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BEFORE
THE TENNESSEE REGULATORY AUTHORITY

PETITION OF TENNESSEE- AMERICAN WATER COMPANY FOR APPROVAL OF A QUALIFIED INFRASTRUCTURE INVESTMENT PROGRAM, AN ECONOMIC DEVELOPMENT INVESTMENT RIDER, A SAFETY AND ENVIRONMENTAL COMPLIANCE RIDER, AND PASS-THROUGHS FOR PURCHASED POWER, CHEMICALS, PURCHASED WATER, WHEELING WATER COSTS, WASTE DISPOSAL AND TRA INSPECTION FEE	)))))))))))))	Docket No. 13-00130

DIRECT TESTIMONY
of
WILLIAM H. NOVAK

ON BEHALF OF
THE CONSUMER ADVOCATE AND PROTECTION DIVISION
OF THE
TENNESSEE ATTORNEY GENERAL'S OFFICE

December 20, 2013

IN THE TENNESSEE REGULATORY AUTHORITY
AT NASHVILLE, TENNESSEE

IN RE:	)	
	)	
PETITION OF TENNESSEE AMERICAN	)	
WATER COMPANY FOR APPROVAL OF A	)	
QUALIFIED INFRASTRUCTURE INVEST-	)	
MENT PROGRAM, AN ECONOMIC	)	
DEVELOPMENT INVESTMENT RIDER,	)	**DOCKET NO. 13-00130**
A SAFETY AND ENVIRONMENTAL	)	
COMPLIANCE RIDER, AND PASS-	)	
THROUGHS FOR PURCHASED POWER,	)	
CHEMICALS, PURCHASED WATER,	)	
WHEELING WATER COSTS, WASTE	)	
DISPOSAL, AND TRA INSPECTION FEE	)	

AFFIDAVIT

I, Hal Novak, CPA, on behalf of the Consumer Advocate Division of the Attorney General's Office, hereby certify that the attached Direct Testimony represents my opinion in the above-referenced case and the opinion of the Consumer Advocate Division.

Hal Novak

HAL NOVAK

Sworn to and subscribed before me
this 19th day of Dec., 2013.

Emily Knight

NOTARY PUBLIC

EMILY KNIGHT STATE OF TENNESSEE NOTARY PUBLIC DAVIDSON COUNTY, TENN.

My commission expires: July 6, 2015

My Commission Expires JULY 6, 2015

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ATTACHMENTS

Attachment WHN-1	William H. Novak Vitae
Attachment WHN-2	Legislative History of House Bill 191 House Finance, Ways & Means Committee March 13, 2013

Q1. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND OCCUPATION FOR THE RECORD.

A1. My name is William H. Novak. My business address is 19 Morning Arbor Place, The Woodlands, TX, 77381. I am the President of WHN Consulting, a utility consulting and expert witness services company.[1]

Q2. PLEASE PROVIDE A SUMMARY OF YOUR BACKGROUND AND PROFESSIONAL EXPERIENCE.

A2. A detailed description of my educational and professional background is provided in Attachment WHN-1 to my testimony. Briefly, I have both a Bachelors degree in Business Administration with a major in Accounting, and a Masters degree in Business Administration from Middle Tennessee State University. I am a Certified Management Accountant, and am also licensed to practice as a Certified Public Accountant.

My work experience has centered on regulated utilities for over 30 years. Before establishing WHN Consulting, I was Chief of the Energy & Water Division of the Tennessee Regulatory Authority where I had either presented testimony or advised the Authority on a host of regulatory issues for over 19 years. In addition, I was previously the Director of Rates & Regulatory Analysis for two years with Atlanta Gas Light Company, a natural gas distribution utility with operations in Georgia and Tennessee. I also served for two years as the Vice President of Regulatory Compliance for Sequent Energy Management, a natural

[1] State of Tennessee, Registered Accounting Firm ID 3682.

gas trading and optimization entity in Texas, where I was responsible for ensuring the firm's compliance with state and federal regulatory requirements.

Q3. ON WHOSE BEHALF ARE YOU TESTIFYING?

A3. I am testifying on behalf of the Consumer Advocate & Protection Division ("CAPD" or "the Consumer Advocate") of the Tennessee Attorney General's Office.

Q4. HAVE YOU PRESENTED TESTIMONY IN ANY PREVIOUS TENNESSEE-AMERICAN WATER COMPANY CASES?

A4. Yes. I presented testimony in Dockets U-86-7402, U-87-7534, 89-15388, 91-05224, 93-06946, 10-00189, 12-00149 and 12-00157 concerning Tennessee-American Water Company ("TAWC" or "the Company") as well as testimony concerning TAWC in other generic tariff and rulemaking matters. In addition, I previously advised the TRA on issues in other TAWC dockets where I did not present testimony.

Q5. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A5. My testimony will support and address the CAPD's positions and concerns with respect to the Company's Petition. Specifically, I will address the Company's proposals for the Qualified Infrastructure Investment Program ("QIIP"), the Economic Development Investment Rider ("EDI"), the Safety & Environmental

Compliance Rider ("SEC") and the Production Cost and Other Pass-Through Rider ("PCOP").

Q6. WHAT DOCUMENTS HAVE YOU REVIEWED IN PREPARATION OF YOUR TESTIMONY?

A6. I have reviewed the Company's Petition filed on October 4, 2013, along with the testimony and exhibits presented with their filing. In addition, I have reviewed the Company's workpapers supporting their filing. I have also reviewed the Company's responses to the data requests submitted by the TRA as well the Company's responses to CAPD's discovery requests.

Q7. WHAT DO YOU RECOMMEND IN REGARD TO THE COMPANY'S PROPOSAL?

A7. For the Capital Recover Riders (QIIP, EDI and SEC), I recommend that the Company's proposal be modified to include recognition of accumulated deferred income taxes, exclusion of transportation and computer costs, elimination of forecasted cost recovery,

For the Expense Recovery Rider (PCOP), I recommend that the Company's proposal be modified to exclude double recovery of portions of the TRA Inspection Fee, recognition of forfeited discounts in the revenue conversion factor and recognition of the TRA's 15% water loss policy in calculating the maximum amount of certain expenses.

