

BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

October 15, 2013

IN RE:

**JOINT PETITION OF TENNESSEE AMERICAN
WATER COMPANY, THE CITY OF WHITWELL,
TENNESSEE, AND THE TOWN OF POWELLS
CROSSROADS, TENNESSEE FOR APPROVAL OF
A PURCHASE AGREEMENT AND A WATER
FRANCHISE AGREEMENT AND FOR THE
ISSUANCE OF A CERTIFICATE OF
CONVENIENCE AND NECESSITY**

**DOCKET NO.
12-00157**

**ORDER APPROVING PURCHASE AGREEMENT, FRANCHISE WATER
AGREEMENT AND CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY**

This matter came before Chairman James M. Allison, Director Kenneth C. Hill, and Director David F. Jones of the Tennessee Regulatory Authority (the “Authority” or “TRA”), the voting panel assigned to this docket, at a regularly scheduled Authority Conference held on June 17, 2013 for consideration of the *Expedited 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 Issuance of a Certificate of Convenience and Necessity* (“*Joint Petition*”) requesting Authority approval of Tennessee American Water Company’s (“TAWC” or “Company”) acquisition of the City of Whitwell’s (“Whitwell”) water system (“System”), the Franchise Agreement with the Town of Powells Crossroads (“Crossroads”) and for the issuance of a Certificate of Public Convenience and Necessity (“CCN”).

BACKGROUND AND JOINT PETITION

On December 27, 2012, TAWC filed its *Joint Petition* with the Authority. In the *Joint Petition*, TAWC, Whitwell and Crossroads (collectively, “Petitioners”) seek the TRA’s consideration and approval, on an expedited basis, of TAWC’s proposed purchase of Whitwell’s water system, the grant of an exclusive water utility franchise agreement between TAWC and Crossroads, and a CCN to allow TAWC to undertake service to Whitwell’s designated service areas, approximately 2,750 metered customers.¹

On January 28, 2013, a *Complaint and Petition to Intervene* (“*Petition to Intervene*”) was filed by the Consumer Advocate and Protection Division of the Office of the Attorney General (“CAPD” or “Consumer Advocate”) requesting to intervene as a party in the proceedings. During the regularly scheduled Authority Conference held on February 13, 2013, the voting panel of Directors voted unanimously to convene a contested case proceeding and appointed General Counsel or her designee as Hearing Officer, for the purpose of preparing this matter for a hearing before the panel.² Subsequently, the Hearing Officer granted the CAPD’s *Petition to Intervene*.³

The *Joint Petition* states that TAWC is a Tennessee corporation authorized to conduct a public utility business in the state of Tennessee and provides residential, commercial, industrial and municipal water service, including public and private fire protection service, to the City of Chattanooga, Tennessee, and surrounding areas.⁴ TAWC serves approximately 75,840 customers.⁵ TAWC is a wholly-owned subsidiary of American Water Works Company, Inc.

¹ Deron E. Allen, Pre-filed Direct Testimony, p. 2 (December 27, 2012).

² *Order Convening a Contested Case and Appointing a Hearing Officer* (February 21, 2013).

³ *See Order Granting Consumer Advocate Intervention in Proceedings and Establishing a Procedural Schedule* (March 28, 2013).

⁴ *Joint Petition*, pp. 2-3 (December 27, 2012).

⁵ *Id.* at 3.

(“AWWC”).⁶ AWWC is the largest water holding company in the United States, providing water and wastewater services to fifteen million people in more than thirty states.⁷ TAWC asserted that it “has a proud 125 year history of providing safe, reliable drinking water to its customers.”⁸

According to the *Joint Petition*, 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.⁹ Whitwell has determined that it is in the best interest of the City of Whitwell and its customers that TAWC acquire the System.¹⁰

Crossroads is a Tennessee municipality that receives its water supply, water treatment and other related services from Whitwell.¹¹ According to the *Joint Petition*, Crossroads has agreed to grant an exclusive franchise to TAWC because it is in the best interest of the Crossroads residents to continue to be served by the System subsequent to the sale to TAWC.¹²

Under the terms of the Asset Purchase Agreement (“Agreement”), TAWC will purchase the assets of the System from Whitwell at the total rate base value of the acquired assets as of the closing date. Water customers will continue to pay their existing rates, and the expenses and revenues of the System will be kept separate from TAWC’s Chattanooga system and will not adversely impact the rates of current TAWC ratepayers.¹³

⁶ See *Joint Petition*, p. 5 (December 27, 2012).

⁷ *Id.*

⁸ *Id.*

⁹ *Id.* at 2.

¹⁰ *Id.* at 3.

¹¹ *Id.* at 2.

¹² *Id.* at 4.

¹³ *Id.*

The Petitioners seek approval of the Purchase and Franchise Agreements and request a CCN to serve the areas and customers currently served by Whitwell.¹⁴ The Petitioners also request approval of accounting and rate base treatments recognizing the full purchase price and the acquisition and transactions costs incurred from this action.¹⁵ In addition, the *Joint Petition* also requests that the Authority:

- Authorize TAWC to apply the existing general rules and regulations applicable to Chattanooga operations to the service area of the current System;
- Allow TAWC to apply its existing depreciation rates to the System;
- Approve “encumbering of the properties comprising the System with the lien of TAWC’s Mortgage Indenture”.¹⁶

The *Joint Petition* maintained “[t]he Purchase Agreement, the franchise contained therein and the requested regulatory treatment and approvals are necessary and proper for the public convenience and properly conserve, promote and protect the public interest.”¹⁷

MAY 6, 2013 HEARING, APPEARANCES AND POST-HEARING FILINGS

A hearing in this matter was held before the voting panel on May 6, 2013, as noticed by the Authority on April 22, 2013.¹⁸ Participating in the hearing were the following parties and their respective Counsel:

TAWC- Melvin J. Malone, Esq. and Junaid A. Odubeko, Esq., Butler, Snow, O’Mara, Stevens & Cannada, PLLC, 1200 One Nashville Place, 150 Fourth Avenue North, Nashville, Tennessee 37219.

