hearing the Consumer Advocate appeared to laud the reduction in Whitwell's water loss from the 2011 audited financial statement to the 2012 audited financial statement. *See Tr. Vol. I* at 13 – 16 and at 111. At a later stage of the hearing, however, the Consumer Advocate suggested that Whitwell's water loss renders the System, or at least a certain portion of it, completely worthless. Here, the Consumer Advocate overlooks that the assets are still in service, that some assets have already been repaired or replaced, that other potential causes of water loss may be discovered and that the unaccounted for water is trending downward.

regulatory treatment sought, the approval of the franchise with the Town of Powells Crossroads ("Crossroads"), and the granting of a Certificate of Convenience and Necessity to serve the areas currently served by Whitwell.

Respectfully submitted this 24th day of May, 2013.

BUTLER, SNOW, O'MARA, STEVENS & CANNADA, PLLC

By:_____

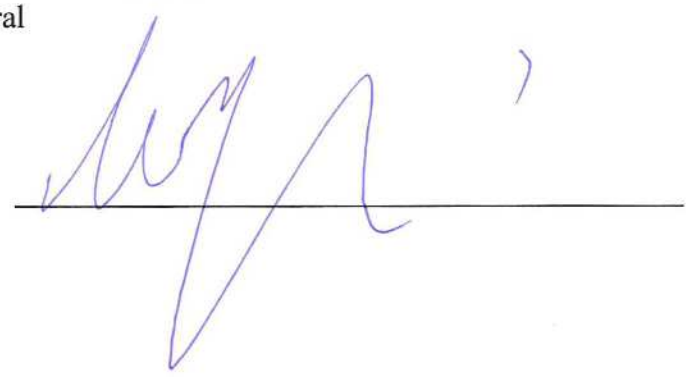
Melvin J. Malone
Junaid Odubeko
The Pinnacle at Symphony Place
150 3rd Avenue South, Suite 1600
Nashville, TN 37201
(615) 651-6705 (Office Telephone)
(615) 651-6701 (Facsimile)
melvin.malone@butlersnow.com
junaid.odubeko@butlersnow.com

Counsel for Tennessee-American Water Company

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing has been served electronically to the following this 24th day of May, 2013.

Cynthia Kinzer
Charlena Aumiller
Ryan McGehee
Vance Broemel
Consumer Advocate and Protection Division
Office of the Attorney General
P.O. Box 20207
Nashville, TN 37202



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United Cities Gas Co. v. Tennessee Pub. Serv. Comm'n

Court of Appeals of Tennessee, Middle Section
November 6, 1987, Filed
No. 87-106-II

Reporter: 1987 Tenn. App. LEXIS 3046; 88 P.U.R.4th 367

United Cities Gas Company, Petitioner, v. Tennessee Public Service Commission, Respondent

Subsequent History: [*1] Petition to Rehear Overruled November 20, 1987; Permission to Appeal Granted August 22, 1988

Prior History: APPEALED FROM THE TENNESSEE PUBLIC SERVICE COMMISSION.

Disposition: AFFIRMED IN PART; REVERSED IN PART; AND REMANDED

Core Terms

depreciation, res judicata, estimates, material evidence, book value, administrative body, original cost, administrative agency, de novo, judicial review, capricious, prior decision, appraisers

Case Summary

Procedural Posture

Petitioner *gas* company petitioned for direct review of the order of respondent, Tennessee Public Service Commission, which denied the *gas* company's request for a statewide rate increase to compensate it for the purchase of a municipal *gas* system. The *gas* company argued that the matter was not res judicata and that the Commission's determination of the value of the municipal *gas* system was incorrect.

Overview

The *gas* company was a public utility which purchased a municipal *gas* system. The exact cost of the system was unknown, but the *gas* company requested a statewide rate increase. The Commission determined that the value of the municipal system was lower than what the *gas* company claimed, and it denied the request. The *gas* company's motion to reconsider was rejected by the Commission. The *gas* company appealed, and a chancellor ruled in favor of the Commission, but the *gas* company voluntarily dismissed its appeal. The *gas* company filed a new rate petition, and the Commission denied it. The *gas* company petitioned for direct review, and the court remanded. The rulings of the Commission had no res judicata effect because they were never truly final and conclusive. In addition, the Commission in setting rates did not act in a judicial capacity. Therefore, the Commission was not bound by the chancellor's judgment for res judicata purposes. The Commission's refusal to allow the *gas* company to capitalize costs expensed in order to increase the book value of the municipal system was proper, but the Commission's order did not comply with *Tenn. Code Ann. § 4-5-314(c)* and *(d)*.

Outcome

The court remanded the case for further proceedings in accordance with the opinion, and it overruled the Commission's petition to rehear.

LexisNexis® Headnotes

Civil Procedure > ... > Defenses, Demurrers & Objec-

tions > Affirmative Defenses > General Overview
Civil Procedure > Judgments > Preclusion of Judgments > General Overview
Civil Procedure > Judgments > Preclusion of Judgments > Res Judicata

HN1 Res judicata may be successfully pleaded when a judgment on the merits exhausts or extinguishes the cause of action on which it was based, and is an absolute bar to a subsequent suit between the same parties upon the same cause of action, and concludes such parties and their privies not only as to all matters that were actually put in issue and determined, but also as to all matters which might have been put in issue and determined.

Administrative Law > Agency Adjudication > Decisions > Res Judicata
Administrative Law > Judicial Review > Reviewability > Reviewable Agency Action
Civil Procedure > ... > Defenses, Demurrers & Objections > Affirmative Defenses > General Overview
Civil Procedure > Judgments > Preclusion of Judgments > General Overview
Civil Procedure > Judgments > Preclusion of Judgments > Res Judicata

HN2 Final decisions of state administrative agencies are res judicata when the agency action under review is of a judicial nature.

Administrative Law > Agency Adjudication > Decisions > Res Judicata
Administrative Law > Judicial Review > Reviewability > Reviewable Agency Action
Civil Procedure > ... > Defenses, Demurrers & Objections > Affirmative Defenses > General Overview
Civil Procedure > Judgments > Preclusion of Judgments > General Overview
Civil Procedure > Judgments > Preclusion of Judgments > Res Judicata

HN3 Occasionally courts have used language to the effect that res judicata principles do not apply to administrative proceedings, but such language is certainly too broad. When an administrative agency is acting in a judicial capacity and resolves disputed issues of fact properly before it which the parties have had an adequate opportunity to litigate, the courts have not hesitated to apply res judicata to enforce repose.

Administrative Law > Agency Adjudication > Hearings > General Overview
Energy & Utilities Law > Regulators > Public Utility Commissions > General Overview
Energy & Utilities Law > Regulators > Public Utility Commissions > Authorities & Powers
Energy & Utilities Law > Utility Companies > Rates > General Overview

HN4 The Tennessee Supreme Court has repeatedly held that the Tennessee Public Service Commission is an administrative board and not a court, and that its power to fix rates is administrative and not judicial. The fact that proceedings before the Commission bear, in part, a similarity to proceedings of quasi-judicial bodies does not change this holding.

Administrative Law > Agency Adjudication > Review of Initial Decisions
Energy & Utilities Law > Regulators > Public Utility Commissions > General Overview
Governments > Courts > Judicial Precedent

HN5 The Tennessee Public Service Commission is not bound by its prior decisions. While an administrative agency is not legally bound by its prior decisions, the Commission should give substantial weight to a recent order which addresses in detail the same facts and legal arguments presented. Otherwise there would be no end to litigation and no consistency in litigation. It is generally recognized that public utility commissions are not rigidly bound by precedent. The justification usually given is that such commissions should be free to reverse course if public policy demands it.

Administrative Law > Judicial Review > Reviewability > Jurisdiction & Venue
Energy & Utilities Law > Administrative Proceedings > Judicial Review > General Overview
Energy & Utilities Law > Regulators > Public Utility Commissions > General Overview

HN6 The Administrative Procedures Act, *Tenn. Code Ann. § 4-5-322(b)(1)*, provides appeals directly from the Tennessee Public Service Commission decisions to the Court of Appeals of Tennessee , bypassing the Tennessee Chancery Court.

Civil Procedure > ... > Defenses, Demurrers & Objections > Affirmative Defenses > General Overview
Civil Procedure > Judgments > Preclusion of Judg-

ments > General Overview
Civil Procedure > Judgments > Preclusion of Judgments > Res Judicata

HN7 It is an obvious principle of justice that a judgment or decree is binding, in general, only on the parties to the suit, or those in privity with them. And in the application of this principle, it is essential, in order to avoid injustice, that its operation be mutual; both the parties must be alike concluded, or the proceedings cannot be set up as conclusive upon either.

Administrative Law > Agency Adjudication > Decisions > Res Judicata
Administrative Law > Agency Adjudication > Review of Initial Decisions
Civil Procedure > Judgments > Preclusion of Judgments > General Overview
Civil Procedure > Judgments > Preclusion of Judgments > Res Judicata
Energy & Utilities Law > Regulators > Public Utility Commissions > General Overview

HN8 Public service commissions are not generally bound by their previous decisions.

Administrative Law > Agency Adjudication > Review of Initial Decisions
Civil Procedure > US Supreme Court Review > General Overview

HN9 An administrative agency is not disqualified from changing its mind, and when it does, a court still must sit in review of the administrative decision. The ***United*** States Supreme Court and federal appeals courts have repeatedly held that an administrative body may reconsider its approach even in the absence of any new evidence, as long as the change in policy is clearly stated and justified.

Administrative Law > Agency Adjudication > Review of Initial Decisions
Energy & Utilities Law > Regulators > Public Utility Commissions > General Overview
Governments > Local Governments > Administrative Boards

HN10 While the Tennessee Public Service Commission may not arbitrarily ignore its prior rulings from case to case, it is free to change its position on a given issue if it has good reason to do so and supplies a persuasively reasoned explanation for modifying its earlier position.

Administrative Law > Agency Adjudication > Decisions > Res Judicata
Administrative Law > Judicial Review > Reviewability > General Overview
Civil Procedure > ... > Defenses, Demurrers & Objections > Affirmative Defenses > General Overview
Civil Procedure > Judgments > Preclusion of Judgments > General Overview
Civil Procedure > Judgments > Preclusion of Judgments > Res Judicata

HN11 If one party to an action is not bound, by definition there can be no res judicata because the res or issue has not been finally adjudicated. One would not argue res judicata on appeal if a trial court had heard the matter de novo, and an appeal from a de novo administrative hearing should not be treated differently.

Administrative Law > Agency Adjudication > Decisions > Res Judicata
Administrative Law > Judicial Review > General Overview
Administrative Law > Judicial Review > Reviewability > General Overview
Administrative Law > Judicial Review > Standards of Review > Arbitrary & Capricious Standard of Review
Administrative Law > Separation of Powers > Legislative Controls > General Overview
Civil Procedure > Judgments > Preclusion of Judgments > General Overview
Civil Procedure > Judgments > Preclusion of Judgments > Res Judicata
Energy & Utilities Law > Administrative Proceedings > General Overview

HN12 The Administrative Procedures Act, *Tenn. Code Ann. § 4-5-322*, specifically provides for judicial review of contested cases before state administrative bodies. This guards against the arbitrary and capricious exercise of administrative authority; unconstitutional or unlawful rulings by administrative bodies; or the failure to make decisions supported by substantial and material evidence. *Tenn. Code Ann. § 4-5-322(h)*.

Administrative Law > Agency Adjudication > Review of Initial Decisions
Administrative Law > Judicial Review > General Overview
Administrative Law > Judicial Review > Reviewabil-

ity > General Overview
Administrative Law > Judicial Review > Standards of Review > Substantial Evidence
Civil Procedure > Judgments > Preclusion of Judgments > General Overview
Civil Procedure > Judgments > Preclusion of Judgments > Res Judicata
Civil Procedure > Appeals > Standards of Review > De Novo Review

HN13 The Tennessee legislature, in the Administrative Procedures Act, *Tenn. Code Ann. § 4-5-322*, provides for judicial review of administrative orders whenever made, and when an administrative body makes a de novo determination, even upon previously-heard record, the petitioner is entitled to a review of whether that determination meets the standards set out in *Tenn. Code Ann. § 4-5-322(h)*. When an administrative decision is appealed, the courts are merely determining whether that decision is supported by substantial and material evidence, and whether it exceeds constitutional or statutory limits. The administrative body is and must be free to change its mind and if there is substantial and material evidence to justify the change, the courts would have no reason to overturn the new holding. Certainly, in such a situation, it would be fatuous to protest that the matter had been already litigated to the hilt and was therefore res judicata.

Administrative Law > Agency Adjudication > Decisions > Res Judicata
Administrative Law > Agency Adjudication > Review of Initial Decisions
Civil Procedure > Judgments > Preclusion of Judgments > General Overview
Civil Procedure > Judgments > Preclusion of Judgments > Res Judicata
Civil Procedure > Appeals > Standards of Review > De Novo Review
Energy & Utilities Law > Administrative Proceedings > General Overview
Energy & Utilities Law > Administrative Proceedings > Judicial Review > General Overview
Energy & Utilities Law > Regulators > Public Utility Commissions > General Overview

HN14 Where the Tennessee Public Service Commission is willing in its discretion, to make a de novo review of a matter already presented before it, the application of res judicata is wholly inappropriate and the petitioner should be protected by a judicial review of the sufficiency of the Commission's decision.

Energy & Utilities Law > Regulators > Public Utility Commissions > General Overview

HN15 See *Tenn. Code Ann. § 65-4-101*.

Energy & Utilities Law > Regulators > Public Utility Commissions > General Overview
Energy & Utilities Law > Oil, ***Gas*** & Mineral Interests > General Overview
Governments > Public Improvements > General Overview

HN16 It is clear that the purpose of *Tenn. Code Ann. § 65-4-101* is merely to limit the jurisdiction of the Tennessee Public Service Commission by defining as "nonutilities" all government owned electric, ***gas***, water, streetcar, etc. companies. For the purposes of this chapter, for example, the Tennessee Valley Authority would be classified as a "non-utility," despite the fact that it obviously is a utility.

Administrative Law > Judicial Review > Standards of Review > General Overview
Administrative Law > Separation of Powers > Constitutional Controls > General Overview
Civil Procedure > Appeals > Standards of Review > General Overview
Energy & Utilities Law > Administrative Proceedings > Judicial Review > General Overview
Energy & Utilities Law > Administrative Proceedings > Judicial Review > Standards of Review
Energy & Utilities Law > Regulators > Public Utility Commissions > General Overview
Energy & Utilities Law > ... > Public Utility Commissions > Hearings & Orders > Judicial Review

HN17 The standard of review upon appeal of an action of the Tennessee Public Service Commission is given in the Uniform Administrative Procedures Act, *Tenn. Code Ann. § 4-5-322*. *Tenn. Code Ann. § 4-5-322(h)* allows reversal or modification of an agency's decision if the rights of the petitioner have been prejudiced because the administrative findings, inferences, conclusions, or decisions are: (1) In violation of constitutional or statutory provisions; (2) In excess of the statutory authority of the agency; (3) Made upon unlawful procedure; (4) Arbitrary or capricious or characterized by abuse of discretion or clearly unwar-

ranted exercise of discretion; or (5) Unsupported by evidence which is both substantial and material in the light of the entire record.

Administrative Law > Judicial Review > Standards of Review > Substantial Evidence
Communications Law > Regulators > US Federal Communications Commission > Jurisdiction
Energy & Utilities Law > Administrative Proceedings > Judicial Review > General Overview
Energy & Utilities Law > Regulators > Public Utility Commissions > General Overview

HN18 The Tennessee Supreme Court has consistently held that the review of the Tennessee Public Service Commission is for the very limited purpose of determining whether the Commission has acted arbitrarily, or in excess of jurisdiction, or otherwise unlawfully. This, of course, would require that it be supported by substantial and material evidence.

Administrative Law > Judicial Review > Standards of Review > Substantial Evidence
Energy & Utilities Law > Administrative Proceedings > Judicial Review > General Overview
Energy & Utilities Law > Regulators > Public Utility Commissions > General Overview

HN19 The court's task is merely to determine whether the Tennessee Public Service Commission's position is supported by substantial, material evidence and is not arbitrary and capricious or an abuse of discretion. It is not the court's function to decide what, in its opinion, is the best method.

Administrative Law > Judicial Review > Standards of Review > Substantial Evidence

HN20 The question of what constitutes "substantial evidence" has been before the courts many times. Substantial evidence is more than a mere scintilla. It means such relevant evidence as a reasonable mind might accept as adequate to support a conclusion. This language is followed in Tennessee courts. Administrative findings must be supported by the kind of evidence on which responsible persons are accustomed to rely in serious affairs.

Administrative Law > Judicial Review > Standards of Review > Substantial Evidence

HN21 In determining the sufficiency of the evidence, courts must look at all the evidence in the record, not just that which tends to support the agency's finding. Evidence which unexplained might be conclusive may lose all probative force when supplemented and explained by other testimony.

Administrative Law > Judicial Review > Standards of Review > Substantial Evidence

HN22 See *Tenn. Code Ann. § 4-5-322(h)*.

Energy & Utilities Law > Regulators > Public Utility Commissions > General Overview
Governments > Local Governments > Duties & Powers

HN23 There is no doubt that a proper accounting practice is to include all materials and labor incorporated in a project in the capital account.

Energy & Utilities Law > Regulators > Public Utility Commissions > General Overview

HN24 A particular cost and/or depreciation figure might be suitable for one purpose but be unsuitable for another purpose.

Counsel: JAMES L. BOMAR, JR., JACK M. IRION, BOMAR, SHOFNER, IRION & RAMBO, Attorneys for the Petitioner.

HENRY WALKER, General Counsel, Tennessee Public Service Commission, Attorney for the Respondent.

Judges: CANTRELL, J., TODD, P.J., M.S., LEWIS, J., CONCUR.

Opinion by: CANTRELL

Opinion

OPINION

BEN H. CANTRELL, JUDGE

The ***United Cities Gas*** Company has petitioned this court for a review of an order of the Tennessee Public Service Commission, per *Tenn. Code Ann. § 4-5-322*. The order denied ***United Cities***' request for a statewide rate increase to compensate the company for its purchase, in 1983, of the ***City*** of ***Franklin***'s municipal ***gas*** system. The issues presented for appeal are 1) whether the matter is *res judicata* since it has already been litigated between the parties; and 2) if not, whether the Commission's determination of the value of the ***Franklin*** system was correct. Obviously the first issue must be decided before the second can be reached.

The Previous Litigation

After **[*2]** the purchase of the ***Franklin gas*** properties, ***United Cities*** petitioned the Public Service Commission, as part of a general rate increase request, for the inclusion of the purchase price in the company's general rate base. ***United Cities*** is a publicly-traded company which distributes natural ***gas*** to approximately 127,000 customers in five states; about 30 % of its customers are in Tennessee, where the company serves Bristol, Morristown, Maryville-Alcoa, Shelbyville, Columbia, Murfreesboro, ***Franklin***, and Union ***City***. ***United Cities*** falls under the definition of a public utility in *Tenn. Code Ann. § 65-4-101*, and is regulated by the Public Service Commission under § 65-4-104, *et seq.*

The company paid the ***City*** of ***Franklin*** $ 1.4 million for its ***gas*** properties. The parties are agreed that the practice in Tennessee in accounting for acquisition of ***assets*** is to record them at the original cost of the first utility to put them in service, less depreciation. Because the records of the ***Franklin*** system were haphazardly kept until about 1973, the exact original cost of the ***Franklin*** system is unknown, and the company and the Public Service Commission staff came to widely varying estimates of what **[*3]** the depreciated cost was. ***United Cities*** put on evidence to show that the "depreciated book value" at the time of the purchase was over $ 1.5 million, while the PSC staff put the figure at about $ 700,000.

In an order dated June 10, 1985, the Public Service Commission, with Commissioners Jane Eskind, Frank Cochran, and Keith Bissell presiding, found that the book value was the lower of the two figures. On August 11, 1985, on a motion to reconsider, the Commissioners again rejected ***United Cities***' request to recover the amount over $ 700,000 that it had paid for the ***Franklin*** system. ***United Cities*** then appealed the Chancery Court of Davidson County, Which was then the proper court to hear appeals from the Public Service Commission.

The Chancellor, in an opinion issued February 13, ***1986***, ruled in favor of the PSC, and the company filed a notice of appeal to this court. ***United Cities*** then voluntarily dismissed the appeal, however.

United Cities filed a new rate request petition on August 21, ***1986***, and Commissioners Frank Cochran, Keith Bissell and Steve Hewlett heard the petition on January 21, 1987. After a *de novo* review of the exhibits and testimony in the previous petition, the **[*4]** portion of the requested rate increase coming from the ***Franklin*** purchase was for the third time - denied by the Commission. ***United Cities*** has now brought the matter before this court, which now hears appeals directly from the PSC.

The PSC's position on appeal is that res judicata is a bar to this action. It points out that the matter was fully litigated between these same parties, in a court of competent jurisdiction; the parties and the issues were identical; the Chancellor issued a final judgment against ***United Cities***, the appeal from which was voluntarily abandoned; and the matter cannot therefore be relitigated.

Our Supreme Court has said:

HN1 Res judicata may be successfully pleaded when a judgment on the merits exhausts or extinguishes the cause of action on which it was based, and is an absolute bar to a subsequent suit between the same parties upon the same cause of action, and concludes such parties and their privies not only as to all matters that Were actually put in issue and determined, but also as to all matters which might have been

put in issue and determined. *National Cordova Corp. v. **City*** of Memphis, 214 Tenn. 371, 377, 380 S.W.2d 793, 796 (1964).*See also* **[*5]** *Lawlor v. National Screen Service Corp.*, 349 U.S. 322, 326 (1955)

As a preliminary matter, we do not think that the principles of res judicata can apply to this decision of the Public Service Commission. The Commission cites two cases, *Fourakre v. Perry*, 667 S.W.2d 483 (Tenn.App. 1983) and *Purcell Enterprises v. State*, 631 S.W.2d 401 (Tenn.App. 1981), for the proposition that res judicata applies not only to the decisions of courts of law, but also to final decisions of administrative agencies under certain circumstances. In these cases, decisions of the State Board of Claims were given, respectively, collateral estoppel and res judicata effect. *See also Polsky v. Atkins*, 197 Tenn. 201, 270 S.W.2d 497 (1954) (decision of the Commissioner of Finance and Taxation when acting in an adjudicatory capacity entitled to res judicata effect).

There is authority nationwide to support the proposition that ***HN2*** final decisions of state administrative agencies are res judicata when the agency action under review is of a judicial nature.

The seminal case in this field is ***United*** States v. Utah Construction & Mining Co., 384 U.S. 394 (1966). The U.S. Supreme Court stated:***HN3*** "Occasionally **[*6]** courts have used language to the effect that res judicata principles do not apply to administrative proceedings, but such language is certainly too broad. When an administrative agency is acting in a judicial capacity and resolves disputed issues of fact properly before it which the parties have had an adequate opportunity to litigate, the courts have not hesitated to apply res judicata to enforce repose."*384 U.S. at 421-422* (footnotes omitted).

Utah Construction, however, involved an appeal from a decision of a body, the Advisory Board of Contract Appeals, whose findings were statutorily given a "final and conclusive" effect. The Tennessee Public Service Commission fails to meet the above criteria. ***HN4*** The Tennessee Supreme Court has repeatedly held that the Public Service Commission is an administrative board and not a court, and that its power to fix rates is administrative and not judicial. *Hoover Motor Express Co. v. Railroad and Public Utilities Commission*, 195 Tenn. 593, 603, 261 S.W. 2d 233, 238 (1953); *McCollum v. Southern Bell Telephone and Telegraph Co.*, *163 Tenn. 277, 280, 43 S.W.2d 390, 391 (1931)*. The fact that proceedings before the PSC bear, in part, **[*7]** a similarity to proceedings of quasi-judicial bodies does not change this holding. *McMinnville Freight Line v. Atkins*, 514 S.W.2d 725, 726 (Tenn. 1974); *in re Cumberland Power Co.*, 147 Tenn. 504, 515, 249 S.W. 818, 820 (1922).

Nor were any of the orders of the Public Service Commission of a "final or conclusive" nature. Both sides agree that ***HN5*** the Commission is not bound by its prior decisions; as the Commission's order of February 13, 1987 put it: "While an administrative agency is not legally bound by its prior decisions, the Commission should give substantial weight to a recent order which addresses in detail the same facts and legal arguments presented here. Otherwise there would be no end to litigation and no consistenly in litigation." It is generally recognized that public utility commissions are not rigidly bound by precedent. *See, e.g.*, *State ex rel. Churchill Truck Lines v. Public Service Commission*, 734 S.W.2d 586, 593 (Mo.App. 1987); *Citizen's Utilities Co. of Illinois v. Illinois Commerce Commission*, 153 Ill.App.3d 28, 504 N.E.2d 1367, 1370 (1987); *Appeal of K-mart Corp.*, 238 Kan. 393, 710 P.2d 1304, 1307 (1985); *Chesapeake & Potomac Telephone* **[*8]** *Co. v. Public Service Commission*, 300 S.E.2d 607, 613 (W. Va. 1982); *Washington Water Power Co. v. Public Utilities Commission*, 101 Idaho 567, 617 P.2d 1242, 1254 (1980). The justification usually given is that such commissions should be free to reverse course if public policy demands it. 2 *K. Davis, Administrative Law Treatise* § 18.09 (1958).

The Public Service Commission heard ***United Cities*** argue the valuation of the ***Franklin*** system three times - the 1985 hearing, the peti-

tion to rehear, and the ***1986*** hearing. The commission could have changed its holding at any point, and could do so at any time if ***United Cities*** brings the matter before it again. In these circumstances the rulings of the Commission obviously can have no res judicata effect, since they are never truly "final and conclusive". And even if this were not the case, the Commission in setting rates does not act in a judicial capacity, thus failing to meet the test in *Utah Construction*, supra.

The Commission's position on appeal, however, is that ***United Cities*** is bound not by the previous orders of the Commission, but by the judgment against it in Chancery Court, from which the company did not pursue **[*9]** an appeal. Although ***HN6*** the Administrative Procedures Act, *Tenn. Code Ann. § 4-5-322(b)(1)* has been amended to provide appeals directly from Public Service Commission decisions to this court, bypassing the Chancery Court, the Commission avers that this is merely a procedural, not a substantive, change. In other words, this court should be bound by the findings of the Chancellor, just as we would be bound by our own findings if we had been the proper court to hear direct appeals at the time of the original appeal. As the Commission said in its brief: "If this case were now before the Chancellor instead of this Court, there would be little argument on this point. The Chancellor would inform the parties that he had already ruled on this question and was not inclined to adjudicate the issue a second time."

We believe that this is a superficial view. If we accepted the Commission's position, the result would be to allow the Commission to rehear a particular rate case *ad infinitum*, while limiting the regulated utility to only one appeal. The utility would be bound, but the Commission could reverse its position at any time.

As the Supreme Court said more than a century ago, ***HN7*** "It is an obvious **[*10]** principle of justice that a judgment or decree is binding, in general, only on the parties to the suit, or those in privity with them. And in the application of this principle, it is essential, in order to avoid injustice, that its operation be *mutual*; both the parties must be alike concluded, or the proceedings cannot be set up as conclusive upon either." *Simpson v. Jones*, *34 Tenn. (2 Sneed) 36, 39 (1854)* (emphasis in original); 22 Tenn. Jur. *Res Judicata* § 14.

As noted earlier, ***HN8*** Public Service Commissions are not generally bound by their previous decisions. And in this case it seems clear that the Tennessee Public Service commission was not bound by the judgment of the Chancery Court for res judicata purposes. Although the Chancellor found that the Commission's decision was supported by substantial and material evidence, this holding would not act as a bar to a subsequent change of policy by the Commission. Such a reversal of field would obviously be possible given the changing makeup of the Commission, or a simple change of mind. ***HN9*** An administrative agency is not disqualified from changing its mind, *N.L.R.B. v. Local No. 103, International Association of Bridge, Structural, [*11] and Ornamental Iron Workers*, 434 U.S. 335, 351 (1978), and when it does, a court still must sit in review of the administrative decision. *Id.* The U.S. Supreme Court and federal appeals courts have repeatedly held that an administrative body may reconsider its approach even in the absence of any new evidence, as long as the change in policy is clearly stated and justified. *Mobil Oil Corp. v. Federal Power Commission*, 417 U.S. 283, 320 (1974); *Reservation Telephone Cooperative v. Federal Communications Commission*, *826 F.2d 1129, 1135 (D.C.Cir. 1987)*; *American Public Gas* Association v. Federal Power Commission, 567 F.2d 1016, 1031 (D.C.Cir. 1977), *cert. den. 435 U.S. 907 (1978)*; *Boston Edison Co. v. Federal Power Commission*, 557 F.2d 845, 849 (D.C.Cir. 1977) *cert. den. sub nom. Towns of Norwood, Concord, and Wellesley, Mass. v. Boston Edison Co.*, 434 U.S. 956 (1977). We conclude from those cases that ***HN10*** while the Commission may not arbitrarily ignore its prior rulings from case to case, it is free to change its position on a given issue if it has good reason to do so and supplies a persuasively reasoned explanation for modifying its earlier position.