In addition, I also make recommendations regarding restrictions on cost recovery when the Company is exceeding its authorized rate of return, the establishment of a limited life for the tariffs, tariff filing and implementation dates, and annual filing requirements for all of the riders.

Q8. HOW IS YOUR TESTIMONY ORGANIZED?

A8. I'll begin by briefly discussing the enabling legislation for approval of these recovery riders outside of a rate case. I will then address the proposal on the Capital Recovery Riders. Finally, I will discuss my recommendation on the Expense Recovery Rider.

ENABLING LEGISLATION

7

Q9. IS THE TRA AUTHORIZED TO APPROVE THE CAPITAL RECOVERY AND EXPENSE RECOVERY RIDERS PROPOSED BY THE COMPANY?

A9. Yes. Tenn. Code Ann. § 65-5-103(d)(7) which was recently enacted, specifically provides that the Authority is empowered to adopt policies or procedures, that would permit a more timely review and revisions of the rates, tolls, fares, charges, schedules, classifications or rate structures of public utilities, and that would further streamline the regulatory process and reduce the cost and time associated with the ratemaking processes in §§ 65-5-101 and 65-5-103(a).

The Capital Recovery and Expense Recovery Riders proposed by the Company are consistent with Tenn. Code Ann. § 65-5-103(d), and may be approved upon the TRA making a finding that these riders **are in the public interest**.

Q10. WHAT ARE THE REQUIREMENTS FOR THE TRA TO FIND THAT THE CAPITAL RECOVERY AND EXPENSE RECOVERY RIDERS PROPOSED BY THE COMPANY ARE ACTUALLY IN THE PUBLIC INTEREST?

A10. At this point, there is little guidance in the law as to exactly what should be required for the riders to be found in the public interest. Furthermore, since this is one of the first tariffs to be brought before TRA under the requirements of Tenn. Code Ann. § 65-5-103(d), the decision by the Directors will likely establish a precedent for future filings by other utilities.

While the issue of the public interest is certainly open to interpretation, I would recommend that the TRA consider each of the following points for this determination.

1. Whether the proposed tariff is consistent with established TRA ratemaking policies, principles and methodologies;
2. Whether the proposed tariff ensures that recoverable costs are reasonable and prudently incurred by the Company; and
3. Whether the proposed tariff provides for timely, meaningful and transparent review of all rate adjustments.

In my opinion, if the TRA cannot find that the proposed tariffs meet these conditions, then they are not within the public interest requirements of Tenn. Code Ann. § 65-5-103(d).

CAPITAL RECOVERY RIDERS

Q11. PLEASE EXPLAIN THE RELIEF THAT TAWC IS ASKING FROM THE TRA THROUGH ITS PROPOSED CAPITAL RECOVERY RIDERS.

A11. The Company is asking the TRA to approve three separate tariffs that will allow it to recover between rate cases the cost of its incremental capital invested in non-revenue producing infrastructure plant, economic development plant, and safety & environmental plant. The three tariffs that the Company has proposed (QIIP, EDI and SEC), which I refer to collectively as the Capital Recovery Riders, are all designed to work in a similar manner with each recovering its own separate costs.

Q12. PLEASE DESCRIBE THE COSTS THAT EACH OF THE CAPITAL RECOVERY TARIFFS INCLUDE.

A12. As proposed by the Company[2], the QIIP tariff will recover incremental non-revenue producing plant infrastructure invested in the following accounts:

Account 331 – Transmission & Distribution Mains;

Account 333 – Services;

Account 334 – Meters & Meter Installations;

[2] Company Witness VerDouw Direct Testimony, Page 16.

Account 335 – Hydrants;

Account 320 – Water Treatment Equipment, Non-Media;

Account 311 – Pumping Equipment; and

Account 330003 – Capitalized Tank Painting.

As proposed by the Company[3], the EDI Tariff will recover incremental non-revenue producing economic development infrastructure invested in the following accounts:

Account 331 – Transmission & Distribution Mains;

Account 333 – Services;

Account 334 – Meters & Meter Installations;

Account 335 – Hydrants; and

Account 341 – Transportation Equipment.

As proposed by the Company[4], the SEC Tariff will recover incremental non-revenue producing safety & environmental infrastructure invested in the following accounts:

Account 304 – Structures;

Account 320 – Water Treatment Equipment;

Account 311 – Pumping Equipment; and

Account 304200 – Computer & Peripheral Equipment (SCADA).

Q13. SOME OF THESE RIDERS APPEAR TO COVER COSTS FROM THE SAME ACCOUNT. FOR EXAMPLE, ACCOUNT 331 – TRANSMISSION

[3] Company Witness VerDouw Direct Testimony, Page 26.
[4] Company Witness VerDouw Direct Testimony, Page 37.

& DISTRIBUTION MAINS APPEARS TO BE COMMON TO BOTH THE QIIP AND THE EDI TARIFF RIDERS. WILL THIS ALLOW THE COMPANY TO DOUBLE RECOVER THESE COSTS?

A13. No. While there is some overlap between these general accounts to the specific riders, the subaccounts within these general accounts are properly segregated to the appropriate rider. As a result, there is no double recovery of costs for the Capital Recovery Riders as proposed by the Company.

Q14. DO YOU AGREE WITH THE INCLUSION OF EACH OF THE ACCOUNTS PROPOSED BY THE COMPANY IN THE CAPITAL RECOVERY RIDERS?

A14. No. I disagree with including Transportation Equipment in the EDI Tariff. I also disagree with including Computer & Peripheral Equipment (SCADA) in the SEC Tariff.

The legislation authorizing the Company's proposed Capital Recovery Riders is specifically targeted at capital additions to **utility plant infrastructure**. It would therefore appear that plant additions for transportation equipment and computer & peripheral equipment would fail to meet this requirement. As a result, I recommend that these costs be excluded from the Capital Recovery Riders.