Consumer Advocate- Charlena S. Aumiller, Esq. and Vance Broemel, Esq., Office of the Attorney General, Consumer Advocate and Protection Division, P.O. Box 20207, Nashville, Tennessee 37202.

¹⁴ *Id.* at 9.

¹⁵ *Id.*

¹⁶ *Id.* at 9-10.

¹⁷ *Id.* at 8.

¹⁸ See *Notice of Hearing* (April 22, 2013).

TAWC called the following witnesses at the hearing:¹⁹

- ***Deron E. Allen***, President TAWC
- ***Daniel P. Bickerton***, Dir. Business Development, American Water Works Service Co. (“AWWSC”)
- ***Cindy Easterly***, Mayor of Whitwell (adopting the testimony of Steve Hudson, former Mayor of Whitwell, Tennessee)

The Consumer Advocate called as its witness:

- ***William H. “Hal” Novak***, President of WHN Consulting.

Witnesses were subject to cross-examination by the other parties and questions from the panel. In addition, at the start of the Hearing, members of the public were given an opportunity to present comments to the panel.²⁰ No one from the public sought recognition.²¹ Following the Hearing, the panel took the matter under advisement, and the parties filed post-hearing briefs on May 24, 2013 and reply briefs on May 31, 2013.

POSITIONS OF THE PARTIES

The parties have set forth their arguments in full in the record of this docket, in their pre-hearing memoranda, in the presentation of their cases at the Hearing, and in their Post-Hearing Briefs. The following section is intended as a brief summary of the positions of the Petitioners and the Consumer Advocate in this matter.

Consumer Advocate

The Consumer Advocate stated that the acquisition, CCN, and franchise agreement requested for approval by the Petitioners are not in dispute.²² According to the Consumer

¹⁹ Mayor Ralph Chapin, Mayor of Crossroads, did not testify at the Hearing, but his Pre-filed Direct Testimony was made a part of the record. The Consumer Advocate waived cross-examination of Mayor Chapin. See Transcript of Proceedings, Vol. I, pp. 71-72 (May 6, 2013).

²⁰ See Transcript of Proceedings, Vol. I, p. 5 (May 6, 2013).

²¹ *Id.*

²² *Post-Hearing Brief of the Consumer Advocate*, p. 2 (May 24, 2013).

Advocate, several requests in the *Joint Petition* are issues of first impression in Tennessee and it opposed those requests.²³ The CAPD stated:

The accounting and ratemaking treatment request is contested because the Consumer Advocate contends the appropriate time for addressing accounting and rate-making treatment is best performed during a future rate proceeding when the value of the assets are known and measurable, all factors concerning rates are considered, and the ratepayers will have the due process that comes with rate-setting. The Consumer Advocate disputes the deferred accounting request for due diligence costs because these costs are inappropriate costs for a deferred accounting at all [sic].²⁴

The Consumer Advocate's witness, Hal Novak, testified that, in response to a Consumer Advocate data request, the Company stated that it will need to spend additional capital beyond the purchase price in order to provide safe drinking water for the Whitwell customers. Mr. Novak asserted that because additional capital will be needed in the future, the historical book value of the Whitwell system is not an appropriate proxy for the market value.²⁵ Mr. Novak stated that if the Authority allows TAWC to record the Whitwell acquisition at historical cost, it will result in a dilutive effect that would have to be paid by all other TAWC customers, i.e. in increased rates.²⁶ To alleviate this concern, Mr. Novak proposed that the Authority approve the acquisition at this time and defer any decision regarding the accounting and regulatory treatment until all of the necessary capital expenditures are known and measurable.²⁷ In summarizing his testimony at the Hearing, Mr. Novak stated that TAWC is acquiring a defaulting system in need of major upgrades. If the Authority approves this acquisition, it will result in all TAWC customers paying for the necessary upgrades to the Whitwell system.²⁸

The Consumer Advocate recommended that the Authority deny the Petitioners' requests to make any determination that affects rates in the future. In addition, the Consumer Advocate

²³ *Id.* at 3.

²⁴ *Id.*

²⁵ William H. Novak, Pre-Filed Direct Testimony, pp. 4-5 (April 12, 2013).

²⁶ *Id.* at 3-6.

²⁷ *Id.* at 6.

²⁸ Transcript of Proceedings, Vol. II, pp. 244-245 (May 7, 2013).

recommended that the Authority order the utility to file a rate case “after a year or other reasonable time period to allow sufficient information to be gathered and used to fix just and reasonable rates.”²⁹ The Consumer Advocate cites the following reasons why the Authority should not approve rate base treatment at this time and should wait to do so in the context of TAWC’s next rate case:

1. TAWC is asking the Authority to make a rate base determination now that will impact rates in the future. Such action by the Authority denies ratepayers due process because they have had no notice of the impact that TAWC’s ratemaking requests may have on rates. The only information Whitwell has concerning rates is that they will not change following closing. Rate base should be determined at the same time as other components that affect rates to avoid single-issue ratemaking;³⁰
2. TAWC asserts that original cost is the appropriate value to place on the acquired assets, when the condition of the system and the related value will not be known and measurable until the system has been thoroughly inspected, which will not occur until after the acquisition is complete. Once the full cost is known and any asset impairment identified, the true value of the system may be below the net original cost;³¹
3. The valuation of the system overlooks the fact that there has been 43%-53% lost and unaccounted for water over the past two years, and TAWC’s estimate in capital improvements needed to reduce water loss is \$5 million over the next five years;³²
4. Original cost of plant assets in this case is based on potentially flawed financial records.

In the last three annual audits of the City of Whitwell, auditors reported numerous

²⁹ *Post-Hearing Brief of the Consumer Advocate*, p. 16 (May 24, 2013).