[*12] The freedom of the Commission to change its mind, and the importance of this freedom if the Commission is to be able to meet changing conditions, was so obvious that it was simply taken for granted by both parties. When the second rate case was filed, the Commission did not refuse to reconsider the company's position because the issue was res judicata, or because it had previously decided against ***United Cities*** on the same evidence. They considered the evidence *de novo,* and, as it happened, reached the same conclusion as before. Had they not, the weight of judicial authority makes it clear that the Commission would not have been bound by the result of the prior litigation in Chancery Court. And if the Commission was not bound by the Chancellor's ruling -- in other words, if there was no mutuality - neither could the company be bound. ***HN11*** If one party to an action is not bound, by definition there can be no res judicata because the res (the issue) has not been finally adjudicated. One would not argue res judicata on appeal if a trial court had heard the matter *de novo* and we do not think an appeal from a *de novo* administrative hearing should be treated differently.

If we were **[*13]** to accept the Public Service Commission's view, this lack of mutuality would work an obvious injustice. The Administrative Procedures Act, *Tenn. Code Ann. § 4-5-322*, ***HN12*** specifically provides for judicial review of contested cases before state administrative bodies. This was intended by the legislature as a means of guarding against the arbitrary and capricious exercise of administrative authority; unconstitutional or unlawful rulings by administrative bodies; or the failure to make decisions supported by substantial and material evidence. *§ 4-5-322(h).* The Commission's position would allow a petitioner to relitigate a rate case *de novo* endlessly, but would allow only one appeal to the courts from its decision. Once that appeal was made, the Commission could deflect any further judicial review by insisting that the case was res judicata in the courts though not in the Commission.

We think that ***HN13*** the legislature, in passing the Administrative Procedures Act, intended to provide for judicial review of administrative orders whenever made, and that when an administrative body makes a *de novo* determination, even upon previously-heard record, as here, the petitioner is entitled to a **[*14]** review of whether that determination meets the standards set out in *§ 4-5-322(h).* When an administrative decision is appealed, the courts are merely determining whether that decision is supported by substantial and material evidence, and whether it exceeds constitutional or statutory limits. The administrative body, as noted earlier, is and must be free to change its mind and if there is substantial and material evidence to justify the change, the courts would have no reason to overturn the new holding. Certainly, in such a situation, it would be fatuous to protest that the matter had been already litigated to the hilt and was therefore res judicata.

Thus, we conclude that ***HN14*** where the Public Service Commission is willing in its discretion, to make a *de novo* review of a matter already presented before it, the application of res judicata is wholly inappropriate and the legislature intended that the petitioner should be protected by a judicial review of the sufficiency of the Commission's decision. Under the circumstances we find the Commission's res judicata argument to be without merit.

The Issues on Appeal

The main contention of ***United Cities*** on appeal is that the Commission's **[*15]** valuation of the ***Franklin*** property was faulty. However, it has also raised two other issues which we will consider first.

United Cities contends that, in accounting for utility ***assets***, the ***assets*** are recorded at their cost to the utility, which the Uniform System of Accounts of the National Association of Regulatory Utility Commissioners defines as the first "person" devoting the ***assets*** to utility service. It then points to *Tenn. Code Ann. § 65-4-101*, concerning the jurisdiction of the Tennessee Public Service Commission to regulate utilities, which says, in part:

HN15 The term "public utility" as here defined shall not be construed to include the following (hereinafter called nonutilities);

(2) Any county, municipal corporation or other subdivision of the state of Tennessee . . .

From this curious juxtaposition of authority, ***United Cities*** manages to extract the argument that 1) ***Franklin*** was not a utility; 2) ***United Cities*** is the first "person" to devote the property to utility service; ergo, 3) the value of the ***Franklin gas*** system should be recorded at the price ***United Cities*** paid for it.

HN16 It is clear that the purpose of *§ 65-4-101* is merely to limit the jurisdiction of the Public **[*16]** Service Commission by defining as "nonutilities" all government owned electric, ***gas***, water, streetcar, etc. companies. For the purposes of this chapter, for example, the Tennessee Valley Authority would be classified as a "non-utility," despite the fact that it obviously is a utility. The attempt by ***United Cities*** to read the language of this statute literally, and say that the ***Franklin*** system did not become a utility until they purchased it, is specious and will not be discussed further. *See Memphis Power & Light Co. v. City* of Memphis, 172 Tenn. 346, 349, 112 S.W.2d 817, 826 (1937).

United Cities also maintains that the Commission's valuation is at odds with the standards in the Commission staff's audit manual. The PSC's accounting director testified that there was no real conflict; although the manual says that operating efficiencies resulting from a merger may permit a company to recover the price over book value it paid for a utility, the Commission found that the company failed to quantify efficiencies. In any case, the manual is a guide for the internal use of the Commission's staff, as the Commission pointed out. We do not think it is binding on the Commission.

The Commission's **[*17]** *Valuation* We now turn to the issue of the Commission's valuation of the ***Franklin gas*** properties. ***HN17*** The standard of review upon appeal is given, as noted above, in the Uniform Administrative Procedures Act, *Tenn. Code Ann. § 4-5-322*. Subsection (h) allows reversal or modification of an agency's decision "if the rights of the petitioner have been prejudiced because the administrative findings, inferences, conclusions, or decisions are:

(1) In violation of constitutional or statutory provisions;

(2) In excess of the statutory authority of the agency;

(3) Made upon unlawful procedure;

(4) Arbitrary or capricious or characterized by abuse of discretion of clearly unwarranted exercise of discretion; or

(5) Unsupported by evidence which is both substantial and material in the light of the entire record.

The Uniform Administrative Procedures Act did not make any significant changes from prior decisions and statutory law on the standard of review. *C F Industries v. Public Service Commission*, 599 S.W.2d 536, 540 (Tenn. 1980). ***HN18*** The Supreme Court "has consistently held that the review is for the 'very limited purpose of determining whether the commission has acted arbitrarily, or in **[*18]** excess of jurisdiction, or otherwise unlawfully.' ***City*** of Whitwell v. Fowler, 208 Tenn. 80, 343 S.W.2d 897, 899 (1961). This, of course, would require that it be supported by substantial and material evidence." *Id.*

United Cities and the Public Service Commission fundamentally disagree on the proper method to be used in determining the book value of the ***Franklin gas*** system, but ***HN19*** our task is merely to determine whether the Commission's position is supported by substantial, material evidence and is not arbitrary and capricious or an abuse of discretion. It is not our function to decide what, in our opinion, is the best method. *Dunlap v. Dixie Greyhound Lines*, 178 Tenn. 532, 537, 160 S.W.2d 413, 415 (1942).

HN20 The question of what constitutes "substantial evidence" has been before the courts many times. Chief Justice Hughes, in *Consoli-*

dated Edison Co. v. N.L.R.B., 305 U.S. 197, 229 (1938), said: "Substantial evidence is more than a mere scintilla. It means such relevant evidence as a reasonable mind might accept as adequate to support a conclusion." This language has been followed in Tennessee courts. *See, e.g., South Central Bell Telephone Co. v. Tennessee* **[*19]** Public Service Commission, 579 S.W.2d 429, 440 (Tenn.App. 1979). Judge Learned Hand put the test this way: Administrative findings must be "supported by the kind of evidence on which responsible persons are accustomed to rely in serious affairs." N.L.R.B. v. Remington Rand, Inc., 94 F.2d 862, 873 (2d Cir. 1938).

HN21 In determining the sufficiency of the evidence, it is well settled that courts must look at all the evidence in the record, not just that which tends to support the agency's finding. *See, e.g.,* Riehl v. Town of Amherst, 308 N.Y. 212, 215, 124 N.E.2d 287, 288 (1954). ("Evidence which unexplained might be conclusive may lose all probative force when supplemented and explained by other testimony.") As the statute puts it: ***HN22*** "In determining the substantiality of the evidence, the court shall take into account whatever in the record fairly detracts from its weight, but the court shall not substitute its judgment for that of the agency as to the weight of the evidence on questions of fact." Tenn. Code Ann. § 4-5-322(h).

The book value of the ***Franklin*** system is the issue in this case; it is the base on which ***United Cities*** seeks a fair return. The parties agree **[*20]** that in arriving at the book value they are seeking two factors original cost and depreciation.

Three different estimates of the book value of the ***Franklin*** system were put before the Commission. The lowest estimate, and the one accepted by the Commission, was made by Robert Crenshaw, a certified public accountant who has worked for the ***City*** of ***Franklin*** as an outside auditor since 1958. He found the book value (i.e., original cost less depreciation) of the system at the time of the ***United Cities*** purchase to be about $ 700,000.

United Cities entered into evidence report by an independent accounting firm, Fleming-Tegarden Associates, which had been prepared for the ***City*** of ***Franklin*** in order to determine the fair market value of the ***Franklin*** system. This report flatly stated that "it is impossible to accurately state the original cost less depreciation of the plant," but by accepting Mr. Crenshaw's original cost figure and applying a different rate of depreciation arrived at a "Restated Net Value" of $ 1,204,410.

United Cities also hired an independent auditing firm, Wilson, Work, Fossett, and Greer, to determine the book value of the system, and their estimate was $ 1,512,556.

The **[*21]** accountant who prepared the report for Wilson, Work testified that much of the variation in estimates was due to the ***city***'s failure during this period to "capitalize" labor costs. As a company accountant, Mr. Ford, testified, when a private utility digs up a street to install a ***gas*** main, for example, its labor expenses and street repair expenses are included as a part of the capital cost of the job and included in the rate base. In ***Franklin***, for this period, labor costs were not thus capitalized, but "expensed" and left out of the rate base. Street repairs would have been performed by the ***city*** street department as a matter of course, and not billed to the ***gas*** system. Wilson, Work attempted to adjust for this, and ended up with a higher figure that Mr. Crenshaw.

This testimony is discussed in the Commission's original order of June 10, 1985. The Commission found that "the difference between capitalizing a cost or expensing it is only a matter of timing. If a cost is expensed, ratepayers pay for it now; if the cost is capitalized, customers pay for it over a period of future years. The result is the same. Once a cost has been treated as an expense, however, it would be totally inappropriate **[*22]** to refigure those costs at a later date, capitalize them, and make the ratepayers pay twice for the same ***assets***."

HN23 There is no doubt that the proper accounting practice is to include all materials and la-

bor incorporated in a project in the capital account. *See, e.g.*, Commissioner v. Idaho Power Co., 418 U.S. 1, 13 (1974). The ***city*** of ***Franklin*** did not do this, and the Commission concluded that this failure did not prejudice ***United Cities*** for the reasons stated above. Although this conclusion might not represent the best accounting practice, it is supported in the record by the testimony of Archie Hicherson, the Assistant Director of the Accounting Division of the PSC, and Athan Gibbs, the PSC's Financial Analyst. As Mr. Gibbs put it, "[B]eing expired costs, those costs should not be resurrected and charged to future ratepayers. It would be just as improper to take a portion of the revenues that were earned back at that time and impute those revenues to the company. I'm sure you would agree." ***United Cities***' only evidence to contradict these witnesses was the suggestion that ***Franklin***'s ratepayers benefitted from the money made on the sale of the property; therefore, they **[*23]** were not being charged twice.

We conclude that the Commission's refusal to allow ***United Cities*** to capitalize costs that had been expensed in order to increase the book value of the ***Franklin gas*** system is supported in the record as a whole by substantial and material evidence, and we therefore affirm that part of the Commission's order.

Despite all the controversy in the record and the briefs about the way the three appraisers estimated the original costs, the three estimates are quite close. Mr. Crenshaw did the best he could using contract costs for installing the various components of the system where such cost records were available. He relied on someone else, whom he did not identify in the record, to supply -- he estimates where no contracts were available. Wilson, Work made its own determination of the original cost using old records where available and estimates where there were no records. Fleming-Tegarden simply accepted Mr. Crenshaw's estimate as "fall-[ing] within the range of reasonableness".

From all of the foregoing, it appears to us that the furious dispute between ***United Cities*** and the Commission over the original cost of the system is much ado about nothing. Fleming-Tegarden **[*24]** accepted Mr. Crenshaw's estimate as within the range of reasonableness, and Wilson, Work's accountant testified: "My numbers came out basically the same [as Mr. Crenshaw's]". He added, "[T]hose particular ***assets*** in the initial years, my estimates were virtually identical to that as recorded on the company's books. Where the difference lies between my estimate is the remaining period." The real dispute, then, lies in determining what to do with that estimate to arrive at the ***gas*** system's book value at the time of the ***United Cities*** purchase in 1983.

Mr. Crenshaw started doing the auditing work for the ***city*** of ***Franklin*** in 1972 or 1973. At that time he recomputed the depreciation based on a twenty-five year life for everything except machinery and equipment. The reason for the change in the way the depreciation was computed is not explained in the record. The Fleming-Tegarden report had this to say about the change:

At the same time the accounting firm recomputed the accrued depreciation based on a twenty-five (25) year life for everything except machinery and equipment, which was assigned a ten (10) year life. We will have more to say about the cost and the depreciation later **[*25]** in this report.

The point here is that cost and depreciation rates were changed and these changes can have an effect on value. It is important that the appraiser keep in mind the purposes of the appraisal. ***HN24*** A particular cost and/or depreciation figure might be suitable for one purpose but be unsuitable for another purpose.

In addition the Fleming-Tegarden report reflects a different approach to the question of depreciation. The report says:

As stated earlier, it was necessary for the appraisers to restructure the depreciation written off by the ***FRANKLIN*** NATURAL ***GAS*** SYSTEM. Our analysis, an investigation of the records of the system, revealed that in 1973 the depreciation rates for all property, except machinery and equipment, was changed to re-

flect a twenty-five (25) year life. The depreciation rate of four percent (4 %) was applied to all property retroactively. The appraisers investigated this practice as it pertains to regulated companies and found that this has been done in some instances, and in other instances the prior depreciation was not changed. The new depreciation rate would only be applied to future plants investments. It is the appraisers' opinion that the latter **[*26]** is the proper procedure for changing and adjusting depreciation rates.

A check with regulatory officials revealed that natural ***gas*** systems were generally permitted to adjust their depreciation rates from 1970 on. In accordance with this practice, that reflects the industry's concern over the limited supply of ***gas*** in the seventies (70's), we have adjusted the depreciation rate from 1970 back to the date of construction in 1956. The rate of two and one half percent (2.5 %) was prevalent in the industry prior to 1970 and is a reasonable rate during that period of time. The rate of four percent (4 %) has been applied to all property placed in service during and after 1970.

So far as the record shows the treatment of depreciation is the only real difference in the two reports. Applying the Fleming-Tegarden depreciation of 2.5 % for the years prior to 1970, the value of the system would be approximately $ 1,200,000 rather than the $ 700,000 figure arrived at by Mr. Crenshaw.

The Commission did not make any findings concerning the proper rate of depreciation prior to 1970. As we have noted the record does not explain why Mr. Crenshaw recomputed the depreciation at that time. It may **[*27]** have been an arbitrary decision on his part or on the part of the State auditors who were helping municipalities in upgrading their accounting procedures in order to qualify for federal revenue sharing.

In any event, we do not think the Commission's order complies with the mandate of *T.C.A. § 4-5-314(c)* and *(d)*. We, therefore, remand the cause to the Commission for the inclusion in its order of the findings and conclusions that support the rate of depreciation that should be applied to the original cost of the ***Franklin gas*** system.

The cause is remanded for further proceedings in accordance with this opinion. Tax the costs on appeal equally to the parties.

ORDER ON PETITION TO REHEAR

The Public Service Commission has filed a petition to rehear in accordance with Tenn.R.App.P. 39. We are of the opinion that the petition should be overruled. It is so *Ordered.*

CONCUR:

HENRY F. TODD, P.J., M.S

SAMUEL L. LEWIS, JUDGE

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of the Joint Application of UtiliCorp United Inc. and St. Joseph Light & Power Company for Authority to Merge St. Joseph Light & Power Company with and into UtiliCorp United Inc., and, in Connection Therewith, Certain Other Related Transactions.	)))))))	**Case No. EM-2000-292**

SECOND REPORT AND ORDER

Issue Date: February 26, 2004

Effective Date: March 7, 2004

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of the Joint Application of UtiliCorp United Inc. and St. Joseph Light & Power Company for Authority to Merge St. Joseph Light & Power Company with and into UtiliCorp United Inc., and, in Connection Therewith, Certain Other Related Transactions.	)))))))	**Case No. EM-2000-292**

REGULATORY LAW JUDGE: Morris L. Woodruff

SECOND REPORT AND ORDER

PROCEDURAL HISTORY

On October 19, 1999, UtiliCorp United Inc. (UtiliCorp)[1] and St. Joseph Light & Power Company (SJLP) filed a Joint Application seeking authority to merge SJLP with and into UtiliCorp. Following an evidentiary hearing that began July 10 and continued through July 14, 2000, the Commission issued a Report and Order on December 14, 2000. In that Report and Order, the Commission authorized the merger of SJLP and UtiliCorp to proceed as proposed by the applicants. The Commission, however, rejected a Regulatory Plan proposed by UtiliCorp that would have predetermined various matters regarding how the costs of the merger would be treated by the Commission in future UtiliCorp rate cases.

The Commission's Report and Order went into effect on December 27, 2000. Two intervenors, the City of Springfield and AG Processing, filed applications for rehearing on

[1] Since the Commission issued its first Report and Order, UtiliCorp has changed its name to Aquila, Inc. To avoid confusion, the Commission will continue to refer to the co-applicant as UtiliCorp in this Second Report and Order.

December 22, 2000. Both applications for rehearing were denied on January 9, 2001. AG Processing appealed from the decision of the Commission. The Circuit Court of Cole County affirmed the decision of the Commission, but on October 28, 2003, the Supreme Court of Missouri handed down a decision that reversed the judgment of the Circuit Court and directed that the case be remanded to the Commission to "consider and decide the issue of recoupment of the acquisition premium in conjunction with the other issues raised by PSC staff and the intervenors in making its determination of whether the merger is detrimental to the public."[2] The Circuit Court of Cole County issued an order and mandate remanding the case to the Commission on January 7, 2004.

On February 25, 2004, Aquila, Inc. f/k/a UtiliCorp filed a statement of position in which it stated that it will not seek to recoup or recover through rates the acquisition premium or the merger savings or synergies in connection with the merger transaction in its pending rate cases or in any future rate cases before the Commission.

FINDINGS OF FACT

The Commission adopts all the Findings of Fact from its initial Report and Order, except as modified in this Second Report and Order.

When UtiliCorp's shareholders agreed to acquire SJLP's stock, its offer created an acquisition premium of an estimated $92 million. UtiliCorp has never asked the Commission to allow it to directly recover the entire $92 million acquisition premium. Instead, UtiliCorp's proposed regulatory plan asked that the Commission find, in this case, that UtiliCorp should be allowed to include in the rate bases of the SJLP division's retail electric, gas and steam operations in a future rate case, up to fifty percent of the

[2] State ex rel. AG Processing Inc. v. PSC, 120 S.W.3d 732,737 (Mo banc 2003).

unamortized balance of the acquisition premium paid by UtiliCorp for SJLP. UtiliCorp proposed that this recovery would be contingent upon UtiliCorp proving to the Commission in a future rate case that merger synergies are equal to fifty percent of the premium costs and other costs to achieve the synergies. In other words, UtiliCorp asked that it be allowed to recover from SJLP's ratepayers, through its rates, the acquisition premium it paid to purchase SJLP, to the extent that the ratepayers would benefit from the savings arising from the merger.

For regulatory purposes, an acquisition adjustment is simply the difference between the consideration that the purchaser pays for the assets and the net book value of those assets.[3] As a general rule, only the original cost of utility plant to the first owner devoting the property to public service, adjusted for depreciation, should be included in the utility's rate base. That principle is known as the net original cost rule.

The net original cost rule was developed in order to protect ratepayers from having to pay higher rates simply because ownership of utility plant has changed, without any actual change in the usefulness of the plant. If a utility were allowed to revalue its assets each time they changed hands, it could artificially inflate its rate base by selling and repurchasing assets at a higher cost, while recovering those costs from its ratepayers.[4] Thus, ratepayers would be required to pay for the same utility plant over and over again. The sale of assets to artificially inflate rate base was an abuse that was prevalent in the 1920s and 1930s and such abuses could still occur.[5]

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[3] McKinney Direct, Page 15, Lines 6-8.
[4] Hyneman Rebuttal, Page 43.
[5] Featherstone Rebuttal, Page 32.

An acquisition adjustment can be either positive or negative. In other words, when a utility purchases an asset, it may pay more or less than the net original cost of the asset. When the utility pays more than net original cost, it is said to have paid an acquisition premium. But, in some circumstances, a utility may be able to purchase assets at less than net original cost. In that situation, the utility has a negative acquisition adjustment.

Missouri has traditionally applied the net original cost standard when considering the ratemaking treatment of acquisition adjustments. That means that the purchasing utility has not been allowed to recover an acquisition premium from its ratepayers. But it also means that ratepayers do not receive lower rates through a decreased rate base when the utility receives a negative acquisition adjustment. Even if a company acquires an asset at a bargain price, it is allowed to put the asset into its rate base at its net original cost. Similarly, ratepayers do not share in the gains a utility may realize from selling assets at prices above their net original cost. Those gains flow only to the utility's shareholders.

CONCLUSIONS OF LAW

The Commission adopts all the Conclusions of Law from its initial Report and Order, except as modified in this Second Report and Order.

DECISION

In its decision remanding this case to the Commission, the Missouri Supreme Court found that the Commission's original Report and Order was lawful, but not reasonable, because it did not decide whether the acquisition premium was reasonable and whether the inclusion of the acquisition premium in the Commission's cost analysis of the merger would make the merger detrimental to the public. The Supreme Court held that "the PSC erred when determining whether to approve the merger because it failed to consider and

decide all the necessary and essential issues, primarily the issue of UtiliCorp's being allowed to recoup the acquisition premium."[6] The purpose of this report and order on remand is thus to determine whether UtiliCorp should be allowed to recoup the acquisition premium and whether its ability, or inability, to recoup the premium will have any effect on the Commission's determination that the merger is not detrimental to the public interest.

This Commission has consistently applied the net original cost standard when placing a value on assets for purposes of establishing a utility's rates. No party has cited a single instance in which the Commission has allowed a utility to directly recover an acquisition premium through its rates. In support of its request for recovery of the acquisition premium, UtiliCorp cites two Commission cases for the proposition that this Commission is not unalterably opposed to a utility's recovery of an acquisition premium. In both cited cases, In re Missouri-American Water Company[7] and In re Kansas Power and Light Company,[8] the Commission did make statements suggesting that it was not unalterably opposed to the recovery of an acquisition premium in an appropriate case. However, in both cases, the Commission refused to allow the requesting utility to recover the premium in question.

UtiliCorp also cites two Commission cases in which it argues that the Commission has allowed for the indirect recovery of acquisition premium. UtiliCorp indicates that in the case in which the Commission approved Union Electric Company's merger with Central Illinois Public Service Company,[9] it allowed for the recovery of the acquisition premium through operation of an earnings-sharing grid. UtiliCorp also points out that in the case in

[6] State ex rel. AG Processing v. PSC, 120 S.W.3d 732, 736 (Mo banc 2003).
[7] 4 Mo P.S.C. 3d 205 (1995).
[8] 1 Mo P.S.C. 3d 150 (1991).
[9] In re the Application of Union Electric Company, 6 Mo. P.S.C. 3d 28 (1997).

which the Commission approved Kansas City Power & Light Company's plan to merge with Western Resources, Inc.,[10] it approved a rate freeze that would allow enough time for the company to recover the acquisition premium through the operation of regulatory lag. While what UtiliCorp says about those two cases is correct, it is important to note that both cases were resolved through unanimous stipulations and agreement that were approved by the Commission. In neither case did the Commission purport to establish any policy that would apply to UtiliCorp's request to recover its acquisition premium in this case.

UtiliCorp also cites State ex rel. Martigney Creek Sewer Company v. PSC,[11] for the proposition that Missouri case law supports the idea that in some circumstances, a utility should be allowed to recover an acquisition premium in its rates. The Supreme Court's opinion in the Martigney Creek case included a quotation from Priest, Principles of Public Utility Regulation, which acknowledges that the majority of regulatory agencies do not allow for the recovery of an acquisition premium but suggests that there is "much respectable authority to the contrary."[12] However, a reading of the Martigney Creek case indicates that the quotation from Priest is purely dicta. The Martigney Creek case did not even involve a merger or an acquisition premium. Instead, it concerned the Commission's disallowance of depreciation on company property that had been contributed in aid of construction. The Supreme Court indicates in its opinion that it included the Priest quotation merely to rebut a suggestion in oral argument that the purchase price of property automatically established its rate base. The quotation from the Martigney Creek case, while probably a fair overall

[10] In re the Joint Application of Western Resources, Inc., and Kansas City Power & Light Company, 8 Mo. P.S.C. 3d 306 (1999).
[11] 537 S.W.2d 388 (Mo. banc 1976).
[12] Id. at 399.

statement of the law, does not indicate that the Missouri Supreme Court has expressed any support for the recovery of acquisition premium from ratepayers.

For many years, the Commission has used a net original cost standard to place a value on utility plant after a merger. That standard has proven to be fair to utilities as well as to ratepayers. There is no reason to vary from that standard in this case. The Commission concludes that UtiliCorp should not be allowed to recover any of the acquisition premium in its rates.

The Supreme Court's decision remanding this case to the Commission also states that the Commission should determine whether the acquisition premium was "reasonable." All evidence before the Commission indicates that UtiliCorp's acquisition of SJLP was an arms-length transaction between a competent and informed buyer and seller. There is no evidence in the record by which the Commission could determine that the price UtiliCorp chose to pay to acquire SJLP was not reasonable. Much of UtiliCorp's interest in acquiring SJLP may have been based on unregulated properties and businesses over which the Commission has no authority. Indeed, since today's decision makes it clear that it is the responsibility of UtiliCorp's shareholders to pay any acquisition premium, there is no need for the Commission to determine whether the price that UtiliCorp chose to pay for SJLP is reasonable.

With the Commission having decided that UtiliCorp will not be allowed to recover any acquisition premium from its ratepayers, the existence of an acquisition premium cannot alter the Commission's evaluation of whether the merger would be detrimental to the public. Therefore, the Commission will reaffirm its determination from its initial Report

and Order that the merger between UtiliCorp and SJLP is in the public interest because it is not detrimental to the public.

IT IS THEREFORE ORDERED:

1. That the Commission adopts the Ordered Paragraphs from its initial Report and Order except as modified in this Second Report and Order.

2. That UtiliCorp United Inc. shall not be allowed to recover from its ratepayers the acquisition premium arising from the transaction that is approved in this Report and Order.

3. That this Report and Order shall become effective on March 7, 2004.

BY THE COMMISSION

Dale Hardy Roberts
Secretary/Chief Regulatory Law Judge

(S E A L)

Gaw, Ch., Murray and Clayton, CC.,
concur and certify compliance with the
provision of Section 536.080, RSMo 2000.

Dated at Jefferson City, Missouri,
on the 26th day of February, 2004.