Q15. DOESN'T TENN. CODE ANN. § 65-5-103(D)(3)(A)(I) ALLOW FOR INFRASTURCTURE AND EQUIPMENT ASSOCIATED WITH ALTERNATIVE MOTER VEHICLE TRANSPORTATION FUEL?

A15. Yes. However, this provision appears to address **<u>utility infrastructure</u>** investments related to refueling stations for vehicles that are powered by alternative fuels. I have reviewed a transcript prepared by the Consumer Advocate Division of the March 13, 2013 hearing in the House Finance, Ways & Means Committee in which there was a discussion of the portion of the bill dealing with infrastructure for alternative fuels. The transcript is provided in Attachment WHN-2. As reflected by this discussion, the "purchase and/or retrofit" of utility fleet vehicles for alternative fuels as envisioned by the Company does not seem to be covered by this provision.[5] Since transportation equipment is not specifically a component of utility plant infrastructure, I recommend that it be excluded from the Capital Recovery Riders.

Q16. PLEASE DESCRIBE THE PROCESS THAT THE COMPANY WILL USE TO RECOVER ITS COSTS THROUGH THE CAPITAL RECOVERY RIDERS.

A16. The Company intends to first forecast the amount of qualifying incremental non-revenue-producing capital expenditures that it will need to make for the upcoming year. The Company would then implement a rate for each of the Capital Recovery Riders based on the results of this forecast. At the end of the year, the Company would true-up the rates for any difference between the capital expenditures that it projected and the actual amounts incurred, along with a forecast for new qualifying investments for the upcoming year.

[5] Company response to CAPD Data Request, Item 10.

Q17. DO YOU AGREE WITH THIS TYPE OF RECOVERY MECHANISM?

A17. No, I do not. This approach requires separate reviews of the Company's forecast as well as the actual results. Instead, I would recommend that the recovery mechanism be based **only** upon the actual qualifying investment that is placed in service. Under this approach, the Company would compare its actual qualifying investment with the levels approved in the last rate case. The Company would then develop a new annual rate for each of the Capital Recovery Riders based on the actual results achieved.

Q18. WHAT ARE THE ADVANTAGES OF ONLY ALLOWING RECOVERY OF ACTUAL PLANT INVESTMENTS AS OPPOSED TO INCLUDING ACTUAL PLUS FORECASTED PLANT INVESTMENTS IN THE CAPITAL RECOVERY RIDERS?

A18. To begin with, the amounts of actual investment are more readily identifiable since they are based on known amounts. Furthermore, administration of the Capital Recovery Riders would be much easier since it is only based on the actual activity rather than a forecast (and associated true-up) of activity that will change during the year. Finally, if the TRA does allow for recovery of forecasted plant additions in the Capital Recovery Riders, then some attention needs to be given to a provision for refund with interest when the forecast is not achieved. The Company did not include a provision for interest on unfunded plant additions in their Capital Recovery Riders.[6] Therefore, if the TRA does approve a plant forecast mechanism within the Riders as proposed by the Company, then the

[6] See Company response to Item #6 of the TRA Staff Data Request.

Capital Recovery Riders should be modified to include a provision for interest. However, the process for making such a calculation will be quite complex given the timing of revenues and plant additions. It would therefore seem necessary to only include actual plant additions as I have proposed in order to facilitate a timely filing and recovery of the Riders.

Q19. PLEASE DISCUSS THE COST COMPONENTS THAT ARE INCLUDED IN THE CALCULATION FOR EACH OF THE CAPITAL RECOVERY RIDERS.

A19. According to the Company, the Capital Recovery Riders provides revenue sufficient to cover the capital cost, depreciation and tax expense related to the qualifying investment in incremental utility plant.

Q20. DO YOU BELIEVE THAT THESE ARE ALL OF THE NECESSARY COMPONENTS TO REFLECT A COMPLETE COST RECOVERY?

A20. No. The Company has excluded Accumulated Deferred Income Taxes ("ADIT") from the Capital Recovery Riders. ADIT represents the amount of income tax that the Company has been able to defer payment on primarily due to the difference between tax and book depreciation rates. Tennessee has a long-established policy of flowing through the benefits of these tax policies to customers. ADIT is also traditionally recognized in the rate base calculations for most utilities. Therefore, in order to properly calculate the Capital Recovery Rider's impact to the Company's customers, ADIT needs to be taken into account. I therefore recommend that the Company's proposal be modified to include the impact of ADIT.

Q21. HOW HAS THE COMPANY PROPOSED THAT THE CAPITAL RECOVERY RIDERS BE CALCULATED?

A21. All three of the Company's Capital Recovery Riders will be calculated in the same manner. The Company begins with the incremental, non-revenue producing net plant additions for each of its Capital Recovery Riders and multiplies this amount by the pre-tax rate of return approved in its last case to give the total pre-tax return on invested capital. The Company then adds the depreciation expense, property and franchise tax expense, and revenue taxes to the pre-tax return to get the total cost for each rider. This cost is then divided by the volumetric and metered revenues in the Company's last case to give the surcharge rate for each rider. This calculation is summarized below for each of the components.

Net Plant Additions for each Capital Recovery Rider

<u>Multiplied by the Pre-Tax Rate of Return</u>

Pre-Tax Return on Net Plant Additions

Plus Depreciation Expense

Plus Property & Franchise Tax Expense

<u>Plus Revenue Taxes (Gross Receipts & TRA Inspection Fee)</u>

Total Rider Cost

<u>Divided by Rate Case Volumetric & Metered Revenue</u>

<u>Rider Surcharge Rate</u>

Q22. HOW ARE THE NET PLANT ADDITIONS FOR THE CAPITAL RECOVERY RIDERS CALCULATED?