³⁰ *Id.* at 12, 14-16.

³¹ *Id.* at 16-21, 27.

³² *Id.* at 26-27.

material weaknesses in the financial control environment leading one to conclude that the financial statements are unreliable;³³

5. Approval of rate base before the acquisition is complete and all costs are known and measureable would inappropriately shift any risk of overpayment to the Company's other ratepayers. Company protection from this risk removes the incentive for TAWC to negotiate the lowest price;³⁴
6. Waiting to determine rate base until a future rate proceeding is consistent with the decisions in other states for similar acquisitions;³⁵ and
7. TAWC has plans to construct the Dunlap connection even before it has completed system repairs necessary to reduce water loss. The Company has not provided persuasive evidence that the emergency connection is necessary. This is an extraordinary capital expense that may outweigh the benefits to ratepayers and cause rates to "skyrocket." TAWC should be required to provide evidence to the Authority supporting the need for this system extension prior to commencement of the project.³⁶

The Consumer Advocate maintained that deferred accounting treatment for due diligence costs is not reasonable, necessary or prudent for the following reasons:

1. Deferred accounting can violate the prohibition against retroactive ratemaking and/or permit single issue ratemaking;³⁷
2. Although the Authority has not developed specific criteria for authorizing deferred accounting, it has considered and approved deferred accounting for (1) costs related to infrequent, unusual, or extraordinary events, (2) costs outside the company's control and

³³ *Id.* at 21.

³⁴ *Id.* at 29-31.

³⁵ *Id.* at 18.

³⁶ *Id.* at 34-35.

³⁷ *Id.* at 36-37.

(3) costs for which there was no other mechanism for the utility to recover the costs. Due diligence costs do not fit into any of these categories;³⁸

3. Due diligence costs are non-operational costs; therefore, other states have denied recovery of due diligence costs, stating these costs should be borne by the shareholders who benefit most;³⁹ and
4. If due diligence costs are approved for deferral, then revenues associated with the acquisition should be tracked, as well, until the next rate case.⁴⁰

The Consumer Advocate does not dispute the TRA's authority to approve the acquisition but stated the legal limits of its plenary authority do not permit an authorization of rate base and ratemaking treatment in this proceeding.⁴¹ According to the CAPD, TAWC has failed to provide sufficient evidence why the TRA should grant rate base treatment outside of a rate proceeding and before the total value of the assets are known and measureable.⁴² The CAPD averred that TAWC did not incorporate any risk of faulty financial statements and risk of system unreliability into the purchase price.⁴³ Therefore, the Consumer Advocate maintained, granting TAWC's request for rate base treatment would shift risk from shareholders to ratepayers.⁴⁴ While the acquisition will benefit Whitwell customers, the Consumer Advocate expressed concerns that TAWC's existing customers will subsidize improvements to the system.⁴⁵

The CAPD argued that the determination of rate base using net original cost as a starting point is appropriate. Relying solely on financial statements, however, does not meet the burden of proof necessary to determine rate base. The Consumer Advocate asserted that "the record

³⁸ *Id.* at 39.

³⁹ *Id.* at 43-44.

⁴⁰ *Id.* at 46-47.

⁴¹ *Reply Brief of the Consumer Advocate*, p. 5 (May 31, 2013).

⁴² *Id.* at 5-7.

⁴³ *Id.* at 10.

⁴⁴ *Id.* at 4.

⁴⁵ *Id.* at 8.

indicates that many red flags exist that net original cost may require significant reductions for impairments and necessary improvements”⁴⁶ and acquiring assets without knowing their condition contradicts the assertion that rate base is known and measureable.⁴⁷

The Consumer Advocate stated that, as to the Dunlap connection, TAWC points to Mayor Easterly’s testimony that the connection is necessary, even though she is not an engineer and was not involved in meetings discussing the connection. According to the CAPD, Whitwell did not have sufficient information to perform a cost-benefit analysis. The Consumer Advocate disputed TAWC’s assertion that the project is necessary because the system storage is only “one day.”⁴⁸ CAPD maintained that one day is all that the state requires, and the System will have more than one day when the excessive water loss is addressed.⁴⁹

Petitioners

TAWC asserted that it is in the public interest that the Authority grant the *Joint Petition* for TAWC to acquire the Whitwell System.⁵⁰ In the *Joint Petition*, TAWC has also requested approval of accounting and rate base treatments recognizing the full purchase price and the acquisition and transaction costs incurred from this action.⁵¹ TAWC’s witness, Daniel Bickerton, testified that the Company requests that the valuation of Whitwell’s System assets be based on historical original cost at closing.⁵² Bickerton asserted the Company’s position that original cost is the appropriate method to determine the fair value of the assets being purchased, and the Consumer Advocate never asserted that historical cost does not represent the fair market

⁴⁶ *Id.* at 11.

⁴⁷ *Id.* at 11-13.

⁴⁸ *Id.* at 14.

⁴⁹ *Id.* at 13-14.

⁵⁰ See *Joint Petition*, p. 8 (December 27, 2012).

⁵¹ *Id.* at 9.