2007 Mont. PUC LEXIS 54; 259 P.U.R.4th 493

Montana Public Service Commission
July 31, 2007, Done and Dated
DOCKET NO. D2006.6.82; ORDER NO. 6754e

Reporter: 2007 Mont. PUC LEXIS 54; 259 P.U.R.4th 493

IN THE MATTER OF the Joint Application of NorthWestern Corporation and Babcock & Brown Infrastructure Limited, BBI US Holdings Pty Ltd., BBI US Holdings II Corp., and BBI Glacier Corp. for Approval of the Sale and Transfer of NorthWestern Corporation Pursuant to a Merger Agreement

Core Terms

acquisition, customers, merger, premium, dividends, transmission, public utility, ownership, payouts, recommended, electric, energy, capital structure, capital expenditures, adequate service, wind, subsidiary, consolidated, financing, cash flow, ratepayers, issuance, rate base, long-term, proposed transaction, reasonable rate, infrastructure, renewable, discount, goodwill

Counsel

[*1] APPEARANCES: FOR THE APPLICANTS: NorthWestern Corp., John Alke, 40 W. Lawrence, Suite A, Helena, Montana 59601; Babcock & Brown Infrastructure Ltd., Patrick Fleming, 480 E. Park St., Suite 100, Butte MT 59703; FOR THE INTERVENORS: Montana Consumer Counsel, Robert A. Nelson, Montana Consumer Counsel, 616 Helena Avenue, Room 300, P.O. Box 201703, Helena, Montana 59620-1703; John P. Coyle, 1575 I St. NW, Suite 300, Washington, DC 20005-1175; Human Resource Council-District XI/Renewable Northwest Project/Natural Resources Defense Council, Charles E. Magraw, 501 8th Avenue, Helena, Montana 59601; AARP Montana, Stephen C. Bullock, 30 W. 14<th> St., Suite 204, Helena MT 59624; Large Customer Group, Donald Quander, 401 N. 31<st> St., Suite 1500, Billings MT 59101; Heartland Consumers Power District/South Dakota Public Power, Inc., Harley Harris, PO Box 1144, Helena MT 59624; Jenny Kaleczyc, PO Box 1144, Helena MT 59624; Colstrip Energy Limited Partnership/Yellowstone Energy Limited Partnership/International Brotherhood of Electrical Workers Local # 44, Michael Uda, 44 W. 6<th> Ave., Suite 200, HelenaMT 59624-1185; Ammondson, et al., Retirees/Plaintiffs, Cliff Edwards, 1601 Lewis Ave., Suite [*2] 206, Billings MT 59104; Triel Culver, 1601 Lewis Ave., Suite 206, Billings MT 59104; Commission Staff: Al Brogan, Staff Attorney, Kate Whitney, Utility, Division, Eric Eck, Utility Division, Dave Burchett, Utility Division

Panel: Before: Greg Jergeson, Chairman; Doug Mood, Vice Chairman; Brad Molnar, Commissioner; Robert H. Raney, Commissioner; Ken Toole, Commissioner

Opinion

FINAL ORDER

INTRODUCTION

In this Order the Montana Public Service Commission denies the joint application submitted by NorthWestern Corporation and Babcock & Brown Infrastructure, Ltd., et al. for approval of the sale and transfer of NorthWestern pursuant to a merger agreement.

PROCEDURAL BACKGROUND

1. On June 7, 2006, NorthWestern Corporation d/b/a NorthWestern Energy (NorthWestern or NWE) and Babcock & Brown Infrastructure, Ltd. (BBIL), BBI US Holdings Pty. Ltd., BBI US Holdings II Corp.,, and BBI Glacier Corp. filed a joint application with the Montana Public Service Commission (PSC or Commission) asking that the PSC authorize BBIL's acquisition of NorthWestern under an Agreement and Plan of Merger.

2. A *Notice of Application and Intervention Deadline* was issued by the Commission on June 23, 2006. **[*3]** The Commission subsequently granted intervention to: Montana Consumer Counsel (MCC); AARP Montana (AARP); Colstrip Energy Limited Partnership and Yellowstone Energy Limited Partnership (CELP/YELP); Human Resource Council District XI/Natural Resources Defense Council/Renewable Northwest Project (District XI/NRDC/RNP); International Brotherhood of Electrical Workers Local # 44 (IBEW Local # 44); Montana Large Customer Group (LCG); Heartland Consumers Power District and South Dakota Public Power Inc. (Heartland/SDPPI); and the Ammondson, et al. Plaintiffs/Retirees (Ammondson Plaintiffs).

3. On July 20, 2006, the Commission issued a procedural order establishing a schedule for consideration of the application and setting a tentative public hearing date of March 14, 2007, depending on whether any additional issues were identified by PSC staff after receipt of intervenor prefiled testimony. The deadlines in the procedural schedule were suspended by *Notice of Staff Action* issued September 12, 2006, due to pending protective order issues. The procedural schedule was reinstated and amended by *Notice of Staff Action Amending Procedural Schedule* issued October 31, 2006, with the tentative **[*4]** hearing date still scheduled for March 14, 2007. No additional issues were identified by staff.

4. On February 22, 2007, the Commission issued its *Notice of Public Hearing* for the March 14, 2007 hearing. The hearing was held at the PSC offices in Helena from March 14 through March 16, 2007.

5. In addition, 15 public meetings were held by commissioners between February 8 and March 12, 2007, to obtain public comments on the sale proposal in the following towns in NorthWestern Energy's service area: Glasgow, Havre, Lewistown, Great Falls, Hamilton, Missoula, Billings, Bozeman, Butte, Kalispell, Choteau, Conrad, Browning, Cut Bank, and Helena.

6. The Joint Applicants (NorthWestern/BBIL), MCC, District XI/NRDC/RNP, AARP, Heartland/SDPPI, CELP/YELP, and the Ammondson Plaintiffs submitted post-hearing briefs in this docket.

7. At a work session on May 22, 2007, the Commission unanimously voted to direct staff to draft and bring back to the Commission an order discussing all of the issues raised in this docket and denying the joint application.

8. On June 25, 2007, the Joint Applicants submitted a *Joint Petition For Rehearing and To Reopen the Record.* MCC, CELP/YELP, District XI/NRDC/RNP, **[*5]** AARP, IBEW Local # 44, Heartland/SDPPI, and the Ammondson Plaintiffs filed responses to the petition.

9. At a work session on July 24, 2007, the Commission voted unanimously not to reopen the record.

PRELIMINARY LEGAL ISSUES

COMMISSION AUTHORITY

Parties' Arguments

10. On April 25, 2006, NorthWestern announced that it had reached a definitive agreement with BBIL under which BBIL would acquire NorthWestern. On June 16, 2006, NorthWestern and BBIL invoked the Commission's jurisdiction and asked the Commission to issue an order consenting to BBIL's acquisition of the common stock of NorthWestern and the assumption of its debt and modifying Order No. 6505e in Docket D2003.8.109 *(Consent Order).* During the subsequent 11 months, NorthWestern and BBIL fully participated in proceedings before the Commission. However, in their Opening Brief, NorthWestern and BBIL challenged the Commission's authority to reject the sale.

11. NorthWestern and BBIL asserted, "The sole issue for decision is what conditions may be appropriately imposed by the Commission upon the sale." Opening Br. at 2. NorthWestern and BBIL argued, "Any objective analysis of the Commission's authority to address **[*6]** mergers and acquisitions will demonstrate that the Commission's authority, at most, is limited to the imposition of conditions to ensure adequate service at just and reasonable rates." Opening Br. at 5. NorthWestern and BBIL based their argument for the Commission's authority on (1) the refusal of the legislature to enact an explicit statute granting authority to control entry into the utility business or to control utility ownership, Opening Br. at 6-7; and (2) a sentence in Order No. 2027 in Docket No. 3647 that "This Commission does not have authority over transfers and sales of utilities." Re East Side Telephone Company, 77 PUR NS 87, 91 (Mont. Bd. of R.R. Comm'rs 1948). NorthWestern and BBIL concluded, "the Commission does not have the authority to say no; nor the authority to say it wants a different buyer; nor the authority to adopt a net benefit standard." Opening Br. at 7.

12. The intervenors that addressed the issue of the Commission's authority vigorously disputed NorthWestern and BBIL's arguments and asserted that the Commission has the authority to approve, disapprove, or condition the sale and transfer.

13. AARP stated, "In point of fact, **[*7]** the very authority relied upon by the Applicants for the proposition that the Commission has limited authority underscores that the Commission has a critical role to play. This role includes looking to the character and adequacy of service, the facilities providing that service, and whether the public interest is served." AARP Resp. Br. at 2 (citing *Great Northern Utils. v. Public Serv. Comm'n, 88 Mont. 180, 204-206, 211, 293 p. 294 (1930)).* AARP also pointed out that in Docket D2001.1.5, "the Commission denied an application submitted by NorthWestern and Montana Power Company on the grounds that it was inadequate, rejecting the argument that the [a]pplication is limited to a determination [by the Commission] that "Montana Power's Utility operations, as a division or subsidiary of NorthWestern, will continue to be a fit, willing and able provider of adequate service and facilities at just and reasonable rates." AARP Resp. Br. at 3 (alterations in original, internal quotation marks omitted). AARP concluded, "Accordingly, the Commission and the Court have in the past held that Commission's authority is not as limited as applicants would **[*8]** like to suggest." AARP Resp. Br. at 4.

14. CELP/YELP stated, "It is hard to believe that the MPSC has the authority only to approve but not reject the proposed transaction. . . . The authority to approve the transaction logically presupposes that the MPSC has the authority to reject the transaction through conditions or outright denial after reviewing the record." CELP/YELP Resp. Br. at 3.

15. Heartland/SDPPI focused their brief on "the power of the Commission under Montana law to review the proposed merger and, on the basis of that review, to either withhold approval or impose conditions on any approval that are necessary to protect the public interest." Heartland/SDPPI Resp. Br. at 3. First, Heartland/SDP asserted that NorthWestern and BBIL base their argument on a strawman, the lack of certificates of authority for public utilities. Heartland/SDPPI Resp. Br. at 4. They stated, "What is at issue here is not whether B&B must acquire a certificate prior to commencing operation as a public utility, but rather what obligations and duties attach once it assumes that status." Heartland/SDPPI Resp. Br. at 4. Second, Heartland/SDP argued that NorthWestern and BBIL "misstate the facts when **[*9]** they state that 'the Commission recognized long ago that it actually lacks authority over transfers and sale of utilities.'" Heartland/SDPPI Resp. Br. at 4. Heartland/SDPPI contended that the actual holding in the *East Side* case supports the Commission's authority:

> The actual holding of *Eastside* [sic] was that the Commission ***did*** have authority over the abandonment of service by a public utility. That authority alone is more than sufficient to cover the situation at issue here where, in substance, one set of owners of NWEC seek to "abandon" that ownership in favor of another set of owners.

Heartland/SDPPI Resp. Br. at 4, n.4. Heartland/SDP pointed out that the Commission has asserted authority over change of control transactions for a considerable period. Heartland/SDP argued that NorthWestern and BBIL are precluded from challenging the Commission's authority because (1) NorthWestern did not challenge the Commission's conclusion of law that it possessed authority over transfers of utility assets in Docket D2001.1.5 and (2) "a person who invokes the jurisdiction of an administrative agency is subsequently estopped from challenging the same." Heartland/SDPPI Resp. **[*10]** Br. at 6-10. Heartland/SDPPI also asserted that the Commission's authority extends to those actions necessary to effect its express grant of authority and if the Commission determines that either conditioning or outright disapproval is required to protect the public utility function, the action is within the express grant of authority. Heartland/SDP Resp. Br. at 10-16.

16. District XI/NRDC/RNP encouraged "the Commission not to be swayed by what are, basically, gratuitous comments by the joint applicants about the extent of Commission authority." District XI/NRDC/RNP Resp. Br. at 3. They stated, "At a minimum, however, there is something perverse, having submitted to the jurisdiction of the Commission, for NWE and BBI to cast a cloud over the Commission's authority and suggest that if a positive result (from their perspective) is not forthcoming they are not without legal recourse." District XI/NRDC/RNP Resp. Br. at 3.

17. MCC argued, "The Commission has ample authority to condition approval of the proposed acquisition and deny outright authorization to proceed with it . . . ." MCC Resp. Br. at 6. MCC asserted that the Commission authority to ensure a utility's compliance with its **[*11]** public service obligations has been recognized since at least 1927, citing *Gallatin Natural Gas Co. v. Public Serv. Comm'n, 79 Mont 269, 289-90, 256 P. 373, 378-79 (1927).* MCC Resp. Br. at 6. According to MCC, the Commission's authority to regulate mergers and acquisitions is predicated "both on its duty to enforce the public service obligations of utilities under MCA § 69-3-201, and on its 'full power of supervision, regulation, and control of such public utilities' (MCA § 69-3-102)."MCC Resp. Br. at 6.

18. NorthWestern and BBIL, in their Reply Brief, disputed the intervenors' assertions as to the scope of the Commission's authority. They stated, "Contrary to the assertions of the various Intervenors, the Commission did not receive a broad delegation of unspecified authority under the gen-

eral language of *Mont. Code Ann. § 69-3-102*. The reference in that section to the Commission's power of 'supervision, regulation, and control' is expressly limited to the actual provisions of Chapter 3 of Title 69." North Western and **[*12]** BBIL cite *Montana Power Co. v. Public Serv. Comm'n, 206 Mont. 359, 376, 671 P.2d 604 (1983),* for this proposition.

Discussion and Analysis

19. The Commission has consistently exercised authority over mergers, sales, and transfers of utilities and utility property for many years. *See* Docket No. D2001.1.5, Order Nos. 6353 and 6353c (Montana Power Co. to NorthWestern Corp.); Docket No. D98.10.218, Order No. 6103a (PacifiCorp to Flathead Electric Cooperative, Inc.); Docket No. D97.10.191, Order No. 6043b (MCI Communications Corp. to WorldCom, Inc.); Docket No. 97.10.187, Order No. 6025 (Montana -Dakota Utilities Co. to Miller Oil Co.); Docket No. 97.8.140, Order No. 6027 (Lone Mountain Springs Inc. to Big Sky Water and Sewer District No. 363); Docket No. D96.10.169, Order No. 5953 (Communications Network Corp. to WorldCom Network Services, Inc.); Docket No. 93.7.30, Order No. 5731 c (GTE Northwest Inc. to Citizens Telecommunications Co. of Montana); Docket No. 93.5.23, Order No. 5712a (US West Communications, Inc. sale of exchanges); Docket No. 92.11.74, Order No. 5688 (KN Energy, Inc. to Montana-Dakota Utilities Co.); Docket No. **[*13]** 92.1.3, Order No. 5616 (Consumers Gas Co. to Town of Sunburst); Docket No. 91.3.4, Order No. 5553 (Midvale Water Service to Victor and Betty Peltier); Docket No. 90.12.93, Order No. 5536c (Butte Water Co. to Silver Bow Water, Inc./MERDI); Docket No. 90.10.64, Order No. 5517 (Redgate Water Co. to Mike and Jackie Pitzen); Docket No. 90.4.26, Order No. 5487 (Granrud Water Co. to Dennis Granrud); Docket No. 87.9.49, Order No. 5298a (Merger of Pacific Power and Light Co. and Utah Power and Light Co.); Docket No. 86.8.55, Order No. 5237 (Pacific Power and Light Co. to Bigfork County Water and Sewer District); Docket No. 86.3.9, Order No. 5205 (Pacific Power and Light Co. to City of Libby); Docket No. 85.5.20, Order No. 5148 (Somers Water Co. to Somers Water District); Docket No. 84.4.12, Order No. 5084a (Burlington Northern Railroad Co.'s water utility to Sanders County Water District); and Docket No. D82.10.71, Order No. 4472 (Little Chicago Water Co. to Black Eagle Cascade County Water District).

20. NorthWestern and BBIL correctly quote Re East Side Telephone Company, 77 PUR NS 87, 91 (Mont. Bd. of R.R. Comm'rs 1948), but ascribe more authority to the statement **[*14]** than it is entitled. The issues in *East Side* were ownership of the company and whether the Commission should order that abandoned service be continued. 77 PUR NS at 89. No issue arose as to the transfer or sale of the utility or utility assets. The statement that "This Commission does not have authority over transfers and sales of utilities" is not necessary to the determination of the issues in *East Side,* and therefore, is dicta. The Commission is not required to give precedential value to dicta. *C.f. Nehring v. LaCounte, 219 Mont. 462, 471, 712 P.2d 1329, 1335 (1986)* (Court not required to give precedential value to dicta.) The statement in *East Side* is at odds with the more recent, but longstanding, practice of the Commission. To the extent that *East Side* stands for the proposition that the Commission lacks jurisdiction over transfers and sales of public utilities, we expressly overrule it.

21. In Montana, administrative agencies have both express authority and implied authority necessary to discharge their express duties and authority.

22. The Commission's duty is to supervise and regulate **[*15]** the operations of public utilities in conformity with *Title 69, MCA*. *§ 69-1-102, MCA*. The Commission is invested with the full power of supervision, regulation, and control of public utilities. *§ 69-3-102, MCA*. In addition to normally implied powers, the Commission is expressly granted the power to do all things necessary and convenient in the exercise of the powers conferred by Title 69, Chapter 3, excluding ju-

dicial powers. *§ 69-3-103(1), MCA*. *Sections 69-1-102*, *69-3-102* and *69-3-103(1), MCA*, are substantially unchanged from their original form enacted in 1913 and manifest the legislature's recognition that given the complexity of the task assigned to the Commission, it was impossible to enumerate every specific power necessary for effective regulation. The legislature has granted the Commission the general powers necessary to perform the task assigned to it.

23. The Commission's authority over sale **[*16]** and transfers of assets or utilities can be inferred from the unique status of public utilities. Public utilities have an obligation to furnish reasonably adequate service and facilities while charging just and reasonable rates. *§ 69-3-201, MCA*. Because of their obligation to serve, public utilities have a special status in the law as entities affected with a public interest. The Court affirmed this special status in *Great Northern Utils. Co. v. Public Serv. Comm'n, 88 Mont. 180, 205, 293 P. 294, 298 (1930),* quoting Lord Chief Justice Hale: "When 'one devotes his property to a use in which the public has an interest, he in effect grants to the public an interest in that use, and must submit to be controlled by the pubic for the common good to the extent of the interest he has thus created'[.]"The Court also cited from *Munn v. Illinois, 94 U. S. 113 (1876),* "Property becomes clothed with a public interest when used in a manner to make it of public consequence and affect the community at large."*Id.* Logically, a regulated entity that (1) has a duty to provide service, **[*17]** (2) has granted the public an interest in the use of that property, and (3) is affected with a public interest may not sell assets or transfer control of them without the approval of the Commission.

24. The Commission's authority over transfers and sales may be implied from the Commission's authority over complaints. Sections 69-3-321(1)(b) and (c), 324, and 330(3), 501 and 504(1), MCA read as follows:

> **69-3-321. Complaints against public utility - hearing.** (1) The commission shall proceed, with or without notice, to make such investigation as it may deem necessary upon a complaint made against any public utility by any mercantile, agricultural, or manufacturing society or club; by any body politic or municipal organization or association, the same being interested; or by any person, firm, or corporation, provided such person, firm, or corporation is directly affected thereby, that:
>
> (a) . . .
>
> (b) any regulations, measurements, practices, or acts whatsoever affecting or relating to the production, transmission, delivery, or furnishing of heat, light, water, power, or regulated telecommunications service, or any service in connection therewith is in any respect unreasonable, **[*18]** insufficient, or unjustly discriminatory; or
>
> (c) any service is inadequate.
>
> (2) . . . .
>
> **69-3-324. Initiation of action by commission itself.** The commission may at any time, upon its own motion, investigate any of the rates, tolls, charges, rules, practices, and services and after a full hearing as provided in this part may make by order such changes as may be just and reasonable, the same as if a formal complaint had been made.
>
> **69-3-330. Decision by commission.**
>
> (1) . . .
> (2) . . .
> (3) If the commission finds that any regulation, measurement, practice, act, or service complained of is unjust, unreasonable, insufficient, preferential, unjustly discriminatory, or otherwise in violation of the provisions of this chapter or that service is inadequate

or any reasonable service cannot be obtained, the commission may substitute therefore other regulations, measurements, practices, services, or acts and make such order relating thereto as is just and reasonable.
(4) . . . .

These sections give the Commission jurisdiction to receive a complaint, or to initiate a complaint on its own motion, about the acts or practices of public utilities that affect utility service. *Section 69-3-330(3), MCA* **[*19]** , specifically gives the Commission authority to respond to such complaints by "substitute[ing] . . .other . . .practices . . . or acts and mak[ing] such order relating thereto as is just and reasonable." The sale and transfer of a utility or of utility assets is obviously an act or practice of a utility company. Therefore, the Commission's jurisdiction to investigate, hold a hearing on, and respond to such action by public utilities is necessarily implied from these statutes.

25. The Commission's authority over transfers and sales may also be implied from the Commission's authority over the issuance of securities. Sections 69-3-501(2) and 504(1), MCA, read as follows:

69-3-501. Regulation of issuance of securities and creation of liens by utilities.
(1) . . .
(2) The public utility, when authorized by order of the commission and not otherwise, may issue stocks and stock certificates and may issue, assume, or guarantee other securities payable at periods of more that 12 months thereafter for the following purposes"

(a) the acquisition of property;

(b) the construction, completion, extension, or improvement of its facilities;

(c) the improvement or maintenance of its service; **[*20]**

(d) the discharge or lawful refunding of its obligations;

(e) the reimbursement of money actually expended for said purposes from income or from other money; or

(f) any other purpose approved by the commission.

69-3-504. Decision on petition. After such hearing and upon such notice as the commission may prescribe, the commission shall enter its written order approving the petition and authorizing the proposed securities transaction unless the commission shall find that:
(1) such transactions are inconsistent with the public interest;
(2) . . .; or
(3) . . . .

These sections give the Commission authority to deny the issuance of stock, stock certificates, or other securities if the transaction is not in the public interest. Nearly all corporate mergers, including the proposed transaction, require the issuance of new stock or stock certificates. Therefore, the Commission's authority to deny a transaction may be implied from its authority to deny the issuance of stock.

26. The Montana Supreme Court has affirmed the general powers of the Commission and has recognized the jurisdiction of the Commission to take appropriate regulatory action under those general powers. In *State ex rel Billings v. Billings Gas Co., 55 Mont. 102, 173 P. 799 (1918),* **[*21]** the Court stated "A consideration of the statute [Laws 1913, Chapter 52, the Act creating

the Public Service Commission and defining its powers] leads to the conclusion that in its enactment the legislature intended to provide a comprehensive and uniform system of regulation and control of public utilities, by a specially created tribunal, through which the state itself exercises its sovereign power." 55 Mont. at 112. The Court later quoted this language favorably in Great Northern Utilities v. Public Serv. Comm'n, 88 Mont. at 205, 293 P. at 298.

27. In *Billings Gas Co.* the Court held that the rate approved by the Commission was the lawful rate, not the rate set by the franchise contract between the utility and the City of Billings. The Court did not base its holding on the specific language of the statutes (there was none applicable), but on its reading of legislative intent that the Commission has comprehensive control over public utilities. This holding affirmed that the Commission has general and necessarily implied powers, in addition to its explicit powers.

28. *Great Northern Utilities* **[*22]** definitively established the validity of the exercise of general power by the Commission in the furtherance of adequate service and reasonable rates. The court stated the relevant questions as follows: "Is the Commission clothed with the power to fix minimum or precise rates? If that query be answered in the negative, then our labors are ended, for the Commission is a creature of, owes its being to, and is clothed with such powers as are clearly conferred upon it by the statute." 88 Mont. at 203, 293 P. at 298. No statute expressly authorized the Commission to establish minimum or precise rates. The Court discussed the powers of the Commission at length and stated:

> Legislation affecting public utilities, in its earlier stages, had as its chief purpose the prevention of exorbitant charges being made for the product furnished. As the field covered by these utilities broadened, it became apparent that the public interest extended further than merely fixing the charges; that there was embraced as well the character of the service to be rendered, the kind of equipment employed; and that these things, **and others,** are so interdependent that **[*23]** one may not be intelligently regulated and controlled without control being exercised over the others.

88 Mont. 204-05, 293 P. at 298. The Court concluded: "We are of the opinion, therefore, that it was the intention of the legislature to clothe the Commission with the power to fix the precise rate to be charged by the utility for its commodity." 88 Mont. at 218, 293 P. at 303. The Court affirmed the exercise of an implied or general power by the Commission in the furtherance of effective utility regulation.

29. Other cases that support the general and implied authority of the Commission include *Tobacco River Power Co. v. Public Serv. Comm'n, 109 Mont 521, 98 P.2d 886 (1940)Cascade County Consumers Ass'n v. Public Serv. Comm'n, 144 Mont. 169, 394 P.2d 856 (1964)City of Polson v. Public Serv. Comm'n, 155 Mont. 464, 473 P.2d 508 (1970)Montana Consumer Counsel v. Public Serv. Comm'n, 168 Mont. 180, 541 P. 2d 770 (1975)* **[*24]** and *City of Billings v. Public Serv. Comm'n, 193 Mont 358, 631 P.2d 1195 (1981).*

30. Contrary to NorthWestern and BBIL's assertion, *Montana Power Co. v. Public Serv. Comm'n, 206 Mont. 359, 671 P.2d 604 (1983),* did not address the scope of the Commission's implied or general powers. In *Montana Power Co.* the Commission, without notice or hearing, issued an order enjoining the company from taking any action in furtherance of a proposed corporate reorganization. The Court found that issuing an order without notice violated the company's due process rights and that enjoining an action was an exercise of judicial power that was specifically prohibited to the Commission. With respect to the Commission's authority over corporate reorganizations the Court stated:

> The last issue is whether the Commission has subject matter jurisdiction to approve or disapprove the proposed reorganization. We recognize that this question is the central issue in the proceeding taking place before the Commission pursuant to its order of March 1, 1982. We therefore conclude that it would be premature for this Court **[*25]** to attempt to rule on that issue. That issue will not be ripe for our consideration until the decision by the Commission in its own proceeding and subsequent proceedings in the District Court. We therefore do not rule on [this issue].

206 Mont. at 379, 671 P.2d at 615.

31. In addition to the express and implied authority to regulate public utilities, the Commission also has the authority to preserve the benefits of its settlement with NorthWestern and MCC in NorthWestern's bankruptcy. Although NorthWestern may petition the Commission for modification of the settlement (and its implementing order) nothing requires the Commission to consent to a modification.

32. The Commission has the legal, regulatory authority to approve, disapprove, or condition the proposed transaction between NorthWestern and BBIL.

STANDARD OF REVIEW FOR TRANSACTION

33. NorthWestern and BBIL state "the standard of review is whether NorthWestern will continue to provide adequate service and just and reasonable rates." Reply Br. at 21.

34. AARP suggests that the Commission has employed language relating to public interest and public benefit. Heartland/SDPPI imply **[*26]** that the Commission must base its decision on the criteria set out in its written precedents and the *Statement of Factors.*

35. Generally, there are three standards that regulatory commissions employ: the public interest standard, the no-harm to consumers standard, or the net-benefit to consumers standard. In prior orders, the Commission has based its authority on the duty to ensure adequate service at just and reasonable rates, but has not enunciated a specific standard. It may be impossible to enunciate a general standard that is applicable in all cases. For example, if the Commission were faced with the sale of a public utility that was not providing adequate service, it would be appropriate for the Commission to apply a net benefit standard that assured customers would receive adequate service. In another case, a utility may be providing adequate service but just rates for the potential acquirer may be higher than currently charged. In such a situation, it would be appropriate for the Commission to apply a no-harm to consumers standard.

36. For this docket, Commission applies a no-harm to consumers standard.

37. Increased risk of higher rates or inadequate service is a form **[*27]** of harm.

FINDINGS OF FACT

NORTHWESTERN CORP.'S AND BBIL'S JOINT APPLICATION

38. The application provided overviews of NorthWestern (Exh. JA-1, pp. 5-7) and BBIL (Exh. JA-1, pp. 8-10) and asserted that, after NorthWestern conducted an evaluation of its strategic alternatives and considered final bid proposals, the NorthWestern board of directors determined that a sale of the company to BBIL in accordance with the terms of the merger agreement was the best means of maximizing stockholder value and preserving NorthWestern's ability to provide utility service to its customers.

39. According to the application, although the form of the transaction is a merger, the transaction is actually a transfer from NorthWestern to BBIL of 100 percent of NorthWestern's common stock. The proposed transaction will take the form of a merger of BBI Glacier Corp. (Glacier) with and into NorthWestern with NorthWestern surviving the merger as a wholly owned indirect subsidiary of BBIL. Generally, owners of NorthWestern common stock will receive $ 37 per share of stock owned on the effective date of the merger. BBIL will assume NorthWestern's existing debt. NorthWestern will no longer be listed **[*28]** on NASDAQ but NorthWestern will still have publicly traded debt that requires the filing of financial disclosure reports with the U.S. Securities and Exchange Commission (SEC). According to the application, the only changes to NorthWestern will be the identity of its stockholders and ownership under a holding company structure.

40. The applicants stated the application was filed in accordance with the terms of the July 2004 *Stipulation and Settlement Agreement* among NorthWestern, the Montana Consumer Counsel (MCC) and the Commission associated with NorthWestern's emergence from bankruptcy, as well as the terms of the PSC's *Consent Order* in Docket D2003.8.109.

41. The applicants requested the Commission find that NorthWestern has complied with the *Consent Order* provisions and consent to BBIL's acquisition of NorthWestern under the merger agreement, or, in the alternative, determine after hearing in a contested case proceeding that NorthWestern has complied with the terms of the *Consent Order,* consent to BBIL's acquisition of NorthWestern under the merger agreement, and modify the *Consent Order* as necessary to implement the merger agreement.