A22. The Company begins with its incremental, non-revenue producing capital expenditures for each of the Capital Recovery Riders.[7] Next the Company adds in the net cost of removal (if any) from dilapidated plant that was replaced. Finally, the Company deducts contributions in aid of construction (if any) from non-investor supplied funds received for the replacement.

Q23. DO YOU AGREE WITH THE COMPANY'S PROPOSED CALCULATION OF NET PLANT ADDITIONS?

A23. No. First the Company has neglected to include plant retirements in the calculation.[8] These retirements represent plant that the TRA has already recognized in the rate base of the Company's last rate case and on which it is already earning a return upon from plant that is no longer used and useful. These plant retirements need to be netted with the incremental plant additions in order to provide the true net plant additions.

Next, the Company has neglected to include accumulated depreciation in the net plant addition calculation. The accumulated depreciation represents the ratable depreciation that the Company has already recognized elsewhere in the Capital

[7] See specifically Petitioners Exhibit SEC 1 – GMV, EDI-1 – GMV, and QIIP-1 – GMV.

[8] Although the Company states that "these costs will consider the effects of associated retirements" on page 18, lines 8-9 of the direct testimony of witness VerDouw, they have been omitted on Petitioners Exhibit QIIP 1-GMV.

Recovery Rider calculation and should be properly deducted here to provide the true net plant additions.

Finally, the Company has neglected to include accumulated deferred income taxes in the net plant addition calculation as I mentioned earlier in my testimony. These deferred taxes need to be deducted here to provide the true net plant additions.

I therefore recommend that the TRA modify the Company's proposed formula for the calculation of Net Plant Additions to include retirements, accumulated depreciation and accumulated deferred income taxes.

Therefore, the Net Plant formula proposed by the Company needs to be modified to take these components into account as shown in the formula below:

Net Plant Additions for each Capital Recovery Rider (Company Proposal)

Less Plant Retirements

Less Accumulated Depreciation

Less Accumulated Deferred Income Taxes

Net Plant Additions for each Capital Recovery Rider (CAPD Proposal)

Q24. PLEASE EXPLAIN HOW THE COMPANY'S PROPOSED PRE-TAX RATE OF RETURN IS CALCULATED.

A24. The Company's proposed pre-tax rate of return is 9.4522%. To make this calculation, the Company begins with the weighted common and preferred equity returns approved by the TRA in its last rate case and then increases these returns by the revenue conversion factor approved in the same case.[9] The Company next

[9] Revenue Conversion Factor exclusive of forfeited discounts and uncollectible expense.

adds in the cost of both long and short term debt to the equity returns to get the total pre-tax rate of return.

Q25. DO YOU AGREE WITH THE COMPANY'S PROPOSED CALCULATION OF THE PRE-TAX RATE OF RETURN?

A25. No. The Company chose to exclude (to its own detriment) the cost of preferred equity from its pre-tax rate of return calculation even though a provision was made for this cost in the Company's own calculations.[10] In addition, the Company has included a slightly higher long-term debt cost than was approved by the TRA in the last rate case. Although these changes are relatively small, (9.4522% from the Company's filing vs. a corrected calculation of 9.4544%) this pre-tax rate of return will remain constant in the Company's annual filings for the Capital Recovery Riders until the next rate case. I therefore recommend that the TRA adopt 9.4544% as the proper pre-tax rate of return to use in the Capital Recovery Riders. I have included a summary of both the pre-tax return calculation and the revenue conversion factor calculation below in Tables 1 and 2 respectively.

[10] See specifically Petitioners Exhibit SEC 1 – GMV, EDI-1 – GMV, and QIIP-1 – GMV.

TABLE 1 – PRE-TAX RATE OF RETURN COMPARISON		
Component	**TAWC**	**CAPD**
Preferred Equity Return	0.0000%	0.0015%
Common Equity Return	3.4380%	3.4380%
Total Equity Return	**3.4380%**	**3.4395%**
Revenue Conversion Factor (Table 2)	1.645413	1.645413
Pre-Tax Equity Return	**5.6569%**	**5.6894%**
Subsidiary Short-Term Debt	0.0245%	0.0245%
Subsidiary Long-Term Debt	3.1873%	3.1870%
Parent Short-Term Debt	0.0085%	0.0085%
Parent Long-Term Debt	0.5750%	0.5750%
Total Pre-Tax Return	**9.4522%**	**9.4544%**

TABLE 2 – REVENUE CONVERSION FACTOR CALCULATION		
Component	**Amount**	**Balance**
Operating Revenues		1.000000
State Excise Tax	-0.065000	-0.065000
Balance		0.935000
Federal Income Tax	-0.350000	-0.327250
Balance		0.607750
Revenue Conversion Factor		**1.645413**

Q26. HOW IS THE DEPRECIATION EXPENSE FOR THE CAPITAL RECOVERY RIDERS CALCULATED?

A26. The Company uses the same depreciation rates already approved by the TRA to calculate the annual depreciation charges. I agree with this calculation and recommend its inclusion in the Capital Recovery Riders.

Q27. HOW ARE THE PROPERTY TAX AND FRANCHISE TAX EXPENSES FOR THE CAPITAL RECOVERY RIDERS CALCULATED?

A27. For property taxes, the Company takes their effective property tax rate of 1.1011% and then multiplies it by the qualified incremental plant investment in each of the Capital Recovery Riders.[11] For franchise taxes, the Company takes the franchise tax rate of $0.25 per $100 and then multiplies it by the qualified incremental plant investment in each of the Capital Recovery Riders. I agree with both of these calculations and recommend their inclusion in the Capital Recovery Riders.

Q28. HOW ARE THE REVENUE TAXES FOR THE CAPITAL RECOVERY RIDERS CALCULATED?

A28. For this item, the Company takes the effective Uncollectible Expense Rate and the Gross Receipts Tax Rates from the last rate case and then adds the new TRA Inspection Fee tax rate of 0.425% to produce a total revenue tax rate of 4.482% as follows:

Uncollectible Expense Rate	1.057%
Gross Receipts Tax Rate	3.000%
TRA Inspection Fee Rate	0.425%
Total Revenue Tax Rate	**4.482%**

Q29. DO YOU AGREE WITH THE COMPANY'S PROPOSED CALCULATION OF REVENUE TAXES?