⁵² Daniel P. Bickerton, Pre-Filed Rebuttal Testimony, pp. 2-3 (April 19, 2013).

value of the acquired assets. Further, Mr. Bickerton maintained that approval of the historical original cost will allow the Company to recover the full purchase price subsequent to closing.⁵³

Mr. Bickerton testified that Mr. Novak's dilutive effect argument is flawed because it does not take into consideration other factors that impact rates, such as a growing customer base and economies of scale. Bickerton also took issue with Mr. Novak's comparison of average rate base per customer for the Whitwell System and that of the Chattanooga system. Bickerton stated that the calculations are not comparable, since future estimated capital expenses for years one through five are included in Whitwell's rate base calculation, but a similar estimate of capital expenses for the Chattanooga system was not included in its rate base calculation, resulting in a flawed comparison between Whitwell rates and other TAWC rates.⁵⁴

Mr. Bickerton also testified that TAWC proposes to defer and track acquisition (due diligence) expenses necessary to complete the closing of this acquisition transaction. According to Mr. Bickerton these expenses are estimated to be \$55,000.⁵⁵ Once the transaction is complete, these costs will be recorded as a regulatory asset. Mr. Bickerton acknowledged that the Company is only seeking approval to defer these costs, and any approval of the costs themselves and amortization of these costs would occur in the Company's next rate case.⁵⁶

In his Pre-Filed Testimony, Mr. Bickerton also explained the Company's requests for approval of franchise agreements with Whitwell and Crossroads. He stated that these franchises are necessary in order to obtain access to areas necessary to maintain the System within Whitwell and the corporate limits of Crossroads, enabling the continued provision of water service. He stated there are no franchise fees imposed under either franchise agreement.⁵⁷

⁵³ *Id.*

⁵⁴ *Id.* at 3-4.

⁵⁵ Daniel P. Bickerton, Pre-Filed Direct Testimony, p. 3 (December 27, 2012).

⁵⁶ Transcript of Proceedings, Vol. I, pp. 96-97 (May 6, 2013).

⁵⁷ Daniel P. Bickerton, Pre-Filed Direct Testimony, p. 4 (December 27, 2012).

TAWC, in its Post-Hearing Brief, summarized its request of the Authority to (1) approve the acquisition of the Whitwell system for the agreed upon purchase price, (2) approve the accounting, ratemaking and regulatory treatment requested, (3) approve the franchise with Crossroads, and (4) grant a CCN for TAWC to serve the areas currently served by Whitwell.⁵⁸ Using the original cost accounting methodology, the agreed upon purchase price of the system is defined as the total rate base value of the acquired system assets, upon which TAWC will be authorized by the Authority to earn an approved rate of return.⁵⁹ TAWC maintained that the Purchase Agreement and the Franchise Agreements are “necessary and proper for the public convenience and properly conserve[] the public interest.”⁶⁰ Granting a CCN to TAWC will give the Company the exclusive right to provide water to current customers of Whitwell. TAWC stated the record has demonstrated that the acquisition is in the best interests of current and future customers of the Whitwell system through the professional management, long-term planning and sustained investment by TAWC.⁶¹

TAWC asserted that given the current condition of the system, which will require significant infrastructure upgrades, and the Company’s commitment to provide safe and reliable drinking water to the customers, it is seeking full rate base recognition of its investment.⁶² The investment is calculated to be the net book value of the system assets as of the closing date. In order for larger companies such as TAWC to provide necessary relief to financially struggling smaller utilities, it is essential that it be granted “fair and balanced” regulatory treatment.⁶³ TAWC averred that the treatment it requests is reasonable and consistent with TRA’s ratemaking practices and maintained that the TRA has the expressed and implied authority by the General

⁵⁸ *Post Hearing Brief of Tennessee American Water Company* (“TAWC Post-Hearing Brief”), p. 1 (May 24, 2013).

⁵⁹ *Id.* at 2-3.

⁶⁰ *Id.* at 6.

⁶¹ *Id.* at 2-7.

⁶² *Id.* at 4.

⁶³ *Id.* at 5.

Assembly to grant the relief requested in the *Joint Petition*, including the accounting treatment requested.⁶⁴

To support its request for rate base accounting treatment, TAWC made the following arguments:

1. Receiving approval of the accounting, ratemaking and regulatory treatment of the pending acquisition is a pre-condition to the closing of the sale. Given the amount of the purchase price and the significant risk of not recovering its investment, the Company considers it appropriate and prudent to seek approval prior to closing rather than wait until the next rate case;⁶⁵
2. The acquisition will benefit both Whitwell's customers and TAWC's current customers. It will benefit Whitwell customers by improving system reliability and safety to enable growth of the community. Whitwell customers will also benefit from modernization and infrastructure improvements stemming from TAWC's experience, knowledge base, management and overall purchasing power. TAWC's current customers will benefit from an expanded customer base over which to spread the Company's fixed costs which will mitigate the impacts of future rate increases;⁶⁶ and
3. The arms-length transaction and the valuation of the system assets are supported by the evidentiary record, which disproves several of the Consumer Advocate's attempts to discredit the transaction. Regarding the 2010, 2011 and 2012 audited financial statements, TAWC evaluated the statements and did not uncover any significant issues regarding the recording of capital assets. In addition, TAWC was able to visually inspect the above ground assets. The Company stated that the Dunlap interconnection is justified

⁶⁴ *Id.* at 8-9.

⁶⁵ *Id.* at 12-13.

⁶⁶ *Id.* at 14-16.

for emergency and other reasons and will have to be done no matter who owns the system, as testified to by Mayor Easterly. The Company disputed the Consumer Advocate's reliance on the 2003 appraisal of West Valley water system, which is ten years old and was performed by an engineer, not a CPA, for an eminent domain/condemnation proceeding. TAWC did not consider this appraisal in determining the purchase price, as several miles of pipeline have been replaced since that time. As to water loss, Mr. Bickerton testified there can be many causes for the high water loss percentage, such as billing errors.⁶⁷

TAWC claims the evidentiary record does not support the Consumer Advocate's claim that Whitwell was only informed that their rates would not change and not of the future rate impact the transaction would have.⁶⁸ While Mayor Easterly testified that no one talked directly to her about how capital improvement would impact rates, she did not say the Company had not talked to other commissioners.⁶⁹ Mr. Bickerton testified that certain Whitwell representatives were well aware of the accounting and ratemaking treatment sought by TAWC.⁷⁰ TAWC asserted that it also related other events that indicate Whitwell representatives participated fully in the negotiations and were not uninformed as the Consumer Advocate suggests.⁷¹

TAWC argued that the Consumer Advocate had an opportunity during cross-examination to ask Mr. Bickerton questions regarding the number of meetings and the content of the discussions but chose not to ask those questions.⁷² According to TAWC, there is no allegation by a customer, a Whitwell commissioner or by the Consumer Advocate that Whitwell officials

⁶⁷ *Id.* at 16-23.