42. A copy of the merger **[*29]** agreement between NorthWestern and BBIL is included with the application. Exh. JA-1, Appendix 1. The proposed agreement calls for BBIL, through the merger of Glacier into and with NorthWestern, to acquire 100 percent of the outstanding shares of NorthWestern, subject to regulatory and NorthWestern shareholder approvals, for $ 37.00 per share in an all cash transaction, which values NorthWestern at approximately $ 2.2 billion. BBIL will pay approximately $ 1.5 billion, including closing costs, and $ 736 million of existing NorthWestern debt will remain in place.

APPLICANTS' PREFILED DIRECT TESTIMONY

Prefiled direct testimony of Michael J. Hanson (NorthWestern)

43. According to Mr. Hanson, the key objective of the proposed transaction is for NorthWestern to continue to provide adequate service at stable, reasonable rates without the distraction and uncertainty of investors with short-term monetary goals. Mr. Hanson added that BBIL's capital resources will allow NorthWestern to pursue infrastructure development and other growth opportunities in Montana such as generation and transmission.

44. Mr. Hanson described NorthWestern and its utility operations in South Dakota, Nebraska **[*30]** and Montana. NorthWestern's regulated electric utility operations in Montana consist of over 7,000 miles of transmission lines and 20,300 miles of overhead and underground distribution lines to approximately 316,000 customers in 187 communities. NorthWestern also serves as the default electricity supplier for 310,000 residential and commercial customers. On the natural gas side, NWE purchases, stores, transports and distributes natural gas to Montana customers. NWE's regulated natural gas system in the state consists of a distribution system of approximately 3,700 miles of underground pipelines and a transmission system of more than 2000 miles of pipelines. NWE is the default supplier for its natural gas customers in Montana.

45. Mr. Hanson said that, since emerging from bankruptcy in November 2004, NorthWestern has accomplished much to increase its financial stability, as evidenced by quarterly increases in net income, paying debt down to below a 50 percent debt/equity ratio, strong operating cash flows and liquidity, reduced interest expense, improved credit ratings on debt, the disposition of the large majority of its non-utility assets and the resolution of many lawsuits.

46. **[*31]** According to Mr. Hanson, although NorthWestern's corporate headquarters is located in Sioux Falls, South Dakota, the majority of the utility's activities and key utility operational management operate out of Montana. He cited as examples the location in Butte of most of NorthWestern's primary administrative support personnel functions, the System Operations and Control Center, the majority of its energy supply, transmission and distribution operations personnel, and regulatory and government affairs personnel and functions. Mr. Hanson noted that two of the five members of NorthWestern's Energy Supply Board are located in Montana.

47. Mr. Hanson pointed to energy supply as the greatest challenge facing NorthWestern and claimed BBIL understands the situation and supports NorthWestern's efforts to address it. Mr. Hanson said that, with BBIL's support, NorthWestern is in a position to explore all options including the possibility of equity ownership in rate-based generation.

48. Mr. Hanson provided background and information about NorthWestern's strategic review process that resulted in the proposed transaction with BBIL. He said NorthWestern's board of directors ordered a thorough review **[*32]** of the strategic alternatives, including continuing as a stand-alone company, a financial restructuring, various merger scenarios, and sale of the company. After analyzing the alternatives and final proposals, the board determined that a sale was the best means of maximizing stockholder value and preserving NWE's ability to provide adequate service at reasonable rates. Mr. Hanson stated that all bidders for the company were advised to focus on the terms of the bankruptcy settlement agreement, the Consent Order by which the Commission approved the settlement agreement, and the provisions of the Commission's October 2004 *Statement of Factors For Evaluating Proposals To Acquire NorthWestern Energy.* Mr. Hanson said the NorthWestern board decided BBIL's offer provided the best value for all of its customers, employees, regulators and stockholders. Mr. Hanson asserted BBIL will be a long-term owner that is experienced in core utility assets and infrastructure, which is preferable to an owner focused on short term returns, particularly if new investment is required.

49. Mr. Hanson described the proposed transaction as a merger of BBI Glacier Corp., a wholly owned indirect subsidiary **[*33]** of BBIL, with and into NorthWestern with NorthWestern surviving the merger as a wholly owned indirect subsidiary of BBIL and BBI Glacier Corp. ceasing to exist. Details regarding the effect of the merger on NorthWestern's shareholders were provided. Exh. JA-2, pp. 12-14.

50. Under current ownership or the ownership of BBIL, Mr. Hanson stated that NorthWestern will comply with the terms of the bankruptcy stipulation and Consent Order.

Prefiled direct testimony of Michael M. Garland (BBIL)

51. Mr. Garland is the president and member of the board of directors of BBI US Holdings II Corp. (Holdings II) and BBI Glacier Corp. He explained that BBIL, together with Babcock & Brown Infrastructure Trust (BBIT), form Babcock & Brown Infrastructure (BBI). BBI is a utility infrastructure company based in Sydney, Australia, that is listed on the Australian Stock Exchange and has a current enterprise value of approximately $ 4.9 billion. BBI owns companies in electricity transmission and distribution, gas transmission and distribution, transport infrastructure, and has ownership interest in thermal and renewable power generation. According to Mr. Garland,

BBI's energy sector is managed by utility **[*34]** executives with an average of over 25 years experience in the electric and gas transmission and distribution businesses. Mr. Garland said that each operating BBI company is managed locally.

52. Mr. Garland explained that the proposed post-merger structure will involve two BBIL-subsidiary holding companies. He said companies such as BBIL that operate in multiple jurisdictions often form two holding companies to segregate investments, limit the reach of unforeseen liabilities and enable efficient tax structuring. This structure, according to Mr. Garland, enables expansion of the local entity independent of other parent operations and investments and allows BBIL to ring-fence each business, sheltering each from the risks and obligations related to other BBIL businesses. Following the proposed BBIL/North Western merger, the following BBIL companies would constitute the organizational structure:

. BBI US Holdings Pty Ltd. (Holdings Pty) - a wholly-owned Australian direct subsidiary of BBIL that was formed to hold the equity interests of Holdings II.

. BBI US Holdings II Corp. (Holdings II) - a Delaware corporation, a wholly-owned subsidiary of Holdings Pty formed to hold the equity **[*35]** interests in Glacier and, following completion of the acquisition, NorthWestern.

. BBI Glacier Corp. (Glacier) - a Delaware corporation, a wholly-owned indirect subsidiary of BBIL, a special purpose company formed to merge with and into NorthWestern. Glacier is a direct subsidiary of Holdings II, which is in turn a wholly-owned subsidiary of Holdings Pty.

53. Mr. Garland asserted BBIL's commitment to meet the ring-fencing expectations of the Commission and said BBIL will not pledge its interest in NorthWestern to secure financing of other ventures.

54. Mr. Garland described BBIL as an experienced utility infrastructure owner with a conservative approach that owns and operates its assets on a long-term and financially stable basis. He said BBIL's interest in NorthWestern stems from the quality of NWE's assets, its stable existing customer base and its steady growth opportunities, as well as its similarity to BBIL-owned Powerco, a New Zealand electric and gas transmission and distribution company.

55. According to Mr. Garland, the total amount of funds necessary to complete the merger is $ 2.228 billion, of which $ 736 million represents existing NorthWestern debt and the remaining **[*36]** approximately $ 1.492 billion will be funded through a combination of equity contributions by BBIL and debt financing. He explained that approximately $ 987 million is expected to be provided by BBIL from existing cash and from equity issuances in capital markets. BBIL's market capitalization is about $ 1.7 billion, he said. Mr. Garland noted that Moody's Investor Services has informed BBI that, if the transaction is completed and the financial and operating projections are realized, BBI's post-merger investment grade rating (Baa3 stable) will likely be retained.

56. As for the required debt financing, Mr. Garland said BBI has obtained commitments in the amount of $ 505 million for an acquisition bridge financing facility to be provided to Holdings II that is non-recourse to NorthWestern. According to Mr. Garland, the loan will be repaid out of dividends paid by NorthWestern to Holdings II, and it will not be secured in any way by NorthWestern or its assets.

57. Mr. Garland said BBIL assumes little or no refinancing of existing NorthWestern corporate debt will be required to consummate the merger. He noted that NorthWestern's $ 225 million worth of Senior Secured Bonds has a change **[*37]** of control feature that would be triggered if the

bonds are not investment grade as rated by Standard & Poor's and Moody's when the change of control occurs. However, BBIL believes NorthWestern will achieve an investment-grade rating because of those rating agencies' positive announcements in April 2006 regarding NorthWestern's credit rating. Regarding the revolver facility, which also has a change of control trigger, Mr. Garland said BBIL and NorthWestern will work with the lenders to maintain the existing facility.

58. According to Mr. Garland, each of BBIL's companies makes appropriate capital expenditures related to maintenance, replacement, enhancement of existing infrastructure or growth opportunities. He said BBIL is able to access capital markets to supplement NWE's cash flow when necessary. He provided a list of various BBIL companies' capital expenditure commitments for fiscal year 2006. Exh. JA-3, pp. 10-11. NWE local management will bring to the NorthWestern board for approval investment proposals requiring discretionary and growth capital expenditures.

59. Mr. Garland said BBIL considered the bankruptcy stipulation and PSC Consent Order when it made its bid for NorthWestern **[*38]** and that the transaction will substantially comply with them. He said that, although the agreement and order refer to a parent company and NorthWestern will be a wholly-owned BBIL subsidiary under the structure of the proposed transaction, NorthWestern will still operate as a utility company similarly to what it now does as a parent company. In addition, he said, BBIL ring-fences each of its assets and would do the same with NorthWestern.

60. Mr. Garland asserted BBIL satisfies a preponderance of the elements as set forth in the Commission's Statement of Factors as follows:

a. Financial strength and capability. Mr. Garland claimed that BBIL is an investment grade infrastructure owner and a long-term investor in businesses that provide stable, consistent cash flow. According to Mr. Garland, BBIL does not intend to recover any acquisition premium it is paying for NorthWestern from ratepayers; BBIL will maintain the ring-fencing protections of the settlement agreement and consent order; BBIL will maintain existing employee levels for two years and benefit plans for at least two years, and subject to certain conditions, three years; and BBIL will maintain the current funding commitment **[*39]** to NorthWestern's pension plan.

b. Energy supply. According to Mr. Garland, BBIL's energy sector managers average 25+ years experience in electricity generation and electric and gas distribution. He said BBIL will work with NWE to acquire appropriate and balanced supply under the PSC's guidelines and complete the electric default supply portfolio.

c. Infrastructure. Mr. Garland said BBIL will work with NWE to fully implement the Liberty Consulting infrastructure audit recommendations.

d. Demonstrable Montana focus. Mr. Garland said BBIL will retain local management and staff in Montana; focus on local jobs and investment in Montana; continue NorthWestern's current customer and community programs, existing energy assistance and charitable giving programs; and meet conservation and renewable energy commitments.

e. Utility focus. According to Mr. Garland, BBIL agrees with NWE's approach to maintain focus on distributing gas and electricity to its customers in a regulated environment.

f. Customer focus. Mr. Garland said NWE's commitment to meeting the PSC's customer service expectations will not change.

g. Energy utility management experience. Mr. Garland **[*40]** said BBIL is an experi-

enced owner/operator of regulated energy utilities and reiterated the related experience of BBIL's senior energy sector management. He asserted that BBIL's experience will provide NWE additional resources to better serve Montana customers. Mr. Garland listed and described BBIL's energy sector assets (Powerco in New Zealand, IEG in the United Kingdom and elsewhere, Cross Sound Cable in New York, 50 percent of Ecogen Power in Australia, and 50 percent of Redbank Power Station in Australia).

h. Effective functioning in the Montana constitutional, statutory, and regulatory framework. Mr. Garland reiterated BBIL's experience operating in regulated environments.

61. According to Mr. Garland, there will be very little, if any, difference in NorthWestern's daily operations if the transaction is approved. BBIL will keep NorthWestern's current management in place and supports NorthWestern's current business plan. In addition, he said, BBIL intends to create long-term value by continual investment in NWE's infrastructure. Mr. Garland testified that BBIL will assist NorthWestern in continuing to improve its financial strength and access to financial markets and will **[*41]** provide NorthWestern with enhanced access to capital to fund organic growth as appropriate to ensure stable ratings and reduce long-term debt costs. He said BBIL's resources and experience could be helpful as NWE works to improve the energy supply situation in Montana.

INTERVENOR PREFILED TESTIMONY

Response testimony of John W. Wilson (MCC)

62. Dr. Wilson, testifying on behalf of MCC, concluded that the proposed acquisition will adversely affect NWE's ability to provide adequate service at reasonable rates and that, as proposed, it would provide few benefits to Montana customers. He recommended that, if the PSC authorizes the acquisition of NorthWestern by BBIL, certain minimum conditions should apply.

63. Dr. Wilson noted that, although Mr. Hanson touted BBIL's financial resources, BBIL's market capitalization of $ 1.7 billion makes it only a bit financially larger than NorthWestern and there is no evidence that BBIL's parent Babcock & Brown will contribute to NorthWestern's ability to provide utility service. With respect to capital expenditures, Dr. Wilson observed that BBIL's acquisition model only provides for a 2 percent annual increment and that, according to the **[*42]** model, BBIL will not retain earnings for capital expansion or contingencies, but rather will consider and finance those requirements as they arise.

64. Dr. Wilson claimed that BBIL plans to support its proposed $ 2.2. billion acquisition of NorthWestern, which has a $ 1.4 billion rate base, by substantially increasing NWE's equity distributions. According to Dr. Wilson, NorthWestern's 2006 Long Range Forecast projected equity payouts to stockholders totaling $ 203 million for the period 2007-2010 in contrast to BBIL's plans to increase NorthWestern's equity payouts to its investors to $ 660 million over the same period. Dr. Wilson asserted that BBIL plans that NorthWestern will employ four "unusual" practices in order to fund the increased equity distributions: (1) retention of the acquisition premium of $ 700 million in its utility capital structure to justify utility borrowing of $ 180 million for equity distributions and return on equity amounts; (2) use of $ 300 million worth of depreciation over the next 15 years to fund equity payouts rather than new capital expenditures; (3) a BBIL-projected increase in rate of return on NorthWestern's equity-funded rate base to 30 percent by **[*43]** 2023, leveling off between 25 percent and 30 percent through 2046; and, (4) over-recovery in NorthWestern's rates of more than $ 200 million of tax expenses.

65. Dr. Wilson based most of his conclusions about BBIL's plans for NorthWestern on his analysis of the results of BBIL's acquisition model, a tool that Dr. Wilson said was used by BBIL to

evaluate the acquisition of NorthWestern and to arrange financing for it. Dr. Wilson asserted the acquisition model provides the best indication of BBIL's expectations and intentions as the prospective owner of NorthWestern. He categorized the conclusions he reached from his review of the model into two groups as described below.

66. First, Dr. Wilson reached conclusions related to the model's projection that NorthWestern's debt will increase from $ 736 million at the end of 2006 to $ 1.854 billion by the end of 2009 because of large NorthWestern capital expenditures and corporate borrowings in the 2007-09 period, mostly for new transmission investments in the Montana-Idaho line and the 500-Kv Colstrip-NW upgrade. Besides assuming $ 900 million in capital expenditures to fund the two transmission projects, Dr. Wilson claimed BBIL's model also **[*44]** includes $ 153.8 million to fund the planned Colstrip 4 lease buyout and $ 90 million to fund what Dr. Wilson termed an unwarranted equity payout. Dr. Wilson said NorthWestern's equity, excluding acquisition adjustment goodwill, is projected to decline over the same period from $ 732 million to $ 531 million.

67. Second, Dr. Wilson reached conclusions related to what he asserted is BBIL's business practice of paying out 100 percent of cash flow as management fees or dividends, which Dr. Wilson said is contrary to the customary U.S. utility practice of distributing an average of 60-70 percent of net earnings (a smaller subset of cash flow) . According to Dr. Wilson, BBIL expects cash flow from NorthWestern operations to be about 150 percent to 200 percent of net earnings. As a result, he argued, adequacy of NWE service is at risk because BBIL will over-distribute NorthWestern earnings instead of funding and maintaining sufficient reserves.

68. A comparison by Dr. Wilson of the projected equity distributions in NWE's January 2006 Long Range Management Forecast for 2007-2010 with those in the BBIL acquisition model for the same time period showed projected distribution amounts from NWE **[*45]** to BBI "holdco" that range from more than twice the NWE-projected distributions to more than four times the NWE-projected distributions. MCC-3, p. 14.

69. According to Dr. Wilson, BBIL's model shows BBIL initially funds the projected equity payouts by including in rates tax expenses that exceed actual tax payments ("phantom taxes") and later by high and unrealistic earnings projections. In addition, Dr. Wilson claimed BBIL's forecasts keep the $ 700 million acquisition premium in the utility's capital structure. He argued the inclusion explains in part how BBIL will support its $ 2.2 billion capitalization while increasing NorthWestern's forecasted equity distribution, when NorthWestern has only $ 1.4 billion worth of net plant and equipment. He added that the improper inclusion results in unwarranted NorthWestern debt-funded equity distributions in 2008 and 2010 ($ 90 million in borrowing each of those years) by which BBIL "holdco" repays a portion of the debt it plans to issue in 2007 to finance the acquisition premium. Dr. Wilson disputed what he said was BBIL's justification for the extraordinary equity distributions as being needed to achieve a 50/50 debt/equity capital structure **[*46]** by arguing that, if the acquisition premium is excluded from NorthWestern's capital structure, equity declines to a level less than 5 percent due to the very high equity payouts.

70. Dr. Wilson expressed concern that the $ 900 million of new debt BBIL's acquisition model assumes will be invested in the two transmission projects could become a burden for Montana ratepayers. He said BBIL's assumptions about transmission markets and revenues are overly optimistic and, if they do not pan out, ratepayers rather than investors could be at risk. He said regulatory safeguards should be in place to protect against asset depletion at the NorthWestern level because BBIL's forecasts for a sustained level of equity payouts that exceed 150 percent of after-tax earnings for the period 2007-2016 and that exceed 140 percent through 2023 are significantly out of line when compared to the NorthWestern-forecasted payout of 63 percent of earnings and the 63 percent average forecast by Value Line for comparable electric utilities.

71. According to Dr. Wilson, NorthWestern's debt is projected to increase from $ 736 million in 2007 to $ 1.854 billion in 2009 due to debt funding of the planned transmission **[*47]** projects, the planned Colstrip 4 lease buyout, and the $ 90 million equity payout to BBI Holdco to pay off part of BBIL's debt for the original equity acquisition premium. He argued that BBIL's planned debt financing will result in an unacceptable leveraged capital structure, which he said would violate the bankruptcy settlement agreement that required NorthWestern's consolidated total book equity/consolidated total capitalization to never be less than 40 percent. Dr. Wilson claimed that at the NorthWestern utility level, excluding acquisition premiums, leverage is worse. Dr. Wilson provided details and tables related to the projected consolidated and NorthWestern-level capital structures. Exh. MCC-3, pp. 20-25.

72. Dr. Wilson said he requested from BBIL a run of the BBIL acquisition model excluding the inputs and assumptions related to the interstate transmission projects. The requested model run showed that, even without those projects, equity payouts by NWE still significantly exceed 100 percent of total earnings and long-run earnings projections remain excessive and unrealistic. (The charts that comprise Exh. MCC-3, Attachment JW-1, depict projected NorthWestern cash distributions **[*48]** to equity owners under several different assumptions.) Notably, according to Dr. Wilson, equity payouts over the next 15 years greatly exceed total earnings and are much greater than NorthWestern's 2006 equity distribution forecast of under 65 percent as well as distributions projected for comparable utilities. Dr. Wilson claimed payouts of this size are unrealistic, unsustainable and would adversely affect NorthWestern's ability to provide adequate service at reasonable rates.

73. According to Dr. Wilson, BBIL plans to more than double NorthWestern's current level of equity payouts through 2023 by paying out 100 percent of earnings each year, plus issuing "advances to shareholders" that average an additional 40 percent of earnings. Dr. Wilson disputed the accuracy of BBIL's discovery responses to the PSC that implied there would be no change in NorthWestern's current dividend policy.

74. Dr. Wilson said BBIL intends for ratepayers to subsidize the acquisition premium paid by BBIL to acquire NorthWestern. He claimed BBIL will include the acquisition premium in the ratemaking equation in order to justify NorthWestern utility level earnings by including the premium in the equity component **[*49]** of the utility's capital structure. He also argued that, contrary to BBIL's claim that it must issue $ 90 million in NorthWestern opco-level debt in 2008 and in 2010 in order to maintain a 50/50 equity-to-debt ratio, that debt issuance would only be necessary if acquisition premiums are included in NorthWestern's equity balance.

75. Dr. Wilson also asserted that BBIL's model assumes NorthWestern's post-merger plant investment and capital expenditures will be at levels considerably lower than and out of step with those of comparable utilities. He claimed BBIL projects NorthWestern capital expenditures about equal to equity payouts over time, while Value Line projects capital expenditures for comparable utilities at about 2.5 times equity payouts. Dr. Wilson provided a summary of projected capital expenditures for comparable companies. Exh. MCC-3, Attachment JW-4.

76. Additional concerns expressed by Dr. Wilson include: that BBIL's model expects returns on equity that are unrealistic (Exhibit MCC-3, Attachment JW-3); that BBIL's plan to fund the equity payout to BBI Holdco includes reflecting in rates more income tax expenses than are actually paid ("phantom taxes") and that BBIL's **[*50]** use of "phantom taxes" is questionable because it is unclear whether the underlying assumptions related to net operating loss carry forwards are consistent with information submitted by NorthWestern in PSC Docket D2006.10.141 as well as BBIL's failure to recognize there will likely be regulatory questions in a subsequent rate proceed-

ing about the appropriateness of rates that include large increments for tax costs that have not actually been paid.

77. According to Dr. Wilson, the proposed acquisition does not satisfy the objectives of the bankruptcy settlement agreement and the related PSC *Consent Order* or the PSC's October 2004 *Statement of Factors.* He said the proposed acquisition will result in noncompliance with P C.3.a of the *Consent Order,* which sets a 40 percent floor on the equity component of the consolidated capital structure for NorthWestern and its affiliates. He noted this is one of the ring-fencing provisions that is meant to insulate the utility from the risks of non-utility ventures. Dr. Wilson added that overleveraged utilities generally incur higher debt costs, which could result in higher utility rates and/or service quality deterioration.

78. Dr. Wilson **[*51]** contended that BBIL addressed the *Statement of Factors* rhetorically, not substantively.

79. Dr. Wilson recommended that, if the PSC approves the acquisition, the approval should be subject to the following conditions at a minimum:

a. No recovery in retail rates, directly or indirectly, of any portion of the $ 700 million acquisition premium unless it is expressly authorized by the PSC after demonstration by the company of benefits to Montana ratepayers.

b. No deferral of any of the transaction and transition costs incurred by BBIL and NorthWestern as a regulatory asset for future rate recovery. Costs must be borne exclusively by shareholders.

c. No distribution in any year in excess of 100 percent of net earnings from utility operations from NorthWestern to its owners, affiliates, or affiliates' shareholders, either directly or indirectly, without prior PSC approval.

d. Financing for any capital projects for purposes other than providing service to NorthWestern's retail utility customers must be non-recourse to NorthWestern and its customers.

e. Continuation of the structural and financial measures, intercorporate and affiliate transactions requirements, reporting **[*52]** and disclosure requirements, and infrastructure audit compliance requirements from the *Consent Order,* with these modifications:

1) Revise the definition of the term "Parent Company" as necessary throughout P C.1 and P C.2 to ensure NorthWestern controls the public utility assets.

2) Amend P C.3.a to reflect a meaningful post-acquisition basis for determining consolidated book equity and consolidated total capitalization and the financial reporting requirements to which the corporate structure will be subject.f. A requirement that NorthWestern submit rate informational filings with the PSC every 2 years in accordance with P B.1 of the *Consent Order* for 10 years after the merger.

g. A requirement that financial disclosure documents filed by BBIL in the Australian Stock Exchange or the Australian Securities and Investments Commission be publicly filed at the same time with the PSC.

80. Dr. Wilson additionally recommended that any Commission approval make clear that: (1) funds for the new debt issuances must be raised through project financing that depends solely on

project revenues with no recourse to ratepayers; (2) approval of the acquisition does not mean endorsement **[*53]** of BBIL's projected equity payouts and, in fact, they seem excessive, outside industry norms, and unlikely to receive future regulatory approval; (3) NorthWestern's rate of return on rate base will be computed based on a capital structure that excludes acquisition premiums or any type of "goodwill" that exceed net plant value and neither NorthWestern or its owners will recover from ratepayers, directly or indirectly, any acquisition premiums; and (4) the Commission reaffirms the *Consent Order's* provisions that require that neither the consolidated capital structure nor NorthWestern's capital structure fall below 40 percent and that sufficient earnings must be retained to meet potential capital investment needs and to support investment grade ratings at the operating company and consolidated levels.

Response testimony of Ann Gravatt (District XI/NRDC/RNP)

81. Ms. Gravatt applauded the development of the Judith Gap wind project, but indicated that the potential of renewable resources in Montana has yet to be realized. According to Ms. Gravatt, BBIL or any new owner of NorthWestern must expand the development of Montana's robust renewable resources and address any issues that **[*54]** are impeding that development. She said it is possible that changes in law will be enacted that will allow NorthWestern to own and rate base generation. This would require the new owner to make critical and long-lasting decisions about the mix of energy resources and their associated environmental and economic impacts.

82. According to Ms. Gravatt, new ownership of NorthWestern will have to quickly come to grips with the reality that continued business-as-usual reliance on conventional fossil fuel generation is no longer a viable option for utilities now that the financial and environmental risks of global warming are front and center.

83. Ms. Gravatt said that with the completion of the Judith Gap wind project, Montana has about 145 MWs of wind power operating, as compared to over 800 MWs of wind in Washington and around 440 MWs in Oregon, both states with moderate wind resource compared to Montana. She said neighboring states have also recently developed wind power projects, such as Wyoming with just under 290 MW and North Dakota with about 125 MWs and more on the way. Ms. Gravatt is concerned that NorthWestern will proceed haltingly towards additional wind or other renewable energy **[*55]** acquisitions. She argued Montana citizens should not have to wait to get the benefits of reduced risk, economic development, and clean air from its homegrown resources.

84. Ms. Gravatt said she expects the applicants, particularly given BBIL's wind power experience, to increase NorthWestern's investment in new renewables. At the very least, NorthWestern must obviously meet the target created by the statutory Renewable Energy Standards, which require 15 percent of NorthWestern's load must be met with new renewables by 2015. Given that NorthWestern already has about 7 percent with Judith Gap, she said the additional increments of 10 percent by 2010 and 15 percent by 2015 are modest targets, allowing NorthWestern plenty of time to gain operating experience with Judith Gap while starting to explore the addition of other renewables to its resource mix.

85. Ms. Gravatt acknowledged there are challenges associated with the deployment of wind energy on a large scale, such as the usual start-up issues associated with any new resource. The wind's variability at Judith Gap, particularly on an intra-hour basis, has presented more of an issue than anticipated. She said some of the difficulties **[*56]** at the Judith Gap project had nothing to do with the wind. She claimed a lack of communication between NWE default supply, NWE transmission, and Invenergy, the project's owner and operator, at least in the initial months of the proj-

ect, was clearly not helpful. It was not appropriate for NWE to take over a year after the project was approved by the PSC to get the meteorological towers up and transmitting data, according to Ms. Gravatt.

86. She said NorthWestern and BBIL should commit to study and ultimately solve any wind integration issues and to explore with others transmission opportunities to access additional renewable resources in Montana. She viewed as essential NorthWestern's continued involvement in the Northwest Wind Integration Action Plan, convened by the Northwest Power and Conservation Council and the Bonneville Power Administration in August 2006. This group has discussed cooperative strategies, such as area control error (ACE) sharing, standardized regulating resource products, and regional wind forecasting, that could help control area operators manage the variability in their systems.

87. Ms. Gravatt said she is encouraged by BBIL's experience with wind power resources **[*57]** and expects, with BBIL's guidance, NorthWestern should continue to study its system and the wind resources available to determine how to integrate additional wind and renewable resources. With further analysis, NorthWestern will know what sort of additional products, if any " such as load following, regulating or additional transmission " are needed to acquire additional wind or other renewable resources. BBIL's expertise could also be valuable in addressing transmission limitations both inside and outside of Montana.