[11] Property taxes of $2,757,695 divided by Plant in Service of $250,455,533 equals 1.1011% as approved by the TRA in the last rate case.

A29. Not entirely. I do agree with the Company's proposal for the Gross Receipts Tax Rate and the TRA Inspection Fee Rate. However, the Company has chosen to omit the incremental Forfeited Discounts Rate of -0.866% from the last rate case. The Forfeited Discounts rate represents the prompt payment discount forgone by the Company's customers for paying promptly and is a direct offset to the Uncollectible Expense Rate included by the Company. When the Forfeited Discount Rate is included, the total Revenue Tax Rate drops to 3.616%. I therefore recommend that the TRA adopt 3.616% as the proper Revenue Tax rate to use in the Capital Recovery Riders.

Q30. HOW IS THE RATE CASE VOLUMETRIC & METERED REVENUE DETERMINED?

A30. This amount represents the total water sales revenue and is taken directly from the TRA approval in the last rate case. The Company has included $47,073,724 in Volumetric & Metered Revenue in each of the Capital Recovery Riders. I agree with this amount and recommend its inclusion in the Capital Recovery Riders.

Q31. ARE THERE ANY OTHER MODIFICATIONS THAT YOU ARE RECOMMENDING TO THE CAPITAL RECOVERY RIDERS?

A31. Yes. First, I am recommending that the Capital Recovery Riders be suspended in any year when the Company is over-earning its authorized rate of return. Since the purpose of the Capital Recovery Riders are to enable the Company to earn a return on incremental qualified investment between rate cases, the utility's ability to over-earn its return would eliminate this need. In addition, suspension of the Capital Recovery Riders during periods when the Company is achieving its authorized rate of return is especially warranted since the Riders, as proposed by the Company, do not capture any of the cost savings or efficiencies the Riders are expected to produce and do not include other consumer safeguards, such as annual caps on the amounts recoverable through such alternative rate mechanisms.[12] Therefore, the Capital Recovery Riders should be suspended for periods (if any) when the Company is able to over-earn its authorized rate of return. This provision should be relatively easy to implement since the Company already calculates its achieved rate of return for the previous year in their annual report and other appropriate surveillance reports to the TRA. When the results for the rate of return calculation for the preceding year exceed the authorized return, then the Capital Recovery Riders would be suspended for the following year. Secondly, I would recommend that the Capital Recovery Riders be given a finite life of no more than five years. This would give the Company, the CAPD and any other interested parties an opportunity to propose amending the Riders. At that time, the TRA can reevaluate the need for the Capital Recovery Riders and decide if they should be made permanent. In addition, any interested party should be allowed to petition the Authority for re-evaluation of whether the Capital Recovery Riders remain in the public interest in light of intervening circumstances or changed conditions.

[12] See Company responses to Item #4 of the TRA Staff Data Request and Item #3 and Item #21 of the CAPD Data Request.

Thirdly, there seemed to be some confusion in the Company's filing between the three Capital Recovery Riders as to the exact date when the Company would make a tariff filing and the exact date that it would be implemented. To remedy this, I would recommend that the Company make a tariff filing with the TRA for each of the Capital Recovery Riders by March 1st that is based upon the actual results achieved in the preceding calendar year. These Riders could then be implemented and charged to customers beginning on April 1st. However, the Capital Recovery Riders would still be subject to audit by the TRA at any time during the year.

Finally, I would recommend that the Company file exhibits and supporting workpapers (including general ledger support with associated journal entries) along with its annual tariff filing that fully supports the rate charges through the Capital Recovery Riders. In addition, if the TRA approves the use of forecasted plant additions in the Capital Recovery Riders, then the Company should also be required to file testimony that fully describes the purpose of the forecasted plant.

EXPENSE RECOVERY RIDERS

Q32. PLEASE EXPLAIN THE RELIEF THAT TAWC IS ASKING FROM THE TRA THROUGH ITS PROPOSED EXPENSE RECOVERY RIDER.

A32. The Company is asking the TRA to approve a single tariff rider (PCOP) that will allow it to recover between rate cases the incremental cost for purchased power expenses, purchased chemical expenses, purchased water expenses, wheeling charges, waste disposal expenses and TRA Inspection Fee costs. The Expense Recovery Rider differs from the Capital Recovery Riders in that the former relates to current period charges while the latter relates to costs that are capitalized and charged to customers in future periods.

Q33. PLEASE DESCRIBE THE COSTS THAT THE COMPANY HAS PROPOSED TO INCLUDE IN THE EXPENSE RECOVERY RIDER.

A33. As proposed by the Company[13], the PCOP tariff will recover incremental expenses from the levels approved in their last rate case in the following accounts:

Accounts 51000000 - 51099999 – Purchased Water Expense;

Accounts 51510000 - 51599999 – Purchased Power Expense;

Accounts 51800000 - 51899999 – Purchased Chemical Expense;

Accounts 51110000 - 51115000 – Waste Disposal Expense; and

Account 68545000 – TRA Inspection Fee.

Q34. PLEASE DESCRIBE THE PROCESS THAT THE COMPANY HAS PROPOSED TO RECOVER ITS COSTS THROUGH THE EXPENSE RECOVERY RIDER.

A34. The Company intends to first calculate the cost rate per 100 gallons for the expenses described above from their last rate case. Next, the Company would calculate the cost of these same expenses per 100 gallons from the most recent 12 month review period. The difference between these two rates per 100 gallons would then be multiplied by the sales volumes approved in the Company's last

[13] Company Witness VerDouw Direct Testimony, Pages 48-49.

rate case to give the net deferred cost. The net deferred cost is then grossed up for the impact of gross receipts taxes and uncollectible expense to give the total deferred cost.[14] Finally the total deferred cost would be divided by the anticipated sales revenue for the next twelve months to calculate the PCOP rate. At the end of the year, the Company would propose to true-up the PCOP rate for any difference between the total deferred cost and the costs collected through the Expense Recovery Rider.