⁶⁸ *Post-Hearing Reply Brief of Tennessee American Water Company* ("TAWC Reply Brief"), pp. 3-4 (May 31, 2013).

⁶⁹ Transcript of Proceedings, Vol. I, pp. 80-81 (May 6, 2013).

⁷⁰ *TAWC Reply Brief* at 2.

⁷¹ *Id.* at 4-5.

⁷² *Id.* at 4.

did not follow the law in negotiating and approving the acquisition.⁷³ TAWC maintained that the hearing in this docket was properly noticed and an opportunity provided for public comment. Therefore, TAWC maintained that the Consumer Advocate's "notice" argument is without merit.⁷⁴

According to TAWC, the deficiencies in Whitwell's audited financial statements were well known and were considered by TAWC during the evaluation and negotiation process.⁷⁵ TAWC explained that there were many other material factors involved in the decisions reached besides the financial statements, such as water quality, regulatory compliance, property taxes, customer base, current rates, capital improvements, etc. TAWC pointed out that it actually inspected above ground assets during the process, along with flow testing, modeling and other similar planning activities.⁷⁶

In its Reply Brief, TAWC asserted that the TRA has expressed and implied authority to allow the Company to defer its due diligence costs. There have been few cases before the TRA that establish a precedent, and there is no statute or case law prohibiting the TRA from granting the request.⁷⁷ TAWC cited a case in Florida and stated that the requests made by the Florida utility and TAWC are "strikingly similar."⁷⁸ The Florida Public Service Commission granted the company's request and approved the recovery of acquisition costs after finding that the costs were properly classified as a regulatory asset.⁷⁹ TAWC also cited several other cases where states have approved deferral requests, one of them ruling that retroactive ratemaking did not occur as a result.⁸⁰

⁷³ *Id.* at 6-7.

⁷⁴ *Id.*

⁷⁵ *Id.* at 7.

⁷⁶ *Id.* at 9.

⁷⁷ *Id.* at 12.

⁷⁸ *Id.* at 13.

⁷⁹ *Id.*

⁸⁰ *Id.* at 14.

FINDINGS AND CONCLUSIONS

At the Authority Conference held on June 17, 2013, the voting panel deliberated the *Joint Petition*. Upon consideration of the entire record, including all testimony and exhibits, the panel made the following findings and conclusions:

Purchase Price and Rate Base

The Petitioners have made consummation of the purchase of the Whitwell system contingent on the Authority approving the requested accounting and ratemaking treatment of the purchase price of the acquired assets. Based on an overall review and analysis of the accounting exhibit of Mr. Bickerton and the Company responses to TRA Staff's data requests, the panel finds that the asset transfer, as proposed by TAWC, is a reasonable purchase price.

The Petitioners established the purchase price of the Whitwell System would be equal to the rate base value of the water utility assets as of the date of closing, using the original cost method of accounting. In calculating this amount, TAWC relied upon the books and records of Whitwell as provided by city officials and its accountant. TAWC states that "in addition to reviewing Whitwell's financial statements, records and reports provided by it and its accountants, TAWC, among other things, took full advantage of its ability to *actually inspect* the above-ground assets – i.e. plants, tanks, intake structures, booster stations, hydrants, pump -- during the negotiations and valuation processes."⁸¹ TAWC started with actual account balances at June 30, 2011, adjusting for the proposed Crossroads project and assets retained by Whitwell, and projected balances forward net of depreciation to the proposed closing date. TAWC re-established contributions in aid of construction ("CIAC") previously written off by the city net of accumulated amortization of CIAC and deducted this amount from the Utility Plant In Service

⁸¹*Id.* at 8-9 (emphasis in original).

(“UPIS”). All depreciation and amortization amounts were calculated using TAWC approved rates.

The Consumer Advocate spent considerable time during the hearing questioning Mr. Bickerton regarding the value of the assets being purchased. In its *Post-Hearing Brief*, the Consumer Advocate reasserts its position that TAWC based its purchase price upon 2010 through 2012 adverse and qualified audit reports. The Consumer Advocate states that Mr. Bickerton testified that the Company considered these deficiencies but concluded they did not affect the value of the assets.⁸² The CAPD gives the following findings as examples of what it determines to be asset deficiencies that may affect the water company: all required purchases were not subject to the bidding process, inadequate separation of duties, inadequate support for disbursements, inadequate purchase orders and a lack of control over journal entry process.⁸³ The CAPD, however, does not provide any information that would discredit the testimony of Mr. Bickerton that the deficiencies cited in the audits didn’t affect the value of the assets.

The panel considered the information provided during the Hearing regarding the auditor’s opinions in the City of Whitwell’s most recent audit report, which was for the year 2012. The panel acknowledges the fact that the 2012 audit report is a “qualified opinion”; however, it is *not* an adverse opinion. According to the audit report, the opinion was “qualified due to inventory, lack of utilizing receipts, and lack of internal controls related to revenues associated with police fines and fees.”⁸⁴ None of the audit findings directly related to the provision of water services by the System. For these reasons, the panel finds that the 2012 Whitwell audit report does not support discrediting the proposed purchase price.

⁸² *Post-Hearing Brief of the Consumer Advocate*, p. 23 (May 24, 2013).

⁸³ *Id.* at 23-24.

⁸⁴ Hearing Exhibit No. 3, City of Whitwell Audit Report, pp. 52-64 (June 30, 2012).