88. Regarding demand side management (DSM) programs, Ms. Gravatt said NWE has acknowledged the need to expand them in order to give customers access to all cost-effective savings. She said the new owner of NorthWestern must be fully committed to these efforts. According to Ms. Gravatt, NWE should aggressively acquire all cost-effective efficiency on its system and devote sufficient resources, including staff, to the task. Ms. Gravatt questioned whether the lost revenue recovery mechanism is the best possible method of removing the disincentive to utility investments in conservation and achieving fairness for the utility and ratepayer. She said NWE should perform an updated **[*58]** and expanded estimate of the amount of cost-effective demand side resource on the system. She also favors accelerating the acquisition of the resource.

89. Ms. Gravatt asserted that increasing energy costs have imposed significant burdens on Montana's low-income population. She said NorthWestern and any new owner must be aware of the company's continuing obligation to assist low-income customers.

90. Ms. Gravatt stated that BBIL appears to have taken no corporate position on global warming and coal plants. She said BBIL has touted its experience with coal resources and its willingness to bring that experience to develop more coal resources in Montana. In suggesting the possibility of new coal plants in Montana, BBIL made no mention of carbon and global warming. Ms. Gravatt expects BBIL to reconsider its position on coal development in light of the urgent challenge of global warming, and will oppose any plans by NorthWestern to acquire additional conventional coal resources. She claimed that long-term utility commitments to conventional coal-fired generation are imprudent, given that federal legislation controlling carbon is inevitable and imminent in her opinion. She added that several **[*59]** CEOs of the nation's largest utilities now publicly advocate federal controls on carbon.

Response testimony of Thomas Power (District XI/NRDC/RNP)

91. Dr. Power's testimony focused exclusively on the need to locate full control of NorthWestern's Montana operations in Montana and not in Sioux Falls, South Dakota. Dr. Power listed 10 conclusions that the analysis in his testimony supports. Exh. HRC-1, pp. 1-2.

92. In conclusions 9 and 10, Dr. Power recommended that the Commission should condition its approval of the proposed BBIL purchase of NorthWestern on either the movement of NorthWestern's corporate headquarters to Montana or the establishment of a truly independent, stand-alone, Montana company. This is a reasonable condition, Dr. Power said, and pointed out that NorthWestern and BBIL have already entered into an agreement with the South Dakota Public Utilities Commission to keep the corporate offices in South Dakota for three years. He said the Montana PSC should insist that either the corporate offices move to Montana at the end of that time period or that a stand-alone Montana company be established now.

93. Dr. Power noted that in its *Statement of Factors,* the Commission **[*60]** indicated the need for any NorthWestern buyer to have a demonstrable Montana focus. The Commission at that time indicated that the sale of the South Dakota and Nebraska operations would accomplish a Montana focus.

94. Dr. Power noted that the difference between working with NWE and with its predecessor, Montana Power Company (MPC), in an advisory capacity has been dramatic. In the MPC era all of the management functions, including the top leadership, were located centrally in Montana. With NorthWestern's takeover of the non-generating assets of MPC, decision-making within the utility is segmented and confused, according to Dr. Power. Dr. Power said NorthWestern employees in Butte appear to have limited authority and seem to be regularly surprised by decisions made by officers in Sioux Falls. He claimed systematic decision-making has seemed to collapse into an erratic stop-start process that paralyzed decision-making for a time and then produced "emergencies" where decisions had to be made very quickly. He said the long and erratic course of obtaining long-term resources to support default supply provides a good example. He recalled that the Montana First Megawatts facility was in **[*61]** the mix, out of the mix, mysteriously back in the mix again, and then, just as mysteriously, permanently disappeared from the mix altogether.

95. According to Dr. Power, the separation of corporate offices in Sioux Falls and operational offices in Butte have had a negative impact on NWE's ability to make use of its advisory committees. He said the NorthWestern executives making some of the key decisions were never present and, sometimes, even the Montana personnel were not present because they were back in Sioux Falls. He claimed there was regular conflict between some of the Sioux Falls representatives and the advisory committee because those in Sioux Falls did not understand the role of the committee, Montana regulation, or committee members' past involvement with the utility. Dr. Power said the net result of the division of authority was that the advisory committees could not be effectively engaged in assisting NorthWestern in its decision-making in a timely and productive manner.

96. Dr. Power asserted the range of issues that NorthWestern has brought to advisory committees has narrowed considerably. The only partially-functioning committee currently operating focuses exclusively **[*62]** on some of the default supply issues, while in the past there had been advisory committees dealing with low-income, universal systems benefits (USB), natural gas supply strategies, rate design, qualifying facilities, distributed energy policy (net metering, transmission and distribution cost savings, etc.), and legislative proposals. NorthWestern is making decisions on these important issues without the assistance of any advisory committee involvement, according to Dr. Power.

97. Dr. Power described the role of advisory committees as helping the utility test its ideas in a frank and critical setting so that the utility can improve its decisions. NWE's inability to participate productively in that process is worrisome, he said.

98. Dr. Power made clear that he does not believe that the entire corporation is dysfunctional. He said NorthWestern has managed and maintained the transmission and distribution systems well. NorthWestern has also played a very productive role on a variety of other fronts: (1) it has invested in favorably-priced, wind generation that mitigates the price risk associated with future carbon regulation and has been engaged in efforts to understand and manage integrating **[*63]** wind into the electric grid; (2) it has expanded its efficiency and demand side management programs (although Dr. Power said there is more cost effective DSM available to be pursued and it could be pursued on a more aggressive schedule); (3) it defended the USB program and all of its authorized public purposes while endeavoring to strike an appropriate funding balance among the various programs; and (4) it has supported, overall, low income programs during a period of rising market prices for energy focusing not only on low income discounts but also ongoing low income weatherization. Dr. Power said that in most areas NorthWestern has served Montana customers well since it took over the MPC non-generating assets, but that does not mean no further changes are needed within NorthWestern to protect the long-run interests of its Montana customers.

99. Dr. Power claimed that in the past NorthWestern demonstrated that it agreed with the Commission's statement that "management of the utility is most effective when located where the company has the majority of its business." Dr. Power noted that from its founding in 1923 until 1997 the corporate headquarters of NorthWestern was located in **[*64]** Huron, South Dakota, not Sioux Falls. Huron is located in the center of NorthWestern's South Dakota service territory, while Sioux Falls is not even in NorthWestern's utility service territory. According to Dr. Power, prior to NorthWestern launching its ill-fated diversification-through-acquisition venture, it recognized the importance of locating its corporate headquarters in Huron in the center of its service territory. He said, however, that in 1997 NorthWestern's management decided to move the corporate offices to the Sioux Falls, the fastest growing of South Dakota's metropolitan areas. According to Dr. Power, the Sioux Falls corporate headquarters made sense only when NorthWestern was focused on becoming a non-utility business with holdings across the nation. Dr. Power said that, given the catastrophic failure of NorthWestern's diversification ventures, the reason for the Sioux Falls headquarters has been lost and is a remnant of a misguided business venture. Given that NorthWestern is once again primarily a regulated utility, Dr. Power argued its corporate offices ought to be located in Montana where the bulk of its utility activities are located.

100. Dr. Power contended that, **[*65]** in terms of relative importance of NorthWestern's three separate service territories, Montana dominates South Dakota and Nebraska. Montana is the source of approximately 90 percent of NWE's before tax profits. Montana has close to 90 percent of electric energy sales, 84 percent of electric customers, 75 percent of the employees, and two-thirds of natural gas customers and sales. Montana is now the business center of the NorthWestern Corporation, according to Dr. Power.

101. Dr. Power argued the geographic distribution of NorthWestern's corporate officers is completely out of balance with the geographic distribution of business activity, profit potential, risk, employees, and customers. He said there are 15 corporate officers, with 11 of them located in the Sioux Falls corporate headquarters. The Montana corporate officers include four vice-presidents (wholesale operations, retail operations, government and regulatory affairs, and administrative services). NorthWestern has set up an Energy Supply Board that has five members on it. Two of those, Pat Corcoran and David Gates, work in Butte. The other three members of the Energy Supply Board are based in Sioux Falls.

102. Dr. Power recommended **[*66]** the Commission condition any approval of the BBIL-North Western merger on BBIL's agreement to, within a relatively short period of time such as

three years, move NorthWestern's corporate offices to Montana. He argued that NorthWestern needs to know Montana well -- its customers, its regulators, its government officials, and other stakeholders. He said the company has to have its pulse on changing conditions, emerging trends, developing public opinion, and new opportunities and that it cannot do that from a distant corporate headquarters.

103. Dr. Power suggested a three-year period over which corporate leadership would relocate to Montana to avoid the disruption that would ensue from abruptly trying to change the geographic location of corporate headquarters.

104. Alternatively, Dr., Power said NorthWestern could be broken into two autonomous pieces: the South Dakota-Nebraska operations and the Montana operations. After all, according to Dr. Power, NorthWestern Public Service Company successfully served its South Dakota and Nebraska customers for almost 80 years before the Montana operations were added to the corporate mix. Dr. Power suggested the NorthWestern Public Service Company **[*67]** could be resurrected as an independent company owned by BBIL, and the Montana Power Company name could be resurrected in Montana for an independent company also owned by BBIL.

Prefiled response testimony of Barbara Alexander (AARP)

105. Ms. Alexander stated that the purpose her testimony was to address the risks and potential impacts of this transaction on NWE's limited income or payment-troubled customers and to propose conditions that the Commission should adopt if the transaction is approved. The terms "limited income" and "payment troubled" are explained on page 3 of her testimony.

106. Ms. Alexander proposed that the Commission impose the following six conditions associated with any approval of this transaction:

> a. Implementation of a permanent increase in NWE's low income discounts and in the participation rate for the discount program. She recommended that the natural gas discount be increased to at least 30 percent for the winter period (November through April) and the electric discount be increased to 25 percent on a year-round basis. These increased discounts should be funded through current USB rates imposed on all customers, but if those rates are insufficient **[*68]** to maintain the program as participation in the discount increases, the increased funding should be provided by BBIL as a merger benefit at least until NWE files its next rate case or three years, whichever is longer.
>
> b. Adoption by NWE of new eligibility guidelines for the low income discount program. The discount should be available to any customer who is participating in the Low Income Energy Assistance Program (LIEAP), as well as other means-tested state financial assistance programs that reflect the 150-180 percent of federal poverty level. These programs include Food Stamps, Medicaid, Temporary Assistance for Needy Families, Special Supplemental Assistance for Women, Infants and Children, Social Security Disability and other limited income drug prescription programs available in Montana, particularly for seniors. Customers who are already enrolled in these financial assistance programs should be automatically eligible for the NWE discount program. NWE should solicit these customers to enroll through coordinated mailings with other Montana assistance program administrators and allow these customers to orally self-declare eligibility and provide proof of program participation **[*69]** within a reasonable time period.
>
> c. An increase of NWE's contribution to the weatherization program in Montana. Any increase should reflect recommendations from the weatherization administrator and the lo-

cal delivery system for this program, based on their ability to absorb these additional funds and spend them efficiently in any program year.

d. Require that NWE evaluate its USB-funded programs in sufficient detail to determine the effectiveness of these programs and identify potential areas of reform on a regular basis. Ms. Alexander said this will require, with respect to limited income programs, that the utility evaluate the impact of the program on the ability of participating customers to make regular monthly payments, enter into and keep payment agreements, avoid disconnection of service, and reduce the use of the utility's customer care and calling center expenses. She said NWE should be required to track and report routine credit and collection information for all its residential customers, as well as the subset of limited income customers participating in the discount programs. NWE should be required to report annually to the PSC on the operations of its gas and electric **[*70]** USB programs, as well as submit the required credit and collection information that would allow the Commission and the public to determine the status of NWE's limited and payment troubled customers.

e. Require that NorthWestern make its Home Heating Assistance Program more accessible to Montana customers. Ms. Alexander said the program should continue to be funded by NorthWestern and BBIL shareholders until NorthWestern files its next rate case or three years, whichever is longer, as a merger benefit. The program should be made available to any NWE customer with a household income of 185 percent of poverty or less. NWE should conduct outreach efforts to encourage potentially eligible customers to apply for this program and not rely strictly on enrollment activities associated with LIEAP or Energy Share, although those enrollment methods should continue. Rather than targeting all the funds strictly as a heating benefit available to NWE's natural gas or electric heating customers, a lesser grant (in the amount of $ 100-$ 150) should be available to Montana electric customers who do not heat with electricity, but who encounter hardship in paying their NWE electric bill due to high **[*71]** heating costs for other fuels.

f. Require that NWE's call center performance improve so that an average of 80 percent of the calls are answered by a representative within 30 seconds. Ms. Alexander said NWE should be required to achieve this level of performance within 6 months of the approval of the merger. If NWE does not achieve and maintain this level of performance on an annual basis, BBIL should fund a customer credit to NWE's Montana customers in the amount of $ 1 million for each percentage below the 80 percent annual average performance that is achieved. According to information detailed in Ms. Alexander's testimony (see page 24), a review of various service performance indicators for 2004 and 2005 showed a high level of performance for most service metrics, except for the customer call center. Ms. Alexander said NWE's results for "calls answered within 30 seconds" in 2004 and 2005 were at 71.4 percent and 57.4 percent, respectively. She argued the degradation in call center performance from 2004 to 2005 is particularly disturbing.

107. Ms. Alexander said the NorthWestern/BBIL application lacked specificity with respect to the impact of the merger on NWE's limited income **[*72]** or payment troubled residential customers. Ms. Alexander is concerned that customers will bear significant risks associated with the transfer of ownership to an Australian-based investment vehicle that is answerable to shareholders for a stock listed in Australia. She contended the lack of any specific and enforceable service commitments is disturbing because the urge to generate the return on the substantial investment that will be made by BBIL to acquire NorthWestern may result in pressure to cut costs and reduce ex-

penses, thus adversely impacting customer service and service reliability and the ability of limited income and payment troubled customers to maintain utility service.

108. According to Ms. Alexander, customer service activities such as customer call center performance and timely and accurate billing are at risk when a utility with historically good service quality is subjected to pressures to assure adequate profits to absentee landlords. She said fixed-income, limited-income and payment troubled customers rely on access to customer call centers to negotiate payment arrangements, respond to disconnection notices, and enroll in various limited -income programs. The receipt **[*73]** of timely and accurate bills with a well understood and efficient collection routine is crucial to such customers' ability to manage their monthly payments and seek financial assistance which is typically triggered on the receipt of an accurate disconnection notice.

Other Intervenors

109. Heartland/SDPPI, the Large Customer Group, and CELP/YELP submitted statements in which they advised the Commission and other parties that they waived their rights to submit initial prefiled testimony but reserved all other rights of general intervention as well as the right to seek relief from PSC orders concerning issues raised by the PSC or any party.

Written public comments

110. In addition to oral comments received at public hearings around the state, the Commission received written comments from 54 individuals and entities. Forty-one of the written comments opposed the sale. Five of the written comments supported the sale. The remaining eight written comments dealt with a variety of other issues.

111. Most opponents did not support the ownership of NorthWestern Corporation by a foreign corporation. The supporters thought that BBIL would provide capital to NorthWestern, and would **[*74]** help to provide a more stable energy future for Montana customers.

APPLICANTS' REBUTTAL TESTIMONY

Prefiled rebuttal testimony of Michael Hanson (NorthWestern)

112. Mr. Hanson stated that none of the intervenors argued for disapproval of the sale, but rather each intervenor recommended conditions on the sale.

113. Mr. Hanson suggested that the Commission focus on what he said were certain key points of the application. He said NWE is a financially capable utility and that the best interests of the company, customers and regulators are served by ownership by a long-term investor like BBIL that is focused on the utility business and its long-term financial health, rather than by the current ownership by short-term investors that are interested solely in maximizing their gains. He reiterated that, because NWE will remain the operating utility, the sale and merger transaction will be seamless to customers and cause no disruption in ongoing utility operations such as supply procurement. According to Mr. Hanson, BBIL's ownership will mean NWE has access to capital for maintenance, growth, expansion and infrastructure projects at possibly lower costs than NWE could obtain as a stand-alone **[*75]** utility. He said investments in expansion projects requiring additional capital would require approval, as they now do, by a board of directors, and added that BBIL has a direct interest in ensuring its operating companies get the necessary capital to maintain and expand their infrastructure.

114. According to Mr. Hanson, NWE is developing a long-term asset management plan, including expenditure forecasts, that initially will cover 10 years, but is planned to be extended to a 15

-year horizon. He noted that all of BBIL's operating companies have similar asset management plans.

115. Mr. Hanson responded to each of Dr. Wilson's recommended sale conditions as follows:

116. Prohibition of recovery of acquisition premium in rates. Mr. Hanson responded that the applicants have unequivocally affirmed as much.

117. Prohibition on transaction and transition costs recovered in rates. Mr. Hanson responded that the applicants have clearly stated they will not seek rate recovery of these costs.

118. Current stipulation/settlement agreement and ring fencing. Mr. Hanson responded that: (1) the applicants have made clear they will abide by the terms of the agreement after the merger, and **[*76]** note the definition of "Parent" will need to be revised; (2) revision will be required to the agreement's requirement that every board member but one must be independent; and, (3) the ring -fencing provisions and Montana law will continue to provide the PSC with authority to regulate NorthWestern, including rates, utility financing, debt and equity levels.

119. Periodic rate informational filings. Mr. Hanson responded with a proposal that, instead of these filings being required every two years for the next ten years as recommended by Dr. Wilson, they be required to be filed every three years for the next six years.

120. Filings of public financial disclosure documents with the PSC. According to Mr. Hanson, BBIL will agree to notify the Commission when its public financial disclosure documents are being filed in Australia and provide links to the appropriate websites. NorthWestern's financial disclosure documents will be available on the SEC's website.

121. Project financing non-recourse to NorthWestern. Mr. Hanson responded that NorthWestern, to the extent it undertakes capital projects that are not secured by conventional utility assets, will finance those projects by **[*77]** non-recourse project financing.

122. In response to Dr. Power's testimony, Mr. Hanson argued that the location of decision-making individuals is not important when day-to-day business communications are routinely accomplished by email, telephone, and video conferencing. He said these tools facilitate prompt and thorough decision making. Mr. Hanson noted that when decisions must be made that exceed the Montana-located executives' authority, they must seek approval from the CEO or board of directors. Mr. Hanson acknowledged that NorthWestern struggled to adapt to the role of default supplier, but added that even Dr. Power recognized NorthWestern has made substantial progress by nearly completing its supply portfolio while continuing to provide reliable utility service. Mr. Hanson said Dr. Power's criticisms are not related to the proposed change in ownership which is the subject of this proceeding. According to Mr. Hanson, the proposed Montana Advisory Committee (discussed in Patrick Corcoran's rebuttal testimony) should result in improvements in NorthWestern's decision-making processes.

123. Mr. Hanson disagreed with the recommendations for sale conditions made by intervenor witnesses **[*78]** Barbara Alexander and Ann Gravatt. He said NorthWestern has demonstrated leadership and social responsibility regarding renewables, energy conservation and low-income issues, and is committed to continuing that leadership. For that reason, Mr. Hanson argued it is inappropriate and unnecessary to condition the sale as recommended by Ms. Alexander and Ms. Gravatt.

Prefiled rebuttal testimony of Patrick Corcoran (NorthWestern)

124. Mr. Corcoran said that, as part of NorthWestern's efforts to improve its Montana focus and make NorthWestern more responsive to Montana concerns, the company proposes to form a Montana Advisory Committee of external stakeholders representing major customer segments or utility interest groups. The new committee would be comprised of the members of the existing electric default supply Technical Advisory Committee (TAC), with the addition of representatives from AARP, Large Customers, Montana Chamber of Commerce and Montana League of Cities & Towns.

125. In response to Ms. Gravatt's testimony, Mr. Corcoran said NorthWestern will continue to focus on renewable resources and energy conservation, but that those issues are appropriately discussed and considered **[*79]** in other forums and are not the subjects of this proceeding.

126. Mr. Corcoran responded to Ms. Alexander's testimony by first reiterating NorthWestern's commitment to supporting the needs of its low-income customers. He stated that USB programs and funding are not at risk as a result of the proposed sale. Regarding the six sale conditions recommended by Ms. Alexander, Mr. Corcoran argued the first four conditions (increase low-income discount, expand discount eligibility, increase NWE's contribution to weatherization, and require NWE to evaluate and report on its USB-funded programs) are not appropriate subjects for this docket. He said her condition # 5 (reform NorthWestern's Challenge Grant) is inappropriate because AARP's approach will actually discourage this type of program, which is a voluntary shareholder-funded activity begun at NorthWestern's own initiative. Mr. Corcoran contended that Ms. Alexander's proposed sale condition # 6 (require NWE to improve its call center answering performance to 80 percent of calls answered within 30 seconds, with a financial penalty to be funded by BBIL if the performance metric is not met) is based on an anomalous high-level review of a single **[*80]** call center performance measure and seems to be an attempt to leverage the sale to secure the proposed penalty. Mr. Corcoran added that NWE's call center performance is one of the criteria considered by PA Consulting Group when determining which utilities' should be awarded its Service One <TM> award, which NWE has been awarded for the past three years.

Prefiled rebuttal testimony of Steven Boulton (BBIL)

127. Mr. Boulton, the CEO of BBIL, rebutted MCC witness Dr. Wilson's testimony. According to Mr. Boulton, because the intervenors, including MCC, have indicated NorthWestern is providing adequate service at reasonable rates, the only relevant issue in this proceeding is whether NorthWestern will be adversely affected by BBIL's acquisition of it.

128. According to Mr. Boulton, NorthWestern will operate in the same manner after the sale as it does now, except that its shareholder will be one long-term investor. He said BBIL intends to keep NorthWestern in its present form, but as an operating company within a holding company. The rate base, its capitalization, and tariffed services will not be affected by BBIL's acquisition of the company; in fact, they cannot change without **[*81]** the Commission's approval.

129. Mr. Boulton argued that NorthWestern's financial condition should improve after the merger. Nothing about the operation of the company will change, he said, except that with BBIL ownership, NorthWestern will be able to invest in larger growth projects that provide the opportunity to earn an adequate rate of return.

130. Mr. Boulton pointed out that BBIL has already committed to the Commission and to the other regulatory commissions involved that the acquisition premium and any transaction costs will not be recovered in rates, that public financial disclosure documents will be available to regulators, and that NorthWestern's or BBIL's capital projects that are not secured by conventional utility assets will be financed by non-recourse project financing. BBIL has also made clear that

NWE will continue to be subject to the terms of the bankruptcy settlement agreement with changes made to the agreement to revise: the definition of "Parent" to apply to NorthWestern; the board composition to recognize the new board as an internal board, not a public one; and the informational rate filing requirement to require such filings at least every three years over the **[*82]** next six years.

131. Mr. Boulton disputed Dr. Wilson's recommendations resulting from his analysis of BBIL's acquisition model, which Mr. Boulton said was solely intended as an evaluation tool of the NorthWestern acquisition for BBIL management. He contended the model was not designed to serve as an operating model or business plan for NorthWestern. Under BBIL ownership, he said, NorthWestern will develop its own business plan, consistent with BBIL's strategy of empowering local management to run the business. Mr. Boulton criticized Dr. Wilson for focusing his analysis of the proposed acquisition exclusively on the BBIL acquisition model and using it for a purpose for which it was not designed. Mr. Boulton asserted that a key assumption of NorthWestern and BBIL is NorthWestern will use revenues to first pay all operating expenses, including interest and debt service, cash taxes, and prudent and necessary capital expenses, and retains sufficient working capital and cash to fund the day-to-day operating requirements, before any returns are made to the owner.

132. Mr. Boulton stated that, contrary to Dr. Wilson's assertions, BBIL has no intention to extract excessive cash distributions **[*83]** from NorthWestern. He argued that the Commission can ensure NWE's financial viability by: (1) regulation of NWE's rates, including establishment of the capital structure; (2) PSC approval of debt issuances secured by NWE's utility assets in Montana; (3) PSC review of annual regulatory reports, NorthWestern's SEC filings and reports, and the PSC's ability to conduct investigations if concerns arise; and, (4) monitoring NWE's continued implementation of the Liberty Audit recommendations and, possibly, the proposed NWE 10 -year asset management plan.

133. Regarding Dr. Wilson's specific recommendations, Mr. Boulton responded as follows:

a. Prohibition of recovery of acquisition premium in rates. Mr. Boulton responded that NorthWestern and BBIL, in the answer to MCC Data Request MCC-13(b), clearly indicated they do not intend to recover the premium to book in rates. He added that NWE would not be able to do so anyway unless it first obtained PSC approval to include it in rate base or treat it as an amortization expense.

b. Prohibition on transaction and transition costs recovered in rates. Mr. Boulton responded that NorthWestern and BBIL, in the answer to MCC Data Request **[*84]** MCC -063, clearly indicated these costs are being expensed as they occur and tracked in the company's financial statements, and will not be included in future rate filings. He added that NorthWestern would not be able to recover these costs in rates anyway unless it first obtained PSC approval in a rate filing.

c. Project financing non-recourse to NorthWestern. Mr. Boulton responded that NorthWestern and BBIL clearly indicated in the application that they will not issue Montana utility debt, pledge Montana utility assets, or provide loans, guarantees, etc. related to Montana regulated utility assets, except in accordance with Montana law and PSC rules. He noted that the Commission regulates the issuances of securities, including pledges of utility property. He said that, although the acquisition model's assumptions may include some related to future debt issuance as the company grows, any issuance other than non-recourse borrowings is a modeling exercise without effect unless and until the PSC authorizes such debt.

d. Current stipulation/settlement agreement and ring fencing, and recommendations for revisions to Ordering P C.3 of the agreement. Mr. Boulton responded the **[*85]** applicants have made clear they will abide by the terms of the agreement after the merger, and noted the definition of "Parent" will need to be revised and revision will be needed to the agreement's requirement that every board member but one must be independent. He argued there is no need to revise Ordering PP C.3.b & c as recommended by Dr. Wilson because those provisions will remain in place and unchanged. He disputed the need to change Order P C.3.a because the existing definition of consolidated book equity and consolidated total capitalization is consistent with Generally Accepted Accounting Principles while Dr. Wilson's concerns are unwarranted and inconsistent with industry practice.

e. Periodic rate informational filings. Mr. Boulton responded with a proposal that, instead of these filings being required every two years for the next ten years as recommended by Dr. Wilson, they be required to be filed triennially once or twice.

f. Filings of public financial disclosure documents with the PSC. According to Mr. Boulton, BBIL will agree to notify the Commission when its public financial disclosure documents are being filed in Australia and provide links to the appropriate **[*86]** websites.

g. Prohibition on payment of dividends above 100 percent of net income in any year without prior PSC approval. Mr. Boulton argued this condition is inappropriate for these reasons: (1) it appears to apply to all of NorthWestern when the Montana PSC has no jurisdiction over NWE's regulated operations in other states or over NorthWestern's unregulated operations; (2) it usurps the legal authority of NorthWestern's board of directors and could conflict with the board's fiduciary responsibilities and with laws governing dividend payments; (3) it is unnecessary, given the PSC's authority over rates, debt issuance, ability to investigate and audit, and the required rate informational filings; (4) it ignores the fact that consolidated income taxes may be paid by the holding company and not NWE as the operating company, necessitating distributions from NorthWestern to Holdco as the taxpayer for the consolidated group; (5) it fails to take into account that, just because a company may choose to pay more in dividends than its book net income in a year does not mean it is impaired from providing adequate service; and, (6) NWE's proposed long-term asset management plan will demonstrate **[*87]** NorthWestern's commitment to infrastructure investment.

134. Mr. Boulton contended that Dr. Wilson's analysis of BBIL's financial projections contains material flaws that are the result of his misapplication of the acquisition model and from what appears to be his selective use of data to justify erroneous conclusions. In conclusion, Mr. Boulton stated that the information provided in the application, direct and rebuttal testimony, and discovery responses all add up to a convincing demonstration of BBIL's suitability as a purchaser of NorthWestern.

Prefiled rebuttal testimony of Jonathon Sellar (BBIL)

135. Mr. Sellar, BBIL's chief financial officer, rebutted Dr. Wilson's testimony, particularly the conclusions drawn by Dr. Wilson from his analysis of BBIL's acquisition model. According to Mr. Sellar, Dr. Wilson inappropriately applied the acquisition model to the public utility ratemaking process and then claimed it showed how the post-merger NorthWestern will operate.

136. Mr. Sellar stated that the purpose of the model was to evaluate the effect of the transaction on the BBI stockholder; therefore, BBIL included the premium to book in the model so that it

would accurately **[*88]** reflect BBI's economic investment. He reiterated that BBIL has no intention of recovering the acquisition premium in rates.