Q35. HOW HAS THE COMPANY PROPOSED THAT THE EXPENSE RECOVERY RIDERS BE CALCULATED?

A35. The Company begins with a calculation of the amounts approved by the TRA in its last rate case for each of the expense categories described above. These amounts are presented in the table below.

TABLE 3 – RATE CASE PCOP EXPENSES	
Purchased Power Expense	$2,678,772
Chemical Expense	986,930
Purchased Water Expense	51,331
TRA Inspection Fee	131,826
Waste Disposal Expense	213,308
Total Rate Case PCOP Expenses	**$4,062,167**

[14] The testimony of Company witness VerDouw on page 50, line 5 also indicates that the net deferred cost is grossed up for the TRA Inspection Fee. However, the Company's calculation on Petitioner's Exhibit PCOP Sample Calculation-GMV omits the TRA Inspection Fee.

Next the Company divides the rate case PCOP expenses by the sales volumes from the last rate case. The calculation of total rate case sales volumes are presented in the table below.[15]

TABLE 4 – RATE CASE SALES VOLUMES	
Residential (Ccf)	4,349,465
Commercial (Ccf)	3,935,099
Industrial (Ccf)	2,435,940
Other Public Authority (Ccf)	1,180,593
Other Water Utility (Ccf)	1,545,247
Total Rate Case Sales Volumes (Ccf)	**13,446,344**
CCF to 100 Gallons Conversion	7.48
Total Rate Case Sales Volumes (100 Gallons)	**100,578,654**

By dividing the PCOP Expenses of $4,062,167 shown in Table 3 by the rate case sales volumes of 100,578,654 hundred gallons in Table 4, the Company is able to calculate its proposed base rate pass through cost of $0.0404 per hundred gallons which would remain constant until the next rate case.

The Company would then make this same calculation for the most recent 12 month review period in the Expense Recovery Rider. The difference between the base period calculation and the review period calculation is then multiplied by the base period sales volumes of 100,578,654 hundred gallons shown above in Table 4 and grossed up for gross receipts taxes and uncollectible expense to get the total deferred cost. Finally the total deferred cost would be divided by the anticipated sales revenue for the next twelve months to calculate the PCOP rate. At the end of the year, the Company would propose to true-up the PCOP rate for any

[15] The Company included rate case sales volumes in 100 gallons of 100,589,065 on Petitioner's Exhibit PCOP – GMV but no reference was provided as to how this amount was calculated. However, the difference between the Petitioner's Exhibit and the amounts included here are insignificant and actually round away in the rate calculation.

difference between the total deferred cost and the costs collected through the Expense Recovery Rider.

Q36. ARE THERE ANY ISSUES WITH THE COMPANY'S PROPOSED EXPENSE RECOVERY RIDER CALCULATION?

A36. Yes. First, the Company is proposing to recover any changes to the total TRA Inspection Fee in the Expense Recovery Rider without first recognizing any TRA Inspection Fee recoveries already taking place in the Capital Recovery Riders. This will amount to double recovery of portions of the TRA Inspection Fee. The Company recognized this double recovery as an issue in its response to Item 13 of the TRA's data request, but has not proposed any modification to its Expense Recovery Rider to deal with it.

Next, the Company has chosen to omit the incremental Forfeited Discounts Rate of -0.866% in its gross-up calculation for revenue taxes. This same omission was also made by the Company in the Capital Recovery Riders. The Forfeited Discounts rate represents the prompt payment discount forgone by the Company's customers for paying promptly and is a direct offset to the Uncollectible Expense Rate that is included by the Company.

Finally, the Company has omitted any recognition of the TRA's water loss policy.[16] In recent rate cases, the TRA has capped water loss at 15% in calculating certain expenses. The Expense Recovery Rider proposed by the Company fails to capture the TRA's policy on this issue.

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[16] See Company response to Item #48 of the TRA Staff's Data Request.

Q37. ARE THERE ANY OTHER MODIFICATIONS THAT YOU ARE RECOMMENDING TO THE EXPENSE RECOVERY RIDER?

A37. Yes. I am recommending the same general provisions for the Expense Recovery Rider as I did for the Capital Recovery Riders discussed earlier in my testimony. Specifically, the provisions for suspension of the Rider when the Company is over-earning their authorized return, a tariff life of no more than five years, review of the tariff upon the petition of any interested party, general ledger support (with associated journal entries) accompanying the annual tariff filing, and tariff filing and implementation dates of March 1st and April 1st should all be applied to the Expense Recovery Rider.

Q38. DO YOU HAVE ANY OTHER COMMENTS FOR THE TRA TO CONSIDER?

A38. Yes. As indicated above, I am recommending certain modifications to the Company's proposed Capital and Expense Recovery Riders. However, I have not addressed the cost impact for the TRA to continually audit and monitor the costs and rate calculations contained in the annual filings for these Riders. While the TRA Staff currently reviews all of these costs within the context of a rate case, the continuing resource requirements for a new type of annual tariff filing may be a cause for concern.

This concern is especially warranted with respect to the Expense Recovery Rider as it appears the tracking and recovery of these incremental costs would only result in relatively minor changes to rates and consequently to the overall revenues of the Company. In these instances, it may well be that the regulatory costs incurred by the Company, the TRA and other interested parties including the CAPD would outweigh the Riders' benefits as it would contribute little to enhance the Company's opportunity to earn its authorized rate of return between rate case filings.

Q39. DOES THIS COMPLETE YOUR TESTIMONY?

A39. Yes it does. However, I reserve the right to incorporate any new data that may subsequently become available.