The Consumer Advocate also argues in its Post-Hearing Brief that “[r]ate base cannot be determined at this time because the used and useful assets are not known and measurable and evidence strongly suggests asset impairment that should reduce true value below the net original cost.”⁸⁵ In its brief, the CAPD asserts that the water loss of the System impairs its usefulness and that it therefore impairs its value.⁸⁶ TAWC counters this claim by referring to the testimony of Mr. Bickerton and Mayor Easterly who testified that all systems need work and that TAWC is capable of reducing the water loss.⁸⁷ Further, TAWC argues, the Consumer Advocate’s contention that TAWC did not consider these factors when evaluating whether to purchase the System is inaccurate and unsupported by the record. *TAWC’s Post-Hearing Brief* asserts that the Consumer Advocate’s arguments related to the West Valley portion of the Whitwell System are outdated and do not recognize improvements to the system since the appraisal. Mr. Bickerton’s testimony during the Hearing substantiates that this appraisal was done ten years ago, and he personally knows of improvements to the system in the ten years since.⁸⁸ In concluding its rate base arguments, the Consumer Advocate requests that the Authority “deny approving rate base until a time when the used and useful assets and any related impairment are known and measurable.”⁸⁹

After considering the arguments made by both parties regarding rate base, the panel is persuaded by the CAPD’s arguments that the assets being purchased are not used and useful at this time. The Authority has always considered the used and usefulness of assets in rate cases. TAWC is not requesting approval of allocation methods or rate changes for the Whitwell customers during this proceeding. The panel finds that the docket currently before the Authority

⁸⁵ *Post-Hearing Brief of the Consumer Advocate*, p. 16 (May 24, 2013).

⁸⁶ *Id.* at 26-27.

⁸⁷ *TAWC Reply Brief*, p. 8 (May 31, 2013).

⁸⁸ Transcript of Proceedings, Vol. I, p. 140 (May 6, 2013).

⁸⁹ *Post-Hearing Brief of the Consumer Advocate*, p. 29 (May 24, 2013).

is not a rate case, and approving certain allocation methods before the used and usefulness of the asset is known would be improper. TAWC has filed many rate cases with the Authority and should be aware that all of its capital expenditures will be reviewed in any future rate cases for allowance or disallowance based on whether the asset is used and useful. Moreover, the Company admits it is aware that the Authority would consider and approve proper allocation methods in the context of a formal rate case.⁹⁰

The best method for establishing rate base is historical property records along with depreciation schedules. In the absence of complete records, state commissions must then use the best available information to determine a reasonable valuation of the assets being transferred. In this case, historical records were supplied but depreciation schedules were not available. TAWC took historical records and attempted to recreate the associated depreciation expense that should have been booked. The panel finds that this methodology is the best approach at this time. If additional information becomes available prior to TAWC's next rate case, the Authority will certainly take that information into account in establishing a reasonable rate base on which to establish fair and reasonable rates.

Accordingly, upon a complete review of the record, the panel is persuaded that TAWC, along with the corroborating testimony of Whitwell and Crossroads witnesses, presents a reasonably accurate valuation of the System and the associated purchase price at this time. After considering the Consumer Advocate's arguments, the panel finds that there is no evidence to suggest the Company had inaccurately calculated its proposed purchase price and amount it would include in rate base when it files its next rate case. Thereafter, the panel voted unanimously to approve the requested purchase price, as defined in Confidential Exhibit 2 to the

⁹⁰ Daniel P. Bickerton, Pre-Filed Direct Testimony, p. 3 (December 27, 2012).

Purchase Agreement. Further, the panel voted unanimously that the cost of service and determination of rate base be deferred until such time as TAWC petitions to adjust rates.

Future Capital Costs of the Dunlap System

The Consumer Advocate requested that the Authority provide guidance to TAWC regarding the connection to the City of Dunlap's water system. The Consumer Advocate is concerned that any decision about this capital expenditure at this time is premature and the costs may outweigh the benefits to ratepayers.⁹¹

TAWC has maintained it is only making the Authority aware of possible future expenditures that may be necessary in order to provide safe, reliable water to customers of the Whitwell System. The Company is not requesting recovery of the costs of the Dunlap connection in the *Joint Petition*, but rather explaining that such costs will be tracked, so that if the costs are approved in a future proceeding, recovery would be possible.

Generally, the TRA will deny approval of undetermined future capital expenditures. Such action would be providing the Company with an "open checkbook" with future recovery from ratepayers. It is more prudent to let the Company run its business and request approval and recovery of capital expenditures after they occur. At that time, the Authority will determine the necessity of the expenditure and the used and usefulness of the asset.

Acquisition Costs

TAWC seeks to defer approximately \$55,000 in acquisition or "due diligence" costs with approval and recovery of actual costs in its next rate proceeding. TAWC states that approval of due diligence costs is reasonable and within the Authority's power. The Consumer Advocate points out in its Post-Hearing Brief that the Authority has not established any formal rules regarding the establishment of a deferred regulatory asset and its recovery, and Tennessee law

⁹¹ *Post-Hearing Brief of the Consumer Advocate*, pp. 33-35 (May 24, 2013).

provides little guidance on this subject matter.⁹² According to the Consumer Advocate, due diligence costs are “non-operational” and it is unfair for ratepayers to cover such costs when they are not incurred for the provision of water service. The Consumer Advocate argues that since these costs are not for the provision of water service, shareholders, not ratepayers, should bear the costs of due diligence.⁹³ The CAPD requests that if the Authority allows TAWC to defer acquisition costs, these costs should not be allowed as a “regulatory asset” because such distinction implies a probable recovery from ratepayers.⁹⁴

The majority of the panel reasoned that while due diligence costs are not costs associated with the delivery of water services, such costs may be incurred to safeguard the assets of the Company, thus protecting the interests of the shareholders *and* ratepayers. To allow recovery of a cost incurred to benefit shareholders but funded solely by ratepayers is unacceptable. In this docket, the Company failed to provide sufficient evidence to persuade the Authority to allow recovery of due diligence costs above TAWC’s necessary operation costs. For example, a significant amount of the due diligence costs incurred to date and estimated costs post closing are related to services rendered by the AWWSC.⁹⁵ AWWSC allocates its costs to affiliate companies such as TAWC that receive services from AWWSC. TAWC’s allocated share of these costs are already included in its operating expenses and recovered from ratepayers through their base rates. The Company did not produce evidence demonstrating these costs were not already included in the AWWSC allocation or proving that AWWSC needed to hire additional personnel to perform duties related to due diligence activities. Therefore, allowing TAWC to recover these costs could result in a double recovery of the cost or recovery when there was no

⁹² *Id.* at 36-38.