137. According to Mr. Sellar, Dr. Wilson's claim that NorthWestern will increase its equity payouts for the period 2007-2010 to $ 660 million from the $ 203 million projected by NorthWestern in its 2006 Long Range Forecast is not correct. Mr. Sellar contended that the net distributions assumed by BBIL and NorthWestern during this period are about equal because the model shows not only $ 660 million in distributions, but $ 405 million in reinvestment of equity capital by BBIL, which results in a net distribution of $ 255 million.

138. Mr. Sellar responded to Dr. Wilson's four major concerns, which, according to Mr. Sellar, are all related to a misuse of the model:

a. NorthWestern intends to retain for ratemaking the premium to book offered by BBIL. Mr. Sellar responded that this concern is misplaced because the Commission determines regulated rate base and the equity and debt components of it. He said that NorthWestern's current regulated capital structure is about 50/50 debt to equity and that, while the equity component will increase as total rate base **[*89]** increases, the debt component can only increase if the PSC authorizes it. He asserted that for Montana ratemaking purposes, the equity component of rate base will likely increase over time, not decrease.

b. NorthWestern intends to invest annually less than its annual depreciation expense. Mr. Sellar responded that Dr. Wilson's comparison of forecast capital expenditure to a GAAP depreciation charge is not relevant or reasonable. He said that if Dr. Wilson's analysis of capital expenditure as a percentage of GAAP depreciation were extended over the entire 40-year life of the BBIL model rather than to just the first 15 years used by Dr. Wilson, then capital expenditures exceed GAAP depreciation expense. He argued that Dr. Wilson's analysis was faulty because he included in depreciation expense the Colstrip 4 lease buyout cost, but did not include that capital cost when he calculated capital expenditures -- a difference that makes up more than half of Dr. Wilson's "shortfall," according to Mr. Sellar. Further adjustments for remaining GAAP depreciable life of the assets, and inclusion of all depreciation and capital expenditures through the end of 2023, result in a capital expenditure **[*90]** amount well in excess of book depreciation (by $ 258 million), argued Mr. Sellar.

c. BBIL projects a 25- to 30-percent return on its investment by 2023. Mr. Sellar claimed that BBIL's total internal rate of return in regard to the overall consolidated NorthWestern transaction over the 40-year evaluation term is 11.9 percent. With respect to regulated Montana gas and electric rate base return on investment, Mr. Sellar contended the BBIL model projects a return on the electric business of 7.5 percent and a return on the gas business of 7.7 percent over the 17-year evaluation period referenced by Dr. Wilson. Regarding Dr. Wilson's calculation of a rate of return on equity-funded rate base (RREFRB), Mr. Sellar argued that Dr. Wilson's use of consolidated numbers distorts the results. Mr. Sellar said that when he used Dr. Wilson's methodology to calculate RREFRB metric for each of the Montana utilities, the resulting ratios through 2023 for the Montana electric assets was 7.5 percent and 7.7 percent for the gas assets.

d. BBIL proposes to recover "phantom taxes" from ratepayers. Mr. Sellar responded that the availability of NOLs carry forward to NorthWestern is irrelevant to **[*91]** this proceeding. He explained the NOLs were generated by the write-off of some of NorthWestern's unregulated businesses and the investments that resulted in the NOLs were

never included in rate base and are not related to NWE's regulated Montana utility. He said the use of the NOLs will result in higher available cash flow during this period after all other needs are met.

139. Mr. Sellar disputed Dr. Wilson's conclusion that, as a result of the two new transmission projects planned by NorthWestern and supported by BBIL, NorthWestern debt will increase from $ 736 million in 2006 to $ 1.854 billion at the end of 2009, while equity will decline from $ 732 million to $ 531 million. According to Mr. Sellar, the financing of the larger of two transmission projects, as well as the cost of the Colstrip 4 lease buyout if that occurs, will be fully non-recourse to NWE and not included in rate base. He added that Dr. Wilson should have pointed out that in 2010, BBIL's plans call for a $ 400 million injection of equity capital into these projects to repay short-term, non-recourse construction debt and achieve a 50/50 debt/equity capitalization for the largest of the projects and an approximately **[*92]** 50/50 debt/equity capitalization on a consolidated NorthWestern basis.

140. According to Mr. Sellar, Dr. Wilson's contention that BBIL plans excessive equity distributions that are outside of industry norms is incorrect. Mr. Sellar said that if the BBIL projections are adjusted to make them actually comparable to other utilities and if Dr. Wilson's list of comparable utilities is revised and expanded to include utilities similar to NorthWestern with primarily regulated assets, BBIL's projections are consistent with the historical distributions of that utility group. Exh. JA-7, pp. 12-13, and attachment JS-1.

141. Mr. Sellar argued that Dr. Wilson's concern that BBI Holdco financial statements indicate an ongoing balance of less than 3 days of revenues is another result of his misapplication of the BBIL acquisition model, which was not designed to model NorthWestern's working capital management. Mr. Sellar said that, post-merger, BBIL expects NorthWestern to continue to manage its working capital as it does today and that only excess cash not needed to manage its liquidity would be distributed up to BBIL on a quarterly basis.

142. Mr. Sellar concluded by reiterating that BBIL has no **[*93]** intention of extracting excessive distributions from NorthWestern, but rather BBIL intends to be a long-term investor with an interest in ensuring NorthWestern remains a financially strong, customer-focused utility.

COMMISSION ANALYSIS AND DECISION

143. The overriding issue in the docket is whether the proposed transaction poses a threat to NorthWestern's financial health and, therefore, harm or risk of harm to Montana customers. The Commission finds that it does and explains its reasons below.

Recovery of the acquisition premium

144. It is a long held regulatory principle of this Commission that the value of plant in rate base is determined by original cost less depreciation. Original cost of utility property is determined when the asset is first dedicated to public service. The action of selling a utility, absent any compelling reason, is not sufficient to allow an adjustment in rate base to reflect acquisition costs.

145. In this case, BBIL will pay a premium of approximately $ 700 million over NorthWestern's book value to acquire the company. In addition, the Joint Applicants will incur an estimated $ 88 million in transaction costs. No prudent business owner would make **[*94]** such a sizeable investment unless it could recover its costs. The obvious question is: how does BBIL plan to recover the acquisition premium?

146. BBIL witness Mr. Garland testified that BBI will recover the acquisition premium from dividends paid by NorthWestern to Holdings II. TR Vol. 2, p. 40. Mr. Garland explained in a discov-

ery response that: "BBI believes the free cash flow (operating cash flow after debt service and maintenance capital expenditures) will be sufficient to amortize its purchase price." RDR PSC-17(e).

147. Although BBI emphasized at every available opportunity that it would not seek to recover the acquisition premium and transaction costs from customers (see, for example, JA-3, p. 12; JA-4, p. 9; JA-7, p. 3; RDR PSC-017-e; TR Vol. 2, p. 40), the evidence in the record leads to the opposite conclusion. Ratepayers, as the source of NorthWestern's revenues, will foot the bill. As Dr. Wilson testified at hearing:

> There is only one place that cash flow comes from. Cash flow comes from ratepayers. Now, there may be some borrowing to provide for cash flow, but ultimately the ratepayers have to pay for the borrowing. So all of the money comes from the revenues of **[*95]** the company. Most of that from utility rates. Some of it, some of the revenues are going to come from revenues that are produced by Colstrip. Some of it's going to come from revenues that are produced by the transmission investments, but there's only one place that the cash flow comes from. That's from revenues and the basic revenue pot is utility ratepayers. TR Vol. 2, p. 168.

Equity impairment

148. Dr. Wilson's testimony concerning BBIL's financial plans for NorthWestern and the deterioration of NorthWestern's equity capital that would occur under BBIL ownership is compelling. Using BBIL's acquisition model as a road map of its intentions, Dr. Wilson showed that BBIL plans to extract equity from NorthWestern in several ways. First and foremost, BBIL assumes NorthWestern will consistently pay out dividends to its new owner in excess of NorthWestern's net earnings. While U.S. utilities typically pay out 60 to 70 percent of net earnings in dividends, BBIL's acquisition model calls for in excess of 100 percent of net earnings to be paid out annually by NorthWestern through the year 2023. Exh. MCC-3, p. 13 and pp. 16-17. Mr. Sellar's attempt to counter Dr. Wilson's exhibit that **[*96]** depicted comparable U. S. utilities' dividend payout ratios in the range of 70 percent fell flat when Mr. Sellar's own competing exhibit that showed an average 91-percent payout ratio among selected comparable utilities was revealed under cross examination to have been calculated using a "averaging of the averages" method that was clearly biased to support BBIL's high-payout argument. TR, Vol. 3, pp. 180-185.

149. In normal utility operations, retained earnings provide a vital source of financial strength for capital investment and as reserves that are available during unexpected financial strains. Regularly paying out dividends in excess of net earnings by a utility is inappropriate and risky because having insufficient reserves on hand could adversely affect the utility's ability to provide adequate service. Under BBIL ownership, NorthWestern, without retained earnings of its own after meeting its operating costs and required capital expenditures, would have to seek approval from the BBIL board for any additional capital needs or investments. BBIL assured the Commission that funding for necessary or advisable investments would be forthcoming. RDR MCC-088. However, it is apparent **[*97]** that NorthWestern's capital requests would be subject to the discretion of a BBI-controlled board with just one independent director that would be weighing the merits of capital requests from BBIL's numerous operating subsidiaries and would be subject also to BBIL's future financial capability.

150. BBIL's projected equity distributions from NorthWestern exceed by far the 63-percent level of dividends NorthWestern planned for distribution in its January 2006 Long Range Management Forecast for the same time period. Exh. MCC-3, p. 17. In that forecast, NorthWestern projected $ 205 million in dividends for the period 2006-2010. The BBIL model projects $ 660 million in dividends for the same period. TR Vol. 3, pp. 22-23.

151. The plan to upstream all of NorthWestern's available cash flow to its parent stands in stark contrast to NorthWestern's practice since emerging from bankruptcy of working to strengthen its financial posture by using earnings to pay down debt. As a result of that practice, NorthWestern's current debt/equity ratio is around 50/50 when one includes in equity the existing $ 435 million of goodwill on the books, and around 70/30 when the existing goodwill is excluded **[*98]** from the equity calculation. TR Vol. 1, p. 54. The Commission considers 40 percent equity, excluding goodwill, in a utility's capital structure to be barely sufficient and would much prefer to see at least 50 percent equity. It is reasonable to expect NorthWestern would achieve in the near term at least the barely adequate 40-percent equity level if the utility were to continue its present course.

152. However, under BBIL's plan no earnings will be retained at the utility level after operating expenses and required capital expenditures are paid. BBIL does not intend to reserve funds at the utility level. RDR PSC-045. In fact, when the $ 700 million BBIL acquisition premium is added to NorthWestern's balance sheet as a goodwill component to NorthWestern's equity, as it will be under the proposed transaction, the equity side of the utility's capital structure will be artificially inflated by the goodwill amounts, so much so that BBIL intends for NorthWestern to take on debt to balance its debt/equity ratio. BBIL's model projects borrowing by NorthWestern through 2009 for two large interstate transmission investments, the buyout of the Colstrip 4 lease, and even for an equity payout. **[*99]** Taken together, these will increase the utility's debt from about $ 736 million at the time of acquisition to $ 1.8 billion by the end of 2009. Exh. MCC-3, pp. 21 -22. If goodwill is excluded from the equity calculation, NorthWestern's equity will decline under BBI ownership from $ 732 million at acquisition to $ 531 million by year-end 2009. Exh. MCC-3, pp. 21-22. BBIL's model projects NorthWestern's consolidated capital structure (including goodwill) at year-end 2009 to be 27 percent equity/73 percent debt. NorthWestern's "real" equity (which excludes goodwill) will be reduced to a mere 22 percent. Exh. MCC-3, p. 22. By the year 2023 equity could be close to a mere 17 percent. Exh. MCC-3, p. 24. If the model is run excluding the two new transmission projects, the results still show equity payouts that exceed net earnings and an unacceptable, though less dramatic, reduction in the level of NorthWestern's equity capital. Exh. MCC-3, Att. JW-1, pp. 1-2.

BBIL's track record

153. MCC's claim that under BBIL ownership NorthWestern would consistently pay out dividends in excess of net earnings was supported not only by the acquisition model but also by evidence that excessive dividending **[*100]** is BBIL's established practice with at least one existing utility-related subsidiary. Mr. Boulton acknowledged at hearing that the "Consolidated Changes in Equity" ages of the Powerco 2006 annual report showed Powerco paid out dividends in excess of net profits for the past two years and that Powerco's equity balance dropped commensurately over the same period. Exh. MCC-8; TR Vol. 3, pp. 18-21.

154. The record indicates that BBIL does not consider a ratio of equity distribution to net earnings of 91 percent to be excessive. RDR MCC-101; TR Vol. 3, p. 121-122. The Commission disagrees and accepts MCC's assessment that a dividend payout ratio of around 70 percent is normal among comparable utilities.

155. Although Mr. Garland testified that BBIL considered a 50/50 debt-to-equity ratio to be appropriate for NorthWestern at the operating company level and a 60/40 ratio at the consolidated level as required by the bankruptcy stipulation (TR Vol. 2, p. 42), there is record evidence that BBIL's existing operating subsidiaries are leveraged ("geared" is the Australian term) at levels the Commission would consider high for a regulated utility. BBI's 2006 annual report included a chart titled **[*101]** "Current Gearing Status" that showed BBI and its six subsidiaries are lever-

aged in the range of 59 to 90 percent. The utility-related operating subsidiaries, Powerco and IEG, are leveraged at 66 and 67 percent, respectively, which means their equity levels are just 34 and 33 percent, respectively. RDR PSC-29(b); TR Vol. 2, p. 21.

156. Given BBIL's dividend expectations and practices and the highly leveraged capital structures that BBIL has implemented at its existing operating subsidiaries, as well as the financial projections in the acquisition model, it is evident that BBIL's proposed ownership of NorthWestern presents the likelihood that NorthWestern's capital structure will deteriorate and become unacceptably leveraged. This would reverse the prudent course toward financial recovery that NorthWestern has taken since emerging from bankruptcy in 2004. An overleveraged utility would experience increased costs of business. A weak capital structure would have a negative effect on NorthWestern's bond rating, which would increase NorthWestern's costs to borrow money. The Commission has welcomed the improvement in NorthWestern's bond ratings since the company emerged from bankruptcy and **[*102]** expects that trend to continue. Any change that will handicap an improved bond rating is not acceptable to this Commission.

Significance of acquisition model

157. BBIL's rebuttal of MCC's testimony failed to overcome the concern that the transaction poses harm or the risk of harm to Montana ratepayers. Regarding the acquisition model upon which Dr. Wilson's testimony was largely based, BBIL witnesses Mr. Boulton and Mr. Sellar downplayed its significance, arguing it was not an operations or business plan for NorthWestern, but rather an evaluation tool used by BBIL as it considered the acquisition. Mr. Boulton said the model would be set aside once the transaction was consummated. Exh. JA-4, p. 6; TR Vol. 3, p. 110. They claimed MCC had used the model data selectively and inappropriately. Exh. JA-4, p. 7.

158. But contrary to BBIL's representations, the record demonstrates the acquisition model was a significant factor in the BBIL decision to acquire NorthWestern and was relied upon as well by Moody's in its rating assessment review. The model's purpose was clearly stated by Mercer Finance & Risk Consulting, the firm hired by BBI to conduct an audit of the model:

> The objective **[*103]** of the Model is to generate projected cash flow available for debt service, debt service requirements, taxation, cash flow available to equity, equity return analysis and debt cover ratios on the basis of assumptions made and input data provided by the Client... RDR PSC-017(a)

159. BBI decided to submit an offer for NorthWestern based on analysis that was presented to the BBIL and Babcock & Brown Investor Services boards in April 2006. RDR PSC-018(d). The boards' minutes of April 7 refer to just two documents that were presented as the boards considered whether to go forward with the acquisition: the March 30, 2006 Capital Approval Request and the "Project Big" slide presentation dated April 7, 2006. RDR PSC-017(b). The Capital Approval Request included the following statement: "The investment has been evaluated based on a number of economic parameters, however, the current bid amount is based primarily on a 40 year financial model of the Company ...."RDR PSC-017(d). "Valuation metrics," "economic sensitivities," and various rate-of-return scenarios derived from the model figured prominently in the board meeting slide presentation. RDR PSC-017(d).

160. It is evident from the extensive **[*104]** discussions that representatives of Moody's conducted with BBI concerning various aspects of the financial model and from the resulting Moody's ratings assessment for BBIL's debt issuance for the NorthWestern acquisition that the ratings agency relied heavily on the financial model in its review of the transaction. Exhibits MCC-9 [Con-

fidential] & MCC-10 [Confidential]; RDR MCC-025 [Confidential]; TR Vol. 3, pp. 169-177 [Confidential].

161. At hearing Mr. Garland said the financial model provided the ratings agency with "a reasonable expectation of what is going to happen," and "give[s] them a reasonable estimate of the capability of NorthWestern and the BBI entities, in this case, to pay its debt," and agreed with MCC counsel that a financial model would provide Moody's with BBI's best effort to forecast earnings over 40 years. TR Vol. 1, pp. 188-189.

162. Dr. Wilson provided an index of the specific sources for the financial projections and numbers he cited in his testimony, most of which came from the BBIL financial model. Exh. MCC-4. There was no dispute that the numerical values referenced by Dr. Wilson in his testimony were accurate.

163. In response to BBIL's argument that Dr. **[*105]** Wilson had been selective in his use of the model, Dr. Wilson acknowledged his testimony was selectively based on the initial 17 years of model results rather than the entire 40 years reflected in the model. He explained he did so for two reasons. First, the BBI model assumes excessive dividends through the year 2023 will be funded by NorthWestern paying out amounts well in excess of earnings. However, beginning in 2024, the model shows the high payout levels continue without exceeding earnings, but only because the model assumes NorthWestern's annual rate of return on equity will increase to 30 to 40 percent, which is extremely unlikely in Dr. Wilson's opinion. Second, Dr. Wilson argued a 30- to 40-year forecast is too long a time period to be reliable in any event. TR, Vol. 2, p. 140.

164. The Commission agrees with Dr. Wilson's assessment that the model is "the clearest and most detailed indication that we have of BBI's expectations and intentions ... ." Exh. MCC-3, pp. 8-9.

Regulatory oversight

165. BBIL and NorthWestern argued that the Commission's regulatory authority and oversight, in combination with the bankruptcy stipulation's financial and structural protections, **[*106]** would prevent the unacceptable equity deterioration that MCC claimed would occur under BBIL ownership. However, as the Commission learned through its experience with NorthWestern's bankruptcy and as aptly put by MCC counsel John Coyle in his opening statement at hearing, "... bad decisions made in the boardroom don't often show up on the balance sheet of the regulatory agency until it's too late to save customers from the problems that its decisions cause." TR Vol. 1, p. 28.

166. The bankruptcy stipulation has been effective in nurturing the financial health of NorthWestern as it recovers from bankruptcy. Its terms protect the regulated utility and ratepayers from the kinds of corporate misadventures with unregulated affiliates that led to the company's bankruptcy in the first place. However, the stipulation's provisions were developed with the current corporate structure of NorthWestern in mind. The parties to the stipulation did not anticipate a change in ownership such as that proposed by BBIL that would result in NorthWestern becoming a holding company subsidiary or include the provisions necessary to protect ratepayers from the possibility in that event of a corporate parent extracting **[*107]** excessive dividends from the regulated utility subsidiary. In that kind of organizational structure, appropriate ring fencing would include a restriction on dividends to prohibit all of the utility's cash from being upstreamed to the holding company parent, or to paraphrase MCC, installing a ring fence around NorthWestern that includes a roof as well as walls. MCC Resp. Brief, p. 28. As Dr. Wilson noted at hearing, "If they can take all the cash and upstream it, your ring fencing limitations are fairly hollow." TR, Vol. 2, p. 171.

Proposed condition to restrict dividends

167. To their credit, the Joint Applicants accepted the majority of MCC's proposed conditions, albeit with some suggested revisions. However, their steadfast opposition throughout the proceeding to MCC's proposed condition that would require prior Commission approval of dividend payments in excess of 100 percent of net earnings served to confirm the contention that BBIL's intent is to extract excessive equity from NorthWestern in order to recover the acquisition premium. BBIL's argument that its acquisition model was just a theoretical exercise and not a real plan makes its reluctance to accept any restrictions **[*108]** on dividend payouts in excess of 100 percent of net earnings all the more puzzling and troubling. If indeed BBIL has no intention for NorthWestern to pay out excessive dividends, it is difficult to understand why BBIL would not accept the proposed MCC condition to restrict its ability to do so. BBIL's protests that a company -wide dividend restriction oversteps the bounds of the Commission's jurisdiction, is unnecessary in light of the PSC's regulatory authority, ignores the need for NorthWestern distributions to Holdco for tax payment, and incorrectly implies that inadequate service will result if NorthWestern's dividends exceed net income seem inexplicable when the proposed condition was not even an outright prohibition against the dividend practice but simply a requirement for prior Commission approval each time.

168. Perhaps recognizing belatedly the seriousness of the equity deterioration concern raised by MCC, the Joint Applicants proposed in their final brief a minimum 40-percent common equity ratio condition and the exclusion from NorthWestern's balance sheet the goodwill amount resulting from the acquisition premium paid by BBIL. JA Reply Brief, p. 8. That proposal was a step **[*109]** forward by the Joint Applicants but even at that late date they continued to resist the MCC dividend restriction condition. In addition, even though Mr. Hanson agreed at hearing to accept a condition that the existing $ 435 million in goodwill on NorthWestern's books be excluded for ratemaking (TR Vol. I, pp. 234-235), the Joint Applicants did not repeat that offer to exclude the $ 435 million as well as the BBIL acquisition premium in their reply brief. (The Commission notes its agreement with Mr. Hanson that the current amount of $ 435 million of goodwill on NorthWestern's financial statements will be excluded from any future determination of the amount of equity in the capital structure because the Commission does not allow the recovery of acquisition adjustments in any form for ratemaking absent a showing of good cause.)

Statement of Factors analysis

169. The *Statement of Factors* was developed by the 2004 Commission to provide prospective purchasers of NorthWestern, which had just emerged from bankruptcy when the Statement was issued, with guidance regarding the elements and characteristics that would comprise a superior acquisition proposal, in the PSC's judgment. **[*110]** The Commission specifically said the *Statement* was not intended to prejudge any issues that might arise in a sale proceeding or to bind future commissioners. The factors listed in the *Statement* remain relevant to the Commission's evaluation of the proposed sale, given that NorthWestern used them to assess the acquisition proposals it solicited and that intervenors applied them to BBIL's proposal.

170. BBIL said all the right things in response to the *Statement of Factors.* But for the most part, those statements of good intentions were not supported with substantive and binding commitments to meet the factors' expectations. In fairness, it is not possible to know with certainty what future post-acquisition actions BBIL or any prospective purchaser might take that would tip the scale one way or the other regarding many of the factors.

171. The first of the eight evaluation factors, which is the financial strength and capability of the acquirer, is arguably the most important. The *Statement* lists explicit preferences for an acquirer

that is a financially stable, investment grade utility with no expectation of recovering any acquisition premium in rates and that will commit **[*111]** to continuing the post-bankruptcy ring fencing provisions, funding the pension plan, and long-term ownership. BBIL fails to satisfy this factor because, as discussed in this Order, the Commission concludes that BBIL's financial plans for NorthWestern as depicted in its acquisition model belie BBIL's statements that it has no intention of recovering the acquisition premium in rates.

172. Energy Utility Management Experience and Montana Focus are the only two factors that the Joint Applicants successfully demonstrated. Regarding utility management experience, BBIL owns and operates energy distribution and transmission assets worldwide and, until recently, held stakes in two generation assets. Some of BBIL's energy sector managers, notably those who worked at Powerco, have significant experience in a somewhat relevant utility business to add to the experience and expertise of NorthWestern's current managers, who would continue to manage the utility.

173. Regarding a demonstrable Montana Focus, the Joint Applicants reversed their initial position that no additional Montana focus was necessary. Laudably, they committed in their opening brief that NorthWestern would either move its corporate **[*112]** headquarters to Montana after three years or establish a separate Montana regulated operations business entity. Opening Br., p. 38.

174. The remainder of the factors were generally addressed with statements of good intentions but lacked binding, substantive commitments.

Intervenors' recommendations and proposed conditions

175. Intervenors in the case recommended various courses of action to the Commission. District XI/ NRDC/RNP took no position in its response brief, but had advocated in Dr. Power's testimony that NorthWestern improve its Montana focus in recognition of the fact that most of the utility's business is in Montana. NorthWestern responded in its initial post-hearing brief that it would in three years either move its corporate headquarters to Montana or, alternatively, establish a separate Montana regulated operations entity. The Commission's denial of this application does not diminish the importance of NorthWestern's evolution into a Montana-focused utility. The Commission encourages NorthWestern to follow through on its commitment and proceed to either establish a Montana corporate headquarters or a separate Montana regulated operations entity.

176. Heartland/SDPPI **[*113]** took no position. CELP/YELP submitted no testimony in the docket, but recommended denial of the application in their response brief. MCC, AARP, and the Ammondson Plaintiffs recommended approval but only with various conditions.

177. Had the application been approved the Commission would have rejected AARP's and the Ammondson Plaintiffs' proposed conditions. Four of the six AARP conditions related to USB or other existing programs and the appropriate venue for addressing them would be when there is a fully developed record in a general rate case. There is not a fully developed record regarding those items in this docket. The Fuel Fund and Challenge Grant Program was established voluntarily by NorthWestern to assist customers who were facing significant rate increases due to the extremely volatile natural gas market. AARP's proposed condition that would have required shareholders to fund an expanded program is not reasonable. With respect to the penalties proposed for failing to meet the annual average answer time of 80 percent of calls answered within 30 seconds, the proposed penalties are excessive and unreasonable, and would not have been approved by the Commission. NorthWestern **[*114]** pointed out that the call center is staffed to handle normal call traffic. However, at times of widespread weather-related outages, the call center statistics will be adversely affected.

178. Regarding the Ammondson Plaintiffs' proposed condition to require NorthWestern and BBIL to set aside separate funds to pay the $ 21.5 million state court judgment recently won by the Ammondson Plaintiffs, the Commission responds that it does not have statutory authority to enforce judgments from court cases. At hearing Mr. Hanson testified that NorthWestern would pay the judgment if upheld by the appellate court. TR Vol. 1, pp. 94-95. There is no evidence on the record that NorthWestern will be unable to pay the ultimate judgment found to be appropriate by the court. Finally, the Ammondson Plaintiffs admit in their post-hearing brief that NorthWestern has posted a $ 25,800,000 *supersedeas* bond with the state court. Ammondson Plaintiffs' Resp. Br., p. 3.

179. The MCC-proposed conditions were right on the mark in their attempt to ensure the continued ability of NorthWestern to provide adequate service at reasonable rates if the Commission approved the transaction. But the Commission by this **[*115]** Order denies the application. The Joint Applicants chose to submit an application that was short on substance and long on promises. It is neither the Commission's responsibility nor preference to try to "fix" its serious deficiencies and mitigate the harm the proposed transaction poses to ratepayers by adopting conditions to approval. Furthermore, even if the Commission was so inclined, the Commission has no confidence that conditions that would cover all contingencies and risks presented by BBIL ownership could be crafted or effectively enforced.

Status quo vs. BBIL ownership

180. The Commission prefers the model of a stand-alone NorthWestern continuing to improve its financial outlook to the prospect of a BBIL-owned NorthWestern that is making excessive equity distributions to its owner, retaining insufficient earnings at the utility level, and experiencing a deteriorating capital structure " all to the detriment of the utility and Montana customers.

181. Mr. Hanson testified at hearing that NorthWestern is now a financially stable utility that has access to capital markets and is improving its credit ratings, including receiving an investment grade rating on secured debt from **[*116]** Fitch. TR Vol. 1, pp. 101-102. He said that NorthWestern was financially capable on its own of making the investments in the transmission projects and Colstrip 4 that BBIL planned to make if it acquired NorthWestern. TR Vol. 1, p. 114.

182. Mr. Hanson argued that, if the application is denied, the Commission should not expect that NorthWestern will remain a stand-alone utility for long. He claimed that, even though the large stockholders who wanted a NorthWestern sale have sold all or most of their shares, a large percentage of shares are currently held by hedge funds or "merger arbitragers" who bought stock after the sale announcement in anticipation of a short-term return. In Mr. Hanson's opinion, these short-term owners will pressure NorthWestern to find a way to recover their investments if this merger is denied. TR Vol. 1, p. 104-106 and p. 150.