ATTACHMENT WHN-1

William H. Novak Vitae

William H. Novak
19 Morning Arbor Place
The Woodlands, TX 77381

Phone: 713-298-1760
Email: halnovak@whnconsulting.com

Areas of Specialization

Over twenty-five years of experience in regulatory affairs and forecasting of financial information in the rate setting process for electric, gas, water and wastewater utilities. Presented testimony and analysis for state commissions on regulatory issues in four states and has presented testimony before the FERC on electric issues.

Relevant Experience

WHN Consulting – September 2004 to Present
In 2004, established WHN Consulting to provide utility consulting and expert testimony for energy and water utilities. Complete needs consultant to provide the regulatory and financial expertise that enabled a number of small gas and water utilities to obtain their Certificate of Public Convenience and Necessity (CCN) that included forecasting the utility investment and income. Also provided the complete analysis and testimony for utility rate cases including revenues, operating expenses, taxes, rate base, rate of return and rate design for utilities in Tennessee. Assisted American Water Works Company in preparing rate cases in Ohio and Iowa. Provided commercial and industrial tariff analysis and testimony for an industrial intervenor group in a large gas utility rate case. Industry spokesman for water utilities dealing with utility commission rulemaking. Consultant for the North Carolina and Illinois Public Utility Commissions in carrying out their oversight functions of Duke Energy and Peoples Gas Light and Coke Company through focused management audits. Also provide continual utility accounting services and preparation of utility commission annual reports for water and gas utilities.

Sequent Energy Management – February 2001 to July 2003
Vice-President of Regulatory Compliance for approximately two years with Sequent Energy Management, a gas trading and optimization affiliate of AGL Resources. In that capacity, directed the duties of the regulatory compliance department, and reviewed and analyzed all regulatory filings and controls to ensure compliance with federal and state regulatory guidelines. Engaged and oversaw the work of a number of regulatory consultants and attorneys in various states where Sequent has operations. Identified asset management opportunities and regulatory issues for Sequent in various states. Presented regulatory proposals and testimony to eliminate wholesale gas rate fluctuations through hedging of all wholesale gas purchases for utilities. Also prepared testimony to allow gas marketers to compete with utilities for the transportation of wholesale gas to industrial users.

Atlanta Gas Light Company – April 1999 to February 2001
Director of Rates and Regulatory Analysis for approximately two years with AGL Resources, a public utility holding company serving approximately 1.9 million customers in Georgia, Tennessee, and Virginia. In that capacity, was instrumental in leading Atlanta Gas Light Company through the most complete and comprehensive gas deregulation process in the country that involved terminating the utility's traditional gas recovery mechanism and instead allowing all 1.5 million AGL Resources customers in Georgia to choose their own gas marketer. Also responsible for all gas deregulation filings, as well as preparing and defending gas cost recovery and rate filings. Initiated a weather normalization adjustment in Virginia to track adjustments to company's revenues based on departures from normal weather. Analyzed the regulatory impacts of potential acquisition targets.

Tennessee Regulatory Authority – Aug. 1982 to Apr 1999; Jul 2003 to Sep 2004
Employed by the Tennessee Regulatory Authority (formerly the Tennessee Public Service Commission) for approximately 19 years, culminating as Chief of the Energy and Water Division. Responsible for directing the division's compliance and rate setting process for all gas, electric, and water utilities. Either presented analysis and testimony or advised the Commissioners/Directors on policy setting issues, including utility rate cases, electric and gas deregulation, gas cost recovery, weather normalization recovery, and various accounting related issues. Responsible for leading and supervising the purchased gas adjustment (PGA) and gas cost recovery calculation for all gas utilities. Responsible for overseeing the work of all energy and water consultants hired by the TRA for management audits of gas, electric and water utilities. Implemented a weather normalization process for water utilities that was adopted by the Commission and adopted by American Water Works Company in regulatory proceedings outside of Tennessee.

Education

B.A, Accounting, Middle Tennessee State University, 1981
MBA, Middle Tennessee State University, 1997

Professional

Certified Public Accountant (CPA), Tennessee Certificate # 7388
Certified Management Accountant (CMA), Certificate # 7880
Former Vice-Chairman of National Association of Regulatory Utility Commission's Subcommittee on Natural Gas

ATTACHMENT WHN-2

HB 191 March 13, 2013 House of Representatives Finance Ways & Means Committee

Chairman: Okay we'll take item 39, House Bill 191 out of order. Leader McCormick you're recognized.

McCormick: Thank you Mr. Chairman. House Bill 191 is an administration bill in cooperation with the TRA. It has several components but basically it realigns the TRA's funding mechanism which will result in over $1 Million in fee reductions passed down to utilities and hopefully to the consumers too. It also enables the adoption of best practices for more efficient rate reviews which means we're going to bring in and see…

Chairman: Bill's been moved and properly seconded. Do we have questions on the bill? Chairman Sargent, you're recognized.

Sargent: thank you Mr. Chairman. Leader McCormick, let me, I have two questions I'd like to ask and I think you probably know what they are. One of these, we're going to do an annual rate review and normally we did a review after 4 or 5 years and they had a full blown hearing. When we do this will there actually be a review or is it just going to be that they ask for a half percent or a ¾ percent of an increase is that going to be automatic or will they actually have an annual review and see why they need that increase?

McCormick: That's a good question. What they're going to do, as you know in the past, they'd wait several years, 3 to 5 years and longer sometimes and then go in and have a full blown case where a lot of lawyers were hired and a lot of fights and negotiating positions and that type thing. What this does is gives the TRA the ability to really on a constant basis keep an eye on these companies and give them some rate, usually increases I suspect, based on some expenses that they really don't have any control over. It'll be more of, I'd say, a CPA driven process rather than a legal driven process but with the clear understanding that it could turn into a legal process if the system breaks down. So, it has the safeguards of the old system but some efficiencies in the new system.

Sargent: You feel doing it like this, the consumers are still going to be protected and have all the protections they had before?