⁹³ *Id.* at 46

⁹⁴ *Id.* at 47.

⁹⁵ Approximately \$26,155. See TAWC response to First Discovery Request of the Consumer Advocate, Question No. 16 (March 13, 2013).

incremental cost incurred above normal operating expenses. In addition, the Company failed to provide evidence that other due diligence costs for which it seeks recovery provide any benefit to ratepayers or that they are necessary operation costs. Accordingly, the majority of the panel voted to deny TAWC's request to defer due diligence costs but, instead, voted to allow TAWC to expense the amounts as they are incurred.⁹⁶

General Rules and Late Fee

The Company requests that the general rules and late fee contained in the current TAWC tariff be applicable to the Whitwell customers. The Authority has previously found these terms and conditions appropriate for TAWC customers. In addition, the CAPD did not present any evidence in this proceeding to suggest the general rules and late fee are unreasonable and should not apply to Whitwell customers. The panel voted unanimously to apply the general rules and late fee in TAWC's tariff to Whitwell customers

Certificate of Public Convenience and Necessity and Franchise Agreements

Tenn. Code Ann. § 65-4-201 requires a public utility to obtain a CCN from the Authority. Specifically, Tenn. Code Ann. § 65-4-201(a) states:

No public utility shall establish or begin the construction of, or operate any line, plant, or system, or route in or into a municipality or other territory already receiving a like service from another public utility, or establish service therein, without first having obtained from the authority, after written application and hearing, a certificate that the present or future public convenience and necessity require or will require such construction, establishment, and operation, and no person or corporation not at the time a public utility shall commence the construction of any plant, line, system, or route to be operated as a public utility, or the operation of which would constitute the same, or the owner or operator thereof, a public utility as defined by law, without having first obtained, in like manner, a similar certificate; provided, however, that this section shall not be construed to require any public utility to obtain a certificate for an extension in or

⁹⁶ Director Kenneth C. Hill voted with the majority on the acquisition of the Whitwell system and most of the findings supporting the acquisition but disagreed with disallowing due diligence costs for future recovery. Director Hill expressed concern that by not granting deferral of the costs necessary to fully evaluate the acquisition, the Authority may be providing a disincentive to beneficial acquisitions in the future because due diligence helps a utility prevent a bad investment.

about a municipality or territory where it shall theretofore have lawfully commenced operations, or for an extension into territory, whether within or without a municipality, contiguous to its route, plant, line, or system, and not theretofore receiving service of a like character from another public utility, or for substitute or additional facilities in or to territory already served by it.⁹⁷

For a water utility, however, the statute is silent on exactly how the Authority is to evaluate whether or not a CCN should be granted.

To determine whether the award of a CCN benefits the present or future public convenience and necessity, the Authority analyzes the evidence to determine if the applicant has the managerial, financial, and technical ability to operate the utility. That standard is used for evaluating the awarding of a CCN to both competing telecommunications providers (Tenn. Code Ann. § 65-4-201(c)) and wastewater companies (TRA Rule 1220-4-13-.04(1)(b)). The TRA has adopted the same standard for water companies, as has been made clear in previous orders of the Authority, as well as in the information and application for a certificate for water utilities on the TRA's web site.⁹⁸ Therefore, in reviewing an application for a CCN, the Authority must obtain reasonable assurance from evidence presented that the applicant possesses the managerial, financial, and technical ability to operate the utility.

The Authority also looks at evidence of whether the applicant “has demonstrated that it will adhere to all applicable Authority policies, rules and orders” in determining whether to grant or deny a CCN.⁹⁹ This requirement is not only used for evaluating the awarding of a CCN to competing telecommunications providers by statute (Tenn. Code Ann. § 65-4-201(c)), but is also

⁹⁷ Tenn. Code Ann. § 65-4-201.

⁹⁸ See *In re: Petition of Laurel Hills Condominiums Property Owners Association for a Certificate of Public Convenience and Necessity*, Docket No. 12-00030, *Order Denying Certificate of Public Convenience and Necessity and Requiring Divestiture of Water System*, pp. 7-9 (April 18, 2013); See also *In re: Joint Petition of Tennessee American Water Company and Marion County, Tennessee, for Approval of Purchase Agreement*, Docket No. 03-00388, *Order Approving Order, Report and Recommendation of Hearing Officer, CCN, Purchase and Franchise Agreements*, p. 14 of Exhibit A (October 31, 2005). See also *In re: Application of Hickory Star Water Company, LLC for a Certificate of Public Convenience and Necessity for a Regulated Water and Sewer Company Operating in Union County, Tennessee*, Docket No. 99-00485, *Order Granting Certificate of Public Convenience and Necessity*, p. 2 (November 24, 1999).

⁹⁹ Tenn. Code Ann. § 65-4-201(c)(1).

contained in the water utility application for a CCN. Specifically, the water utility application requires the applicant “to [a]ttest that the applicant is aware of and will abide by all applicable Tennessee statutes and TRA Rules governing water utilities”¹⁰⁰

TAWC has been a long standing provider of safe, reliable drinking water to approximately 75,840 customers in Chattanooga and surrounding areas. It is undisputed that TAWC has the technical, managerial and financial capability to provide services to the requested area.¹⁰¹ Whitwell and Crossroads have testified that it is in the best interest of their residents for TAWC to acquire the System. Current and future customers will benefit from the professional management, long-term planning and financial investment of TAWC. Accordingly, the panel voted unanimously to grant TAWC a CCN to serve the areas currently served by the City of Whitwell.