183. Even if Mr. Hanson's prediction is correct that NorthWestern will not remain a stand-alone utility for long if the sale to BBIL is denied, that possibility does not have any bearing one way or the other on the merits of the proposed acquisition at issue in this proceeding.

CONCLUSIONS OF LAW

1. All findings of fact that **[*117]** are properly conclusions of law are incorporated herein and adopted as such.

2. The Commission has provided adequate public notice of all proceedings, and an opportunity to be heard to all interested parties in this docket. *§ 69-3-104, MCA*.

3. The Commission supervises, regulates, and controls public utilities pursuant to *Title 69, Chapter 3, MCA*. *§ 69-3-102, MCA*.

4. The Commission has authority to do all things necessary and convenient in the exercise of the powers granted to it and to regulate the mode and manner of all investigations and hearings before it. *§ 69-3-103, MCA*.

5. Public utilities are required to provide reasonably adequate service and facilities at just and reasonable rates. *§ 69-3-201, MCA*.

6. Pursuant to its authority, the Commission has jurisdiction over and must approve any sale or transfer of a public utility, its assets or utility obligations in order to assure generally that utility customers will receive adequate service and facilities, that utility rates **[*118]** will not increase as a result of the sale or transfer, and that the acquiring entity is fit, willing, and able to assume the service responsibilities of a public utility.

7. The Commission must deny authorization for any securities transaction if the transaction is inconsistent with the public interest. *§ 69-3-504, MCA*.

8. NorthWestern is a public utility subject to the jurisdiction of the Commission.

ORDER

The Commission denies the joint application of NorthWestern Corporation and BBIL, BBI US Holdings Pty Ltd., BBI US Holdings II Corp., and BBI Glacier Corp. for approval of the sale and transfer of NorthWestern Corp. pursuant to a merger agreement because the proposed transaction presents the risk of harm to NorthWestern's financial integrity and to Montana customers of NorthWestern and also denies authorization for the issuance of securities to complete the proposed transaction because such issuance is inconsistent with the public interest.

DONE AND DATED this 31 st day of July 2007 by a vote of 5 to 0.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION

GREG JERGESON, Chairman

DOUG MOOD, Vice-Chairman

ROBERT H. RANEY, Commissioner **[*119]**

BRAD MOLNAR, Commissioner

KEN TOOLE, Commissioner

Tennessee Consumer Advocate v. Tennessee Regulatory Auth.

Court of Appeals of Tennessee, Middle Section, At Nashville
March 5, 1997, FILED
Appeal No. 01A01-9606-BC-00286

Reporter: 1997 Tenn. App. LEXIS 148; 1997 WL 92079

TENNESSEE CONSUMER ADVOCATE, Plaintiff/Appellant, VS. TENNESSEE REGULATORY AUTHORITY AND UNITED CITIES GAS COMPANY, Defendant/Appellee.

Prior History: [*1] APPEAL FROM THE DAVIDSON COUNTY TENNESSEE PUBLIC SERVICE COMMISSION, AT NASHVILLE, TENNESSEE. TN Regulatory Authority Trial No. 95-01134.

Disposition: REVERSED AND REMANDED

Core Terms

notice, staff, cross-examine, judicial notice, impeach, agency member, administrative judge, attorney general, hearing officer, contradict

Case Summary

Procedural Posture

Appellant, the Tennessee Consumer Advocate, petitioned the court for review of administrative decisions of the Tennessee Public Services Commission pursuant to Tenn. R. App. P. 12.

Overview

When a public utility filed with the Commission an application for approval of a scheme of variable rates based upon the wholesale price of gas purchased from the suppliers, the Consumer Advocate was granted leave by the Commission to intervene. The Commission then approved the scheme. The Consumer Advocate argued that the Commission denied it an opportunity to be heard, the decision was void due to ex parte communications having taken place, and that it was not notified of the material noticed or given an opportunity to rebut it. The court reversed and remanded the order, holding that the Commission had failed to give timely notice of certain communications, had failed to give the Consumer Advocate a chance to rebut certain reports, and had committed a violation of basic principles of fairness, making the order invalid.

Outcome

The court reversed, vacated, and remanded the order entered by the Commission.

LexisNexis® Headnotes

Administrative Law > Agency Adjudication > Hearings > General Overview
Civil Procedure > ... > Justiciability > Standing > General Overview
Energy & Utilities Law > Regulators > Public Utility Commissions > General Overview
Energy & Utilities Law > Natural Gas Industry > Distribution & Sale
Energy & Utilities Law > Pipelines & Transportation > Natural Gas Transportation

HN1 By *Tenn. Code Ann. § 65-4-118*, the Consumer Advocate Division of the Office of Attorney General and Reporter may with the approval of the Attorney General and Reporter appear before any administrative body in the interests of Tennessee consumers of public utility services.

Administrative Law > Agency Adjudication > Hearings > General Overview
Energy & Utilities Law > Regulators > Public Utility

Commissions > General Overview
Evidence > ... > Expert Witnesses > Credibility of Witnesses > Impeachment

HN2 See *Tenn. Code Ann. §§ 65-2-109(1)* and *(2)*.

Administrative Law > Agency Adjudication > Hearings > General Overview
Administrative Law > Agency Adjudication > Prehearing Activity
Evidence > Judicial Notice > General Overview

HN3 The issue of consideration of documents and/or communications is not an issue of "judicial notice" or "administrative notice," but an issue of admissibility of evidence and procedural fairness in respect to notice of the matter to be considered and opportunity to cross-examine, or impeach the source or contradict the evidence to be considered. Administrative agencies are permitted to consider evidence which, in a court of law, would be excluded under the liberal practice of administrative agencies. Almost any matter relevant to the pending issue may be considered, provided interested parties are given adequate notice of the matter to be considered and full opportunity to interrogate, cross-examine and impeach the source of information and to contradict the information.

Administrative Law > Agency Adjudication > Prehearing Activity

HN4 See *Tenn. Code Ann. § 4-5-312(b)*.

Administrative Law > Agency Adjudication > Prehearing Activity

HN5 See *Tenn. Code Ann. § 4-5-313(6)*.

Administrative Law > Agency Adjudication > Hearings > General Overview
Administrative Law > ... > Statutory Rights > Impartial Decisionmaker > General Overview
Administrative Law > ... > Statutory Rights > Impartial Decisionmaker > Ex Parte Contacts

HN6 See *Tenn. Code Ann. § 4-5-304(a)(b)*.

Counsel: Charles W. Burson, Attorney General & Reporter, L. Vincent Williams, Consumer Advocate Division, Nashville, TN, ATTORNEY FOR PLAINTIFF/APPELLANT.

H. Edward Phillips, III, Tennessee Regulatory Authority, Nashville, TN, ATTORNEY FOR DEFENDANT/APPELLEE.

Judges: HENRY F. TODD, PRESIDING JUDGE, MIDDLE SECTION, CONCUR: BEN H. CANTRELL, JUDGE, WILLIAM C. KOCH, JR., JUDGE

Opinion by: HENRY F. TODD

Opinion

OPINION

The petitioner, Tennessee Consumer Advocate, has petitioned this Court for review of administrative decisions of the Tennessee Public Services Commission pursuant to T.R.A.P. Rule 12. By order entered by this Court on October 3, 1996, the review is limited to an order entered by the Commission on May 3, 1996. However, the circumstances stated hereafter require reference to an order previously entered by the Tennessee Public Service Commission on May 12, 1995.

The Parties.

Prior to June 30, 1996, the Public Service Commission controlled the charges of public utilities in Tennessee. On June 30, 1996, the Public Service **[*2]** Commission was discontinued by enactment of the Legislature which created the Tennessee Regulatory Commission which has been substituted for the Public Service Commission in proceedings before this Court.

HN1 By *T.C.A. § 65-4-118*, the Consumer Advocate Division of the Office of Attorney General and Reporter may with the approval of the Attorney General and Reporter appear before any administrative body in the interests of Tennessee consumers of public utility services.

United Cities Gas Company is a public utility which purchases and distributes natural gas through its pipelines to patrons in parts of Tennessee.

The Administrative Proceedings.

On January 20, 1995, United filed with the Public Utilities Commission (hereafter P.S.C.), an application for approval of a scheme of variable rates based upon the wholesale price of gas purchased from suppliers.

P.S.C. granted leave to the Consumer Advocate to intervene.

On May 12, 1995, the P.S.C. entered an order approving the proposed scheme on condition that an independent consultant be engaged to review the "mechanism" and report to the commission annually.

On October 31, 1995, United Gas submitted to the Commission for approval, a **[*3]** contract with Consulting & Systems Integration, providing that the work was to be performed by a Mr. Frank Creamer. Subsequently, United Gas requested that Anderson Consulting be substituted for Consulting Systems because Mr. Creamer had severed his connection with Consulting Systems and affiliated with Anderson.

The May 3, 1996, order of the Commission, which is the subject of this appeal, approved the contract with Anderson Consulting and thereby satisfied all of the conditions for activation of the rate plan conditionally approved in the May 12, 1995 order.

On appeal, the Consumer Advocate presents ten issues for review. Only those which relate to the May 3, 1996, order will be considered.

The appellant's fourth, fifth, sixth and seventh issues are:

> IV. The commission's action violated statutory provisions, was asked upon unlawful procedure, was arbitrary and capricious, or was clear error when it took judicial notice of a report prepared by a consultant of UCG.
>
> V. The Consumer Advocate was denied an opportunity to be heard as to the propriety of taking judicial notice of the report.
>
> VI. The Consumer Advocate division was not notified of the material noticed **[*4]** and afforded an opportunity to contest and rebut the facts or material so noticed.
>
> VII. A decision of the Tennessee Public Service Commission is void or voidable when agency members receive aid from staff assistants, and such persons received ex parte communications of a type that the administrative judge hearing officer or agency members would be prohibited from receiving, and which furnish, augment, diminish or modify the evidence in the record in violation of *Tenn. Code Ann. § 4-5-304(b)*.

At a hearing before the Commission on February 3, 1996, the following occurred:

> Mr. Irion: We have the independent consultant here. Does the Commission on wish to hear from him?
>
> Chairman: I think what we have agreed to is just summarize his testimony.
>
> Mr. Williams: He has not made any testimony, and --
>
> Mr. Irion: He has only filed a report, and he is not technically our witness or --
>
> Mr. Williams: I think he is their witness. They chose him and paid for him. We did not have any choice. The Consumer Advocate was not given any choice in the matter who was going to be the witness.
>
> Chairman: The Commission can take judicial notice of that, that record. **[*5]** That's our record.
>
> Com. Hewlett: This is our consultant.
>
> Mr. Hal Novak: That's correct, sir. The Commission staff chose this consultant.

Chairman: We can take judicial notice of that and it can referred to in your argument here.

Mr. Williams: I would say that the Commission staff approved the consultant after the company selected the consultant.

Mr. Novak: That's not true, sir.

Chairman: Well, now wait a minute now, fellows. We can take judicial notice, and will take judicial notice of all our records and reports like that to the Commission and you can refer to that in your argument.

Mr. Williams: What I would also like to do, Commissioner, maybe we need to have a longer period of time. I would like to know what the staff's position -- it was indicated that the staff had a position that the rule operated effectively, that the Commissioners had obviously heard and were considering. I would like disclosure under the statute of the staff's position on why they think that it operates correctly.

Com. Hewlett: Well, that would be in my way of thinking not impossible to get into the record, but very difficult it is most appropriate, as I understand **[*6]** the law, for us to discuss with our technical staff. That's the reason that the Consumer Advocate Division was created because of the ex parte concerns of when our staff were parties to the case and when they are not. Our staff, as I understand it, it not a party to this case, and they are a resource for us for analyzing anything that is before this Commission. In this case this situation. So, I think you are trying to make a party to the case somebody that is not.

Mr. Williams: No, sir, what we are trying to do is get all the salient information on the record. The statute explicitly, the UAPA explicitly requires that the Commission disclose when it has any of the position papers that are presented by the staff, and the Public Records Act does not prevent the disclosure of those items either.

Chairman: We will rule on that at the beginning of the meeting at 1:30.

Mr. Williams: Okay.

Chairman: Well, we will evaluate that with our legal counsel, and rule on it before issuing an order or in the order in this manner.

The record of proceedings clearly indicates that the Commission considered a report of an expert despite the objections of the Consumer Advocate and **[*7]** his efforts to impeach the report by cross-examination of the expert. *T.C.A. § 65-2-109(1)* and *(2)*, ***HN2*** authorize the consideration of a broad spectrum of evidence. However, no authority is cited to empower the Commission to deny a protesting party access to all evidence considered by the Commission and opportunity to impeach it by cross-examination of the origin of such evidence.

HN3 The issue of consideration of documents and/or communications is not an issue of "judicial notice" or "administrative notice," but an issue of admissibility of evidence and procedural fairness in respect to notice of the matter to be considered and opportunity to cross-examine, or impeach the source or contradict the evidence to be considered.

It is elementary that administrative agencies are permitted to consider evidence which, in a court of law, would be excluded under the liberal practice of administrative agencies. Almost any matter relevant to the pending issue may be considered, provided interested parties are given adequate notice of the matter to be considered and full opportunity to interrogate, cross-examine and impeach the source of information and to contradict the information.

No error is found **[*8]** in the consideration of informal forms of communication. However, er-

ror is found in the failure to give timely notice of the communication with opportunity to question, cross-examine and impeach the source and contradict the information.

As illustrated by the above quotation from the record, the Commission was unfamiliar with basic rules of fairness in an administrative hearing.

> *Tenn. Code Ann. § 4-5-312(b)*
>
> ***HN4*** Procedure of hearing. To the extent necessary for full disclosure of all relevant facts and issues, the administrative judge or hearing officer shall afford to all parties the opportunity to respond, present evidence and argument, conduct cross-examination, and submit rebuttal evidence, as restricted by a limited grant of intervention or by the prehearing order. (Emphasis added.)
>
> *Tenn. Code Ann. § 4-5-313(6)*
>
> ***HN5*** Parties must be notified before or during the hearing, or before the issuance of any initial or final order that is based in whole or in part on facts or material noticed, of the specific facts or material noticed and the source thereof, including any staff memoranda and data, and be afforded an opportunity to contest and rebut the facts or material **[*9]** so noticed.
>
> *Tenn. Code Ann. § 4-5-304(a)(b)*
>
> ***HN6*** Ex parte communications.
>
> (a) Unless required for the disposition of ex parte matters specifically authorized by statute, an administrative judge, hearing officer or agency member serving in a contested case proceeding may not communicate, directly or indirectly, regarding any issue in the proceeding, while the proceeding is pending, **with any person without notice and opportunity for all parties to participate in the communication.**
>
> (b) Notwithstanding subsection (a), an administrative judge, hearing officer or agency member may communicate with agency members regarding a matter pending before the agency or may receive aid from staff assistants, members of the staff of the attorney general and reporter, or a licensed attorney, **if such persons do not receive ex parte communications** of a type that the administrative judge, hearing officer or agency members would be prohibited from receiving, **and do not furnish, augment, diminish or modify the evidence in the record.** (Emphasis added.)

This Court concludes that the Commission committed a violation of basic principles of fairness in failing to afford the Consumer **[*10]** Advocate reasonable access to the materials to be considered and reasonable opportunity to cross-examinate or otherwise impeach the origin of such materials.

For the foregoing reasons, the order entered by the Public Service Commission on May 3, 1996, is reversed, vacated, and the cause is remanded to the Tennessee Regulatory Authority for such further proceedings and actions as it may deem appropriate including a reconsideration of the subject of the May 3, 1996, order of the Public Service Commission.

Should the Regulatory Authority reach a conclusion different from that expressed in the May 3, 1996, order of the Commission, the way may be opened for a further consideration of the subject matter of the May 26, 1995, order, in which event the authority will be free to examine the merits of the order and the proposal dealt with therein.

Of particular interest and concern are the propriety of omitting certain income from considering "fair return," of "rewarding" utility for keeping its expenses at the minimum, and of utilizing the services of an expert employed by the utility. These issues have not been discussed in this opinion because of the limitation

of the scope of the appeal **[*11]** granted by this Court.

Costs of this appeal are assessed against the Tennessee Regulatory Authority.

REVERSED AND REMANDED.

HENRY F. TODD

PRESIDING JUDGE, MIDDLE SECTION

CONCUR:

BEN H. CANTRELL, JUDGE

WILLIAM C. KOCH, JR., JUDGE

BellSouth Telcoms. v. Bissell

Court of Appeals of Tennessee, Middle Section, At Nashville
August 28, 1996, FILED
Consolidated Appeal No. 01A01-9504-BC-00165

Reporter: 1996 Tenn. App. LEXIS 537; 1996 WL 482975

BELLSOUTH TELECOMMUNICATIONS, INC. d/b/a SOUTH CENTRAL BELL TELEPHONE COMPANY, Petitioner/Appellant, v. KEITH BISSELL, CHAIRMAN; STEVE HEWLETT, COMMISSIONER; SARA KYLE, COMMISSIONER; Constituting the Tennessee Public Service Commission, Respondents/Appellees.

Subsequent History: [*1] As Corrected September 19, 1996.

Prior History: APPEAL FROM THE TENNESSEE PUBLIC SERVICE COMMISSION AT NASHVILLE, TENNESSEE. Tennessee Public Service Commission Docket Numbers: 94-02610, 94-04482, 94-04483, 94-04485, 95-01137, 95-01139, 95-01140, 95-01141, 95-01142, 95-02207, 95-02208, 95-02639, 95-02640, 95-02641.

Disposition: AFFIRMED AND REMANDED

Core Terms

tariffs, intralata, telecommunications service, customers, interlata, telephone, carriers, administrative agency, suspend, dialing, intervene, public service, certificate, territory, file a petition, long distance, toll, interexchange, convenience and necessity, arbitrary and capricious, consolidated, defer

Case Summary

Procedural Posture

Respondent public service commission (PSC) granted tariffs requested by several telephone service companies. Petitioner telephone service provider challenged the PSC's decision granting the tariffs.

Overview

Several telephone service companies applied to the PSC for an increase in their tariff rates. Petitioner intervened in the action seeking suspension of the tariffs and to set hearings, asserting that the PSC should have denied the tariffs because they violated prior PSC orders and policies and that the proceeding violated the Tennessee Telecommunications Reform Act of 1995. The court determined that its scope of review was limited to determining whether the PSC's decision was an abuse of discretion, arbitrary or capricious. The court affirmed the PSC's judgment, finding no abuse of discretion, arbitrariness, or capriciousness and that its review was to be made in deference to the PSC because it was acting within its area of specialized knowledge, experience, and expertise. The court further held that the alleged violation of the Tennessee Telecommunications Act was not properly before it for review because the issue had not been presented to the PSC for determination.

Outcome

The judgment of the PSC granting the tariffs requested by the telephone service companies was affirmed.

LexisNexis® Headnotes

Energy & Utilities Law > Utility Companies > General Overview
Energy & Utilities Law > Utility Compa-

nies > Rates > General Overview

HN1 A tariff is the schedule of prices and regulations for a particular service which is filed with the public service commission and serves as the official published list of charges, terms and conditions governing the provision of the service or facility. Tariffs functions in lieu of a contract between an end user and a service provider.

Communications Law > Federal Versus State Law > Intrastate Communications > State Regulation of Intrastate Communications
Energy & Utilities Law > Utility Companies > General Overview

HN2 Except as exempted by provisions of state or federal law, no individual or entity shall offer or provide any individual or group of telecommunications services, or extend its territorial areas of operations without first obtaining from the commission a certificate of convenience and necessity for such service or territory; provided, that no telecommunications services provider offering and providing a telecommunications service under the authority of the commission on June 6, 1995, is required to obtain additional authority in order to continue to offer and provide such telecommunications services as it offers and provides as of June 6, 1995. *Tenn. Code Ann. § 65-4-201(b)* (Supp. 1995).

Administrative Law > Judicial Review > General Overview

HN3 Pursuant to *Tenn. Code Ann. § 4-5-322(h)*, the court may affirm the decision of a state agency or remand the case for further proceedings. The court may reverse or modify the decision if the rights of the petitioner have been prejudiced because of administrative findings, inferences, conclusions or decisions are: (1) in violation of constitutional or statutory provisions; (2) in excess of the statutory authority of the agency; (3) made upon unlawful procedure; (4) arbitrary or capricious or characterized by abuse of discretion or clearly unwarranted exercise of discretion; or (5) unsupported by evidence which is both substantial and material in the light of the entire record. In determining the substantiality of evidence, the court shall take into account whatever in the record fairly detracts from its weight, but the court shall not substitute its judgment for that of the agency as to the weight of the evidence on questions of fact.

Administrative Law > Judicial Review > Standards of Review
Administrative Law > Judicial Review > Standards of Review > General Overview
Energy & Utilities Law > Administrative Proceedings > Judicial Review > General Overview
Energy & Utilities Law > Administrative Proceedings > Judicial Review > Standards of Review
Energy & Utilities Law > Regulators > Public Utility Commissions > General Overview
Energy & Utilities Law > ... > Public Utility Commissions > Hearings & Orders > Judicial Review

HN4 The court examines the public service commission's adjudicatory decisions using the same standards of review applicable to the decisions of other administrative agencies.

Administrative Law > Judicial Review > Standards of Review > General Overview
Administrative Law > Judicial Review > Standards of Review > De Novo Standard of Review
Environmental Law > Solid Wastes > Disposal Standards

HN5 Courts defer to the decisions of administrative agencies when they are acting within their area of specialized knowledge, experience, and expertise. The court does not review the factual issues de novo, and therefore, does not substitute its judgment for the agency's as to the weight of the evidence. The court may construe statutes, and apply the law to the facts.

Administrative Law > Judicial Review > Standards of Review > Arbitrary & Capricious Standard of Review
Civil Procedure > Appeals > Standards of Review > Clearly Erroneous Review

HN6 Under *Tenn. Code Ann. § 4-5-322(h)(4)*'s "arbitrary and capricious" standard, the court should determine whether the administrative agency has made a clear error in judgment. An arbitrary decision is one not based on any course of reasoning or exercise of judgment, or

one which disregards the facts or circumstances of the case without some basis that would lead a reasonable person to reach the same conclusion.

Administrative Law > Judicial Review > Standards of Review > General Overview
Environmental Law > Solid Wastes > Disposal Standards

HN7 In reviewing an administrative decision with regard to *Tenn. Code Ann. § 4-5-322(h)(5)*, the court should examine the record carefully to determine whether the administrative agency's decision is supported by such relevant evidence as a rational mind might accept to support a rational conclusion. This amounts to something less than a preponderance of the evidence, but more than a scintilla or glimmer.

Administrative Law > Agency Rulemaking > General Overview
Communications Law > ... > Regulated Entities > Telephone Services > General Overview
Energy & Utilities Law > Regulators > Public Utility Commissions > General Overview
Energy & Utilities Law > Utility Companies > General Overview
Governments > Local Governments > Metropolitan Statistical Areas
Governments > State & Territorial Governments > Boundaries

HN8 A state's power to regulate extends to all local access and transport areas within its boundaries. The Tennessee Public Service Commission (PSC) has regulatory authority over the telephone companies of the state. The PSC exercises co-mingled legislative, executive, and judicial functions. The PSC must base the exercise of its rulemaking or adjudicatory authority on state law.

Administrative Law > Judicial Review > General Overview
Administrative Law > Judicial Review > Reviewability > General Overview
Administrative Law > Judicial Review > Reviewability > Standing
Administrative Law > Judicial Review > Standards of Review > General Overview
Energy & Utilities Law > Administrative Proceedings > General Overview
Energy & Utilities Law > Administrative Proceedings > Judicial Review > General Overview
Energy & Utilities Law > Regulators > Public Utility Commissions > General Overview
Energy & Utilities Law > ... > Public Utility Commissions > Hearings & Orders > Judicial Review
Environmental Law > Administrative Proceedings & Litigation > Judicial Review

HN9 A person who is aggrieved by a final decision of the Public Service Commission in a contested case is entitled to judicial review. *Tenn. Code Ann. § 4-5-322(a)(1)* (1991). Upon review, the court may affirm the decision of the agency or remand the case for further proceedings. *Tenn. Code Ann. § 4-5-322(h)*. When appealing a decision of the Public Service Commission, an aggrieved person shall file their petition for review in the court. *Tenn. Code Ann. § 4-5-322(b)(1)*. Thereafter, the court must confine its review to the record and decide the issues without a jury. *Tenn. Code Ann. § 4-5-322(g)*.

Counsel: SANDRA L. RANDLEMAN, CHARLES L. HOWORTH, JR., BellSouth Telecommunications, Inc., Nashville, Tennessee, ATTORNEYS FOR PETITIONER/APPELLANT.

VAL SANFORD, JOHN KNOX WALKUP, Gullett, Sanford, Robinson & Martin, Nashville, Tennessee, ATTORNEYS FOR AT&T COMMUNICATIONS OF THE SOUTH CENTRAL STATES, INC. AND MCI TELECOMMUNICATIONS CORPORATION.

ROGER A. BRINEY, ESQ., AT&T Communications of the South Central States, Atlanta, Georgia, OF COUNSEL FOR AT&T COMMUNICATIONS OF THE SOUTH CENTRAL STATES, INC.

MARTHA P. MCMILLIN, ESQ., MCI Telecommunications Corporation, Atlanta, Georgia, OF COUNSEL FOR MCI TELECOMMUNICATIONS CORPORATION.

D. BILLYE SANDERS, Waller Lansden Dortch & Davis, Nashville, Tennessee, ATTORNEY FOR SPRINT COMMUNICATIONS COMPANY L.P.

BENJAMIN W. FINCHER, Sprint Communications Company L.P., Atlanta, Georgia, ATTORNEY FOR SPRINT COMMUNICATIONS COMPANY L.P.

DIANNE F. NEAL, General Counsel, Tennessee Public Service Commission, Nashville, Tennessee.

Judges: SAMUEL L. LEWIS, JUDGE, CONCUR: BEN H. CANTRELL, JUDGE, WILLIAM C. KOCH, Jr., JUDGE

Opinion by: SAMUEL L. LEWIS

Opinion

OPINION

Introduction

This appeal involves the judicial review of five Tennessee Public Service Commission orders. The orders approved tariffs filed by AT&T **[*2]** Communications of the South Central States, Inc., Sprint Communications Company, L.P., and MCI Telecommunications Corporation. BellSouth Telecommunications Inc., d/b/a South Central Bell, has appealed directly to this Court pursuant to Tenn.R.App.P. 12. They assert that the Tennessee Public Service Commission (Commission or PSC) should have denied the tariffs, as they violated the Commission's prior orders and policies. Additionally, BellSouth contends that the tariffs at issue in this proceeding violate the Tennessee Telecommunications Reform Act of 1995.

We have decided that the PSC did not act arbitrarily or abuse its discretion in approving the tariffs. Also, we decline to decide whether the tariffs violate the Tennessee Telecommunications Reform Act of 1995. The Commission did not render a decision with respect to its interpretation of the Tennessee Act. Accordingly, we affirm the Commission's decision.

Procedural History

This case began on September 8, 1994, the date AT&T filed Tariff No. 94-200 [1] in the offices of the Tennessee Public Service Commission. From that date to June 8, 1995, AT&T filed thirteen additional tariffs [2], MCI filed three tariffs [3], and Sprint filed **[*3]** two tariffs. [4] After each of these companies filed their respective tariffs, petitioner/appellant, BellSouth Telecommunications, Inc. ("BellSouth"), filed petitions for leave to intervene, to suspend the tariffs, and to set hearings.

As to the first six tariffs filed, including five AT&T tariffs and one MCI tariff, the Commission granted BellSouth's petitions to intervene, suspended the tariffs, and **[*4]** consolidated the petitions into docket number 94-02610. On February 22, 1995, the Commission heard oral arguments concerning the six petitions. In its final order, dated March 24, 1994, the Commission held "that the promotions and tariffs involved here are consistent with previous orders and rulings of this Commission and should be approved."

On April 24, 1995, BellSouth filed a petition to review pursuant to Rule 12 of the Tennessee Rules of Appellate Procedure. The petition asked that this court review the March 24, 1995 order as it applied to all six of the tariffs ("Appeal One"). Later, AT&T and MCI filed a joint notice of appearance pursuant to Rule 12(e) of the Tennessee Rules of Appellate Procedure. Sprint, pursuant to Rule 21(b) of the

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[1] ***HN1*** A tariff is the schedule of prices and regulations for a particular service which is filed with the Commission and serves as the official published list of charges, terms and conditions governing the provision of the service or facility. Tariffs functions in lieu of a contract between an end user and a service provider.

[2] The numbers of the AT&T tariffs are 94-200, 94-277, 94-289, 94-292, 94-293, 94-280, 94-284, 95-014, 95-016, 95-103, 95-094, 95-127, 95-139, and 95-140.