McCormick: I do feel like it and I had some questions myself. I'm carrying the legislation but I think we need to ask tough questions about legislation that we carry not just other people's legislation and something that keeps cropping up that reassures me is that the Commission will have the ability and as the words are written to act in the public interest. Which is vaguely defined which I think gives them a lot of authority to go in if the system is being abused to step in and change things if they need to in the public interest.

Sargent: Chairman, thank you for that. For those, I just wanted to make sure that we had that on the record. The other question I have is under Section 5. Section 5 as you know where natural gas companies would be able to set up, and there's been a lot of talk about this, set up their own substation or sell natural gas for cars and trucks. Is that, do you see that as the intent of the legislation?

McCormick: You know Chairman, this is one that just came up yesterday and I hate to make this last any longer but I don't want to give you the wrong answer. If I have the Committee's permission I'd like to call up possibly Chairman Allison to address that question, if that's okay with the Chairman too and both Chairmen.

Chairman: Without objection we're out of session. If you would, come forward and state your name for the record.

Allison: I'm Jim Allison, I'm the Chairman of the Tennessee Regulatory Authority. The answer to your question is what it deals with is a procedural change in how we will go about looking at those rates. It does not guarantee recovery, it does not say that there will be any cross-subsidization of the fuel, motor fuel dispenser by residential consumers or anything of that nature but the alternative rate making procedures, all of them, are permissive and it would require that finding that the public interest, like the Leader stated.

Chairman: You're recognized.

Sargent: Thank you Mr. Chairman. My question is, is it the intent of natural gas companies to go into set up, I'll say natural gas stations through-out the state and have the rate payers paying for that infrastructure and not as a commercial entity? Is there, I want to make sure we don't have rate payers paying for infrastructure where we have commercial entities out there that have to basically pay for their own infrastructure.

Allison: There is no intent in this legislation to allow any other class of consumers to subsidize the facilities that would go into providing natural gas as a motor fuel.

Sargent: And is also your understanding that natural gas companies do not intend to set up stations throughout the state? And they're going to lead back to the retailers of the Mapcos and the Exxons and the Shell stations of the world to do that?

Allison: I can't really address what the intentions of the natural gas companies are but as the Regulatory Authority we will assure there is no cross-subsidization going on as we implement the various rates.

Sargent: Okay. Thank you. Thank you Mr. Chairman.

Chairman: Representative Armstrong, you're recognized.

Armstrong: Thank you Mr. Chairman and Chairman Sargent brings up a very interesting question as it relates to, you know, natural gas vehicles and of course, realizing that natural gas is becoming the transportation fuel. Certainly I didn't know if the agency had looked at the conversion from petroleum based fuel to natural gas and setting up the rules and regulations along that line. Even if you look at the available information that's out there, all our utilities, they're converting the coal fired plants, the TVA's just converted to natural gas at some of their largest, some of their largest facilities over to natural gas and then with all of the reports about how much natural gas is available in this country with all the finings (?) or the shale gas and the fracking and all of this, have we looked at a comprehensive study of Tennessee looking at the use of natural gas and also as a transportation fuel? Because I think the last statistic that I saw that natural gas on a BTU level would cost about $1.29 per gallon if we switched over from gas that's costing what $4.40 a gallon now. Has this agency looked at going in that direction for natural gas fueling and for providing those infrastructures?

Allison: There's a lot of talk nationally about, not only natural gas, but other alternative fuels. For example, I drove up here from Shelbyville in an electric car yesterday. So, it's an emerging part of the technology of our country. At the TRA we have had some limited experience with natural gas as a motor fuel, we do have at least one and I think perhaps 2 natural gas companies that have established refueling stations. They are not on the side of the interstate where everybody knows where they are but they are for people who have limited natural gas vehicles already and we've established tariffs for those dispensing facilities already so we have looked at it in a limited sense but I would have to say in a comprehensive sense we have not had a formal study like you're suggesting.

Armstrong: And when you mention tariffs, we know we've got taxes on our fuel to pay for road costs but when it comes to electric vehicles, when it comes to natural gas vehicles, there's no money being collected for the infrastructure and I'm kind of following along with the Chairman was talking about. Certainly we can even get into how other states actually distribute gas to not only commercial but to residential, you know, in Georgia an individual gets to choose which company, which market they buy gas from and the utility is only the deliverer of that. In Tennessee we've got a different type of structure and I didn't know if you were looking at that, where the utility only charges you for the transportation but you pay a commodity price from someone else. And Texas has a totally deregulating both electric and natural gas. Are we looking at some of these because there's a significant difference in natural gas prices to consumers in Georgia is a big difference than what we pay here in Tennessee. In Tennessee we pay different rates in between different consumers. The only ones subject to any type of hedge, whether it's low or high, are the private companies but certainly those utilities out here that are making money off the commodity price, have we looked at basically talking to them and saying, hey, put in your infrastructure cost and let the consumer have a choice and let the businesses have a choice where they buy their natural gas?

Allison: There is some of that going on in the natural gas industry all, already in Tennessee. For example, we have a number of large users of natural gas that buy directly from alternative sources and then use the local distribution company just for a delivery mechanism so there are situations in place in Tennessee where that's occurring as well. It hasn't been penetrated to the individual homeowner level. I used to work in Georgia it's got its plusses and minuses, to deal with that. It becomes a very complex arena but it hasn't penetrated down to the individual level here in Tennessee yet but we do have a number of large consumers who already do just that.

Armstrong: Okay, but your experience in Georgia, certainly, I think it would benefit the residential consumers to look at that option and see if it would be some savings on that residential user. And I didn't know if you had plans within the TRA to look at things of that nature.

Allison: We don't have anything specifically planned but we'll certainly talk about it after the discussion today.

Chairman: Any further questions for the Chairman? Seeing none. Thank you for being with us today. Without objection, we're back in session. Leader McCormick?

McCormick: I renew my motion Mr. Chairman.

Chairman: Any further questions. Seeing none. Is there objections to questions? Hearing none, all in favor of moving house bill 191 to full finance, say aye, those opposed. Bill moves out.