Pursuant to Tenn. Code Ann. § 65-4-107, the TRA must approve any franchise agreements granted to a public utility. The statute provides in pertinent part:

No privilege or franchise hereafter granted to any public utility by the state of Tennessee or by any political subdivision of the state shall be valid until approved by the authority, such approval to be given when, after hearing, the authority determines that such privilege or franchise is necessary and proper for the public convenience and properly conserves the public interest, and the authority shall have power, if it so approves, to impose such conditions as to construction, equipment, maintenance, service or operation as the public convenience and interest may reasonably require...

TAWC requests TRA approval of the franchise agreements because they are necessary to obtain access to areas necessary to maintain the System within Whitwell and the corporate limits of Crossroads, enabling the continued provision of water service. The Mayor of Whitwell testified that TAWC’s acquisition of the Whitwell System is in the City’s best interest, and the community is supportive of the transaction. The Mayor of Crossroads testified that Crossroads is

¹⁰⁰ See <http://www.tn.gov/tra/telecomfiles/WaterApplication.pdf> (Certificate of Public Convenience and Necessity (CCN) Water Utility Application, Version 1.00, II(C)(4) (June 23, 2006)).

¹⁰¹ *Post-Hearing Brief of the Consumer Advocate*, p. 49 (May 24, 2013).

supportive of TAWC acquiring the System and would like to be served by the Whitwell System after the transfer to TAWC. According to TAWC, there are no franchise fees imposed under the franchise agreement with Whitwell or Crossroads.

The panel found that TAWC's franchise agreements with Whitwell and Crossroads are proper for the public convenience and properly conserve the public interests, and the panel voted unanimously to approve the franchise agreements.

Mortgage Lien on Acquired Property

TAWC requests that the Authority approve encumbering the newly-acquired properties comprising the System with the lien of the Company's Mortgage Indenture. The Company verified that its Mortgage Indenture requires that newly acquired assets be included in the lien of the Mortgage Indenture.¹⁰² The requirement that newly acquired property be pledged as security in the acquiring party's financing arrangements is common in the merger and acquisition dockets considered by the Authority.

The Authority reviews requests to pledge assets pursuant to Tenn. Code Ann. § 65-4-109 which requires approval when such requests conform to applicable law and that its purpose meets with the Authority's approval. Tenn. Code Ann. § 65-4-109 states:

No public utility shall issue any stocks, stock certificates, bonds, debentures, or other evidences of indebtedness payable in more than one (1) year from the date thereof, until it shall have first obtained authority from the authority for such proposed issue. It shall be the duty of the authority after hearing to approve any such proposed issue maturing more than one (1) year from the date thereof upon being satisfied that the proposed issue, sale and delivery is to be made in accordance with law and the purpose of such be approved by the authority.

The CAPD did not express any opposition to TAWC's request to encumber the newly acquired assets, nor has it alleged that it is unlawful. By approving TAWC's acquisition of the System, the purpose of the asset encumbrance necessarily meets TRA approval. As such, the

¹⁰² *Tennessee American Water Company's Response to TRA's January 22, 2013 Data Request, Response to Question No. 7 (January 28, 2013).*

panel voted unanimously to approve the request of TAWC to encumber the newly-acquired properties comprising the System with the Company's Mortgage Indenture.

IT IS THEREFORE ORDERED THAT:

1. The *Expedited 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 Issuance of a Certificate of Convenience and Necessity* filed by Tennessee American Water Company, the City of Whitwell, Tennessee, and the Town of Powells Crossroads, Tennessee, is approved, in part, and denied, in part.

2. The Purchase Agreement, which includes an exclusive franchise with the City of Whitwell, is approved.

3. The Franchise Agreement between the Town of Powells Crossroads and Tennessee American Water Company is approved.

4. Pursuant to Tenn. Code Ann. § 65-4-201, a Certificate of Public Convenience and Necessity is granted to Tennessee American Water Company to serve the areas and customers currently served by the City of Whitwell.

5. The purchase price amount found in the response to the Tennessee American Water Company's Data Response Item No. 35 filed on April 4, 2013, and defined in Confidential Exhibit 2 to the Purchase Agreement is approved.

6. The deferral of approximately \$55,000 in acquisition expenses for possible future recovery is denied.¹⁰³

¹⁰³ Director Kenneth C. Hill did not vote with the majority on this issue.

7. The proposed tariff as defined in Tennessee American Water Company's revised Exhibit D dated April 22, 2013, containing service rates applicable to Whitwell customers is approved.

8. Tennessee American Water Company is authorized to apply its TRA-approved general rules and regulations applicable to its Chattanooga operations to the customers of the Whitwell System including the Company's existing five percent late fee.

9. Tennessee American Water Company is authorized to apply its current depreciation rates and contributions in aid of construction amortization rates to the purchase price of the new system.

10. Any action related to cost of service or inclusion in rate base is deferred until such time as a rate case is filed with the Authority.

11. Pursuant to Tenn. Code Ann. § 65-4-109, Tennessee American Water Company is authorized to encumber the newly acquired properties comprising the City of Whitwell System with the Company's Mortgage Indenture.

12. The authorization and approval given hereby shall not be used by any party, including, but not limited to, any lending party, for the purpose of inferring an analysis or assessment of the risks involved.

13. This decision is not intended to create any liability on the part of the Tennessee Regulatory Authority, the State of Tennessee or any political subdivision thereof.

Chairman James M. Allison and Director David F. Jones concur. Director Kenneth C. Hill concurs in part and dissents in part as noted above.

ATTEST:



Earl R. Taylor, Executive Director