[3] The numbers of the MCI tariffs are 94-247, 95-003, and 95-009.

[4] The numbers of the Sprint tariffs are 94-269 and 95-008.

Tennessee Rules of Appellate Procedure, filed a Notice of Appearance, and requested that this Court allow it to adopt the briefs of intervenors AT&T and MCI. We granted the motion.

The next set of tariffs at issue includes two AT&T tariffs and one Sprint tariff. Again, BellSouth responded to the filings of the tariffs with petitions to intervene, to set hearings, and to suspend. Although the Commission failed to consolidate these petitions, **[*5]** it did treat them similarly. It granted BellSouth's petitions to intervene, but denied BellSouth's requests to suspend the tariffs. On May 12, 1995, the Commission filed its final order as to all three tariffs and stated as follows: "These tariffs were not in violation of the Commission's policy on intraLATA competition as established in prior Commission Orders and should be allowed to remain in effect." BellSouth appealed this decision on July 7, 1995, by filing a petition to review pursuant to Rule 12 ("Appeal Two").

The third group of tariffs includes two AT&T tariffs, two MCI tariffs, and one Sprint tariff. For all practical purposes, the history of this group is the same as that of the second group. BellSouth filed petitions as to each tariff. The Commission then granted the petitions to intervene, but denied BellSouth's requests that the Commission suspend the tariffs. The Commission held a hearing and entered a final order on May 12, 1995. The Commission concluded "that these tariffs were not in violation of any prior Commission Order and should be allowed to remain in effect." In response to the Commission's order, BellSouth filed a petition to review pursuant to Rule 12 ("Appeal **[*6]** Three").

The fourth group of tariffs includes two tariffs filed by AT&T. After the filings, BellSouth filed two petitions to "suspend the tariff filing, convene a contested case, and allow leave to intervene." In separate orders, the Commission allowed BellSouth to intervene in both proceedings and denied both of BellSouth's requests to suspend the tariffs. Later, the Commission considered the tariffs at its conference and concluded "that the[] tariffs were not in violation of the Commission's policy on intraLATA competition as established in prior Commission Orders and should be allowed to remain in effect." Following the decision in these cases, BellSouth filed a petition to review pursuant to Rule 12 on September 8, 1995 ("Appeal Four").

The final group of tariffs also involves only AT&T. On May 22, 1995, AT&T filed one tariff, and on June 8, 1995, AT&T filed two additional tariffs. In June 1995, BellSouth filed three petitions to "suspend [the] tariff filing, convene a contested case, and allow leave to intervene." Unlike the other cases, here the Commission denied BellSouth's petitions to intervene and its requests to suspend the tariffs. The Commission found: "Bell's filings **[*7]** fail to allege any new issues or evidence raised by these tariffs other than those previously reviewed and decided by the Commission." Once again, BellSouth filed a petition to review pursuant to Rule 12 on September 25, 1995 ("Appeal Five").

Thus, as of September 25, 1995, BellSouth had five appeals pending in this court. As a result, on September 26, 1995, the Commission, AT&T, and MCI filed a joint motion to consolidate the appeals and a memorandum in support of the motion. This court reserved judgment on the motion until October 25, 1995, when it ordered the appeals consolidated.

As these facts developed, another set of facts relevant to the outcome of this case began to unfold. On June 6, 1995, Governor Don Sundquist signed the Telecommunications Reform Act of 1995 ("the Act") into law. 1995 Tenn. Pub. Acts Ch. 408 § 7. Section seven of the Act amended *Tennessee Code Annotated section 65-4-201* by adding subsection (b). This subsection provides as follows:

> (b) ***HN2*** Except as exempted by provisions of state or federal law, no individual or entity shall offer or provide any individual or group of telecommunications services, or extend its territorial areas of operations without **[*8]** first obtaining from

> the commission a certificate of convenience and necessity for such service or territory; provided, that no telecommunications services provider offering and providing a telecommunications service under the authority of the commission on June 6, 1995, is required to obtain additional authority in order to continue to offer and provide such telecommunications services as it offers and provides as of June 6, 1995.

Tenn. Code Ann. § 65-4-201(b) (Supp. 1995).

On July 24, 1995, AT&T filed a petition asking the Commission to amend its existing certificate of convenience and necessity. AT&T wanted the commission to authorize it to "provide interexchange telecommunication services throughout Tennessee regardless of LATA boundaries." An administrative judge held a hearing and issued an initial order on September 22, 1995. In the initial order, the judge denied AT&T's petition to amend its certificate of convenience and necessity, but issued AT&T a new certificate as a "Competing Telecommunications Service Provider." On October 13, 1995, the Commission entered an order ratifying the initial order of the administrative judge. None of the parties in the present **[*9]** action filed an appeal as to this order before time expired.

At the beginning of oral argument, BellSouth stated that it was voluntarily dismissing the appeal as to the AT&T tariffs. As a result, Appeal Four and Appeal Five are voluntarily dismissed because both contained only AT&T tariffs. Further, AT&T had filed seven of the tariffs in the remaining appeals. Thus, this court is left with three appeals, which we consolidated into one appeal, and a total of five tariffs, three filed by MCI and two filed by Sprint. BellSouth has presented this court with two issues as to each of the tariffs. The issues are as follows:

> [I] Whether the tariffs at issue in this proceeding violate the Tennessee Public Service Commission's Orders and its policy on intraLATA competition? [II] Whether the tariffs at issue in this proceeding violate the Telecommunication reform Act of 1995?

Standard of Review

Tenn. Code Ann. § 4-5-322 provides the appropriate standard of review for Tennessee appellate courts reviewing state agency decisions. Subsection (h) of that statute states:

> (h) ***HN3*** the court may affirm the decision of the agency or remand the case for further proceedings. The **[*10]** court may reverse or modify the decision if the rights of the petitioner have been prejudiced because of administrative findings, inferences, conclusions or decisions are:
>
> (1) In violation of constitutional or statutory provisions;
>
> (2) In excess of the statutory authority of the agency;
>
> (3) Made upon unlawful procedure
>
> (4) Arbitrary or capricious or characterized by abuse of discretion or clearly unwarranted exercise of discretion; or
>
> (5) Unsupported by evidence which is both substantial and material in the light of the entire record.
>
> In determining the substantiality of evidence, the court shall take into account whatever in the record fairly detracts from its weight, but the court shall not substitute its judgment for that of the agency as to the weight of the evidence on questions of fact.

BellSouth contends that subsections (1), (4), and (5) provide grounds for reversal.

This ***HN4*** Court examines the Commission's adjudicatory decisions using the same standards of review applicable to the decisions of other ad-

ministrative agencies. Jackson Mobilphone Co., Inc., v. Tennessee Public Service Com'n, 876 S.W.2d 106, 110 (Tenn.Ct.App. 1993). Thus, we observe the narrow, **[*11]** statutorily defined standard contained in Tenn. Code Ann. § 4-5-322(h)(4), and Tenn. Code Ann. § 4-5-322(h)(5), rather than the broad standard used in other civil appeals. Wayne County v. Tennessee Solid Waste Disposal Control Bd., 756 S.W.2d 274, 279 (Tenn.Ct.App. 1988); *citing* CF Indus. v. **Tennessee** Pub. **Serv**. **Comm'n**, 599 S.W.2d 536, 540 (Tenn. 1980).

Additionally, ***HN5*** courts ***defer*** to the decisions of administrative agencies when they are acting within their area of specialized knowledge, experience, and expertise. Wayne County v. Tennessee Solid Waste Disposal Control Bd., at 279; *citing* Southern Ry. v. State Bd. of Equalization, 682 S.W.2d 196, 199 (Tenn.1984); Freels v. Northrup, 678 S.W.2d 55, 57-58 (Tenn. 1984). We do not review the factual issues de novo, and therefore, do not substitute our judgment for the agency's as to the weight of the evidence. *Id. citing* Humana of Tennessee v. Tennessee Health Facilities Comm'n, 551 S.W.2d 664, 667 (Tenn. 1977). However, we may construe statutes, and apply the law to the facts. Sanifill of Tennessee v. Tennessee Solid Waste Disposal Control Bd., 907 S.W.2d 807, 811 (Tenn. 1995).

As to ***HN6*** Tenn. Code **[*12]** Ann. § 4-5-322(h)(4)'s "arbitrary and capricious" standard, this court should determine "whether the administrative agency has made a clear error in judgment." Jackson Mobilphone Co., Inc., v. Tennessee Public Service Com'n, at 110-11. An arbitrary decision is one not based on any course of reasoning or exercise of judgment, or one which disregards the facts or circumstances of the case without some basis that would lead a reasonable person to reach the same conclusion. *Id.*

Tenn. Code Ann. § 4-5-322(h)(5) does not define what amounts to "substantial and material evidence." However, ***HN7*** in reviewing an administrative decision with regard to Tenn. Code Ann. § 4-5-322(h)(5), this court should examine the record carefully to determine whether the administrative agency's decision is supported by "such relevant evidence as a rational mind might accept to support a rational conclusion." Jackson Mobilphone Co., Inc., v. Tennessee Public Service Com'n at 111, *quoting* Clay County Manor v. State Dep't of Health & Environment, 849 S.W.2d 755, 759 (Tenn. 1993). In general terms this amounts to something less than a preponderance of the evidence, but more than a scintilla **[*13]** or glimmer. Wayne County v. Tennessee Solid Waste Disposal Control Bd., at 280.

The Development of Long Distance Telephone Regulation in the

United States

Early this century the American Telephone and Telegraph Company (AT&T) developed a long distance telephone network superior to its competitors. Later, AT&T'S long distance dominance extended to local calling when it limited connection of its long distance network to its local service network. Eventually, AT&T monopolized all telephone traffic in the United States. *See* GTE Sprint Communications Corp. v. Public Util. Comm'n, 753 P.2d 212, 213 (Colo. 1988). In 1974 the U.S. Department of Justice, responded to AT&T's hegemony by filing an antitrust claim. This claim, settled in 1982, resulted in the largest judicially supervised divestiture in American history. [5]

[*14] The 1982 court-approved order, also known as the Modified Final Judgment (MFJ), accomplished two things significant to this appeal:

(1) it divested AT&T of its twenty-two subsidiaries, which now operate independently as

[5] At the time of the settlement, or "Modified Final Judgment," AT&T was the largest corporation in the world. In 1980 the Bell System's total operating revenues exceeded $ 50 billion which constituted almost two percent of the gross national product of the U.S. that year. United States v. American Tel. & Tel. Co., 552 F. Supp. 131, 152 (D.D.C. 1982), *aff'd sub nom.* Maryland v. United States, 460 U.S. 1001, 75 L. Ed. 2d 472, 103 S. Ct. 1240 (1983).

regulated local monopolies. *United States v. American Tel. & Tel. Co.*, 552 F. Supp. 131, 226 (D.D.C. 1982), *aff'd sub nom. Maryland v. United States*, 460 U.S. 1001, 75 L. Ed. 2d 472, 103 S. Ct. 1240 (1983);

(2) it created a new framework of ownership and rate structure by establishing "Regional Bell Operating Companies" (RBOCs), like BellSouth, which were to divide their territories into new geographical classifications known as "local access and transport areas" (LATAs). *GTE Sprint Communications Corp. v. Public Communications Corp. v. Public. Util. Comm'n*, at 214.

The MFJ allowed the RBOCs to retain a monopoly over local telephone services, but precluded the RBOC's from providing any long distance services. *United States v. American Tel. & Tel. Co.*, at 227-8. Thus, the RBOCs can carry intraLATA traffic (local), but not interLATA traffic (long distance). The MFJ divided the original AT&T territory into 163 LATA's nationally, 5 of which are in Tennessee. ***HN8***

[*15] A state's power to regulate extends to all LATAs within its boundaries. *GTE Sprint Communications Corp. v. Public Util. Comm'n*, 753 P.2d at 214. The Tennessee Public Service Commission has regulatory authority over the telephone companies of this state. *Tennessee-Cable Television Ass'n v. Tennessee Public Service Com'n*, 844 S.W.2d 151, 155 (Tenn.App. 1992). The Commission exercises comingled legislative, executive, and judicial functions. *Id.* at 158; *citing Blue Ridge Transp. Co. v. Pentecost*, 208 Tenn. 94, 343 S.W.2d 903, 904 (Tenn. 1961). Like other administrative agencies, the PSC must base the exercise of its rulemaking or adjudicatory authority on state law. *Id.* at 161.

At divestiture some state public utility commissions, including Tennessee's, initially barred interexchange carriers, [6] (IXCs) from providing intraLATA services. Nevertheless, technological advances in the 1980's brought new service capabilities to the IXCs. The knowledge of these capabilities prompted the IXCs to approach the PSC and request permission to provide some intraLATA services. On July 27, 1991, the PSC responded to the IXC's request and denied them intraLATA certificates which **[*16]** would have permitted them to compete freely in the intraLATA market. However, in an unprecedented step, the Commission agreed to allow the IXCs to provide some intraLATA communications services in 4 specific instances. These instances were exceptions to the PSC rule prohibiting intraLATA competition. Each exception involved access arrangements for the termination and/or origination of calls in local telephone exchanges. The four exceptions to the Commission's policy prohibiting intraLATA communication include:

(1) intraLATA calls made by customers subscribing to interLATA special access (Megacom -like) services;

(2) calls made over private lines that complete the intraLATA portion of an interLATA private line service;

(3) intraLATA "800" calls which are part of an interLATA offering; and

(4) calls prefixed by 10-XXX, 950-XXXX, or some other type of access code which users dial to reach the subscriber's interLATA carrier.

[*17] In its Order the Commission stated:

> Tennesseans may enjoy the benefits of "one-stop shopping" using a single carrier to handle both intra- and interLATA toll calls -- without opening the LATA's to competition and without [the] threatening value of service pricing. . . .
>
> The Commission approves the parties' proposal in this proceeding to "unblock" certain types of intraLATA toll calls. The Commission finds that the reasons for LEC blocking are

[6] Interexchange carriers are facilities based providers of intrastate, interLATA telecommunications services. In Tennessee these providers include AT&T, MCI and Sprint.

> no longer sufficient to outweigh the benefit of making these IXC services available on a statewide basis.

In a footnote on page 5 of the June 27, 1991 Order the PSC stated:

> Since the IXC's applications for intraLATA authority are denied, the carriers' tariff shall continue to describe only interLATA services. The applicants may, however, advertise that the carriers are able to provide statewide service to certain types of customers.

Later in the Order the Commission added:

> The Commission approves the parties proposal in this proceeding to "unblock" certain types of intraLATA toll calls. The Commission finds that the reasons for LEC blocking are no longer sufficient to outweigh the benefit of making **[*18]** these IXC services available on a statewide basis.
>
> As previously discussed, the purpose of this Order is not to promote intraLATA competition between the applicants and the LEC's (local exchange carriers like BellSouth) but to give certain IXC customers the convenience of using one carrier for all intrastate and interstate toll calls.

The Commission added a footnote which provides in part:

> The Commission has consistently followed a policy of protecting local exchange carriers from IXC competition in the intraLATA toll market.

On appeal, BellSouth seeks review of the Commission's orders of March 24, 1995, and May 12, 1995, approving MCI and Sprint tariffs. BellSouth argues that the tariffs violate the Tennessee Public Service Commission's orders and its policy on intraLATA competition. Specifically BellSouth claims that the tariffs "promote," "describe," and "solicit" the use of interexchange services for calls which are not incidental to interLATA service. Stated differently, BellSouth argues the tariffs approved in 1995 permits the interexchange carriers to impermissibly compete in the intraLATA services market.

Analysis

I. Whether the tariffs at issue in this proceeding violate the Commission's prior orders and policy on intraLATA competition.

[*19] BellSouth asserts the 1995 PSC ruling contradicts the Commission's 1991 Order and earlier rulings. However, this Court believes that the June 27, 1991 Order is dispositive as to the issues in this appeal. The PSC historically has made its intent to prevent intraLATA competition clear. However, the June 1991 Order created four exceptions which permit interexchange carriers to carry intraLATA calls. As the Commission stated:

> The Commission approves the parties proposal in this proceeding to "unblock" certain types of intraLATA toll calls. The Commission finds that the reasons for LEC blocking are no longer sufficient to outweigh the benefit of making these IXC services.
>
> As previously discussed, the purpose of this Order is not to promote intraLATA competition between the applicants and the LEC's (local exchange carriers like BellSouth) but to give certain IXC customers the convenience of using one carrier for all intrastate and interstate toll calls.

MCI and Sprint argue that the tariffs they filed simply represent an application of the permissible intraLATA exceptions created **[*20]** in 1991. They submit that the tariffs subject to this appeal do not wrongfully promote intraLATA services, but involve interexchange activity consistent with the Commission's current policy.

To properly determine the controversy between the parties we consider each tariff separately.

MCI 94-247

MCI filed Tariff 94-247 on October 28, 1994. The tariff allegedly offers credits to customers of "MCI Metered Use Service Option J" (MCI Vision) if their "incremental intraLATA usage" exceeds $ 100.00. For those customers accessing the service via a "PBX," the tariff offers a credit of up to $ 250.00 if their intraLATA usage exceeds certain amounts.

The text of the tariff states in part:

> MCI Vision IntraLATA Usage Promotion
>
> Beginning on November 27, 1994, and ending April 14, 1995, MCI will provide the following promotion to new and existing customers of Metered Use Service Option J (MCI Vision) who enroll in the promotion.

An MCI tariff filed with the PSC describes "MCI Vision" as:

> An outbound customized telecommunications service which may include an inbound 800 service option using Business Line, WATS Access Line, or Dedicated Access Line Termination. It provides **[*21]** a unified service for single or multi-location companies using switched, dedicated, and card origination, and switched and dedicated termination.

MCI claims the tariff only contemplates the completion of intraLATA calls in exception category one (special access), exception category three (800 calls part of an interLATA offering), or exception category four (10-XXX prefixed or other dialing code calling). This Court cannot verify with certainty that a category one or category four exception applies. However, it does appear that MCI tariff 94-247 involves intraLATA "800" calls which are a part of an interLATA offering (category three). Thus, this Court cannot assert that "the administrative agency has made a clear error in judgment." *Jackson Mobilphone Co., Inc., v. Tennessee Public Service Com'n*, at 110-11. We agree with the Commission that the tariff is "consistent with previous orders and rulings of this Commission and should be approved."

SPRINT 94-269

The Commission's Final Order on this tariff contains the following statement:

> The Commission considered these tariffs at its regularly scheduled April 18, 1995 Commission Conference. It was concluded after careful **[*22]** consideration of the entire docket constituting the record in this matter, the Commission's prior decisions in Docket Nos. 89-11065 and 94-02610, the provisions of all applicable rules and statutes, particularly the provisions of *TCA 65-5-203*; that these tariffs were not in violation of the Commission's policy on IntraLATA competition as established in prior Commission Orders and should be allowed to remain in effect.

We have reviewed the text of Sprint Tariff 94-269, the PSC's order, and the briefs filed by the parties. Although neither BellSouth nor Sprint has adequately described the rationale for their positions as to this tariff, we cannot affirmatively say that the Commission's "findings, inferences, conclusions or decisions" are so arbitrary as to require reversal. This Court will defer to the decisions of administrative agencies when they are acting within their area of specialized knowledge, experience, and expertise. *Wayne County v. Tennessee Solid Waste Disposal Control Bd.*, 756 S.W.2d 274 (Tenn.Ct.App. 1988). As the Circuit Court of Appeals for the District of Columbia recently stated:

> Where, as here the issue is the Commission's interpretation of a tariff, **[*23]** we defer to its reading if it is "reasonable [and] based upon factors within the Commission's expertise."

American Message Centers v. F.C.C., 311

U.S. App. D.C. 64, 50 F.3rd 35, 39 (D.C. Cir. 1995); *quoting* *Diamond Int'l Corp. v. FCC*, 201 U.S. App. D.C. 30, 627 F.2d 489, 492 (D.C. Cir. 1980).

MCI 95-003

This tariff involves a reduction to MCI's per-minute usage rates for its basic long distance service, Dial One/Direct Dial. It also revises the Time of Day chart to reflect accurate times. The tariff for Dial One/Direct Dial, also known as "Option A" describes the service as:

> [A] one-way, dial in - dial out multipoint service allowing the customer to originate and terminate calls via MCI-provided local business telephone lines. Subscribers to Dial One/ Direct Dial Service may originate calls only from telephones which are served by end offices that have been converted to equal access. Customers served by end offices that have been converted to equal access may originate call by dialing 10222.

Thus, it seems the tariff comports with the limitations imposed by the June 27, 1991 Order. The tariff only describes interLATA services, and users complete intraLATA **[*24]** calls via exception category four (10XXX prefixed or other dialing code calling).

The Commission's May 12, 1995 Order declared that MCI 95-003 "allowed consumers one-stop shopping" for telecommunications services and found no violation of any prior Commission Order.

This Court affirms the Commission's decision to uphold MCI Tariff 95-003, since the services contemplated fall squarely within an exception category. Thus, we do not consider the Commission to have been "arbitrary and capricious" in arriving at their conclusions as to this tariff.

MCI 95-009

MCI 95-009 involves the introduction of a service plan known as "Friends & Family Option B" and the introduction of a new Personal 800 option, "Personal 800 Plan R." Personal 800 Plan R describes the service as:

> Personal 800 Plan R provides a telephone number at which calls may be received from any location within the state of Tennessee for a monthly subscription fee and one-time installation fee as identified in MCI'S F.C.C. Tariff No.1. MCI will provide to the customer and 800 telephone number, a 4-digit Security Code, and a 6 digit Rerouting Code which will allow the customer to use the "Follow-Me" Routing feature. The **[*25]** customer will be charged the per minute usage rates as described in MCI's F.C.C. Tariff No. 1.

This service plan comports with the 1991 Commission Order as it involves the use of "800" calls as a part of an interLATA offering (Category 3). The tariff for Friends and Family Option B is a variant of Option A or "Dial One/ Direct Dial." The tariff for Option A describes the service as:

> [A] one-way, dial in-dial out multipoint service allowing the customer to originate and terminate calls via MCI -provided local business telephone lines. Subscribers to Dial One/Direct Dial Service may originate calls only from telephones which are served by end offices that have been converted to equal access. Customers who prescribe to MCI may originate calls by dialing 1. All customers served by end offices that have been converted to equal access may originate calls by dialing 10222.

This plan uses exception category four of the 1991 PSC order (10XXX prefixed or other dialing code calling). Thus, MCI Tariff 95-009 complies with current Commission orders. We find that the approval of this tariff by the Commission was not "arbitrary and capricious" pursuant to *Tenn. Code Ann.* § 4-5-322(h)(4).

[*26] SPRINT 95-008

The Commission considered this tariff in a docket with MCI 95-003 and MCI 95-009. The Commission, as it had done in every tariff except MCI 94-247, refused to suspend the tariff as BellSouth had requested, finding "no basis on which to suspend the tariff." After reviewing Sprint Tariff 95-008 we too find no provision which violates the Commission's 1991 Order governing intraLATA competition. Thus, we affirm the Commission's conclusion as to this tariff.

We believe that BellSouth has not demonstrated that the MCI and Sprint tariffs were so inconsistent as to warrant this Court's finding the 1995 Commission Orders arbitrary and capricious. Additionally, we agree with MCI's position that the determinative issue in these cases was whether or not the tariff filings were consistent with the 1991 Commission Order. As this determination involves a review of the Commission's orders, the issues in this case were legal in nature. Thus, we need not decide whether "substantial and material evidence" supports the Commission's decision as required by *Tenn. Code Ann. § 4-5-322(h)(5)*.

II. Whether the Tariffs violate the 1995 Tennessee Telecommunications Act?

As previously **[*27]** discussed, the Telecommunications Reform Act of 1995 ("the Act") amended *Tennessee Code Annotated section 65-4-201* by adding the following subsection:

> (b) Except as exempted by provisions of state or federal law, no individual or entity shall offer or provide any individual or group of telecommunications services, or extend its territorial areas of operations without first obtaining from the commission a certificate of convenience and necessity for such service or territory; provided, that no telecommunications services provider offering and providing a telecommunications service under the authority of the commission on June 6, 1995, is required to obtain additional authority in order to continue to offer and provide such telecommunications services as it offers and provides as of June 6, 1995.

Relying on this amendment, BellSouth argued that MCI and Sprint lacked the authority to offer the services proposed in their tariffs because they failed to obtain the necessary certificates of public convenience. Despite its arguments, BellSouth must fail as to this issue because it is not properly before this court.

Tennessee Code Annotated section *§ 4-5-322* defines this court's **[*28]** scope of review. Pursuant to that section, "[***HN9*** a] person who is aggrieved by a final *decision* in a contested case is entitled to judicial review . . . ." *Tenn. Code Ann. § 4-5-322(a)(1)* (1991) (emphasis added). Upon review, this court "may affirm the *decision* of the agency or remand the case for further proceedings." *Id. § 4-5-322(h)* (emphasis added). When appealing a decision of the Public Service Commission, an aggrieved person shall file their petition for review in this court. *Id. § 4-5-322(b)(1)*. Thereafter, this court must confine its review to the record and decide the issues without a jury. *Id. § 4-5-322(g)*. This limited standard of review prohibits this court from reviewing an issue which the Commission did not decide.

In this case, the Commission did not decide if the tariffs violated the Act. BellSouth never raised the issue before the Commission. The Commission never addressed the issue in any of its orders relating to the five tariffs, and the record does not contain any evidence as to the issue. The only issue *decided* by the Commission was whether their approval of the tariffs was consistent with their Order from 1991. It is only on appeal **[*29]** to this court, that BellSouth raises the issue of a violation of the Act. Because there was neither a *decision* nor a record for this court to review, this court lacks the authority to address the issue on appeal. Moreover, it is not the role of this court to delve into the complicated issues facing administrative agencies unless called on to do so. This court is to give deference to the decisions of an administrative agency which has acted within

its area of specialized knowledge. *Wayne County v. Tennessee Solid Waste Disposal Control Bd.*, 756 S.W.2d 274, 279 (Tenn. App. 1988). We are not to substitute our judgment for that of the agency on highly technical matters. *Id.* at 280.

The Federal Telecommunications Act of 1996

On February 16, 1996, the U.S. Congress passed the Telecommunications Act of 1996. This Act does not provide for the wholesale preemption of state regulation of telecommunications services. Instead, the Act permits states to retain authority if the state regulation is consistent with it. In examining the provisions of the Federal Telecommunications Act of 1996, we find nothing which would alter our decision in this appeal. We believe the Commission's Orders **[*30]** governing the services of MCI and Sprint to be consistent with the 1996 Federal Act. [7]

[*31] For the foregoing reasons we affirm the judgment of the Tennessee Public Service Commission. We tax costs on appeal to the Appellants, BellSouth.

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[7] The Court considered the following provisions of the 1996 Federal Telecommunications Act:

The caption of the Act:

> An Act to promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies.

Section 253:

> (a) IN GENERAL - No state or local statute or regulation, or other State or local legal requirement, may prohibit or have the effect or prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service.
>
> (b) STATE REGULATORY AUTHORITY - Nothing in this section shall affect the ability of a state to impose, on a competitively neutral basis and consistent with section 254, requirements necessary to preserve and advance universal service, protect the public safety and welfare, ensure the continued quality of telecommunications services, and safeguard the rights of consumers.
>
> (c) STATE AND LOCAL GOVERNMENT AUTHORITY - Nothing in this section affects the authority of a State or local government to manage the public rights-of-way or to require fair and reasonable compensation from telecommunications providers, on a competitively neutral and nondiscriminatory basis, if the compensation required is publicly disclosed by such government.
>
> (d) PREEMPTION - If, after notice and an opportunity for public comment, the Commission determines that a State or local government permitted or imposed any statute, regulation, or legal requirement that violate subsection (a) or (b), the Commission shall preempt the enforcement of such statute, regulation, or legal requirement to the extent necessary to correct such violation or inconsistency.

Section 261 (b):

> EXISTING STATE REGULATIONS - Nothing in this part shall be construed to prohibit any State Commission from enforcing regulations prescribed prior to the date of enactment of the Telecommunications of 1996 in fulfilling the requirements of this part, to the extent that such regulations are not inconsistent with the provision of this part.

Section 261(c):

> Nothing in this part precludes a State from imposing requirements on a telecommunications carrier for intrastate services that are necessary to further competition in the provision of telephone exchange service or exchange access, as long as the State's requirements are not inconsistent with this part or the Commission's regulations to implement this part.

SAMUEL L. LEWIS, JUDGE

BEN H. CANTRELL, JUDGE

CONCUR:

WILLIAM C. KOCH, Jr., JUDGE